Derivatives and Hedging Accounting Handbook

July 2019

PREFACE

In June 1998, the Financial Accounting Standards Board (FASB or Board) issued FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. Since then, the Board issued the following related Statements:

- Statement No. 137, Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133, An Amendment of FASB Statement No. 133 (Statement 137) (June 1999);
- Statement No. 138, Accounting for CertainDerivative Instruments and Certain Hedging Activities, An Amendment of FASB Statement No. 133 (Statement 138) (June 2000);
- Statement No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities (Statement 149) (April 2003); and
- Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities, An Amendment of FASB Statement No. 133 (Statement 161) (March 2008).

Statement 133, as amended by Statements 137, 138, 149, and 161 is referred to in this Derivatives and Hedging Accounting Handbook (Handbook) as the Standard or Statement 133.

In connection with the Standard, the FASB established the Derivatives Implementation Group (DIG) for the purpose of addressing Statement 133 implementation issues. Some of those issues arose almost immediately upon issuance of the Standard, and some of them have arisen more recently. Since 1998, the FASB staff, through the DIG process, has provided guidance on over 150 implementation issues. This Handbook is designed to help interpret and apply the Standard as well as the related DIG Issues.

The Handbook includes paragraphs of the Standard, which are shaded. Each of these paragraphs is followed by interpretations and examples to illustrate key points. Many of the interpretations and examples are based on information discussed in the Standard's Implementation Guidance, Background Information, and Basis for Conclusions as well as DIG Issues. The discussion that follows the excerpted paragraphs additionally includes our understanding and views as well as practice that developed after the Standard was issued. Also, at the end of selected sections, questions and answers are provided that address issues we believe are illustrative of those that commonly arise in practice.

Due to the significant number of DIG Issues cleared by the Board since the issuance of the Standard, the full text of those Issues could not be published with the Handbook. Users of the Handbook can access those Issues, which are referenced below the applicable paragraph of the Standard and throughout the relevant text herein, by accessing the FASB Web site at www.fasb.org and by referring to KPMG's DIG - Final Resolutions, Including KPMG Observations. The Handbook contains an appendix that lists the title of all of the cleared DIG Issues.

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Issues. The printed version of the Handbook was issued in July 1998. The electronic version is updated periodically. The sections of the Handbook and their latest updates are as follows:

- Section One: General Overview (updated July 2008)
- Section Two: Applicability and Freestanding Derivative Instruments (updated July 2019)
- Section Three: Embedded Derivative Instruments (updated July 2019)
- Section Four: Recognition and Measurement (updated March 2012)
- Section Five: Fair Value Hedging (updated June 2016)
- Section Six: Cash Flow Hedging (updated August 2016)
- Section Seven: Hedging Foreign Currency Exposures (updated June 2016)
- Section Eight: Accounting by Entities that do not Report Earnings as a Separate Caption in a Statement of Financial Performance (updated September 2004)
- Section Nine: Disclosure (updated June 2016)
- Section Ten: Transition Issues (updated December 2007)
- Section Eleven: Tax Issues Relating to Derivative Instruments (updated December 2006)

The guidance contained in the Handbook is based on authoritative accounting literature. It may be affected by future guidance issued by the Board, the SEC, the FASB staff through the DIG process, the EITF, or other relevant bodies with authority to affect accounting principles that are generally accepted in the United States of America. We recommend that you consult a Financial Instruments and Derivatives Resource in your area when analyzing specific issues that may be affected by the Standard.

Beginning July 1, 2009 the FASB Accounting Standards Codification (ASC) became the sole source of authoritative GAAP, except for rules and interpretive releases of the SEC, which are sources of authoritative GAAP for SEC registrants. The FASB no longer considers new standards authoritative in their own right. Instead, their role is to update the Codification, and provide the basis for conclusions regarding the change in the Codification.

The Codification project’s intention was to retain existing GAAP. The Codification includes all level A–D GAAP. The goal of the Codification was to capture and codify standards and essential implementation guidance. The Codification excludes nonessential material such as some information contained in the Basis for Conclusions.

The Handbook includes both the references to pre-codification standards (e.g. Statement 133 or Statement 52) as well as DIG issues followed by the new FASB ASC references, in parentheses. In addition, references to Statement 133 or Standard in the Handbook mean the same as referring to ASC Topic 815, Derivatives and Hedging. Lastly, as the FASB did not codify most of the Background Information and Basis for Conclusions, which are often cited in the Handbook, references to un-codified paragraphs in these sections have been retained.
Appendix A of this Handbook displays a detailed list of all cross references between Statement 133 and its codified standard ASC Topic 815. The cross references between the DIG Issues and ASC Topic 815 are also provided in an Appendix to the DIG - Final Resolutions, Including KPMG Observations Handbook.

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KPMG LLP
July 2019
Executive Summary

INTRODUCTION

The Financial Accounting Standards Board (FASB or Board) issued FASB Statement No. 133 (Statement 133 or Standard), in June 1998. The Standard was a response to the growing criticism of U.S. generally accepted accounting principles in the accounting for and reporting of derivatives and hedging activities. The Standard applies to all entities and became effective as of the beginning of the first fiscal quarter of the fiscal year beginning after June 15, 2000.

In the years that have followed the issuance of the Standard, the FASB has amended the Standard and has cleared numerous issues identified by its Derivatives Implementation Group (DIG). Those amendments and the significant volume of DIG Issues speak to the complexity and breadth of the Standard and difficulty in its application.

KEY DECISIONS

In developing the Standard, the Board reached four fundamental decisions that became its cornerstones. These are:

- derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements;
- fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments;
- only items that are assets or liabilities should be reported as such in financial statements; and
- special accounting for items designated as being hedged should be provided but should be limited to qualifying transactions. One criterion for qualification should be an assessment of offsetting changes in fair values or cash flows for the risk being hedged.

With these as cornerstones, the Board developed an accounting model for derivative instruments and hedging activities. That accounting model represented a sea change from the accounting principles that previously applied and has been one that has been a challenge for entities, their auditors, and a number of other relevant parties.

DERIVATIVE INSTRUMENT ACCOUNTING MODEL

The Standard (ASC paragraphs 815-10-15-83 through 15-139) comprehensively defines a derivative instrument. In particular, the definition encompasses traditional freestanding derivative financial instruments, certain commodity contracts, and derivative instruments that are embedded in other contracts or instruments.

The Standard (ASC paragraphs 815-15-25-1, 815-15-30-1) requires that derivative instruments that require separate accounting be recorded in the statement of financial position at fair value; the accounting for the gain or loss due to changes in fair value of the derivative instrument...
depends on whether the derivative instrument qualifies as a hedge\(^1\). If the derivative instrument does not qualify as a hedge, gains or losses reflecting changes in fair value are reported in earnings. However, if the derivative instrument qualifies as a hedge, the accounting varies based on the type of risk being hedged. The Standard (ASC Section 815-20-25) permits hedge accounting for the following three risks:

- Changes in fair values due to fixed rates or prices: for example, the risk of changes in the fair value of a fixed-rate investment security may be reduced or eliminated by a fair value hedge.
- Changes in cash flows due to variable rates or prices: for example, the risk of changes in cash flows from a variable-rate debt obligation may be reduced or eliminated by a cash flow hedge.
- Changes in fair values, cash flows, or net investment in foreign operations due to variability of foreign currency exchange rates: for example, the risk of changes in the foreign currency exchange rates inherent in the forecasted purchase of equipment to be paid for in a foreign currency may be reduced or eliminated by a foreign currency hedge.

The accounting for fair value hedges, cash flow hedges, and foreign currency hedges is highlighted below.

### Fair Value Hedges

For fair value hedges, gains or losses on derivative hedging instruments are recorded in earnings each reporting period. In addition, gains or losses on the hedged item attributable to the hedged risk are recognized in earnings. Consequently, if gains or losses on the derivative hedging instrument and the related hedged item do not completely offset, the difference (i.e., ineffective portion of the hedge) is recognized currently in earnings.

### Cash Flow Hedges

For cash flow hedges, the reporting of gains or losses on derivative hedging instruments depends on whether the gains or losses are effective at offsetting changes in the cash flows of the hedged item. The effective portion of the gain or loss on the derivative hedging instrument is accumulated in other comprehensive income (OCI) until recognized in earnings during the period that the hedged forecasted transaction impacts earnings. The ineffective portion of the gain or loss from the derivative hedging instrument is recognized in earnings immediately.

\(^1\) An alternative to fair value measurement for certain interest rate swaps is provided under the simplified hedge accounting approach. The simplified hedge accounting approach was introduced by the Private Company Council under ASU 2014-03 and provides a practical expedient for certain private companies to apply hedge accounting. Under the simplified hedge accounting approach, a receive-variable, pay-fixed interest rate swap may be measured at settlement value instead of fair value. The simplified hedge accounting approach and the conditions that need to be met in order to qualify for the approach are discussed beginning at paragraph A6.70a of Section 6.
Foreign Currency Hedges

For foreign currency hedges, the Standard (ASC paragraph 815-20-25-28) permits an entity to use the following three accounting models to hedge its exposure to foreign currency risk:

- The fair value hedge accounting model is used to account for hedges of the currency exposure inherent in a foreign-currency-denominated unrecognized firm commitment or a recognized asset or liability (including an available-for-sale security). The accounting requirements for this model are identical to the aforementioned requirements for other fair value hedges.

- The cash flow hedge accounting model is used to account for hedges of the currency exposure inherent in a foreign-currency-denominated forecasted transaction, a forecasted intercompany transaction, an unrecognized firm commitment, or the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability. The accounting requirements for this model generally follow the aforementioned requirements for other cash flow hedges.

- Consistent with FASB Statement No. 52, Foreign Currency Translation (ASC Topic 830, Foreign Currency Matters), the Standard (ASC paragraph 815-20-25-66) permits an entity to hedge the foreign currency risk inherent in a net investment in a foreign operation. The effective portion of the gain or loss on the hedging instrument is reported in OCI as part of the cumulative translation adjustment. The ineffective portion of the gain or loss is recognized in earnings immediately.

FINANCIAL REPORTING ENVIRONMENT UNDER STATEMENT 133

In the years since Statement 133 became effective, entities have had to deal with the Standard’s breadth and complexity. The difficulties experienced by entities have involved issues of identification of derivatives, particularly those embedded in nonderivative instruments or contracts, measurement of derivatives at fair value, and establishing and maintaining effective hedging relationships. In addition, entities have had their accounting under Statement 133 scrutinized by regulators, investors and lenders. The combination of those factors has led to a continuing need for guidance on the Standard in this challenging financial reporting environment.

DERIVATIVES AND HEDGING ACCOUNTING HANDBOOK

To help interpret and apply the Standard and its related DIG Issues, KPMG has prepared the Derivatives and Hedging Accounting Handbook (Handbook). The Handbook provides a detailed discussion of the Standard’s requirements and related implementation guidance. The Handbook is organized as follows:

Chapter 1 General Overview
Chapter 2 Applicability and Freestanding Derivative Instruments
Chapter 3 Embedded Derivative Instruments
Chapter 4 Recognition and Measurement
Chapter 5 Fair Value Hedging
Chapter 6 Cash Flow Hedging
Chapter 7 Hedging Foreign Currency Exposures
Chapter 8 Accounting by Entities That Do Not Report Earnings as a Separate Caption in a Statement of Financial Performance
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# Derivatives and Hedging Accounting Handbook

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INTRODUCTION

This section discusses the introductory paragraphs of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended (Statement 133 or Standard), including the four fundamental decisions made by the Financial Accounting Standards Board (FASB or Board) in developing Standard. It then provides an overview of the general concepts of the accounting model built from these four fundamental decisions.

INTRODUCTION TO THE STANDARD

1.01 The first two paragraphs of Statement 133 discuss Standard's purpose and the reasons why it was needed. Paragraphs 1 and 2 (ASC paragraph 815-10-05-2) are as follows:

1. Statement addresses the accounting for derivative instruments,\(^1\) including certain derivative instruments embedded in other contracts, and hedging activities.

2. Prior to this Statement, hedging activities related to changes in foreign exchange rates were addressed in FASB Statement No. 52, Foreign Currency Translation FASB Statement No. 80, Accounting for Futures Contracts, addressed the use of futures contracts in other hedging activities. Those Statements addressed only certain derivative instruments and differed in the criteria required for hedge accounting. In addition, the Emerging Issues Task Force (EITF) addressed the accounting for various hedging activities in a number of issues.

\(^1\) Words defined in Appendix F, the Glossary, are set in **boldface type** the first time they appear.

2.01 In the years prior to the issuance of the Standard, concern grew about the accounting and disclosure requirements for derivative instruments and hedging activities. Changes in global financial markets and related financial innovations led to the rapid development and use of new derivative instruments to manage exposures to risk, including interest rate risk, foreign exchange risk, price risk, and credit risk. Concern about inadequate financial reporting also was heightened by the publicity surrounding large derivative instrument losses reported by certain entities and the lack of information about the extent to which the entities were using derivative instruments. As a result, the U.S. Securities and Exchange Commission (SEC), as well as others, urged the Board to deal expeditiously with accounting and reporting problems in this area.

2.02 One of the Board’s objectives in issuing the Standard was to resolve several perceived problems with the accounting and reporting practices for derivative instruments and hedging activities that existed before the issuance of the Standard. Specifically, those problems included:

- The accounting guidance was incomplete. (Only a few types of derivative instruments were specifically addressed in accounting standards.)

- The accounting guidance that did exist was not consistent. (The required accounting treatment differed depending on the type of instrument used in hedging and the type
of risk being hedged. Accounting guidance also was inconsistent on whether qualification for hedge accounting was based on risk assessment at an entity-wide or an individual-transaction level.)

- The accounting guidance was difficult to apply. (A single, comprehensive approach to accounting for derivative instruments and hedging activities was lacking.)
- The accounting guidance promoted different recognition for the same instruments. (Some derivative instruments were recognized in the financial statements, others were not. If recognized in the financial statements, some gains and losses on derivative instruments were deferred from earnings recognition and reported as part of the carrying amount of a related item or as if they were freestanding assets or liabilities.)

2.03 The Board believes the Standard increases the visibility, comparability, and understandability of the risks associated with derivative instruments by requiring that all derivative instruments be reported as assets or liabilities and measured at fair value. Moreover, because the Standard provides comprehensive guidance for all derivative instruments and hedging activities, the Board believes it reduces the incompleteness, inconsistency, and application difficulties that previously existed.

**FOUR CORNERSTONES OF ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

3.01 In developing the accounting model for derivative instruments and hedging activities, the Board made four fundamental decisions that have become the cornerstones of the Standard. These decisions are discussed in paragraph 3 of the Standard (ASC paragraphs 815-10-10-1 and 815-20-10-1) and have been expanded on in Appendix C of the Standard. Exhibit 1.1 below depicts the four cornerstones underlying the accounting for derivative instruments and hedging activities. A discussion of each of the four fundamental decisions follows.

Exhibit 1.1: Four Cornerstones of Accounting for Derivative Instruments and Hedging Activities

<table>
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<td>Derivative instruments are assets or liabilities.</td>
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© 2019 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
3.02 Paragraph 3 of the Standard (ASC paragraph 815-10-10-1) begins with the following:

3. In developing the standards in this Statement the Board concluded that the following four fundamental decisions should serve as cornerstones underlying those standards:

**Derivative Instruments are Assets or Liabilities**

3a.01 The first fundamental decision made by the Board in developing the accounting model for derivative instruments is introduced in paragraph 3(a) of the Standard (ASC paragraph 815-10-10-1(a)) as follows:

3a. Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.

3a.02 The Board concluded that derivative instruments are assets or liabilities and, therefore, should be recognized as such in the financial statements. The Board believes that recognizing derivative instruments as assets or liabilities makes financial statements more complete and more informative.

3a.03 By concluding that derivative instruments are assets or liabilities, the Board indicated that the instruments represent rights or obligations and embody the characteristics of assets and liabilities described in FASB Concepts Statement No. 6, *Elements of Financial Statements* (SFAC 6). In particular, the Board believes that the ability to settle a derivative instrument in a gain position by receiving cash, another financial asset, or a nonfinancial asset is evidence of a right to a future economic benefit and is compelling evidence that the derivative instrument is an asset. Similarly, the payment of cash, a financial asset, or a nonfinancial asset to settle a derivative instrument in a loss position is evidence of an obligation to sacrifice assets in the future and indicates that the derivative instrument is a liability.

**The Only Relevant Measure for Derivative Instruments Is Fair Value**

3b.01 The second fundamental decision is discussed in paragraph 3(b) of the Standard (ASC paragraph 815-10-10-1(b)) and addresses how a derivative instrument should be measured.

3b. **Fair value** is the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Derivative instruments should be measured at fair value, and adjustments to the carrying amount of hedged items should reflect changes in their fair value (that is, gains or losses) that are attributable to the risk being hedged and that arise while the hedge is in effect.

3b.02 The Board concluded that fair value for financial assets and liabilities provides more relevant and understandable information than cost or cost-based measures. In particular, the Board believes that fair value is more relevant to financial statement users than cost when assessing the liquidity or solvency of an entity because fair value reflects the current cash equivalent of the entity’s financial instruments rather than the price of a past transaction. With the passage of time, historical prices become irrelevant in assessing liquidity or solvency.
3b.03 The Board believes that fair value measurement is practical for most financial assets and liabilities and continues to pursue its objective to have all financial instruments measured at fair value in the statement of financial position. Fair value measurements can be observed in markets or estimated by references to markets for similar instruments. When market information is not available, fair value can be estimated using other measurement techniques, such as discounted cash flow analyses or pricing models.

3b.04 The Board also concluded that fair value is the only relevant measurement attribute for derivative instruments for many of the same reasons as for financial instruments in general. In addition, the Board concluded that amortized cost is not a relevant measure for derivative instruments because the historical cost of a derivative instrument often is zero; yet a derivative instrument generally can be settled at any time for an amount equal to its fair value. 1

3b.05 FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (ASC Topic 320, Investments--Debt and Equity Securities), provides reasoning that amortized cost may be relevant for debt securities that will be held to maturity because generally that cost, absent default, will be realized at maturity and any interim unrealized gains or losses will reverse. The Board concluded, however, that for derivative instruments or for other financial instruments that reasoning does not hold true. The volatility of derivative instrument fair values and the irrelevance of amortized cost for derivative instruments convinced the Board that fair value is the only relevant measure for derivative instruments and that all derivative instruments should be reported in the financial statements at fair value.

Only Assets and Liabilities Should Be Recorded As Such

3c.01 The third fundamental decision is discussed in paragraph 3(c) of the Standard (ASC paragraph 815-10-10-1(c)) and builds on the first fundamental decision (i.e., that derivative instruments are assets or liabilities and should be reported as such in the financial statements).

3c. Only items that are assets or liabilities should be reported as such in financial statements.

3c.02 The Board decided that derivative instruments are assets or liabilities and, as such, should be reported in the financial statements (fundamental decision 1) and measured at fair value (fundamental decision 2). If derivative instruments are measured at fair value, the losses and gains resulting from changes in the derivative instrument’s fair value must be reported in the financial statements; however, losses or gains on derivative instruments are not separate assets or liabilities because they do not have the essential characteristics of assets or liabilities pursuant to SFAC 6. Specifically, a loss on a derivative instrument is not an asset because no future economic benefit is associated with it. The loss cannot be exchanged for cash, a financial asset, or a nonfinancial asset used to produce something of value, or used to settle liabilities. Similarly, a gain on a derivative instrument is not a liability because no obligation exists to sacrifice assets

1 An alternative to fair value measurement for certain interest rate swaps is provided under the simplified hedge accounting approach. The simplified hedge accounting approach was introduced by the Private Company Council under ASU 2014-03 and provides a practical expedient for certain private companies to apply hedge accounting. Under the simplified hedge accounting approach, a receive-variable, pay-fixed interest rate swap may be measured at settlement value instead of fair value. The simplified hedge accounting approach and the conditions that need to be met in order to qualify for the approach are discussed beginning at paragraph A6.70a of Section 6.
in the future. Consequently, the Board concluded that losses or gains on derivative instruments should not be deferred and reported as assets or liabilities in the statement of financial position.

**Special Hedge Accounting Should Be Provided Only for Qualified Transactions**

3d.01 The fourth and final fundamental decision made by the Board in developing the accounting model for derivative instruments is discussed in paragraph 3(d) of the Standard (ASC paragraph 815-10-10-1(d)). It describes when hedge accounting is appropriate.

3d. Special accounting for items designated as being hedged should be provided only for qualifying items. One aspect of qualification should be an assessment of the expectation of effective offsetting changes in fair values or cash flows during the term of the hedge for the risk being hedged.

3d.02 Given that hedge accounting is elective and relies on management’s intent, it should be limited to transactions that meet reasonable criteria. The Board concluded that hedge accounting should not be permitted in all cases in which an entity could assert that a relationship exists between items or transactions. Instead, the Board decided that hedge accounting should be provided only if the derivative (or nonderivative in very limited circumstances) hedging instrument is expected to be, and actually is, effective at offsetting changes in fair values or cash flows of the hedged item.

3d.03 This offset criterion precludes hedge accounting for certain risk management techniques, such as hedges of strategic risk. The Board gave as an example, a U.S. manufacturer, with no export business that designates a derivative instrument to buy U.S. dollars for Japanese yen as a hedge of its U.S. dollar sales. Such a transaction would fail the requirement that the cash flows of the derivative instrument are expected to be highly effective in achieving offsetting cash flows on the hedged transaction. While a weakened yen might allow a competitor to sell goods imported from Japan more cheaply, undercutting the domestic manufacturer’s prices and reducing its sales volume and revenues, it would be difficult for the U.S. manufacturer to demonstrate a high degree of offset between a decline in U.S. sales revenue due to increased competition and cash inflows on a foreign currency derivative instrument. Any relationship between the exposure and the derivative instrument typically would be indirect, would depend on elasticity of price, and would be only one of many factors influencing future results.

3d.04 Hedge accounting is limited to the direct effects of price changes of various kinds (e.g., commodity prices, interest rates) on fair values of assets and liabilities and the cash flows from transactions, including qualified forecasted transactions.

3.03 Paragraph 3 of the Standard (ASC Topic 815-10-10-1) concludes with a reference to Appendix C of the Standard where the four fundamental decisions are discussed in more detail:

3. Those fundamental decisions are discussed individually in paragraphs 217 - 231 of Appendix C.

3.04 With those four decisions as its cornerstones, the Board developed an accounting model for derivative instruments and hedging activities.
GENERAL CONCEPTS OF THE ACCOUNTING MODEL FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

4.01 The general concepts of the accounting model for derivative instruments and hedging activities are summarized in paragraph 4 of the Standard (ASC paragraph 815-10-05-4 through 05-6) as follows:

4. This Statement standardizes the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, by requiring that an entity recognize those items as assets or liabilities in the statement of financial position and measure them at fair value. If certain conditions are met, an entity may elect to designate a derivative instrument as follows:

a. A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment,\(^2\) that are attributable to a particular risk (referred to as a fair value hedge)

b. A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk (referred to as a cash flow hedge)

c. A hedge of the foreign currency exposure of (1) an unrecognized firm commitment (a foreign currency fair value hedge), (2) an available-for-sale security (a foreign currency fair value hedge), (3) a forecasted transaction (a foreign currency cash flow hedge), or (4) a net investment in a foreign operation.

This Statement generally provides for matching the timing of gain or loss recognition on the hedging instrument with the recognition of (a) the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk or (b) the earnings effect of the hedged forecasted transaction. Appendix A provides guidance on identifying financial instruments subject to the scope of this Statement and on assessing hedge effectiveness and is an integral part of the standards provided in this Statement. Appendix B contains examples that illustrate application of this Statement. Appendix C contains background information and the basis for the Board’s conclusions. Appendix D lists the accounting pronouncements superseded or amended by this Statement. Appendix E provides a diagram for determining whether a contract is a freestanding derivative subject to the scope of this Statement.

\(^2\) An unrecognized firm commitment can be viewed as an executory contract that represents both a right and an obligation. When a previously unrecognized firm commitment that is designated as a hedged item is accounted for in accordance with this Statement, an asset or a liability is recognized and reported in the statement of financial position related to the recognition of the gain or loss on the firm commitment. Consequently, subsequent references to an asset or a liability in his Statement include a firm commitment.

4.02 Paragraph 4 of the Standard provides (ASC paragraphs 815-10-05-4 through 05-6 provide) an overview of the general concepts of the accounting model for derivative instruments and hedging activities pursuant to the Standard. Specifically, this paragraph addresses the following:
• How derivative instruments should be recognized in the statement of financial position;
• Risks for which special hedge accounting is appropriate; and
• Timing of the gain and loss recognition on the derivative (or nonderivative) hedging instrument and the hedged item.

How Derivative Instruments Should Be Recognized In the Statement of Financial Position

4.03 Consistent with the Board’s first two fundamental decisions, the Standard requires that all derivative instruments be reported in the statement of financial position as assets or liabilities and measured at fair value. In determining the fair value of a derivative instrument, an entity should use the definition of fair value set forth in FASB Statement No. 157, *Fair Value Measurements* (ASC Topic 820, *Fair Value Measurements and Disclosures*). The accounting for changes in fair value of the derivative instrument depends on whether the derivative instrument qualifies for hedge accounting.

4.04 Any derivative instrument not designated as a derivative hedging instrument or not meeting the criteria for hedge accounting (refer to Chapters 5, 6, and 7 for discussion of hedge accounting criteria) is treated as a speculative contract. Accordingly, changes in the fair value of the derivative instrument are recognized in earnings each reporting period.

Risks for Which Special Hedge Accounting Is Appropriate

4.05 In addition, the Standard also codifies the types of risk that may be hedged. The hedgeable risks under the Standard are as follows:

• Changes in fair values due to fixed rates or prices: for example, a fixed-rate available-for-sale security exposes its owner to the risk of changes in the security’s fair value because of its fixed terms.

• Changes in cash flows due to variable rates and prices: for example, a variable-rate debt obligation exposes its issuer to changes in interest payments due to its variable terms.

• Changes in fair values, cash flows, or net investments in foreign operations due to variability of foreign currency exchange rates: for example, the anticipated purchase of a piece of equipment to be paid for in a foreign currency exposes the buyer to cash flow variability in its functional currency (i.e., functional-currency-equivalent cash flow variability) due to changes in the foreign currency exchange rates.

4.06 In addition to the types of foreign currency hedges noted in paragraph 4(c) of the Standard (ASC paragraph 815-10-05-4(c)), an entity may designate a hedge of the foreign currency exposure of (1) changes in fair value of a recognized asset or liability, (2) changes in forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability and (3) changes in functional-currency-equivalent cash flows associated with an unrecognized firm commitment.
4.07 As a result of the codification of the types of risks that may be hedged, entities may be required to modify their views of hedgeable risks in order to align their hedging objectives with the hedgeable risks codified by the Standard.

Timing of the Gain and Loss Recognition on the Derivative (Or Nonderivative) Hedging Instrument and the Hedged Item

4.08 Finally, paragraph 4 of the Standard (ASC paragraph 815-10-05-6) specifies that for transactions meeting the hedge accounting criteria, the timing of the gains and losses from the derivative (or nonderivative) hedging instrument generally is matched with the offsetting losses and gains from the hedged item.

4.09 The accounting model developed in the Standard is discussed in a comprehensive manner in the chapters that follow.
Section Two: Applicability and Freestanding Derivative Instruments (updated July 2019)

INTRODUCTION

Before applying the accounting guidance of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, amended (Statement 133 or Standard), it is important to understand what is considered a derivative instrument and whether the instrument is subject to the requirements of the Standard. This chapter discusses the defining characteristics of a derivative instrument and the instances in which instruments or contracts may meet the definition of a derivative instrument but are explicitly excluded from the scope of the Standard.

The chapter begins by addressing the entities that are affected by the Standard. It then analyzes the definition of a derivative instrument and the unique characteristics embodied in a derivative instrument. Finally, this chapter discusses instruments that are excluded from the scope of the Standard, even if they otherwise meet the definition of a derivative instrument. The discussion in this chapter is limited to freestanding instruments.

In addition to freestanding derivative instruments, the Standard applies to certain components of nonderivative instruments or contracts that contain features or terms that behave in a manner similar to derivative instruments. These components are known as embedded derivative instruments. Chapter 3 discusses how to identify and analyze embedded derivative components, and how to account for the embedded derivative component once it has been identified.

WHICH ENTITIES ARE AFFECTED BY THE STANDARD?

**5.01** Paragraph 5 of the Standard (ASC paragraph 815-10-15-1) addresses the entities to which the Standard applies:

> 5. This Statement applies to all entities. Some entities, such as not-for-profit organizations and defined benefit pension plans, do not report earnings as a separate caption in a statement of financial performance. The application of this Statement to those entities is set forth in paragraph 43.

**5.02** The Standard applies to all entities that apply U.S. generally accepted accounting principles (GAAP) as promulgated by the Financial Accounting Standards Board (FASB or Board). Organizations that have elected under paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, as amended, to apply FASB Statements and Interpretations must also apply the Standard, provided it does not conflict with or contradict pronouncements of the Governmental Accounting Standards Board.

**5.03** The Standard generally requires entities that do not report earnings as a separate caption in a statement of financial performance, such as certain not-for-profit organizations or defined benefit pension plans, to report the impact of derivative activities as a change in net assets in the period of change. (See Chapter 8 for a discussion of the accounting for derivatives by entities that do not report earnings as a separate caption in a statement of financial performance.)
## WHAT IS A DERIVATIVE INSTRUMENT?

### 6.01

Paragraph 6 of the Standard (ASC paragraph 815-10-15-83) introduces the three basic characteristics of a derivative instrument (paragraphs 7 - 9, and paragraph 57 of the Standard (ASC paragraphs 815-10-15-87 through 15-139) expand that discussion), as follows:

6. A derivative instrument is a financial instrument or other contract with all three of the following characteristics:

- **(a)** It has (1) one or more **underlyings** and (2) one or more **notional amounts**\(^3\) or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.\(^4\)

- **(b)** It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

- **(c)** Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Notwithstanding the above characteristics, loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 21 of FASB Statement No. 65, Accounting for Mortgage Banking Activities(as amended) (ASC paragraph 948-310-25-3), shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). Paragraph 10(i) (ASC paragraph 815-10-15-13(i)) provides a scope exception for the accounting for loan commitments by issuers of certain commitments to originate loans and all holders of commitments to originate loans (that is, the potential borrowers).

---

\(^3\) Sometimes other names are used. For example, the notional amount is called a face amount in some contracts.

\(^4\) The terms **underlying, notional amount, payment provision, and settlement** are intended to include the plural forms in the remainder of this Statement. Including both the singular and plural forms used in this paragraph is more accurate but much more awkward and impairs the readability.

---

Derivatives Implementation Group (DIG) Issues related to this paragraph are A1, A3, A5, A6, A8, A10, A13, A16, A17, A18, A23, B11, and B25. See DIG Issues Index.

### 6.02

Before the issuance of the Standard, a derivative instrument was not defined in accounting literature. The Board initially thought of defining a derivative instrument by reference to instruments commonly understood to be derivative instruments (e.g., swaps, options, and forwards). However, the Board recognized that with the continued expansion of financial markets and development of innovative financial instruments and other contracts, a definition based on examples could quickly become inadequate or obsolete. Thus, the Board concluded that to improve accounting guidance and to deal with new instruments that may be developed in the future, it would be necessary to define a derivative instrument based on distinguishing characteristics, which may or may not always coincide with what some market participants will consider to be a derivative instrument.
6.03 During the deliberations that led to the Standard, the definition of a derivative instrument was limited to financial instruments. By limiting the definition, the Standard would have excluded contracts that settle net for a commodity or other types of nonfinancial instruments. The Board believes that some of these contracts have essentially the same characteristics as, and present risks similar to, a financial derivative instrument. To prevent accounting for and measuring similar contracts differently, the scope of the Standard was expanded from derivative financial instruments to derivative instruments.

6.04 The Board concluded that a derivative instrument is a financial instrument or other contract that has all of the following basic characteristics:

- The instrument or contract has (1) one or more underlyings and (2) one or more notional amounts or payment provisions, or both.
- The instrument or contract requires no, or a small, investment at the inception of the contract (i.e., the initial net investment is zero, or smaller than would be required for other types of contracts expected to have similar responses to changes in market factors).
- The instrument or contract requires or permits net settlement, can readily be settled net by a means outside of the contract, or provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

6.05 These characteristics, which must be incorporated in the instrument or contract for it to be considered a derivative instrument under the Standard, are discussed in paragraphs 7 - 9 and paragraph 57 of the Standard (ASC paragraphs 815-10-15-87 through 15-139), and later in this chapter.

6.06 Notwithstanding the definition of a derivative instrument provided in the Standard, the Board decided that for practical reasons, all loan commitments that relate to the origination of mortgage loans that will be held for sale must be accounted for as derivatives under the Standard by the issuer (that is, the potential lender). However, the potential borrower under the loan commitment is precluded from accounting for the instrument as a derivative. See Paragraphs 10i.01 - 10i.10 of this chapter for further information.

UNDERLYING, NOTIONAL AMOUNT, AND PAYMENT PROVISION

7.01 Paragraph 7 of the Standard (ASC paragraphs 815-10-15-87 through 15-93) expand on the characteristics of a derivative instrument discussed in paragraph 6(a) (ASC paragraph 815-10-15-83(a)); that is, having one or more underlyings and one or more notional amounts or payment provisions, or both, as follows:

7. Underlying, notional amount, and payment provision. An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with
the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

DIG Issues related to this paragraph are A6 and A11. See DIG Issues Index.

7.02 A derivative instrument can have one or more underlyings, one or more notional amounts or payment provisions, or both. In the following paragraphs, we analyze each of the concepts of underlying, notional amount, and payment provision.

**Underlying**

7.03 An underlying is any variable factor (usually a price or an index) whose changes are observable or otherwise objectively verifiable and that, along with either the notional amount or payment provision, determines the cash flows or other exchanges (i.e., settlement) required by the derivative instrument. As a result, it follows that the value of a derivative instrument generally changes, and its settlement is provided for by direct reference to changes in one or more underlyings. An underlying is not the asset or liability referenced in the derivative instrument, but, rather, the price or rate associated with the referenced asset or liability, which usually is one or some combination of the following:

- Security price or security price index;
- Commodity price or commodity price index;
- Interest rate or interest rate index;
- Credit rating or credit index;
- Exchange rate or exchange rate index;
- Insurance or catastrophe loss index; or
- Climatic or geological condition (such as temperature, earthquake severity, or rainfall), another physical variable, or a related index.

7.04 The following are examples of typical derivative instruments and the associated underlying:

<table>
<thead>
<tr>
<th>Derivative Instrument</th>
<th>Underlying</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate swap</td>
<td>Interest rate index (e.g., LIBOR, Prime)</td>
</tr>
<tr>
<td>Debt or equity forward</td>
<td>Security price (e.g., stock price of ABC Corp.)</td>
</tr>
<tr>
<td>Commodity forward</td>
<td>Commodity price (e.g., oil or corn price)</td>
</tr>
<tr>
<td>Foreign currency swap</td>
<td>Applicable exchange rate (Euros or Pesos)</td>
</tr>
</tbody>
</table>
Credit derivative  Credit rating or index of the named party

7.05 An underlying cannot, by itself, determine the value or settlement of a derivative instrument. Such value or settlement typically is determined through the interaction between the changes in the underlying and the notional amount, which is the number of units specified in the contract. The next section discusses the notional amount.

7.06 The concept of an underlying has created confusion in practice. We believe this confusion is attributable to a general misinterpretation of what is an underlying. As discussed above, an underlying is any variable factor whose changes are observable or otherwise objectively verifiable. An underlying is not a fixed price or rate. For example, in an interest rate swap with a variable leg based on the 3-month US$ London Interbank Offered Rate (LIBOR), plus 200 basis points, the underlying is neither the fixed leg of the swap, nor the entire variable leg. Rather, it is the 3-month US$ LIBOR (the index). Although many derivative instruments contain a fixed price or rate, that fixed price or rate represents the exercise price or strike price of the contract, not its underlying. A contract with a variable exercise price or rate, including a contract that exactly tracks the underlying to the contract, also can have an underlying. For example, assume an entity enters into two contracts. The first contract is for the purchase of 100 shares of ABC Corp.’s publicly-traded stock in 6 months at $10 per share. The second contract is for the purchase of 100 shares of ABC Corp.’s publicly-traded stock in 6 months at the then-prevailing market price for the stock. The underlying in both contracts is the market price per share of ABC Corp.’s publicly-traded stock. However, as ABC Corp.’s stock price changes, the change in value of the first contract will be attributable to the interaction between the exercise price, the underlying, and the notional amount. For a variable price contract like the second contract, the fair value would be expected to be at, or near, zero since the exercise price of the contract (the then-prevailing market price for ABC Corp.’s publicly-traded stock) is the same as the underlying for the contract.

7.07 Another common contract is one with both a fixed and variable exercise price. Such contracts may be referred to as mixed-attribute contracts or fixed-basis contracts and are common in the commodities industry. An example of a commodity contract containing features of both fixed-price contracts and floating-price contracts is a transaction between a buyer and a seller of crude oil. For example, assume the buyer is a refinery in California that seeks to use crude oil in the production of unleaded gasoline. The buyer agrees in January to buy 1,000 barrels of a specific type of crude oil in July from the seller at the July 1 West Texas Intermediate (WTI) price index price plus $1.00 per barrel. The contract appears to be primarily a floating-price contract, but includes a fixed margin above that price. While the fixed $1.00 differential is commonly referred to as the basis differential, it reflects multiple factors, such as quality of the oil, and timing and location of the delivery. If not fixed, the basis differential can be very volatile, because it captures the passage of time (a financing element), changes in relative value of different qualities (or grades) of crude to each other (light versus heavy, sweet versus sour), and changes in the attractiveness of locations from the central pricing hub (Cushing, Oklahoma) relative to each other factor. Supply and demand is a critical factor in influencing the changes in basis due to quality and location. For example, an increase in imports of light crude through the Gulf of Mexico corridor will tend to lower the basis differential for light crude (falling prices due to increased supply) and tend to direct domestic supplies of light crude to northern U.S. locations (because the foreign oil fills southern U.S. demand), lowering
the basis differential for contracts calling for delivery at northern points (again due to increased supply in the North). The basis differential therefore is not a simple fixed transport charge, but rather a complex and volatile variable in itself.

7.08 This crude oil contract contains two underlyings. The first underlying is the market price for WTI crude oil. The second underlying is the basis differential between the specific type of crude oil to be purchased at a specific location (for example, WTI at Cushing, Oklahoma) and the actual crude oil to be purchased at the specified location. The two underlyings are each a variable whose changes are observable or otherwise objectively verifiable. These contracts are common in locations where the value of oil moves in tandem with a common pricing location (for example, Cushing, Oklahoma for New York Mercantile Exchange (NYMEX) contracts); however, due to physical distance from the related pricing point and regional supply and demand for oil, the price of the oil in locations outside the common pricing location is different. (See DIG Issue A11 for further reference.)

7.09 While an underlying is typically a price or index whose changes are observable or otherwise objectively verifiable, an underlying can be any variable or factor whose changes are observable or otherwise objectively verifiable. The occurrence or nonoccurrence of a specified event is also a variable or factor that qualifies as an underlying. For example, a contract that requires payment if certain conditions are met and does not require payment if those conditions are not met contains an underlying. The underlying is the occurrence (or nonoccurrence) of the specified conditions in the contract. Such underlyings are sometimes referred to as on/off switches – when the switch is on, the specified conditions occurred and a payment is required and when the switch is off, the specified conditions did not occur and a payment is not required.

Notional Amount

7.10 The notional amount is the contractual amount, or factor, that will be used to determine the cash flows or other exchanges required under the contractual terms of the derivative instrument. A notional amount is the number of units specified in the contract (e.g., an amount of currency, number of shares, number of bushels, pounds) that is applied to the change in one or more underlyings to assist in determining the settlement or value of the derivative instrument.

7.11 Although the notional amount is readily determinable in most derivative contracts involving financial instruments (e.g., interest rate derivatives, foreign currency derivatives, equity derivatives), determining whether a nonfinancial contract (e.g., commodity contracts) includes a notional amount can be a complex judgment when the contract lacks a specific number of units to be bought or sold. Determining whether a contract contains a notional amount must be based on information in the contract, attachments, appendices, or other legally binding side agreements.

7.12 One technique an entity may use to quantify and objectively validate the notional amount in a contract that lacks a specific notional amount is to consider a contract’s settlement and default provisions. If the provisions refer to anticipated quantities or the use of average historical quantities to calculate settlement, the contract generally contains a notional amount. If the notional amount cannot be reliably and objectively quantified with information explicitly contained in the contract, attachments, appendices, or other legally binding side agreements, a notional amount should not be estimated.
7.13 For contracts that contain a range of notional amounts (referred to as optionality), identifying the notional amount is further complicated by the need to first determine whether the contract is a requirements contract or a nonrequirements contract. A requirements contract represents an agreement to purchase or sell as many units as needed of a specified item, with or without defined limits, by/to the end-user of the item being purchased or sold. To be a requirements contract, we believe the contract must contain language that limits the use of the subject item to consumption by the buyer and its affiliates (and, thus, does not allow the buyer to be a reseller of the subject item to other entities). Requirements contracts are common in most industries that use commodities as either a raw material or energy source in the production process.

7.14 The following sections discuss identifying a notional amount in both requirements contracts and nonrequirements contracts that contain optionality as it relates to quantity. (See DIG Issue A6 for further reference.)

REQUIREMENTS CONTRACTS

7.15 Generally, entities should first examine their contracts to determine whether the contract contains explicit provisions that support the presence of a determinable quantity that reflects the buyer’s needs. If the contract supports the presence of a determinable quantity, the contract is deemed to have a notional amount.

7.16 Determining a notional amount for requirements contracts is complicated when the contract has minimum, maximum, and other quantity provisions. When a contract contains a minimum quantity that must be delivered or purchased, the contract will always have a notional amount equal to at least the minimum quantity. However, in cases in which another quantity is readily and objectively quantified from the other provisions of the contract, and that other quantity is greater than the minimum quantity required by the contract, that other quantity will represent the notional amount of the contract. Contracts with a maximum quantity that can be delivered or purchased may or may not have a notional amount. That is, the existence of a maximum quantity does not in and of itself represent a notional amount. The analysis of a requirements contract with a maximum quantity provision is consistent with the analysis of a contract that has no set quantity provisions (i.e., no minimum or determinable quantities). If the quantity to be sold or purchased under the contract cannot be readily and objectively quantified from the other provisions of the contract, the contract does not contain a notional amount. If the quantity that can be readily and objectively determined is greater than the maximum in the contract, the maximum quantity is the notional amount. If the quantity that can be readily and objectively determined is less than the maximum in the contract, the determined amount is the notional amount. Another common provision in requirements contracts is the combination of minimum and maximum provisions in the same contract. As with contracts that contain a minimum quantity, such contracts will always have a notional amount equal to at least the minimum quantity. In cases in which another quantity can be readily and objectively quantified from the other provisions of the contract, and that other quantity is between the minimum and maximum quantities, that other quantity represents the notional amount of the contract. If the quantity that can be readily and objectively determined is greater than the maximum in the contract, the maximum quantity is the notional amount. Regardless of the notional amount identified at the onset of a requirements contract, the determination of that contract’s notional amount must be
performed over the life of the contract and potentially could result in the fluctuation of the
notional amount if, for instance, the default provisions reference a rolling cumulative average of
historical usage.

7.17 To illustrate the concepts surrounding the determination of a notional amount in
requirements contracts, the following are examples of requirements contracts that contain
optionality as it relates to the quantities to be purchased. Following each example is an analysis
of whether the requirements contract is deemed to have a notional amount as discussed in
paragraph 6(a)(2) of the Standard (ASC paragraph 815-10-15-83(a)(2)).

Example 2.2: Requirements Contracts

Contract 1: Straight Requirements Contract

Contract 1 allows Company A to purchase only as many units as required to satisfy its needs
(i.e., to be used or consumed) for the commodity during the period of the contract. That is,
Company A is not permitted to buy more than its actual needs (e.g., it cannot buy excess units
for resale). Does the contract have a notional amount as discussed in paragraph 6(a)(2) of the
Standard (ASC paragraph 815-10-15-83(a)(2))? 

*Analysis*

It depends. If the requirements contract contains explicit provisions that support a determinable
quantity reflecting the buyer’s needs, then that contract has a notional amount pursuant to the
definition in the Standard. One technique to readily and objectively quantify and validate the
notional amount in a requirements contract is to analyze the contract’s settlement and default
provisions. Often the default provisions of requirements contracts will specifically refer to
anticipated quantities to utilize in the calculation of penalty amounts in the event of
nonperformance. Other default provisions stipulate penalty amounts in the event of
nonperformance based on average historical usage quantities of the buyer. If those amounts are
determinable, they should be considered the notional amount of the contract. The identification
of a requirements contract’s notional amount may require the consideration of volumes or
formulas contained in attachments or appendices to the contract or other legally binding side
agreements. In circumstances in which Company A identifies a notional amount, that notional
amount is considered part of a forward-type component and the additional optionality in the
contract (that is, the ability of Company A to purchase additional units beyond the identified
notional amount) is ignored for purposes of applying Standard. If the notional amount is not
determinable because quantifying the amount would be highly subjective and relatively
unreliable (e.g., if a contract does not contain settlement and default provisions that explicitly
reference quantities or provide a formula based on historical usage), the contract is not
considered to contain a notional amount as that term is used in the Standard.

Contract 2: Requirements Contract with a Specified Maximum Quantity

Contract 2 allows Company B to purchase only as many units as needed to satisfy its needs up
to a maximum of 100 units. That is, Company B is not permitted to buy more than its actual
needs (e.g., it cannot buy excess units for resale). Does the contract have a notional amount as
discussed in paragraph 6(a)(2) of the Standard (ASC paragraph 815-10-15-83(a)(2))? 

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Analysis

It depends. The same considerations discussed above with respect to Contract 1 also apply to Contract 2; however, the notional amount cannot exceed 100 units. Assume Company B determines that the requirements contract contains a notional amount and that notional amount is 75 units. In essence, Company B has determined that the requirements contract comprises a forward-type component to purchase 75 units and an option-type component to purchase 25 units. The option-type component exists because the requirements contract allows Company B to purchase up to a maximum of 100 units and Company B has determined that 75 units represent the notional amount. Since the contract is a requirements contract, that option-type component is ignored for purposes of applying the Standard.

Contract 3: Requirements Contract with a Specified Minimum Quantity

Contract 3 requires Company C to purchase a minimum of 60 units and allows Company C to purchase as many additional units as it needs in excess of 60 units. Company C is not permitted to buy more than its needs (e.g., it cannot buy excess units for resale). Does the contract have a notional amount as discussed in paragraph 6(a)(2) of the Standard (ASC paragraph 815-10-15-83(a)(2))?

Analysis

Yes. The same considerations discussed above with respect to Contract 1 also apply to Contract 3; however, the notional amount of Contract 3 cannot be less than 60 units. A contract that specifies a minimum number of units always has a notional amount equal to at least the required minimum number of units. In circumstances in which a notional amount in excess of the minimum quantity is identified by Company C, that higher notional amount is considered a forward-type component of the entire contract and the additional optionality in the contract (i.e., the ability of Company C to purchase additional units beyond the identified notional amount) is ignored for purposes of applying Standard.

Contract 4: Requirements Contract with Specified Minimum and Maximum Quantities

Contract 4 requires Company D to purchase a minimum of 60 units and allows Company D to purchase additional units up to a maximum of 100 units to satisfy its needs. Company D is not permitted to buy more than its needs (e.g., it cannot buy excess units for resale). Does the contract have a notional amount as discussed in paragraph 6(a)(2) of the Standard (ASC paragraph 815-10-15-83(a)(2))?

Analysis

Yes. The same considerations discussed above with respect to Contract 1 also apply to Contract 4; however, the notional amount of Contract 4 cannot be less than 60 units or greater than 100 units. A contract that specifies a minimum number of units always has a notional amount equal to at least the required minimum number of units. In circumstances in which a notional amount in excess of the minimum quantity is identified by Company D (but less than the maximum amount permitted by the contract), that higher notional amount is considered a forward-type component of the entire contract and the additional optionality in the contract (i.e., the ability of Company D to purchase additional units beyond the identified notional amount up to the
maximum amount) is an option-type component that is ignored for purposes of applying the Standard.

NONREQUIREMENTS CONTRACTS

7.18 For nonrequirements contracts, the methodology for determining a notional amount generally is consistent with the methodology for requirements contracts; however, the existence of optionality as it relates to quantity to be delivered or purchased, as discussed below, may lead to a conclusion that the contract is an option, a forward, or a combination of both. In general, entities should examine their nonrequirements contracts to determine whether the contract contains explicit provisions that support the presence of a determinable quantity. If the contract supports the presence of a determinable quantity, the contract will be deemed to have a notional amount. (It should be noted that if the contract also meets the other criteria of paragraph 6 of the Standard (ASC paragraph 815-10-15-83), the contract will meet the definition of a derivative.)

7.19 As with requirements contracts, determining the notional amount for nonrequirements contracts is complicated when the contract has minimum, maximum, and other quantity provisions. When a nonrequirements contract contains a minimum quantity that must be delivered or purchased, the contract always will have a notional amount equal to at least the minimum quantity. If another quantity can be readily and objectively quantified from the other provisions of the contract, and that other quantity is greater than the minimum, that other quantity will represent the notional amount of the contract. For nonrequirements contracts with a maximum quantity that can be delivered or purchased, the contract always will have a notional amount equal to the amount of the maximum quantity under the contract, even if another quantity can be readily and objectively quantified from the other provisions of the contract. Another common provision in nonrequirements contracts is the combination of maximum and minimum provisions in the same contract. In these cases, as with contracts that contain a maximum quantity, the contract will always have a notional amount equal to the maximum quantity, even if another quantity can be readily and objectively quantified from the other provisions of the contract. Thus, in a contract where a maximum quantity is specified, the determination whether a contract is a requirements contract or nonrequirements contract is significant because, in the latter case, the notional amount will always be the maximum amount cited in the contract, and in the former, it may or may not be that amount.

7.20 To illustrate the concepts surrounding the determination of a notional amount in nonrequirements contracts, the following are examples of nonrequirements contracts that contain optionality as it relates to the quantity to be delivered or purchased. Compare these example contracts to those illustrated in Example 2.2 in Paragraph 7.17 of this chapter. Following each example is an analysis of whether the contract is deemed to have a notional amount as discussed in paragraph 6(a)(2) of the Standard (ASC paragraph 815-10-15-83(a)(2)) and whether the contract is an option, a forward, or a combination of both.
Example 2.3: Nonrequirements Contracts

Contract 1: Straight Contract

Contract 1 allows Company A to purchase as many units as it wants. Does the contract have a notional amount as discussed in paragraph 6(a)(2) of the Standard (ASC paragraph 815-10-15-83(a)(2))? 

Analysis

Similar to the analysis for Contract 1 in Paragraph 7.17 above, if the notional amount cannot be quantified using language in the contract or its attachments, appendices, or other legally binding side agreements, quantifying the amount is highly subjective and relatively unreliable. Such a contract is considered not to contain a notional amount as that term is used in the Standard. In circumstances in which a notional amount is identified by Company A and the contract meets the other conditions in paragraph 6 of the Standard (ASC paragraph 815-10-15-83), the contract will be a forward derivative.

Contract 2: Contract with a Specified Maximum Quantity

Contract 2 allows Company B to purchase up to a maximum of 100 units. Does the contract have a notional amount as discussed in paragraph 6(a)(2) of the Standard (ASC paragraph 815-10-15-83(a)(2))? 

Analysis

Since the contract allows the purchase of up to 100 units (i.e., 0 units to 100 units), the contract represents an option to purchase the subject commodity. If the option meets the other conditions in paragraph 6 of the Standard (ASC paragraph 815-10-15-83), it will require derivative accounting. The characterization of this as an option is different from the result for a requirements contract with similar terms discussed in Paragraph 7.17 above. In that analysis, if a notional amount could be readily and objectively quantified from the terms of the contract (with an upper limit of 100), and it met the other conditions in paragraph 6 of the Standard (ASC paragraph 815-10-15-83), the contract would represent a forward contract with a notional amount equal to the quantity readily and objectively determined from the terms of the agreement (i.e., an amount equal to or less than 100 units). In the nonrequirements contract analysis presented here, the contract is deemed to be an option contract with a notional amount of 100 units, even if another quantity equal to or less than 100 units could be readily and objectively determined from the terms of the agreement.

Contract 3: Contract with a Specified Minimum Quantity

Contract 3 requires Company C to purchase a minimum of 60 units and allows Company C to purchase as many units as it wants in excess of 60 units. Does the contract have a notional amount as discussed in paragraph 6(a)(2) of the Standard (ASC paragraph 815-10-15-83(a)(2))? 

Analysis

Based on the terms of the contract, Contract 3 comprises two features: a forward component to purchase 60 units and an option component to purchase amounts in excess of 60 units. In the example contract, the notional amount of the forward component is clear, 60 units; however, the notional amount of the option component is not determinable (assuming there is not language in
the agreement, or related side agreements, that would allow the company to determine the notional amount). Since the forward contract contains a notional amount of 60 units, if the contract meets the other conditions in paragraph 6 of the Standard (ASC paragraph 815-10-15-83), the contract will require derivative accounting.

**Contract 4: Contract with Specified Minimum and Maximum Quantities**

Contract 4 requires Company D to purchase a minimum of 60 units and allows Company D to purchase as many units it wants in excess of 60 units up to a maximum of 100 units. Does the contract have a notional amount as discussed in paragraph 6(a)(2) of the Standard (ASC paragraph 815-10-15-83)?

**Analysis**

Based on the terms of the contract, Contract 4 comprises two features: a forward component to purchase 60 units and an option component to purchase an additional 40 units. Given these terms, the notional amount for the entire contract is 100 units. If the entire contract meets the other conditions in paragraph 6 of the Standard (ASC paragraph 815-10-15-83), the entire contract will require derivative accounting.

7.21 As discussed above, whether a contract is a requirements contract or a nonrequirements contract affects both the determination of whether a notional amount exists and the amount of the notional. Further, and sometimes even more importantly, a requirements contract that is deemed to contain a notional amount, contains optionality as it relates to quantity, and meets the remaining criteria in paragraph 6 of the Standard (ASC paragraph 815-10-15-83) would always be considered a forward contract. However, a nonrequirements contract that contains optionality as it relates to quantity (and, therefore, the notional amount) and meets the remaining criteria in paragraph 6 of the Standard (ASC paragraph 815-10-15-83) may be considered a forward contract, an option contract, or a combination of an option and forward contract. Such characterizations as forward or option contracts may impact the contract’s eligibility for the normal purchases and normal sales exception outlined in paragraph 10(b) of the Standard (ASC paragraph 815-10-15-13(b)) (as discussed in Paragraphs 10b.01 - 10b.58 of this chapter).

7.22 In many derivative contracts a notional amount is either explicitly stated or can be reliably and objectively quantified with information explicitly contained in the contract, attachments, appendices or other legally binding side agreements. However, in other derivative contracts a payment provision, as discussed below, may be present instead.

**Payment Provision**

7.23 A derivative instrument need not contain a notional amount. That is, rather than reference a notional amount, a derivative instrument may contain a provision that requires payment if an underlying changes in a specified way. For example, an instrument may include a payment provision that requires a specified payment if a referenced interest rate increases by 300 basis points. The settlement or value of a derivative instrument typically is determined by the interaction of the notional amount with the underlying. In contrast, a payment provision specifies the settlement amount if the underlying behaves in a specified manner. A contract need only reference a notional amount or contain a payment provision to compute the contract’s periodic settlements and resulting changes in fair value.
The following are examples of underlyings and notional amounts or payment provisions (or both) for common derivative instruments:

<table>
<thead>
<tr>
<th>Derivative Instrument</th>
<th>Underlying</th>
<th>Notional Amount or Payment Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000 interest rate swap to pay 7% interest and receive LIBOR plus 300 basis points</td>
<td>LIBOR</td>
<td>$10,000 (notional amount)</td>
</tr>
<tr>
<td>Futures contract to purchase 100,000 barrels of crude oil</td>
<td>Price of crude oil</td>
<td>100,000 barrels of crude oil (notional amount)</td>
</tr>
<tr>
<td>Forward contract to sell 100,000 ounces of gold for $30,000,000</td>
<td>Price of gold</td>
<td>100,000 ounces of gold (notional amount)</td>
</tr>
<tr>
<td>Forward contract to purchase 100,000 ounces of gold at the market price on the settlement date</td>
<td>Price of gold</td>
<td>100,000 ounces of gold (notional amount)</td>
</tr>
<tr>
<td>Put option on 10,000 shares of Company A at $10 per share</td>
<td>Price of Company A’s shares of stock</td>
<td>10,000 shares (notional amount)</td>
</tr>
<tr>
<td>Put option to pay $15,000 if Company A’s stock price falls below $30 per share</td>
<td>Price of Company A’s shares of stock</td>
<td>$15,000 (payment provision)</td>
</tr>
<tr>
<td>Contract that requires Company B to pay Company C $10,000 if Company C does not receive a $10,000 principal repayment from a loan it issued to Company D</td>
<td>Occurrence or nonoccurrence of the principal payment from Company D</td>
<td>$10,000 (payment provision)</td>
</tr>
</tbody>
</table>

**INITIAL NET INVESTMENT**

Paragraph 8 of the Standard (ASC paragraphs 815-10-15-94 through 15-98) expands on the characteristic of a derivative instrument discussed in paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)), as follows:
8. **Initial net investment.** Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for time value (for example, a premium on an option) or for terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price). Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged. A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying. If the initial net investment in the contract (after adjustment for the time value of money) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying or to incur the obligation related to the underlying, the characteristic in paragraph 6(b) is met. The amount of that asset acquired or liability incurred should be comparable to the effective notional amount* of the contract.

*The effective notional amount is the stated notional amount adjusted for any leverage factor.

DIG Issue related to this paragraph is A1. See [DIG Issues Index](#).

**8.02** Paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)) states that one of the characteristics of a derivative is that the contract requires no initial net investment, or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors (i.e., the initial net investment characteristic). This characteristic is stated from the perspective of only one party to the contract, but it determines the application of the Standard for both parties.

**General Criteria**

**8.03** Paragraph 8 of the Standard (ASC paragraphs 815-10-15-94 through 15-98) provides further guidance by outlining three criteria, all of which must be met for a contract to have the initial net investment characteristic. These criteria are:

- The initial net investment is not equal to the [effective] notional amount, or the [effective] notional amount, plus a premium, or minus a discount (referred to herein as criterion 1);
- The initial net investment is not determined by applying the [effective] notional amount to the underlying (referred to herein as criterion 2); and
- The initial net investment (after adjustment for the time value of money) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying, or to incur the obligation related to the underlying (referred to herein as criterion 3).

**8.04** Even though all three criteria must be met for a contract to have the initial net investment characteristic, a specific criterion may be particularly applicable to one type of contract versus
another. For example, when a contract contains an underlying that does not relate to a specific asset, such as a contract that relates to interest rates or foreign exchange rates, criterion 2 is more on point. When a contract contains an underlying that relates to a specific asset, such as a forward purchase contract for an unrelated company’s stock, criteria 1 and 3 are more on point. Nevertheless, entities must consider all three criteria to evaluate whether a contract has the initial net investment characteristic.

8.05 Criteria 1 and 2 use the term effective notional amount. The effective notional amount is the stated notional amount adjusted for any leverage factor. Therefore, when a contract has leverage, the stated notional amount must be adjusted to an effective notional amount before applying any of the initial net investment criteria discussed in Paragraph 8.03 above. For example, if a prepaid interest rate swap with a stated notional amount of $10,000,000 pays interest at a rate of two times LIBOR, the effective notional amount for purposes of determining whether a contract meets the initial net investment characteristic would be $20,000,000 (Notional amount * the leverage factor) ($10,000,000 * 2).

8.06 The FASB decided not to establish a quantitative threshold for evaluating whether a contract meets the initial net investment characteristic. Instead, broad qualitative guidance was provided in paragraph 8 of the Standard (ASC paragraphs 815-10-15-96), which states that the initial net investment must be “less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged. . . .” We believe the “less, by more than a nominal amount” concept should be used in all of the three criteria discussed in Paragraph 8.03 above, where applicable, when evaluating the initial net investment characteristic. Therefore, we believe:

- If the initial net investment is equal to or greater than the amounts calculated as described in Paragraph 8.03 above, the contract does not meet the initial net investment characteristic; and

- If the initial net investment is less than the amounts calculated as described in Paragraph 8.03 above, the contract will meet the initial net investment characteristic only if it is “less, by more than a nominal amount.”

CRITERION 1

8.07 In general, the Board concluded that providing the opportunity to participate in some or all of the price changes of an underlying without actually having to own an associated asset or owe a liability is a basic feature that distinguishes most traditional derivative instruments (e.g., futures contracts on specified Treasury bonds) from nonderivative instruments (e.g., Treasury bonds on which the futures contracts are based). Therefore, the Board decided that a contract that requires the holder or writer to invest or receive the entire notional amount of the contract (or the notional amount, plus a premium, or minus a discount) is not a derivative instrument. However, instruments for which a nominal initial investment is made to compensate for the time value of money or terms that are more or less favorable than market would meet the requirements of paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)). The following example illustrates this criterion:
Example 2.5: Initial Net Investment

ABC Corp. wishes to participate in changes in the fair value of 10,000 shares of a specific marketable equity security.

ABC may participate in the fair value changes of the security by purchasing 10,000 shares of that security. Purchasing the shares will require an initial investment equal to the current price for 10,000 shares and will result in other benefits of ownership, such as the receipt of dividends (if any) and the ability to vote the shares. Such a transaction is not a derivative instrument because an initial investment is required.

Alternatively, ABC may enter into a forward purchase contract with a notional amount of 10,000 shares of that specific security and an underlying that is the price of the security. A simple forward contract entered into at the current forward price for 10,000 shares of the equity instrument will not require an initial investment equal to the notional amount (or the notional amount plus a premium, or minus a discount), will not permit ABC to take possession of the shares at inception of the forward contract, and will not entitle ABC to the rights of security ownership such as receiving dividends and voting the shares. The forward contract would meet criterion 1 as described in Paragraph 8.03 above.

CRITERION 2

8.08 To illustrate the application of criterion 2, the paragraphs that follow discuss three prepaid interest rate swaps and the analysis required under paragraph 8 of the Standard (ASC paragraphs 815-10-15-94 through 15-98) when determining whether the prepaid interest rate swap meets the characteristic of a derivative as described in paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)).

First Prepaid Interest Rate Swap

8.09 Company A pays $1,228,179 to enter into a prepaid interest rate swap contract that requires the counterparty to make quarterly payments based on a $10,000,000 effective notional amount and a variable interest rate equal to three-month US$ LIBOR. The prepaid swap contract is characterized as an at-the-money two-year, interest rate swap with a $10,000,000 notional amount, a fixed interest rate of 6.65%, and a variable interest rate of three-month LIBOR, for which the fixed leg has been fully prepaid. The amount of $1,228,179 is the present value of the eight quarterly fixed payments of $166,250 (($10,000,000 * 6.65% / 4) – the present value is based on the implied spot rate for each of the eight payment dates under the assumed initial yield curve and assumes both parties to the contract have the same AA credit rating). Company A is required to make an initial net investment that is determined by applying the effective notional amount of $10,000,000 to the underlying (three-month US$ LIBOR) for each of the eight payment dates specified by the terms of the contract.

8.10 Because the LIBOR swap rate reflects the applicable portions of the forward three-month US$ LIBOR rate curve for the settlement dates that relate to the specific payments under the swap, the initial net investment is considered to have been determined by applying the effective notional amount to the underlying and then adjusted for the time value of money. As a result, the prepaid interest rate swap contract does not meet criterion 2, and thus does not meet the
definition of a derivative in its entirety because it does not satisfy the characteristic of a derivative described in paragraph 8 of the Standard (ASC paragraphs 815-10-15-94 through 15-98) related to the initial net investment in the contract.

8.11 In contrast, if we assume all the same facts above except Company A is required to pay an initial net investment of $1,200,000, Company A must use judgment to determine whether the initial net investment is less than the amount calculated in criterion 2 ($1,228,179) “by more than a nominal amount.” If the conclusion is that it is, then the contract meets criterion 2.

Second Prepaid Interest Rate Swap

8.12 A contract that requires an initial net investment that is in excess of the amount determined by applying the effective notional amount to the underlying is also not a derivative in its entirety because it does not satisfy the characteristic of a derivative described in paragraphs 6(b) and 8 of the Standard (ASC paragraphs 815-10-15-83(b) and 815-10-15-94 through 15-98) of the Standard related to the initial net investment in the contract. To illustrate, assume Company B pays $1,782,245 to enter into a prepaid interest rate swap contract that requires the counterparty to make quarterly payments based on a $10,000,000 effective notional amount and a variable interest rate equal to the sum of three-month US$ LIBOR plus 300 basis points. The prepaid interest rate swap contract is characterized as an at-the-money two-year interest rate swap with a $10,000,000 notional amount, a fixed interest rate of 9.65%, and a variable interest rate of three-month US$ LIBOR plus 300 basis points, for which the fixed leg has been fully prepaid. The amount of $1,782,245 is the present value of the eight quarterly fixed payments of $241,250 (($10,000,000 * 9.65% / 4) – the present value is based on the implied spot rate for each of the eight payment dates under the assumed initial yield curve and assumes both parties to the contract have the same AA credit rating).

8.13 Even though the variable rate is three-month US$ LIBOR plus 300 basis points, the underlying in this interest rate swap is three-month US$ LIBOR. Therefore, the amount determined by applying the effective notional amount ($10,000,000) to the underlying (three-month US$ LIBOR), adjusted for the time value of money, is $1,228,179. (Note that this is the same amount as calculated in Paragraph 8.09 above since the net terms of the swap are identical.) The initial net investment for the prepaid interest rate swap is $1,782,245, an amount that is in excess of $1,228,179 – the amount referred to in paragraph 8 of the Standard (ASC paragraphs 815-10-15-94 through 15-98) as being determined by applying the effective notional amount to the underlying. Consequently, the prepaid interest rate swap does not meet criterion 2 and thus is not a derivative in its entirety.

Third Prepaid Interest Rate Swap

8.14 Determining whether the initial net investment is “less, by more than a nominal amount” is a matter of judgment and should be based on the specific facts and circumstances. To illustrate, assume Company C pays $1,043,490 to enter into a contract that requires the counterparty to make quarterly payments based on a $10,000,000 effective notional amount and a variable interest rate equal to the three-month US$ LIBOR minus 100 basis points. In the event that three-month US$ LIBOR is less than 100 basis points, Company C is obligated to make additional payments to the counterparty. The prepaid interest rate swap contract is characterized as an at-the-money two-year interest rate swap with a $10,000,000 notional amount, a fixed interest rate
of 5.65%, and a variable interest rate of three-month US$ LIBOR minus 100 basis points, for which the fixed leg has been fully prepaid. The amount of $1,043,490 is the present value of the eight quarterly fixed payments of $141,250 (($10,000,000 * 5.65% / 4) – the present value is based on the implied spot rate for each of the eight payment dates under the assumed initial yield curve and assumes both parties to the contract have the same AA credit rating).

8.15 Even though the variable rate is three-month US$ LIBOR minus 100 basis points, the underlying in this interest rate swap is three-month US$ LIBOR. Therefore, the amount determined by applying the effective notional amount ($10,000,000) to the underlying (three-month US$ LIBOR), adjusted for the time value of money, is $1,228,179. (Note that this is the same amount as calculated in Paragraph 8.09 above since the net terms of the swap are identical.) The initial net investment for the contract is $1,043,490, an amount that is less than $1,228,179 – the amount referred to in paragraph 8 of the Standard (ASC paragraphs 815-10-15-94 through 15-98) as being determined by applying the effective notional amount to the underlying. As a result, the contract is not fully prepaid because Company C has not prepaid all obligations imposed on it by the contract. The difference of the shortfall of $184,689 (($1,228,179 minus $1,043,490) or about 15%) is more than a nominal amount when compared to $1,228,179. We believe the amount would need to be significantly smaller than $184,689 in order to be considered “a nominal amount.” Consequently, the prepaid interest rate swap is considered to meet criterion 2.

CRITERION 3

8.16 To illustrate the application of criterion 3, the paragraphs that follow discuss two prepaid forward contracts and the analysis required under paragraph 8 of the Standard (ASC paragraphs 815-10-15-94 through 15-98) when determining whether the forward contract meets the characteristics of a derivative as described in paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)).

First Prepaid Forward Contract

8.17 Company D enters into a forward contract that requires the purchase of one share of an unrelated company’s common stock in one year for $110 (the market forward price) when the current price of one share of the unrelated company’s common stock is $105. At inception of this forward contract, Company D elects to prepay the contract, pursuant to the terms of the contract, in the amount of $105. Company D will not take possession of the unrelated company’s common stock for one year and will not be entitled to the rights of security ownership (such as receiving dividends and voting the shares). Because Company D has prepaid the contract, no further payments are required upon receipt of the unrelated company’s common stock in one year. Company D will participate in all of the price changes of the unrelated company’s common stock.

8.18 The initial net investment made by Company D is $105 and the initial net investment that would be commensurate with the amount that would be exchanged to acquire the unrelated company’s common stock is $105. Since the initial net investment of $105 is equal to the market price of the unrelated company’s common stock at inception of the forward contract of $105, the forward contract will not meet the initial net investment characteristic. Consequently, the prepaid forward contract is not considered to meet criterion 3.
Second Prepaid Forward Contract

8.19 Company E enters into a forward contract that requires the purchase of one share of an unrelated company’s common stock in one year for $110 (the market forward price) when the current price of one share of the unrelated company’s common stock is $105. At inception of this forward contract, Company E elects to prepay a portion of the contract, pursuant to the terms of the contract, in the amount of $95 and will pay $12 upon receipt of the stock in one year. Company E will not take possession of the unrelated company’s common stock for one year and will not be entitled to the rights of security ownership (such as receiving dividends and voting the shares). Company E will participate in all of the price changes of the unrelated company’s common stock.

8.20 The initial net investment made by Company E is $95 while the initial net investment that would be commensurate with the amount that would be exchanged to acquire the unrelated company’s common stock is $105. Since the initial net investment of $95 is less than the market price of the unrelated company’s common stock at inception of the forward contract of $105, the forward contract will meet the initial net investment characteristic only if $95 is considered less, by more than a nominal amount and after adjustment for the time value of money, than $105. The difference of the shortfall of $10 (or about 9.5%) is more than a nominal amount. We believe the amount would need to be significantly smaller than $10 in order to be considered “a nominal amount.” Consequently, the forward contract is considered to meet criterion 3.

THE FULLY PREPAID CONCEPT

8.21 Implicit in criteria 2 and 3 is the requirement that the initial net investment of a nonoption contract must not fully prepay the contract in order for the contract to meet the initial net investment characteristic. A nonoption contract is fully prepaid if one party invests either (a) the fair value of all its future cash outflows under the contract and no longer has to sacrifice additional assets to settle the contract or (b) an amount equal to the amount that would be exchanged to acquire the underlying asset(s) or to incur the obligation related to the underlying. The swaps entered into by Companies A and B as discussed in Paragraphs 8.09 - 8.13 of this chapter were prepaid with an amount equal to, or greater than, the present value of the fixed-rate payments while the forward contract entered into by Company D as discussed in Paragraphs 8.17 - 8.18 of this chapter was prepaid with an amount equal to the market price of the unrelated company’s common stock at inception of the forward contract. As a result, these contracts are considered fully prepaid and do not meet the initial net investment characteristic. Therefore, these contracts are not derivatives in their entirety.

8.22 While the swap entered by Company C as discussed in Paragraphs 8.14 - 8.15 of this chapter was prepaid by an amount equal to the present value of the fixed-rate payments, the contract was not fully prepaid since the entity might be required to make additional payments if the LIBOR rate were to decline below 1%. As a result, the contract meets criterion 2 of the initial net investment characteristic. While a payment was made at inception of the forward contract entered by Company E as discussed in Paragraphs 8.19 - 8.20 of this chapter, that amount was less, by more than a nominal amount, than the market price of the unrelated company’s common stock at inception of the forward contract. Consequently, the forward contract is considered to meet criterion 3.
Application Issues When Applying the Criteria in Paragraph 8 of the Standard (ASC paragraphs 815-10-15-94 through 15-98)

8.23 To facilitate the understanding of the initial net investment criteria, the paragraphs that follow summarize some of the more common application issues, including:

- Determining the appropriate discount rate;
- Additional analysis under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14);
- Applying the requirements to currency swaps; and
- Applying the requirements in a transfer of financial assets accounted for as a sale under FASB Statement No. 140 (ASC Topic 860, Transfers and Servicing).

DETERMINING THE APPROPRIATE DISCOUNT RATE

8.24 When applying the requirements of criterion 2 as discussed in Paragraph 8.03 of this chapter, an entity must determine the present value of future cash payments using an appropriate discount rate. Consideration must be given to the credit rating of the variable-rate payor in determining the appropriate discount. Specifically, if the party that is obligated to make the variable payments has a different credit rating (i.e., different from AA – the presumed discount rate for LIBOR swaps), the effect of that different creditworthiness should be reflected in the discount rate used to determine the present value of the amount payable by that party under the contract.

8.25 Therefore, the discount rate should consider differences in credit ratings between the variable-rate payor (the counterparty who has not prepaid) and the LIBOR discount curve, which assumes a counterparty credit rating of AA, as follows:

- If the variable-rate payor has a credit rating below AA, a discount rate higher than LIBOR should be used, thus lowering the amount calculated in criterion 2; or
- If the variable-rate payor has a credit rating higher than AA, a discount rate lower than LIBOR should be used, thus raising the amount calculated in criterion 2.

8.26 It should be noted that the credit rating of the fixed-rate payor is not considered in determining the discount rate used in calculating the amount in criterion 2 because the future payments are due from the variable-rate payor.


8.27 If an entity concludes that an instrument is not a derivative in its entirety after applying the provisions in paragraph 8 of the Standard (ASC paragraphs 815-10-15-94 through 15-98), the entity must assess whether the instrument contains an embedded derivative that, pursuant to paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14), requires separate accounting as a derivative.

8.28 For example, although the prepaid interest rate swaps discussed in Paragraphs 8.09 - 8.13 of this chapter do not meet the definition of a derivative in their entirety, the entities must evaluate
the contract to determine whether the contract contains an embedded derivative that requires separate accounting as a derivative. Both entities may conclude that the prepaid interest rate swap is a hybrid instrument that is composed of a debt host contract and an embedded derivative. As more fully discussed in Chapter 3, the identification of the terms of the embedded derivative is subject to judgment.

8.29 The analysis of embedded features is one of the most complicated aspects of the Standard. Refer to Chapter 3 for a detailed discussion of the embedded features analysis.

8.30 Not used.

CURRENCY SWAPS

8.31 There was some debate during deliberations of the Standard as to whether currency swaps that require an exchange of different currencies at both inception and maturity meet the initial net investment characteristic of the Standard. To some, the requirement to exchange notional amounts at the inception of the contract would appear to exclude these instruments as derivative instruments under the Standard because there is a requirement to make an initial investment. The Board noted that a currency swap could be analyzed by dividing it into two transactions. The first part of a currency swap simply is an exchange of foreign currencies, which generally occurs at the inception of the contract. The second part of a currency swap is a forward contract to re-exchange the currencies for a specified price at a specified date in the future.

8.32 As stated in paragraph 8 of the Standard (ASC paragraph 815-10-15-94), “others [derivative instruments] require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged.” It is the Board’s observation that the initial exchange of currencies does not constitute an initial investment equal to the notional amount of the contract. Instead, it is the exchange of one kind of cash for another kind of cash of equal value – not a transaction that gives rise to a derivative instrument. The balance of the agreement, the forward contract element of the swap, however, obligates and entitles both parties to exchange specified currencies on specified dates, at specified prices and may be accounted for as derivative instrument if it meets the definition of a derivative instrument pursuant to paragraph 6 of the Standard (ASC paragraph 815-10-15-83).

TRANSFER OF FINANCIAL ASSETS ACCOUNTED FOR AS A SALE UNDER FASB STATEMENT NO. 140 (ASC TOPIC 860)

8.33 A similar analysis as that described in Paragraphs 8.31 - 8.32 above may be applied to a transfer of financial assets accounted for as a sale under FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (Statement 140) (ASC Topic 860), in which the transferor is both obligated and entitled to repurchase or redeem assets that are not the same, or substantially the same, as the transferred assets from the transferee at a fixed or determinable price. In that transaction, the initial exchange is a transfer of financial assets for cash – not a transaction that gives rise to a derivative instrument. However, the accompanying forward contract that gives the transferor the right and obligation to repurchase or redeem the assets is a separate derivative instrument under the Standard if the criteria in paragraph 6 of the Standard (ASC paragraph 815-10-15-83) are met.
NET SETTLEMENT

9.01 Net settlement generally can be defined as a one-way transfer of an asset, usually cash, from the counterparty in a loss position to the counterparty in a gain position. In contrast, gross settlement involves a two-way transfer, whereby Counterparty A transfers an asset (usually cash) to Counterparty B, and Counterparty B transfers an asset to Counterparty A. To meet the net settlement criterion of the Standard, the contract generally must explicitly require or permit net settlement, be readily settleable net by a means outside the contract, or put the receiving party in a position that is essentially equivalent to net settlement.

9.02 Paragraph 9 of the Standard (ASC paragraphs 815-10-15-99 through 15-124) expand on the concept of the net settlement of a derivative instrument discussed in paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)), as follows:

9. Net settlement. A contract fits the description in paragraph 6(c) if its settlement provisions meet one of the following criteria:

(a) Neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.

(b) One of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.

(c) One of the parties is required to deliver an asset of the type described in paragraph 9(a), but that asset is readily convertible to cash or is itself a derivative instrument. An example of that type of contract is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash. Another example is a swaption—an option to require delivery of a swap contract, which is a derivative.

Derivative instruments embedded in other contracts are addressed in paragraphs 12-16 (ASC Sections 815-15-05 and 815-15-15).

5 FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, states that assets that are readily convertible to cash “have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price” (paragraph 83(a)). For contracts that involve multiple deliveries of the asset, the phrase in an active market that can rapidly absorb the quantity held by the entity should be applied separately to the expected quantity in each delivery.

DIG Issues related to this paragraph are A3, A5, A7, A8, A10, A12, A13, A14, A15, A17, A18, A19, A21, A23, B11, B25, B38, C13, and G2. See DIG Issues Index.
9.03 The net settlement characteristic in paragraph 6(c) and paragraph 9 of the Standard (ASC paragraphs 815-10-15-83(c) and 815-10-15-99 through 15-124) is among the most complex of all the defining criteria of a derivative instrument. There are potentially a number of factors to consider before determining whether a contract meets the net settlement characteristic of the definition of a derivative instrument in paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)). These factors are discussed in the following paragraphs and are illustrated in Exhibit 2.1 in Paragraph 9.06.

9.04 Based on the guidance in paragraphs 6(c) and 9 of the Standard (ASC paragraphs 815-10-15-83(c) and 815-10-15-99 through 15-124), net settlement can be accomplished in any of the following ways:

- Contractual net settlement: The terms of the contract require or permit net settlement (paragraphs 6(c) and 9(a) of the Standard (ASC paragraphs 815-10-15-83(c) and 815-10-15-100));
- Market mechanism: There is a market mechanism that facilitates net settlement of the contract (paragraphs 6(c) and 9(b) of the Standard (ASC paragraphs 815-10-15-83(c) and 815-10-15-110)); or
- Delivery of an asset that puts the recipient in a position not substantially different from net settlement (paragraphs 6(c) and 9(c) of the Standard (ASC paragraphs 815-10-15-83(c), 815-10-15-119 and 15-120).

9.05 The following sections address the three methods of net settlement that meet the net settlement characteristic of the definition of a derivative instrument in paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)). Although some contracts may meet all three methods of net settlement (e.g., certain exchange-traded forward contracts), only one method needs to be present for the instrument to meet the net settlement characteristic. Therefore, when analyzing possible derivative instruments relative to paragraph 6(c) (ASC paragraph 815-10-15-83(c)), all three methods must be considered before determining that a contract does not meet the net settlement characteristic.

9.06 The following exhibit illustrates the net settlement characteristic:
Exhibit 2.1: Net Settlement Characteristic

Contractual Net Settlement

9.07 Paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100) indicates that contractual net settlement occurs when neither party is required to deliver an asset (a) that is associated with the underlying and (b) that has a principal amount, stated amount, face amount, number of shares, or other denomination that is equal to the notional amount (or notional amount plus a premium or minus a discount). For example, in most interest rate swap transactions, a net cash settlement occurs periodically whereby neither party is required to deliver an asset associated with the underlying in the swap (e.g., the LIBOR rate) with a principal amount equal to the notional amount of the contract. Consequently, such a swap would meet the characteristic of net settlement.

9.08 When applying the provisions of paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100), the following should be noted:

- If the asset delivered is not associated with the underlying and that asset has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount in the contract, the net settlement criterion has been met. This is the case even if the asset delivered is not readily convertible to cash.

- If the asset delivered is associated with the underlying and that asset has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount in the contract, the net settlement criteria described in paragraph 9(a) (ASC paragraph 815-10-15-100) has not been met; however, the settlement criterion described in paragraphs 9(b) and 9(c) of the Standard (ASC paragraphs 815-10-15-110, 815-10-15-119 and 15-120) should be reviewed.

9.09 In general, contracts that do not contain a notional amount but instead contain a payment provision would meet the characteristic of contractual net settlement. For example, Company A executes a contract that requires a specified payment, $1 million, if a referenced interest rate, LIBOR, increases by 300 basis points. The required settlement of the instrument – the exchange
of $1 million – would meet the criteria in paragraph 9(a) (ASC paragraph 815-10-15-100) since neither party is required to deliver an asset (in the example, cash) that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (since there is no notional amount).

9.10 As discussed in paragraph 57(c) of the Standard (ASC paragraphs 815-10-15-100, 15-103(a), 15-103(b), 15-111, and 15-129 through 15-132), a contract that implicitly or explicitly requires, or has an option for, net settlement (regardless of which party has the option) meets the net settlement characteristic for a derivative instrument. In contractual net settlements, neither party to the derivative contract is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (since there is no notional amount).

9.11 Various issues surrounding the contractual net settlement concept discussed in paragraphs 9(a) and 57(c) of the Standard (ASC paragraph 815-10-15-100; ASC paragraphs 815-10-15-103(a), 15-103(b), 15-111, and 15-129 through 15-132) have arisen in practice. In the following paragraphs we will discuss some of the more common issues, including:

- Contractual net settlement effected with assets other than cash;
- Penalties for nonperformance;
- Payment over time; and
- Put and call options on debt instruments

CONTRACTUAL NET SETTLEMENT EFFECTED WITH ASSETS OTHER THAN CASH

9.12 In paragraph 57(c) of the Standard (ASC paragraphs 815-10-15-100, 15-103(a), 15-103(b), 15-111, and 15-129 through 15-132), and subsequent DIG resolutions, the Board and the FASB staff elaborated on the concept of contractual net settlement. DIG Issue No. A17, “Contracts That Provide for Net Share Settlement,” addresses an option, warrant, or other contract that provides for net share settlement as a settlement alternative. In such a contract, the party with a loss delivers to the party with a gain an amount of common shares (which is the asset related to the underlying) with a current fair value equal to the gain. In the example provided in the DIG Issue, the stock underlying the equity contract relates to a privately-held company. In its Response to the Issue, the FASB staff stated that paragraph 57(c)(1) (ASC paragraph 815-10-15-100) is explicit in stating that any form of net settlement, which may be made in cash or delivery of any other asset, whether or not it is readily convertible to cash, would meet the net settlement requirement of a derivative. (See DIG Issue A17 for further reference.)

PENALTIES FOR NONPERFORMANCE

9.13 Another issue surrounding contractual net settlement relates to contracts that contain penalties for nonperformance. In paragraph 57(c)(1) of the Standard (ASC paragraph 815-10-15-103(a)), the Board stated a penalty for nonperformance in a purchase order is a net settlement
provision if the amount of the penalty is based on changes in the price of the items that are the subject of the contract. Such penalties for nonperformance are common in physical commodity contracts whereby physical delivery of the underlying commodity is required pursuant to the contract; however, if a party to the contract defaults, the penalties for nonperformance, to be paid by the party with the loss (regardless of whether it is the defaulting party) to the party with the gain, are equal to the difference between the current spot price for the commodity and the price per the contract multiplied by the notional amount of the contract. In paragraph 57(c)(1) of the Standard (ASC paragraph 815-10-15-103(b)), the Board states, however, that a fixed penalty for nonperformance is not a net settlement provision. After issuance of the Standard, several issues have arisen related to the penalties for nonperformance provision of the Standard, including asymmetrical nonperformance penalties and nonperformance penalties that contain both variable and fixed components.

Asymmetrical Nonperformance Penalties

9.14 An asymmetrical default provision requires the defaulting party to compensate its counterparty’s loss but the defaulting party does not have the right to demand any gain from its counterparty. In DIG Issue No. A8, “Asymmetrical Default Provisions,” the FASB staff analyzed asymmetrical default penalties common in many contracts and stated that any nonperformance penalty provision that requires the defaulting party to compensate the nondefaulting party for any loss incurred but does not allow the defaulting party to receive the effect of favorable price changes (i.e., an asymmetrical default provision) does not give a contract the characteristic described as net settlement under paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100). The FASB staff drew a distinction between asymmetrical default provisions and the symmetrical default provisions discussed in the previous paragraph because the default provisions discussed in the previous paragraph allow the defaulting party to receive both the upside (i.e., a defaulting party in a gain position would be entitled to that gain even though it was the defaulting party) and the downside inherent in the contract. Further, since each counterparty to a contract that contains a symmetrical default provision is in the same gain or loss position after a default as it was before the default, either counterparty could elect to default, without any economic impact. These qualities of the default provisions discussed in paragraph 57(c) (ASC paragraphs 815-10-15-100, 15-103(a), 15-103(b), 15-111, and 15-129 through 15-132) equate to a de facto contractual net settlement provision as each party to the contract is in the same position as if a contractual net settlement provision actually existed in the contract. This is in contrast to contracts with asymmetrical default penalties in which there is no economic incentive for either party in a contract to default since the defaulting party gains nothing and the nondefaulting party is only made whole if it incurred a loss when it buys or sells the subject of the contract at the current market price.

9.15 However, a pattern of having the asymmetrical default provision applied in contracts between two counterparties would indicate the existence of a tacit agreement between those parties that the party in a loss position always would elect the default provision, thereby resulting in the understanding that there always would be net settlement. In such a situation, those contracts may meet the characteristic described as net settlement in paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100). (See DIG Issue A8 for further reference.)
Nonperformance Penalties That Contain Both Variable and Fixed Components

9.16 As discussed in DIG Issue No. A5, “Penalties for Nonperformance that Constitute Net Settlement,” some nonperformance provisions contain both variable and fixed penalties. While, in many cases, the variable component is based on changes in the price of the items that are the subject of the contract, the fixed component often is significant enough, at all times during the contract, to make the possibility of nonperformance under the contract remote. In such cases, the contract would not be considered to contain a net settlement provision under paragraphs 9(a) and 57(c)(1) of the Standard (ASC paragraphs 815-10-15-100, 815-10-15-103(a) and 15-103(b)) provided the fixed component, in effect, economically compels performance under the contract and would thereby economically preclude net settlement. For the fixed component to be considered significant enough to make the possibility of nonperformance under the contract remote, the magnitude of the fixed incremental penalty should be assessed by comparing the fixed penalty amount to the total cash outlay under the contract, excluding any penalties. If the fixed penalty exceeds 10% of the total cash outlay under the contract, excluding any penalties, we believe the fixed incremental penalty would be considered significant enough to make the possibility of nonperformance under the contract remote and, thus, the contract would not meet the net settlement provisions within ASC paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100). The analysis of the fixed incremental penalty should be assessed on a stand-alone basis, not in relation to the overall penalty (i.e., exclusive of the variable component), and is required only at the inception of the contract. However, the fixed incremental penalty must be expected to be significant enough at all times during the term of the contract. For example, a contract could not be structured to have a large fixed incremental penalty only at its inception and not thereafter and, thus, avoid the conclusion that the contract contains a net settlement provision as described in paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100). (See DIG Issue A5 for further reference.)

PAYMENT OVER TIME

9.17 Certain contracts have implicit or explicit provisions that allow the net gain or loss under the contract to be paid or received over several periods (e.g., through a structured payout). The parties to these contracts may enter into a financial instrument that provides for the gain or loss under the original contract to be received or paid over a specified time period. In other words, the contract provides for net settlement but the contract is not immediately settled with cash. Generally, these contracts will meet the requirements of paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100) unless additional investing or borrowing is required to obtain the benefits of the contract by either party. That is, if the terms of the contract require one party to invest funds in or borrow funds from the other party so that the party in a gain position under the contract can obtain the value of the gain only over time as a traditional adjustment of the yield on the amount invested or the interest element on the amount borrowed, the contract would not be considered to have the net settlement characteristic of paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100). However, if the yield on the amount invested or borrowed is nontraditional (e.g., an unusually high return for a short period of time), the contract would be considered to have the net settlement characteristic of paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100). (See DIG Issue A13 for further reference.)
Example 2.6: Net Settlement of a Forward Contract

Company A and Company B enter into a forward contract whereby Company A agrees to sell Commodity X to Company B for a fixed price in three months. Either party has the option to forego physical settlement and to net cash settle the contract. If net cash settlement occurs, the gain or loss under the contract would be paid over a two-month period.

The deferred settlement of a contract through a structured payout of the net gain or loss over a specified time period meets the characteristic of net settlement contained in paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100). Effectively, the structured payout is a note receivable representing the payment under the contract.

PUT AND CALL OPTIONS ON DEBT INSTRUMENTS

9.18 Although DIG Issue No. B38, “Embedded Derivatives: Evaluation of Net Settlement with Respect to the Settlement of a Debt Instrument through Exercise of an Embedded Put Option or Call Option,” specifically addresses embedded puts and calls on debt, its guidance is also applicable when analyzing contractual net settlement for a freestanding put option issued by a debtor on its own debt instrument and for a freestanding call option held by the debtor on its own debt instrument (See Paragraphs A3.08 - A3.11 of Chapter 3 for a discussion of the impact of DIG Issue B38 on embedded put and call options). DIG Issue B38 indicate that the potential settlement of a debtor’s obligation to a creditor that would occur upon exercise of a freestanding put or call option meets the net settlement characteristic in paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100) because the potential settlement would not be considered to involve the delivery of an asset. This conclusion applies regardless of whether the creditor returns evidence of the debtor’s indebtedness (e.g., the creditor returns a note payable marked paid to the debtor), even though some may believe that the creditor is delivering an asset (i.e., the note receivable due from the debtor). Also, the cash paid to the creditor in settling the debtor’s obligation is not associated with the underlying (e.g., interest rates) because cash is not related to any underlying for the freestanding put or call option. Therefore, neither party is required to deliver an asset that is associated with the underlying, so the net settlement criterion in paragraph 9(a) (ASC paragraph 815-10-15-100) is met.

9.19 The guidance in DIG Issue B38 does not apply to put or call options that are added by a third party contemporaneously with or subsequent to the issuance of a debt instrument (DIG Issue B3 provide guidance on accounting for put or call options that are attached to a debt instrument). In situations in which a put or call option is attached by a third party (e.g., an investment banker) and physical settlement is required upon exercise of the option, we believe that the net settlement requirements in paragraph 9(a) (ASC paragraph 815-10-15-100) and 9(b) (ASC paragraph 815-10-15-110) (existence of a market mechanism for the net settlement of the derivative) are not met; therefore, the debt itself (i.e., the asset required to be delivered upon exercise of the option) would need to be readily convertible to cash as described in paragraph

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1 In this fact pattern, the prepayment option is attached by a third party, so the underlying debt instrument is considered an asset subject to the guidance in paragraph 9(a) (ASC paragraph 815-10-15-100), rather than a liability of the holder or writer of the option as contemplated for prepayment options that are subject to the guidance in DIG Issue B38.
9(c) of the Standard (ASC paragraphs 815-10-15-119 and 15-120) in order to meet the net settlement criterion (See Paragraphs 9.26 – 9.48 of this chapter for a discussion of the readily convertible to cash criterion). This evaluation would need to be performed by both the third party who attached the option to the debt instrument and the investor who acquired the debt instrument with the attached option since they are the parties to the contract. Therefore, it is important for investors/creditors to understand the terms of a put or call option on a debt instrument (i.e., who is the counterparty to the option) to be able to properly evaluate whether the option should be accounted for as a derivative instrument under the Standard.

**Market Mechanism**

9.20 As discussed in paragraph 9(b) of the Standard (ASC paragraph 815-10-15-110), a contract for which there is an established market mechanism that facilitates net settlement outside the contract meets the net settlement characteristic established in paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)). This form of net settlement focuses on the contract itself and not on the underlying assets to be delivered or received in the contract. The Board focused on whether there is a mechanism in the market for net settlement of the contract because it observed that many derivative instruments are actively traded and can be closed or settled before the contract’s expiration or maturity by net settlement in active markets. For example, most contracts traded on the national stock and commodities exchanges can be settled net on a daily basis, even though the contract may have a remaining term of several months or years. Once a contract is settled net on the national exchange, the party with the loss delivers to the party with the gain cash equal to the current gain/loss. Further, once net settlement has been completed, neither party to the original contract has any remaining rights or obligations pursuant to the contract.

9.21 In its basis for conclusions, the Board stated the term *market mechanism* should be interpreted broadly (i.e., the market mechanism need not be limited to an active market). In the following paragraphs, we discuss the general principle underlying the concept of *market mechanism* and some of the more common issues experienced in practice, including:

- Primary characteristics of a market mechanism; and
- Ongoing requirements related to the determination of the existence of a market mechanism.

**PRIMARY CHARACTERISTICS OF A MARKET MECHANISM**

9.22 In several DIG Issues, the FASB staff interpreted the term *market mechanism*, including what type of arrangement would constitute a market mechanism. The staff codified the various interpretations surrounding the concept of market mechanism into DIG Issue No. A21, “Existence of an Established Market Mechanism That Facilitates Net Settlement under Paragraph 9(b).” In that Issue, the staff stated that, regardless of its form, an established market mechanism as contemplated by paragraph 9(b) of the Standard (ASC paragraph 815-10-15-110) must have all four of the primary characteristics described below. In addition to the four primary characteristics, the staff provided indicators to describe the primary characteristics necessary when determining whether a method of settling a contract qualifies as an established market mechanism under paragraph 9(b) of the Standard (ASC paragraph 815-10-15-110). Although an established market mechanism must have all four of the primary characteristics described below,
it need not have all of the indicators outlined below each characteristic for an entity to conclude that a market mechanism exists for a particular contract.

(1) *It is a means to settle a contract that enables one party to readily liquidate its net position under the contract.* A market mechanism is a means to realize the net gain or loss under a particular contract through a net payment. Net settlement may occur in cash or another asset. A method of settling a contract that results in only a gross exchange or delivery of an asset for cash (or other payment in kind) does not satisfy the requirement that the mechanism facilitate net settlement as contemplated by paragraph 9(b) of the Standard (ASC paragraph 815-10-15-110).

The assessment of whether a market mechanism exists under paragraph 9(b) of the Standard (ASC paragraph 815-10-15-110) should be performed on an individual contract basis, not on an aggregate-holdings basis. Consequently, if an entity held several identical contracts, the analysis performed under paragraph 9(b) of the Standard (ASC paragraph 815-10-15-110) is whether any one of the contracts can be liquidated. If one of the contracts can be liquidated, then all of those identical contracts meet the net settlement criterion. One could debate that if the entity attempted to liquidate all of the contracts at once, the entity could suffer a loss from the market’s downward reaction to its inability to absorb all of the contracts at once; however, because the market mechanism test is applied on a singular contract basis, the potential inability for the market to absorb all of the contracts at once does not matter. (See DIG Issue A3 for further reference.)

The following are indicators that primary Characteristic 1 is met:

- Access to potential counterparties is available regardless of the seller’s size or market position.
- Risks assumed by a market maker as a result of acquiring a contract can be transferred by a means other than by repackaging the original contract into a different form.

(2) *It results in one party to the contract becoming fully relieved of its rights and obligations under the contract.* A market mechanism enables one party to the contract to surrender all future rights or avoid all future performance obligations under the contract. The focus of this characteristic is whether a venue exists that will relieve either party of all rights and obligations under the contract and to liquidate its net position without incurring significant transaction costs.

There are contracts that require one of the parties to obtain the other’s permission to assign rights and obligations under the contract to a third party. Such a requirement does not, in and of itself, preclude the contract from possessing the net settlement characteristic under paragraph 9(b) of the Standard (ASC paragraph 815-10-15-110) as a market mechanism.

If there is a market mechanism, exclusive of the permission clause, the probability of the counterparty’s withholding permission to assign the contract must be evaluated. In such cases, if the likelihood that permission would be withheld is remote, the contract possesses a net settlement provision. However, if it is reasonably possible or probable
that permission would be withheld, the contract does not have a net settlement provision. We believe such likelihood should be reassessed periodically throughout the contract’s term. (See DIG Issue A7 for further reference.)

The ability to enter into an offsetting contract, in and of itself, does not constitute a market mechanism because the rights and obligations from the original contract survive (except that an offsetting contract with the same counterparty may relieve the entity of its rights and obligations under the original contract which, together with the original contract, would provide for net settlement). Generally, the offsetting contract carries a new set of legal rights and obligations, which offset, rather than relieve, the original contract’s set of legal rights and obligations. (See DIG Issue A15 for further reference.)

The following are indicators that primary Characteristic 2 is met:

- There are multiple market participants willing and able to enter into a transaction at market prices to assume the seller’s rights and obligations under a contract.
- There is sufficient liquidity in the market for the contract as indicated by the transaction volume as well as a relatively narrow observable bid/ask spread.

(3) Liquidation of the net position does not require significant transaction costs. For the purposes of assessing whether a market mechanism exists under paragraph 9(b) of the Standard, an entity should consider transaction costs to be significant if they are 10% or more of the fair value of the contract.

Determining whether transaction costs are significant under paragraph 9(b) of the Standard (ASC paragraph 815-10-15-110) can be complex because the focus of paragraph 9(b) of the Standard (ASC paragraph 815-10-15-110) is on whether the contract (that is, the net gain or loss in the contract) can be settled in the market and not whether the underlying assets to be delivered under the contract can be sold in the market. Since at inception most contracts will have a fair value of zero, we believe the determination of the significance of the transaction costs must be evaluated based on the fees and transaction costs charged by third parties to settle the gain or loss that resulted from similar contracts.

(4) Liquidation of the net position under the contract occurs without significant negotiation and due diligence and occurs within a time frame that is customary for settlement of the type of contract. A market mechanism facilitates easy and expedient settlement of the contract. As discussed under primary Characteristic 1, those qualities of a market mechanism do not preclude net settlement in assets other than cash.

- The following are indicators that primary Characteristic 4 is met:
- Binding prices for the instrument are readily obtainable.
- Transfers of the instrument involve standardized documentation (rather than contracts with entity-specific modifications) and standardized settlement procedures.
• Individual contract sales do not require significant negotiation and unique structuring.
• The closing period is not extensive because of the need to permit legal consultation and document review.

ONGOING REQUIREMENTS RELATED TO THE DETERMINATION OF THE EXISTENCE OF A MARKET MECHANISM

9.23 In practice, the conclusion about whether a market mechanism exists may change over time; consequently, the evaluation of whether a market mechanism exists should be performed on an ongoing basis throughout a contract’s life (see DIG Issue A18 for further reference). However, the assessment of whether transaction costs are significant (related to whether a venue exists that will relieve either party of all rights and obligations under the contract and to liquidate that contract’s net position) should be performed both at inception of the contract and, if a condition other than the significance of transactions costs changes such that the contract would now otherwise qualify as a derivative. When such a change occurs, the contract must satisfy the 10% conversion costs significance test discussed in Paragraph 9.38, if relevant, for the contract to be considered a derivative.

9.24 If events after the inception or acquisition of a contract result in the establishment of a market mechanism and, therefore, cause a contract to meet the definition of a derivative instrument when it previously did not, the contract must be accounted for as a derivative under the Standard beginning on that later date. Accordingly, if a contract meets the definition of a derivative after acquisition by an entity, the contract must immediately be recorded at its then-current fair value with the offsetting entry recorded in earnings. The contract may then be designated as a hedging instrument, provided that the hedge criteria of the Standard are met (see Chapters 5, 6, and 7). During the period in which the contract does not meet the definition of a derivative, the contract cannot be designated as the hedging instrument or the contingent hedging instrument in any hedging relationship.

9.25 If a contract ceases to be a derivative and an asset or liability had been recorded for the contract (representing its fair value at the date the contract ceases to be a derivative), the holder of the contract should apply other generally accepted accounting principles that are applicable to that contract prospectively. In some cases, the other principles that should be applied may be clearly identifiable. In other cases, there may not be accounting rules that deal specifically with the instrument concerned. Indeed the entity’s previous practice may have been not to recognize any asset or liability for such an instrument until physical settlement. In such instances, the holder of the contract should not automatically eliminate the contract’s carrying value (i.e., the contract’s new cost basis.) Instead, the holder of the contract should adopt an accounting approach consistent with the fundamental recognition and measurement criteria contained in FASB Statements of Financial Accounting Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises (SFAC 5), and No. 6, Elements of Financial Statements (SFAC 6). The holder of the contract should consider whether the instrument underlying any asset or liability balance continues to meet the definition of an asset or liability and whether the cost basis of any asset is recoverable. The holder also should consider the requirement to provide for any probable and estimable loss contingency in accordance with FASB Statement No. 5, Accounting for Contingencies (Statement 5) (ASC Topic 450,
Contingencies). If a contract that formerly qualified as a derivative previously was designated as a cash flow hedge, the accumulated gain or loss included in other comprehensive income should be accounted for in accordance with paragraphs 31 and 32 of the Standard (ASC paragraphs 815-30-35-38 through 35-41 and 815-30-40-1 through 40-3). That is, it should be reclassified into earnings in the same periods in which the hedged forecasted transaction affects earnings, or when the forecasted transaction becomes probable of not occurring. However, if the continued reporting of a loss in other comprehensive income would lead to recognizing a net loss on the hedging instrument and the hedged transaction, the combined loss that is not recoverable should be reclassified into earnings immediately.

**Readily Convertible to Cash**

9.26 The third method of net settlement, addressed in paragraph 9(c) of the Standard (ASC paragraphs 815-10-15-119 and 15-120), is the settlement of a contract through the delivery of an asset that is associated with the underlying in a denomination equal to the notional amount of the contract and that is readily convertible to cash or is itself a derivative. In effect, this settlement method puts the recipient in a position not substantially different from net settlement. In general, this settlement alternative requires that the counterparties be indifferent about whether they receive gross cash, net cash, or the subject of the contract in settlement if all three settlement methods are economically similar. The methods are considered economically similar if the receipt of the subject of the contract is readily convertible to cash or is in itself a derivative instrument and, therefore, the conversion of such item into cash is readily available.

9.27 In general, net settlement distinguishes a derivative from a nonderivative by permitting a contract to be settled without either party accepting the risks and costs customarily associated with owning and delivering the asset associated with the underlying (for example, storage, maintenance, and resale). However, if the assets to be exchanged or delivered are associated with the underlying of the contract and are themselves readily convertible to cash, or are derivative instruments, those risks are minimal or nonexistent. Settlement using those assets is not substantially different from net, or cash, settlement and, therefore, the parties to contracts involving those assets generally should be indifferent about whether they exchange cash or the assets associated with the underlying. In view of the indifference, the Board decided to include as one of the methods that facilitates net settlement, the settlement with assets that puts the recipient in a position not substantially different from net, or cash, settlement.

9.28 Under paragraph 9(c) of the Standard (ASC paragraphs 815-10-15-119 and 15-120), there are two types of assets that, if delivered pursuant to the terms of the contract, put the recipient in a position not substantially different from net settlement. The first type of assets, those that are readily convertible to cash, is discussed in Paragraphs 9.29 - 9.47 below. The second type of assets, those that are themselves derivative instruments, is discussed in Paragraph 9.48 below.

9.29 The concept of readily convertible to cash is one of the most difficult and most important concepts in the Standard. To facilitate understanding of the term, the following sections discuss the concept of readily convertible to cash and some of the common practical difficulties in applying the concept:

- Definition of readily convertible to cash:
- Assets required to be delivered are interchangeable, fungible units;
• Quoted market prices are available for the assets to be delivered;
• Quantity to be delivered can be rapidly absorbed into an active market without significantly affecting the quoted price; and
• Significance of transaction costs.
• Publicly-traded securities with constraints as to their tradability delivered as settlement of a warrant.
• Timing of the evaluation of whether an item to be delivered is readily convertible to cash.
• Combination of two or more separate transactions.
• Delivered asset is itself a derivative.

DEFINITION OF READILY CONVERTIBLE TO CASH

9.30 As indicated in footnote 5 to paragraph 9(c) of the Standard, the term readily convertible to cash is defined in paragraph 83(a) of SFAC 5, as assets that have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price. This definition results in three requirements, all of which must be met for an asset to be deemed readily convertible to cash. The requirements are:

- The assets required to be delivered pursuant to the contract comprises interchangeable, fungible, units;
- Quoted market prices are available for the assets to be delivered; and
- The quantity to be delivered pursuant to the contract can be rapidly absorbed into an active market without significantly affecting the quoted price.

9.31 Given the above definition and guidance in paragraph 57(c) of the Standard (ASC paragraphs 815-10-15-100, 15-103(a), 15-103(b), 15-111, and 15-129 through 15-132), the following common examples are provided to assist entities in determining whether the asset being delivered is readily convertible to cash:

- An actively traded security is generally readily convertible to cash.
- A security that is not actively traded may be readily convertible to cash. A security that is publicly traded but for which the market is not very active is readily convertible to cash if the number of shares or other units of the security under the contract is small relative to the daily transaction volume. That same security is not readily convertible to cash if the number of shares or other units of the security under the contract is large relative to the daily transaction volume (even if the purchaser can use the security as collateral in a borrowing).
- Commodities for which there is an active market (e.g., precious metals, oil and gas, or grains) may be readily convertible to cash.
A foreign currency unit that is readily convertible into the functional currency of the reporting entity may be readily convertible to cash (i.e., the market for the currency unit is active and no regulatory restrictions exist governing the trade of the currency unit).

To understand the concept of readily convertible to cash, the following paragraphs discuss each of the criteria set out in Paragraph 9.30 above.

**Assets Required to Be Delivered Are Interchangeable, Fungible Units**

As required by SFAC 5, to be considered readily convertible to cash, the assets subject to the contract must be comprised of interchangeable (fungible) units. In Merriam-Webster’s Collegiate Dictionary, fungible is defined as “being of such a nature that one part or quantity may be replaced by another equal part or quantity in the satisfaction of an obligation.” Interchangeable is defined as “capable of being interchanged; especially: permitting mutual substitution.” We believe that all commodity products as well as many manufactured products would meet criterion one of the definition of readily convertible to cash.

**Quoted Market Prices Are Available for the Assets to Be Delivered**

In general there are four kinds of markets in which instruments can be bought, sold or originated:

- **Exchange Market.** An exchange or auction market provides high visibility and order to the trading of instruments. Exchange markets typically have readily available quoted market prices. Examples of exchange markets include stock markets and commodity markets. We believe exchange markets contain quoted market prices as that term is used in SFAC 5.

- **Dealer Market.** Dealers stand ready to trade – either buy or sell – for their own account, thereby providing liquidity in the market. Dealer markets typically have readily available quoted market prices. Examples of dealer markets include over-the-counter markets. We believe dealer markets contain quoted market prices as that term is used in SFAC 5.

- **Brokered Market.** Brokers attempt to match buyers with sellers but do not stand ready to trade for their own account. Brokered markets typically do not have readily available quoted market prices. We believe most brokered markets do not contain quoted market prices as that term is used in SFAC 5.

- **Principal-to-Principal Market.** Both originsations and resales are negotiated independently, with no intermediary, and little information is readily available related to the transaction. We believe principal-to-principal markets do not contain quoted market prices as that term is used in SFAC 5.

**Quantity to Be Delivered Can Be Rapidly Absorbed Into an Active Market Without Significantly Affecting the Quoted Price**

Determining whether “quantities to be delivered can be rapidly absorbed into an active market without significantly affecting the quoted price” requires judgment. An entity would need
to consider the quantity of the asset under the contract relative to daily transaction volume and how the market price would be affected if that quantity were sold within a few days. (See DIG Issue A10 for further reference.)

9.36 In general, a publicly-traded security delivered in settlement of an instrument or contract can be rapidly absorbed into an active market without significantly affecting the quoted price if the number of shares or units of the security being delivered is small relative to the daily trading volume of that security. Determining whether the number of shares or other units of the security is small relative to the daily trading volume of the security will require judgment, and should be based on whether it is considered economically feasible to convert the security into cash within a few days without significantly affecting the security price. (See DIG Issue A12 for further reference.)

9.37 For contracts that involve multiple deliveries of the asset, the phrase in an active market that can rapidly absorb the quantity held by the entity should be applied separately to the expected quantity in each delivery. Therefore, an entity must determine whether an active market can rapidly absorb the quantity held by the entity for each expected quantity in each separate delivery for contracts that have multiple delivery dates. For example, when determining whether the assets to be delivered in a five-year supply contract that obligates an entity to deliver 100 units of a commodity at a specified price each month are readily convertible to cash, the entity must determine whether the separate deliveries of 100 units can be rapidly absorbed by the market at the respective delivery dates. The entity need not consider whether the total delivery of 6,000 units can be rapidly absorbed by the market on a single date. Similarly, whether the spot market is able to absorb the quantity specified in the entire five-year contract (6,000 units) within a few days is irrelevant because the performance of the contract is spread out over a five-year period. (See DIG Issue A19 for further reference.)

Significance of Transaction Costs

9.38 Even if the assets under a contract are fungible, have quoted market prices and are in a quantity that can be rapidly absorbed into an active market without significantly affecting the quoted price, additional costs to convert the assets into cash must be considered to conclude that the contract is net settleable under paragraph 9(c) of the Standard (ASC paragraphs 815-10-15-125 through 15-127). This is because these additional costs would affect whether the counterparties to a contract would be indifferent to settle the contract net in cash or by receiving the assets under the contract. These costs are not restricted to transaction-related conversion costs (e.g., sales commissions and transaction fees) but also include all costs incurred in taking possession of the asset and converting the asset to cash (e.g., transportation and temporary storage). For purposes of assessing the significance of these costs and, therefore, the applicability of the readily convertible to cash concept of the Standard to the contract, an entity should consider the estimated conversion costs to be significant only if they are 10% or more of the gross sales proceeds (based on the spot price at the inception of the contract) that would be received from the sale of those assets in the closest or most economical active market. If the entity determines that the estimated costs that would be incurred to immediately convert the asset to cash are not significant, then receipt of that asset puts the entity in a position not substantially different from net settlement. This assessment of the significance of those conversion costs
should be performed only at inception of the contract, even if those costs rise over time and eventually exceed 10% of the gross sales proceeds. (See DIG Issue A10 for further reference.)

9.39 For example, an entity enters into a forward contract to purchase a fixed number of barrels of oil for $500 million. The contract is to be settled by physical delivery of the oil. The oil is fungible and there are quoted prices available in an active market that can readily absorb the quantity of oil being purchased under the contract without significantly affecting the price. The gross proceeds, based on the spot price of the oil at inception of the contract, are estimated at $480 million. The entity expects to incur costs associated with transportation, temporary storage, and sales commissions of $45 million in converting the oil to cash. Since the conversion costs are less than 10% of the estimated sales proceeds at the inception of the contract (10% of the estimated sales proceeds is $48 million and the estimated costs to convert the oil is $45 million), the oil is considered readily convertible to cash and the contract meets the net settlement criterion in paragraph 9(c) of the Standard (ASC paragraphs 815-10-15-119 through 15-120).

9.40 After the issuance of the Standard, several issues have arisen about the application of the readily convertible to cash criterion. The sections below address some of the more common items.

PUBLICLY-TRADED SECURITIES WITH CONSTRAINTS AS TO THEIR TRADABILITY DELIVERED AS SETTLEMENT OF A WARRANT

9.41 Certain warrants may require publicly-traded securities to be delivered at settlement while the sale or transfer of those publicly-traded securities is restricted for a specified period of time beginning on the date that the warrant is exercised. The underlying shares of common stock of warrants that are issued by a company for its own common stock (or the stock of its consolidated subsidiary) that otherwise would be considered readily convertible to cash, but that are restricted from sale or transfer for more than 31 days from the date the stock purchase warrant is exercised, are not considered readily convertible to cash as that phrase is used in the Standard for the issuer or the holder of the warrant. A restriction of more than 31 days is considered sufficiently significant to conclude that the underlying stock is not readily convertible to cash. It is important to note, however, that this guidance applies to only stock purchase warrants issued by a company for its own shares of common stock (or the stock of its consolidated subsidiary). We believe that stock purchase options issued by a company for its own shares of stock that are physically settled (which are identical to stock purchase warrants) would also be within the scope of this guidance. Aside from such warrants and stock purchase options, however, the FASB staff has stated that there should be no analogous accounting for other instruments with restrictions on tradability or disposal. Accordingly, for example, forward contracts on an entity’s shares and commodity contracts that contain a restriction about the transfer or sale of the shares or commodity to be delivered under the contract could not be analogized to this guidance. (See DIG Issue A14 for further reference.)

TIMING OF THE EVALUATION OF WHETHER AN ITEM TO BE DELIVERED IS READILY CONVERTIBLE TO CASH

9.42 The evaluation of whether items to be delivered under a contract are readily convertible to cash must be performed at inception of the contract and on an ongoing basis throughout the contract’s life. See Paragraphs 9.23 - 9.25 of this chapter for a discussion of the same concept.
relating to paragraph 9(b) of the Standard (ASC paragraph 815-10-15-110). (See DIG Issue A18 for further reference.)

9.43 As stated above, the determination of whether an asset is readily convertible to cash may change over time (e.g., as markets for the subject of the contract change in liquidity or as instruments become listed on, or delisted from, stock exchanges); therefore, contracts that previously did not involve assets considered to be readily convertible to cash may at a later date meet that characteristic. However, we believe that the assessment of whether transaction costs are significant to determine whether assets are readily convertible to cash in an active market should be performed only at inception of the contract or when a contract subsequently meets the definition of a derivative. Specifically, if a condition other than the significance of transaction costs changes such that the contract would now otherwise qualify as a derivative, the significance of the transaction costs must be reevaluated. When such a change occurs, the contract must satisfy the 10% conversion costs significance test, if relevant, for the contract to be considered a derivative. To apply the conversion costs significance test to an existing contract, an entity must determine whether the conversion to cash of the asset subject to the contract requires incurring significant costs. As more fully discussed in Paragraph 9.38 of this chapter, if conversion costs are determined to be less than 10% of the gross sales proceeds based on the spot price at the inception of the contract, the contract would meet the net settlement criterion in paragraph 9(c) of the Standard (ASC paragraphs 815-10-15-119 and 15-120). Conversely, if factors other than the significance of the transaction costs change such that the contract would no longer be considered a derivative, the significance of the conversion costs is not relevant since the contract will no longer meet the definition of a derivative whatever the outcome of the test.

9.44 As discussed above, the 10% quantitative test is performed only at the inception of the contract, based on the then market value (spot value) of the assets (i.e., estimated gross sales proceeds). Thus, if the costs to convert the asset at the contract’s inception date are less than 10% of the estimated gross sales proceeds, the asset is considered readily convertible to cash, even if those costs rise over time and eventually exceed 10% of the gross sales proceeds. Conversely, if at the inception date the costs to convert the asset to cash equal or exceed 10% of the estimated gross sales proceeds, the asset would not be considered readily convertible to cash, even if those costs decrease over time to a point where they are less than 10% of the estimated gross sales proceeds.

COMBINATION OF TWO OR MORE SEPARATE TRANSACTIONS

9.45 Certain transactions can be structured so that the combination of two or more separate contracts that do not meet the definition of a derivative are executed simply to circumvent the provisions of the Standard. For example, assume an entity simultaneously executes a contract to sell 2,000,000 bushels of corn to a counterparty and a contract to purchase 1,900,000 bushels of corn from the same counterparty. Further, assume 1,900,000 bushels of corn is considered significant to the corn market. On a gross basis, neither contract is readily convertible to cash because the market cannot rapidly absorb the specified quantities without significantly affecting the price. However, on a net basis, the entity has a forward sale contract for 100,000 bushels of corn, a quantity that can be rapidly absorbed by the market and, thus, is readily convertible to cash.
9.46 To prevent accounting manipulations, the FASB staff developed the following indicators that should be considered in the aggregate and, if present, would cause certain transactions to be viewed as a unit, not separately, to determine whether the transactions meet the definition of a derivative:

- The transactions were entered into contemporaneously and in contemplation of one another;
- The transactions were executed with the same counterparty (or structured through an intermediary);
- The transactions relate to the same risk; and
- There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

9.47 Even though the Standard uses an individual contract basis to determine whether a contract meets the definition of a derivative, when evidence exists that an entity entered into two or more separate transactions to circumvent provisions of the Standard, the transactions must be evaluated as one. We believe that identifying separate transactions to be combined will be difficult in practice. In addition, judgment will need to be applied to conclude that there was no substantive business purpose for separately structuring the transactions. (See DIG Issue K1 for further reference.)

DELIVERED ASSET IS ITSELF A DERIVATIVE INSTRUMENT

9.48 As discussed in paragraph 9(c) of the Standard (ASC paragraphs 815-10-15-119 and 15-120), contracts that can be settled by delivery of an asset that is a derivative instrument would satisfy the requirement for net settlement in paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)). The example provided in paragraph 9(c) of the Standard (ASC paragraph 815-10-15-120) is a swaption. A swaption is generally an option to enter into an interest rate swap at some future date or to cancel an existing swap in the future.

Illustration of the Net Settlement Characteristic of a Derivative

9.49 The net settlement characteristic in paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)) is the most complex of all the defining criteria of a derivative instrument. The following are examples of common contracts and whether the contract contains this characteristic:

<table>
<thead>
<tr>
<th>Description of Contract</th>
<th>Is Net Settlement Present?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A enters into a transaction in which it will exchange nonexchange traded fixed-rate debt for highly liquid, publicly-traded common stock in the future.</td>
<td>Yes. Because one of the parties is required to deliver an asset associated with one of the underlyings (changes in the price of the publicly-traded stock) and that asset is readily...</td>
</tr>
<tr>
<td>Scenario</td>
<td>Conclusion</td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>------------</td>
</tr>
<tr>
<td>Company A enters into a transaction in which it will exchange cash for highly liquid publicly-traded preferred stock in the future.</td>
<td>Yes. Because one of the parties is required to deliver an asset associated with the underlying (changes in the price of the publicly-traded preferred stock) and that asset is readily convertible to cash, the criterion in paragraph 9(c) of the Standard (ASC paragraphs 815-10-15-119 and 15-120) is met.</td>
</tr>
<tr>
<td>Company A enters into a transaction in which it will exchange an equity-method investment in a private investee for highly liquid publicly-traded common stock in the future.</td>
<td>Yes. Because one of the parties is required to deliver an asset associated with one of the underlyings (changes in the price of the publicly-traded common stock) and that asset is readily convertible to cash, the criterion in paragraph 9(c) of the Standard (ASC paragraphs 815-10-15-119 and 15-120) is met.</td>
</tr>
<tr>
<td>Company A enters into a transaction in which it will exchange an equity-method investment in a private investee for cash in the future.</td>
<td>No. Net settlement is not met because one of the parties is required to deliver an asset associated with one of the underlyings (changes in the price of the equity-method investment) and thus the criterion in paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100) is not met. There is no market mechanism to facilitate net settlement of the contract and, thus, the criterion in paragraph 9(b) of the Standard (ASC paragraph 815-10-15-110) is not met. Finally, the asset received is not readily convertible to cash because it is a private investee.</td>
</tr>
</tbody>
</table>

**WHAT INSTRUMENTS OR CONTRACTS ARE EXCLUDED FROM THE STANDARD?**

**10.01** The Board excluded certain instruments and contracts from the scope of the Standard even though the instruments and contracts may possess all of the required characteristics of a derivative instrument under paragraph 6 of the Standard (ASC paragraph 815-10-15-83). The Board attempted to develop a comprehensive definition of a derivative instrument; however, the Board did not want to rewrite the accounting for certain contracts for which explicit accounting
literature already existed. The instruments that are specifically excluded from the scope of the Standard, as discussed in paragraph 10 of the Standard (ASC paragraph 815-10-15-13), include:

- Regular-way security trades;
- Normal purchases and normal sales;
- Certain insurance contracts;
- Financial guarantee contracts;
- Certain contracts that are not traded on an exchange;
- Derivatives that serve as impediments to sales accounting;
- Investments in life insurance;
- Certain investment contracts;
- Certain loan commitments; and
- Certain registration payment arrangements.

10.01a In addition, EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease," states that leases that are within the scope of Statement 13 (ASC paragraph 840-10-15-20) are not derivative instruments subject to Statement 133, although a derivative embedded in a lease may be subject to Statement 133.

10.02 It is important to note that some of the above exclusions apply to both parties to the contract while others apply to only one party to the contract. Each of the exclusions in paragraph 10 of the Standard (ASC paragraph 815-10-15-13) is discussed in detail in the following paragraphs.

10.03 Paragraph 10 of the Standard (ASC paragraph 815-10-15-13) begins with the following:

10. Notwithstanding the conditions in paragraphs 6-9, the following contracts are not subject to the requirements of this Statement:

**Regular-Way Security Trades**

10a.01 Paragraph 10(a) of the Standard (ASC paragraph 815-10-15-15) excludes contracts that are considered regular-way security trades, as follows:

10a. Regular way security trades. Regular way security trades are contracts that provide for delivery of a security within the time generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. However, a contract for an existing security does not qualify for the regular way security trades exception if it requires or permits net settlement (as discussed in and or if a market mechanism to facilitate net settlement of that contract (as discussed in and exists, except as provided in the following sentence. If an entity is required to account for a contract to purchase or sell an existing security on a trade date basis, rather than a settlement date basis, and thus recognizes the acquisition (or disposition) of the security at the inception of the contract, then
the entity shall apply the regular way security trades exception to that contract. A contract for the purchase or sale of *when issued* securities or other securities that do not yet exist is addressed in.

DIG Issue related to this paragraph is C18. See DIG Issues Index.

10a.02 The exclusion in paragraph 10(a) of the Standard (ASC paragraphs 815-10-15-15 and 15-16 apply) applies to either party to the contract as long as each meets the requirements discussed below. Issues related to the regular-way securities trade exception are:

- Contracts that require delivery of existing securities that are readily convertible to cash;
- Contracts that are required to be accounted for on a trade-date basis;
- Contracts for the purchase or sale of when-issued and similar securities; and

**CONTRACTS THAT REQUIRE DELIVERY OF EXISTING SECURITIES THAT ARE READILY CONVERTIBLE TO CASH**

10a.03 Contracts that require delivery of existing securities that are readily convertible to cash meet the exclusion in paragraph 10(a) (ASC paragraph 815-10-15-15 and 15-16) if the contract contains the following two characteristics:

- The contract does not provide for net settlement as described in Paragraphs 9.07 – 9.19 of this chapter nor does a market mechanism exist to facilitate net settlement (as described in Paragraphs 9.20 - 9.25 of this chapter), and
- The contract requires delivery of securities within a time period after the trade date that is customary in the market in which the trade takes place.

10a.04 Such a contract is a typical regular-way security contract. A regular-way security trade arises from the trade of a specified existing security that is settled on a gross basis (i.e., physically settled with the specified security). It is fairly common for the normal trading of securities to have a time delay between the date the trade is initiated and the date it is settled. This delay results in a forward contract; however, the Board did not intend this type of contract to be included in the scope of the Standard.

10a.05 The notion of a regular-way security trade is based on marketplace regulations or conventions and not the normal practices of an individual entity. For example, if it is required or customary for certain securities on a specified exchange to settle within three days, a contract requiring settlement in more than three days is not a regular-way security trade. This is true even if the entity customarily enters into contracts to purchase those same securities more than three days forward. Therefore, a forward purchase or sales contract arising in connection with the sale of that same security that is expected to be settled in five days may not be excluded from the scope of this Standard because five days is not the normal settlement convention for that specified exchange. This forward contract would have to be evaluated in the same manner as any
other potential derivative instrument contract to determine whether it would meet the criteria of a

10a.06 Regulations or conventions may be more difficult to determine for foreign or less active
exchanges; however, the provisions in paragraph 10(a) of the Standard (ASC paragraphs 815-10-
15-15 and 15-16) apply only if the holder or writer of the contract is required to deliver assets
that are readily convertible to cash. Therefore, the regulations or conventions of the marketplace
should be reasonably apparent because the related market must be sufficiently active to rapidly
absorb the quantities involved without significantly affecting the price.

CONTRACTS THAT ARE REQUIRED TO BE ACCOUNTED FOR ON A TRADE-
DATE BASIS

10a.07 Regular-way security trades of existing securities were explicitly excluded from the
scope of the Standard to avoid resolving the issue of preferable accounting treatment in the
debate over trade date versus settlement date. Existing accounting literature is inconsistent about
when transfers of various financial instruments should be recognized. Some transfers are
recognized at the date of trade (trade-date accounting) while others are recognized on the date
the financial instrument is transferred and the transaction is settled (settlement-date accounting).
By requiring regular-way security trades of existing securities that are readily convertible to cash
to be accounted for as derivative instruments, the Standard would have effectively required
settlement-date accounting for the ultimate purchases and sales of the securities of those
transactions. The Board felt the resolution of settlement-date versus trade-date accounting was
not an objective of this Standard.

10a.08 Accordingly, if an entity is required to account for a contract to purchase or sell an
existing security, or a when-issued or similar security as discussed below, on a trade-date basis
under existing accounting principles, rather than a settlement-date basis, the entity should apply
the exclusion in paragraph 10(a) of the Standard (ASC paragraphs 815-10-15-15 and 15-16) to
that contract. That is, accounting principles that require the securities underlying a forward
contract to be recognized or derecognized in the financial statements at inception of the forward
contract are not changed.

CONTRACTS FOR THE PURCHASE OR SALE OF WHEN-ISSUED AND SIMILAR
SECURITIES

10a.09 The Board considered limiting the exception for regular-way security trades to purchases
or sales of existing securities. The Board noted that a forward contract for a regular-way security
trade of an existing security entitles the purchaser to receive, and requires the seller to deliver, a
specific security. The delay is a matter of market regulations and conventions for delivery. In
contrast, a forward contract for when-issued or other forms of a nonexistent security does not
entitle or obligate parties to exchange a specific security. Instead, it entitles the issuer and holder
to participate in price changes without being required to own or deliver an asset that is associated
with the underlying. For that reason, the Board would have preferred that a forward contract on a
nonexistent security be subject to the requirements of the Standard.

10a.10 However, the Board was concerned that including, for example, to-be-announced (TBA)
Government National Mortgage Association (GNMA) forward contracts and other forward
contracts for when-issued securities within the scope of the Standard would subject entities to
potentially burdensome regulatory disclosure requirements for transactions in derivative instruments. On balance, the Board decided to extend the regular-way exclusion to contracts for the purchase or sale of when-issued securities or other securities that do not yet exist provided:

- There is no other way to purchase or sell that security;
- Delivery of that security and settlement will occur within the shortest period possible for that type of security; and
- It is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery of a security when it is issued.

10a.11 A contract for the purchase or sale of when-issued securities or other securities that do not yet exist is eligible to qualify for the regular-way security trades exception even though that contract permits net settlement (as discussed in Paragraphs 9.07 - 9.19 of this chapter) or a market mechanism to facilitate net settlement of that contract exists (as discussed in Paragraphs 9.20 - 9.25 of this chapter). However, the entity must document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery. Net settlement of contracts in a group of contracts similarly designated as regular-way security trades would call into question the continued exemption of such contracts. We believe that, by analogy to DIG Issue No. C12, “Interpreting the Normal Purchases and Normal Sales Exception as an Election,” the regular-way security trade exclusion for when-issued or similar securities is effectively an election. However, once an entity complies with the documentation requirements noted above, which can be done at the inception of the contract or a later date, the entity cannot, at a later date, change its election and account for the contract as a derivative.

10a.12 In addition, as noted above, if an entity is required to account for the purchase or sale of when-issued securities or other securities that do not yet exist on a trade-date basis, rather than a settlement-date basis and, thus, recognizes the acquisition or disposition of the underlying securities at the inception of the contract, that entity should apply the regular-way security trade exception to those contracts. (See DIG Issue C18 for further reference.)

The following example illustrates the application of the above criteria:

Example 2.8: To-Be-Announced (TBA) GNMA Security Purchase

OP Inc. enters into a forward contract to purchase a TBA GNMA security that settles in three months. The TBA GNMA security is identified by issuer, contractual maturity of the underlying loans, and the net coupon. The forward purchase contract meets the definition of a derivative. It is probable at inception and throughout the contract term that it will not settle net and will result in physical delivery of the security when it is issued. The TBA GNMA security could also be purchased one and two months forward. The forward purchase contract would be accounted for as a derivative under the Standard. OP may not apply the regular-way trade exception to this contract since the forward delivery in three months is not the shortest period possible for the TBA GNMA security. OP could consider designating the forward purchase contract as the hedging instrument in a cash flow hedge of the forecasted transaction that will be consummated upon gross settlement of the forward purchase contract as discussed in DIG Issue No. G2,
APPLICATION OF EITF 96-11 (ASC PARAGRAPHS 815-10-15-141, 815-10-25-17, 815-10-30-5, AND 815-10-35-5)

10a.13 The consensus in EITF 96-11 (ASC paragraphs 815-10-15-141, 815-10-25-17, 815-10-30-5, and 815-10-35-5), which is discussed below, continues to apply to those forward contracts, as well as purchased options, that are not subject to the Standard. Forward contracts may not be subject to the Standard because they are considered regular-way security trades. In addition, forward contracts and purchased options may not be subject to the Standard because they do not possess all the required characteristics of a derivative under paragraph 6 of the Standard (ASC paragraph 815-10-15-83). Contracts not subject to the Standard but included in the scope of EITF 96-11 (ASC paragraphs 815-10-15-141, 815-10-25-17, 815-10-30-5, and 815-10-35-5) are not eligible to be hedging instruments. 10a.14 EITF 96-11 (ASC paragraphs 815-10-15-141, 815-10-25-17, 815-10-30-5, and 815-10-35-5) require that forward contracts and purchased options, not subject to the Standard, with no intrinsic value at acquisition that are entered into to purchase securities that will be accounted for under Statement 115 (ASC Topic 320, Investments -- Debt and Equity Securities) and whose terms require physical settlement should, at inception, be designated as held-to-maturity, available-for-sale, or trading and accounted for in a manner consistent with the accounting prescribed by (ASC Topic 320) for that category of securities. Thus, for a held-to-maturity contract, the changes in its fair value would not be recognized unless a decline in the fair value of the underlying security is other than temporary, in which case a loss would be recognized in earnings. For an available-for-sale contract, the changes in its fair value would be recognized in other comprehensive income as they occur unless a decline in the fair value of the underlying security is other than temporary. For a trading contract, the changes in its fair value would be recognized in earnings as they occur.

Normal Purchases and Normal Sales

10b.01 Paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-51) extends the concept in paragraph 10(a) of the Standard (ASC paragraphs 815-10-15-15 and 15-16) to items other than financial instruments or derivative instruments as follows:

10b. Normal purchases and normal sales. Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. The following guidance should be considered in determining whether a specific type of contract qualifies for the normal purchases and sales exception:

(1) Forward contracts (non-option-based contracts). Forward contracts are eligible to qualify for the normal purchases and normal sales exception. However, forward contracts that contain net settlement provisions as described in either paragraph 9(a) or paragraph 9(b) are not eligible for the normal purchases and normal sales exception unless it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical
delivery.’ Net settlement (as described in paragraphs 9(a) and 9(b)) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses or are otherwise settled net on a periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for this exception.

(2) Freestanding option contracts. Option contracts that would require delivery of the related asset at an established price under the contract only if exercised are not eligible to qualify for the normal purchases and sales exception, except as indicated in paragraph 10(b)(4) below.

(3) Forward contracts that contain optionality features. Forward contracts that contain optionality features that do not modify the quantity of the asset to be delivered under the contract are eligible to qualify for the normal purchases and normal sales exception. Except for power purchase or sales agreements addressed in paragraph 10(b)(4), if an option component permits modification of the quantity of the assets to be delivered, the contract is not eligible for the normal purchases and normal sales exception, unless the option component permits the holder only to purchase or sell additional quantities at the market price at the date of delivery. In order for forward contracts that contain optionality features to qualify for the normal purchases and normal sales exception, the criteria discussed in paragraph 10(b)(1) must be met.

(4) Power purchase or sales agreements. Not withstanding the criteria in paragraphs 10(b)(1) and 10(b)(3), a power purchase or sales agreement (whether a forward contract, option contract, or a combination of both) that is a capacity contract also qualifies for the normal purchases and normal sales exception if it meets the criteria in paragraph 58(b).

However, contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that meets none of the criteria in paragraphs 15(a)-15(d) b) shall not be considered normal purchases and normal sales. For contracts that qualify for the normal purchases and normal sales exception, the entity shall document the designation of the contract as a normal purchase or normal sale. For contracts that qualify for the normal purchases and normal sales exception under paragraphs 10(b)(1) and 10(b)(3), the entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery. For contracts that qualify for the normal purchases and normal sales exception under paragraph 10(b)(4), the entity shall document the basis for concluding that the agreement meets the criteria in paragraph 58(b). The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract. Failure to comply with the documentation requirements precludes application of the normal purchases and normal sales exception to contracts that would otherwise qualify for that exception.
Contracts that are subject to unplanned netting (referred to as a book out in the electricity utility industry) do not qualify for this exception except as specified in paragraph 58(b).

DIG Issues related to this paragraph are B11, B18, C10, C12, C15, C16, C20, E17, and J19. See DIG Issues Index.

GENERAL REQUIREMENTS

10b.02 The exclusion in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-51) applies to either party to the contract as long as each meets the requirements discussed below. Although the requirements to qualify for the normal purchases and normal sales scope exception vary depending on the type of contract, the following three requirements must be met for any contract to qualify for the exception:

- The asset under the contract is delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. See Paragraphs 10b.03 - 10b.07.
- The contract does not have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased. See Paragraphs 10b.08 – 10b.19.
- The entity must document the designation of the contract as a normal purchase or a normal sale at inception of the contract. See Paragraphs 10b.20 - 10b.26.

Quantities Expected to Be Used or Sold Over a Reasonable Period

10b.03 To qualify for the exception in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-51), a contract’s terms must be consistent with the terms of an entity’s normal purchases or normal sales; that is, the assets under the contract must be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business.

10b.04 Judgment will be required to determine whether a contract is for the delivery of assets in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. In making this determination, the entity should consider all relevant factors, such as:

- The quantities provided under the contract and the entity’s need for the related asset based on prior experience and projected usage over a reasonable period;
- The locations to which delivery of the items will be made;
- The period of time between entering into the contract and delivery; and
- The entity’s prior practice for those contracts.

10b.05 Evidence such as past trends, expected future demand, other contracts for delivery of similar items, the entity’s and industry’s customs or practices for acquiring and storing the related goods, and the entity’s operating location should help in identifying contracts that qualify as normal purchases and normal sales. For example, a physically settled forward contract for the purchase of a three-month supply of rubber inventory would be considered to be for quantities expected to be used or sold over a reasonable period in the normal course of business if the

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manufacturer that entered into this contract normally maintains more than a three-month supply of rubber inventory.

10b.06 The Board discussed and acknowledged that the application of the aforementioned factors of a normal purchase or normal sale to specific transactions may result in accounting that is not symmetrical between the two parties to the transaction. That is, a sale may be considered normal by the seller (i.e., quantity sold to the buyer is normal in the course of its business) and, therefore, not accounted for as a derivative instrument, while the buyer may deem the purchase not to be ordinary (i.e., quantity purchased was greater than could be used in a reasonable period in the normal course of its business) and, therefore, would account for the contract as a derivative instrument in accordance with the Standard. While the Board believes that accounting by both parties to a contract generally should be symmetrical, it decided that requiring symmetry would be impractical in this instance.

10b.07 It is important to note that the asset being delivered under the contract can be for resale by the reporting entity, for example, retailers and wholesalers. There is no overall limitation in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-51) that the asset be consumed by the reporting entity for the contract to qualify for the normal purchases and normal sales exception. However, entities that actively trade commodities may not be able to establish an expected quantity to be used or sold in the normal course of business. Traders enter into contracts with the objective of generating profits from the movements in price and market price movements influence their trades. This is inconsistent with the concept of expected quantities to be delivered and used in the normal course of business. Therefore, we believe purchase and sale contracts related to trading activities generally would not qualify for the normal purchases and normal sales exception.

Contract Pricing and Embedded Derivatives

10b.08 In order for a contract to qualify for the normal purchases and normal sales exception, it cannot have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased. In order to determine whether the contract has a price based on an underlying that is not clearly and closely related to the asset being sold or purchased, an entity must review the contract pricing as well as determine whether any embedded derivatives prohibit the application of the exception.

Contract Pricing

10b.09 Certain contracts have a price adjustment clause that is based on an underlying that is different from the asset to be delivered under the contract. The Standard requires that for such a contract to be considered a normal purchase or normal sale, the underlying must be clearly and closely related to the asset being delivered. For example, a forward contract to purchase corn that is indexed to an equity index would not have an underlying that is clearly and closely related to the corn and, therefore, the contract would not meet the normal purchases and normal sales exception. However, if an entity entered into a forward contract to sell chocolate and the price was indexed to sugar, the underlying may be considered clearly and closely related to chocolate and the contract may qualify for the normal purchases and normal sales exception in the Standard if the other requirements of paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-51) were met.
10b.10 The phrase *not clearly and closely related* in paragraph 10(b) of the Standard (ASC paragraph 815-10-15-30) with respect to the normal purchases and normal sales scope exception is used to convey a meaning that is different from the meaning in paragraphs 12(a) and 60 of the Standard (ASC paragraphs 815-15-25-1(a), 815-10-15-16 and 815-15-55-119) with respect to the relationship between an embedded derivative and the host contract in which it is embedded. For purposes of determining whether a contract qualifies for the normal purchases and normal sales scope exception, the application of the phrase *not clearly and closely related to the asset being sold or purchased* should involve an analysis of both qualitative and quantitative considerations.

10b.11 In general, the broad concept is that if the underlying in a price adjustment incorporated into a purchase or sales contract is reasonably related to either the costs of the asset subject to the contract or the fair value of that asset, then the price adjustment would not be an impediment for the contract to qualify for the normal purchases and normal sales exception in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-51). Further, when analyzing the underlying to a price adjustment contained in a contract, such underlying is deemed clearly and closely related to the contract unless evidence suggests otherwise.

10b.12 There is no requirement to analyze the ingredients or factors of the asset related to the contract being assessed. Instead, the analysis is specific to the contract being considered for the normal purchases and normal sales scope exception and may include identification of the components of the asset being sold or purchased. A price adjustment incorporated into a contract is *not clearly and closely related to the asset being sold or purchased* in any of the three circumstances discussed below.

10b.13 The first circumstance is that the underlying is extraneous (that is, irrelevant and not pertinent) to both the changes in the cost and the changes in the fair value of the asset being sold or purchased, including being extraneous to an ingredient or direct factor in the customary or specific production of that asset. We believe the word *and* in the above condition is important. For an underlying in a price adjustment to be considered not clearly and closely related, the underlying must be extraneous to both the changes in the costs incurred as a result of the asset being sold or purchased and the changes in the fair value of the asset. By including the word and, some indices and other price adjustments may still meet the clearly and closely related requirement of paragraph 10(b) of the Standard (ASC paragraph 815-10-15-30) because, while they may be extraneous to the costs incurred to produce or purchase the asset, they may not be extraneous to the fair value of the asset (or vice versa). In addition, the analysis of whether the underlying is extraneous may be made by comparing it with an ingredient or direct factor in the specific production of the asset or to one that is customary to the production. Thus, entities do not have to ascertain the ingredients or factors of the asset related to the contract.

10b.14 The second circumstance is when the underlying is not extraneous, as discussed above, but the magnitude and direction of the impact of the price adjustment is not consistent with the relevance of the underlying. That is, the magnitude of the price adjustment based on the underlying is significantly disproportionate to the impact of the underlying on the fair value or cost of the asset being purchased or sold (or of an ingredient or direct factor, as appropriate). Although we believe that an underlying in a price adjustment cannot contain leverage and still qualify as clearly and closely related, this criterion does allow for the indexing of ingredients in an asset. Specifically, the criterion allows for the price adjustment to the contract to be proportionately equal to the value of the ingredients or direct factors in the asset subject to the
contract being analyzed. For example, if the costs to produce Widget X comprises 50% steel, 25% labor, and 25% overhead, the price adjustment to the contract could possibly contain an adjustment equal to 50% of the change in the steel price and 25% change in CPI, or both, and still qualify as clearly and closely related.

10b.15 The third and final circumstance is if the underlying is a currency exchange rate involving a foreign currency that meets none of the criteria in paragraphs 15(a) - 15(d) of the Standard (ASC paragraph 815-15-15-10) for that reporting entity. That is, if a price adjustment contained in a contract being reviewed for the normal purchases and normal sales exception contains an underlying involving a foreign currency that meets none of the criteria in paragraphs 15(a) - 15(d) of the Standard (ASC paragraph 815-15-15-10), that price adjustment incorporated into the contract is not clearly and closely related to the asset being sold or purchased and, therefore, the contract would not qualify for the normal purchases and sales exception.

10b.16 Paragraphs 15(a) - 15(d) of the Standard (ASC paragraph 815-15-15-10) require that, for a payment provision to be considered clearly and closely related, the payment must be denominated in a currency that is (a) the functional currency of any substantial party to that contract, (b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce, (c) the local currency of any substantial party to the contract, or (d) the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary. These concepts are the same as those discussed in Chapter 3 in the context of embedded derivatives. To illustrate, assume Company A, located in Saudi Arabia, enters into a forward contract to sell 100,000 barrels of crude oil to Company B, which is located in Canada. Neither company is a U.S. dollar functional currency entity. However, the price of a barrel of oil in the contract is denominated in U.S. dollars. Since crude oil transactions are routinely denominated in U.S. dollars in international commerce, Company A or Company B could designate the contract as a normal purchase or normal sale, as long as the other criteria in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-51) are met.

*Embedded Derivatives*

10b.17 A contract that is a derivative in its entirety and that qualifies for the normal purchases and sales exception is not evaluated further under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) for an embedded derivative. The Standard did not intend for a contract both to meet the definition of a derivative in its entirety and be considered a hybrid instrument that contains an embedded derivative that requires separate accounting. The normal purchases and normal sales exception is written narrowly to permit only a subset of contracts with specific characteristics to qualify. If a contract has characteristics that extend beyond those described in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-51), the application of the exception is not permitted and the contract, in its entirety, must be accounted for as a derivative.

10b.18 There has been confusion surrounding the term *clearly and closely related* in paragraph 10(b) of the Standard (ASC paragraph 815-10-15-30) and the use of the same term in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) (the embedded feature provisions of the Standard, see Chapter 3 for a discussion of embedded features). By including the term clearly and closely related in paragraph 10(b) (ASC paragraph 815-10-15-30), the Board did not intend for entities to review a contract that is eligible for the normal purchases exception.
and normal sales exception to determine whether it has an embedded feature under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1 and 815-15-25-1). If a contract that would otherwise be eligible for the normal purchase and normal sale exception contains a pricing feature that is considered clearly and closely related to the asset being sold or purchased within the meaning of paragraph 10(b) of the Standard (ASC paragraph 815-10-15-30), further analysis for embedded derivatives is not necessary once the contract has been reviewed relative to those provisions. Alternatively, if a contract that would otherwise be eligible for the normal purchases and normal sales exception contains a pricing feature that is not considered clearly and closely related to the asset being sold or purchased within the meaning of paragraph 10(b) of the Standard (ASC paragraph 815-10-15-30), or does not meet the remaining provisions of the paragraph, the contract will not qualify for the exception and the entire contract must be accounted for as a derivative instrument. (See DIG Issue B18 for further reference.)

10b.19 To illustrate the above concepts, consider the following example:

Example 2.9: Purchase Contract Denominated in a Foreign Currency

An entity enters into a forward purchase contract to buy rice at 1000 yen per bushel. Assume the subject contract meets the definition of a derivative in the Standard. If the yen is not (a) the functional currency of any substantial party to that contract, (b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce, (c) the local currency of any substantial party to the contract, or (d) the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary, the contract would not meet the normal purchases and normal sales exception and the entire contract would be required to be accounted for as a derivative. If, however, any of the criteria (that is, (a) – (d)) were met, as well as the remaining criteria in paragraph 10(b) (ASC paragraphs 815-10-15-22 through 15-51), further analysis of the embedded foreign currency pricing feature would not be necessary and the entire contract would be eligible for the normal purchases and normal sales exception.

Instead, assume the contract did not meet the definition of a derivative. Analysis of the contract relative to paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-51) would not be relevant as the normal purchases and normal sales exception relates only to contracts that are in their entirety derivative instruments. Under this scenario, the contract would have to be reviewed relative to paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) to determine whether an embedded feature exists (i.e., a foreign currency embedded feature). Chapter 3 discusses the accounting for embedded features existing in a contract that in its entirety does not meet the definition of a derivative.

Documentation

10b.20 For a contract to qualify for the normal purchases and normal sales exception, the entity must document the designation of the contract as a normal purchase and normal sales exception and, we believe, the basis for such designation. Documentation may be for individual contracts or groups of similar contracts. The group approach may be useful to entities that apply the normal purchases and normal sales exception to most or all of their similar contracts for future
purchases or sales of nonfinancial assets. As discussed in Paragraphs 10b.30 for forward contracts (nonoption based), 10b.44 for forward contracts that contain optionality features, and 10b.52 for power purchase or sales agreements, additional documentation is required but depends on the type and characteristics of the derivative contract.

10b.21 Failure to comply with the documentation requirements precludes application of the normal purchases and normal sales exception to contracts that would otherwise qualify for that exception. In essence, an entity has the ability to elect to apply the exception in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-51) or account for the contract as a derivative under the Standard by not documenting that contract as qualifying for the normal purchases and normal sales exception. In addition, an entity may elect to apply the normal purchases and normal sales exception to a derivative contract either at the inception of the contract or at a later date. However, once an entity elects to apply the exception in paragraph 10(b) (ASC paragraphs 815-10-15-22 through 15-51), it cannot subsequently change the election and account for the contract as a derivative under the Standard. (See DIG Issue C12 for further reference.)

10b.22 In general, we believe that an entity can apply the normal purchases and normal sales exception to one contract and not apply the exception to another contract with similar terms and usage. However, inconsistent application of the normal purchases and normal sales exception to contracts with similar terms and usage will make it difficult to apply the exception to any contract since an entity’s past practices with similar contracts is a factor that should be considered in determining whether application of the exception is appropriate (see Paragraph 10b.04 above). In other words, the entity would need to prepare sufficient documentation supporting a contract as normal to overcome the fact that similar contracts historically have not been considered normal and may have been settled net (in other words, not by physical receipt or delivery of the underlying asset).

10b.23 Regardless of how an entity documents its initial application of the exception, the entity needs to assess whether a contract qualifies for the normal purchases and normal sales scope exception only at the inception of the contract or when that contract is designated as a normal purchases or normal sales contract, if later. However, we believe an entity needs to reassess the rationale for that assessment when conditions change and a contract that was previously being accounted for as a normal purchase or normal sale under the Standard no longer qualifies for that exception (e.g., because similar contracts are being net settled). In those cases, the documentation should include an analysis of how the assessment affects other similar contracts.

10b.24 Net settlement of an individual contract that previously was designated as a normal purchase or normal sale could call into question the classification of all similar contracts designated as normal purchases or normal sales. In other words, the entity must consider whether the unplanned net settlement of a contract designated as a normal purchase or normal sale affects its intent for all existing similar contracts that are not expected to be net settled and any future similar contracts. Even though this concept of tainting is similar to the one in Statement 115 (ASC Topic 320), we do not believe it is as restrictive. Statement 115 notes in paragraphs 8 and 15 (ASC paragraphs 320-10-25-6, 25-9 and 320-10-35-10 through 35-12) that sales or transfers of held-to-maturity securities may call into question an entity’s intent to hold other debt securities to maturity. Statement 115 (ASC Topic 320) notes that for such transactions not to taint other held-to-maturity securities, the transactions must be “isolated, non-recurring, and
unusual.” In addition, Statement 115 (ASC Topic 320) states that such transactions “should be rare.”

10b.25 The Board did not include in the Standard definitive guidelines about the tainting of other contracts. We believe that if an entity has a valid business reason for net settling a contract for which the normal purchases and normal sales exception was being applied, the net settlement would not prevent the entity from applying the normal purchases and normal sales exception to similar contracts currently or in the future as long as a clear differentiation can be made between the net settled contract and the other contracts. For example, an entity may net settle a contract designated as a normal purchase or normal sale because of a significant deterioration in the counterparty’s creditworthiness. That circumstance would not affect the status of other contracts with other counterparties similarly designated as normal purchases or normal sales contracts. However, if an entity has a history of net settlement for a specific type of contract, the entity usually would be precluded from applying the normal purchases and normal sales exception to that type of contract currently and in the future.

10b.26 Consolidated entities often include multiple autonomous units that independently manage their operations, including their risk management activities. These units may separately enter into contracts to manage various risks. We believe a contract that was net settled by one unit within a consolidated group should not call into question the use of the normal purchases and normal sales exception for similar contracts for all other units within the consolidated group if each unit is autonomous and independently manages it operations, including its risk management activities.

SPECIFIC REQUIREMENTS

10b.27 The exception in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-51) applies only to contracts that involve future delivery of assets (other than financial instruments or derivative instruments). In addition to the requirements discussed above and depending on the type of contract, there are various other requirements that also must be met to qualify for the normal purchases and normal sales scope exception. The Standard describes four types of contracts and the application of the exception to those types of contracts. The following four types of contracts and the additional requirements that must be met for those contracts to qualify for the normal purchases and normal sales scope exception are discussed below:

- Forward contracts (nonoption-based contracts). See Paragraphs 10b.28 - 10b.34.
- Freestanding option contracts. See Paragraph 10b.35.
- Forward contracts that contain optionality features. See Paragraphs 10b.36 - 10b.44.
- Power purchase or sales agreements. See Paragraphs 10b.45 - 10b.57.

Forward Contracts (Nonoption-based Contracts)

10b.28 Nonoption-based and forward contracts are eligible for the normal purchases and normal sales exception. If the underlying assets of the contract are readily convertible to cash (as discussed in Paragraphs 9.26 - 9.47 of this chapter), there are no additional requirements to be met to qualify for the normal purchases or normal sales exception (see Paragraphs 10b.01 -
If, however, the contract permits net settlement (as discussed in Paragraphs 9.07 - 9.19 of this chapter) or there is a market mechanism that facilitates net settlement of the contract (as discussed in Paragraphs 9.20 - 9.25 of this chapter), an entity also must conclude that it is probable, at inception and throughout the term of the individual contract, that the contract will not settle net and will result in physical delivery, to qualify for the normal purchases or normal sales exception. The use of the term probable is consistent with its use in paragraph 3 of Statement 5 (ASC paragraph 450-20-25-1), which describes probable as “likely to occur.” The Board believes the term probable requires a significantly greater likelihood of occurrence than the term “more likely than not.”

It is important to note that the above paragraph addresses two points. The first is that an entity must determine that it is probable the contract will not settle net. The second is that an entity must determine that it is probable the contract will result in physical delivery. An inability to conclude on either point disqualifies the contract from the normal purchases and normal sales exception. In addition, any net settlement (as discussed in Paragraphs 9.07 - 9.19 of this chapter) or settlement through a market mechanism (as discussed in Paragraphs 9.20 - 9.25 of this chapter) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all similar contracts as normal purchases or normal sales.

As discussed in Paragraphs 10b.20 above, an entity is required to document the designation of the contract as a normal purchases and normal sales exception. When performing that documentation for a forward contract that permits net settlement (as discussed in Paragraphs 9.07-9.19 of this chapter) or if there is a market mechanism to facilitate net settlement (as discussed in Paragraphs 9.20 - 9.25 of this chapter), the entity also must document the basis for concluding that it is probable that the contract (a) will not settle net and (b) will result in physical delivery.

The normal purchases and normal sales exception is not permitted for contracts that require cash settlements of gains or losses or otherwise settle gains or losses on a periodic basis, including individual contracts that are a part of a series of sequential contracts intended to accomplish the ultimate acquisition or sale of a commodity (e.g., crude oil) because those settlements are considered net settlements. An example of such a contract is an exchange traded futures contract. Because futures contracts require daily cash settlements of gains or losses, such contracts do not meet the normal purchases or normal sales exception even if it is the intention of the entity to settle the contract gross at maturity. An entity may designate contracts that require cash settlements of gains or losses or otherwise settle gains or losses on a periodic basis as the hedging instrument in an all-in-one hedge, under DIG Issue G2, provided the contract is ultimately expected to be settled gross. If the other cash flow hedge criteria are met, a derivative contract may be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the forecasted transaction that will occur upon settlement of the derivative contract itself. See Chapter 6 for further discussion of cash flow hedging.

Contracts that are subject to unplanned netting (referred to as a book out in the electricity utility industry) do not qualify for the normal purchases and normal sales scope exception except for certain power purchase or sale agreements as described in Paragraphs 10b.45 - 10b.57 of this chapter. In addition, contracts that call for flash title do not qualify for the normal purchases and normal sales scope exception.
normal sales scope exception. Flash title is an instantaneous flow-through of title caused by purchases and sales of certain commodities for delivery at the same time and location. Flash title does not constitute physical settlement of a contract.

10b.33 In certain contracts, an entity agrees to pay a specified price for a specified quantity of a product regardless of whether it takes delivery. Those contracts often are referred to as take-or-pay contracts. If those contracts are not leases within the scope of FASB Statement No. 13, Accounting for Leases (Statement 13) (ASC Topic 840, Leases), and they meet the definition of a derivative, they are subject to the requirements of the Standard. When deciding whether the normal purchases and normal sales exception can be applied to a take-or-pay contract that is not a lease or does not contain a lease and meets the definition of a derivative, all of the requirements in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-51) must be met including that it is probable at inception and throughout the terms of the individual contract that the contract will not settle net and will result in physical delivery if the contract is considered a forward-type contract.

10b.34 We believe a service contract cannot qualify for the normal purchases and normal sales exception. We believe performing a service does not comply with the requirement of physical delivery. Furthermore, paragraph 58(b) (ASC paragraph 815-10-15-37) states “the exception in paragraph 10(b) (ASC paragraphs 815-10-15-22 through 15-51) applies only to a contract that involves future delivery of assets” and the normal purchases and sales exception applies only to the purchase or sale of assets.

Freestanding Option Contracts

10b.35 Except as discussed in paragraph 10(b)(4) of the Standard (ASC paragraph 815-10-15-45), (see Paragraphs 10b.45 - 10b.57 of this chapter for further information), freestanding option contracts that would require delivery of the related asset at an established price under the contract only if exercised are not eligible to qualify for the normal purchases and normal sales exception. Those option contracts only contingently provide for the purchase or sale of the asset since exercise of the option contract is not assured. As a result, an entity cannot determine at inception of the contract that it will be probable throughout its term that physical delivery under that specific contract will occur. (See DIG Issue C10 for further reference.) This prohibition applies to both parties to the contract.

Forward Contracts That Contain Optionality Features

10b.36 Certain forward purchase and sale contracts may contain optionality related to pricing or to the quantity to be bought or sold under the contract. Optionality related to pricing generally does not affect whether a contract qualifies for the normal purchases and normal sales exception since it does not affect the quantity to be delivered under the contract. An example of such a contract is a purchase contract to buy a specified quantity of a commodity at the current market price on the date of purchase, not to exceed a specified maximum price (a cap) or not less than a specified minimum price (a floor). If the contract meets the definition of a derivative, as well as the other criteria for the normal purchases and normal sales exception, it would be eligible for the normal purchases or sales exception. However, in some instances, optionality related to pricing can affect a contract’s ability to qualify for the normal purchases and normal sales exception. This is the case when the optionality in pricing is attributable to a price adjustment
clause that is based on an underlying that is different from the asset to be delivered under the contract (i.e., not clearly and closely related to the asset to be delivered). Paragraphs 10b.08 - 10b.19 of this chapter discuss the issues surrounding those contracts.

10b.37 Other forward purchase and sale contracts contain optionality that affects the quantity to be bought or sold. A forward contract that requires the purchase of a specified quantity at an established price(s) plus an option to purchase specified additional quantities is an example of that type of contract. The option to buy specified additional quantities within the forward contract may be at an established price(s) or at the market price at the date of delivery. The optionality in a forward contract to purchase additional specified quantities at an established price(s) within the contract only contingently provides for sales or purchases, since the exercise of the option is not assured and typically depends on future changes in the price of the underlying. Because of the contingent nature, an entity cannot determine at the inception of the contract that it will be probable throughout its term that physical delivery will occur. Accordingly, except as provided in paragraph 10(b)(4) of the Standard (ASC paragraph 815-10-15-45) (see Paragraphs 10b.45 - 10b.57 of this chapter for further information), forward contracts with specified quantity optionality at an established price in the contract are not eligible for the normal purchases and normal sales exception. Note that the forward-component of the contract is not separate from the option-component and, therefore, the entire contract does not qualify for the normal purchases and normal sales exception (see Paragraph 10b.42 of this chapter). This applies to both parties to the contract. However, if the optionality related to the quantity expires and there is no further uncertainty over the quantity to be delivered, the contract could qualify prospectively for the normal purchases and sales exception if the other criteria of paragraph 10(b) (ASC paragraphs 815-10-15-22 through 15-51) are met. (See DIG Issue C10 for further reference.)

Example 2.10: Forward Contract With Optionality

NYM Company enters into a forward contract to purchase a specified quantity of a commodity that is readily convertible to cash. The contract’s purchase price is a fixed amount per unit that is below the current market price. If the market price on the date of purchase has fallen below a specified level, NYM is required to purchase a specified additional quantity of the commodity at a fixed price above the current market price (that is, the counterparty has the right to put additional quantities to NYM Company at a specified price). The contract entered into by NYM is a compound derivative consisting of a forward component to purchase the commodity at a fixed price and a written option component that obligates NYM to purchase additional quantities of the commodity at a fixed price above the current market price. Since the optionality modifies the quantity to be delivered, the contract is not eligible for the normal purchases and normal sales exception.

10b.38 A forward contract that contains optionality as it relates to quantity can qualify for the normal purchase and normal sale exception (a) if the optionality does not provide benefit to the holder beyond the assurance of a guaranteed supply of the underlying commodity for use in the normal course of business and (b) permits the holder to purchase additional quantities at the market price at the date of delivery only. Thus, the option component will always have a fair value at, or near, zero. For example, a forward contract that requires the purchase of a specified quantity at an established price(s) with an option clause to purchase additional specified...
quantities at the market price at the date of delivery can qualify for the normal purchases and normal sales exception. Because the option component does not provide a benefit to the holder beyond the assurance of a guaranteed supply of the underlying commodity for use in the normal course of business and the option component permits the holder to purchase additional specified quantities at the market price at the date of delivery only, the entire contract still would qualify for the normal purchases and normal sales scope exception. In the example, the option component always will have a fair value of, or near, zero and would not result in delivery of the related asset at an established price under the contract. Many contracts have this type of optionality particularly in manufacturing industries whereby the purchaser contracts to purchase a minimum quantity of the subject commodity at an established price with an option to purchase additional specified quantities at the market price to assure an additional supply of the commodity if needed. (See DIG Issue C16 further reference.)

10b.39 As discussed in Paragraphs 7.15 - 7.17 of this chapter, a requirements contract represents an agreement to purchase or sell as many units as needed, with or without defined limits, to the end-user of the commodity that is being sold. A requirements contract may include optionality related to the quantity. If a requirements contract contains a forward component and optionality related to quantity, the entire contract is nevertheless considered a forward contract and, thus, would be eligible for the normal purchases and normal sales exception as a nonoption-based forward contract. Consequently, a requirements contract with specified quantity optionality still can qualify for the normal purchase and sale exception. However, a similar contract (that is not considered a requirements contract) that has the same specified quantity optionality would not qualify for the normal purchases and normal sales exception. Therefore, for purposes of ascertaining whether a contract is eligible for the normal purchases and normal sales exception, it is important to first determine whether the contract is a requirements or nonrequirements contract; whether it is a forward, an option, or a combination of both; and, the notional amount of the contract. (See Paragraphs 7.10 - 7.22 of this chapter.)

10b.40 To illustrate, assume a derivative contract requires Company A to purchase a minimum of 60 units and a maximum of 100 units at an established price under the contract. If the contract is a requirements contract and, based on explicit provisions in the contract, the notional amount is determined to be 80 units, the contract would be considered a forward contract to buy 80 units and the contract would be eligible to qualify for the normal purchases and normal sales exception. However, if the derivative contract is not a requirements contract and, based on explicit provisions in the contract, the notional amount is determined to be 80 units, the contract would be considered a compound derivative that comprises a forward component for 80 units and an option component for 20 units. The entire contract would not be eligible for the normal purchases and normal sales exception as a result of the optionality related to quantity.

10b.41 In contrast, assume a derivative contract requires Company B to purchase a minimum of 60 units, and allows Company B to purchase as many units as it wants at an established price under the contract. In addition, the contract is not a requirements contract and there are no provisions that allow another notional amount to be readily and objectively quantified. As discussed in Paragraphs 7.18 - 7.22 of this chapter, this contract would be a forward contract with a notional amount of 60 units. The contract would be eligible for the normal purchases and normal sales exception.
10b.42 An entity is not permitted to bifurcate the forward contract component and the option contract component of a contract that in its entirety meets the definition of a derivative and then assert that the forward contract component is eligible to qualify for the normal purchases and normal sales scope exception. Paragraph 18 of the Standard (ASC paragraph 815-20-25-71(a)(2)) indicates that an entity is prohibited from separating a compound derivative into components that represent different risks. While paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) require(s) that certain derivatives that are embedded in non-derivative hybrid instruments must be split out from the host contract and accounted for separately as a derivative, the requirement to bifurcate a contract does not apply to a contract that meets the definition of a derivative in its entirety.

10b.43 Instead of entering into a forward contract that contains optionality as it relates to quantity, an entity may enter into two separate contracts – a forward contract and an option contract – that economically achieve the same results as the single contract. In doing so, the separate forward contract would be eligible to qualify for the normal purchases and normal sales exception (see Paragraphs 10b.28 - 10b.34 of this chapter); however, the separate option contract would not be eligible to qualify for the normal purchases and normal sales exception (see Paragraph 10b.35 of this chapter).

10b.44 As discussed in Paragraphs 10b.20 above, an entity is required to document the designation of the contract as a normal purchases and normal sales exception. When performing that documentation for a forward contract that permits net settlement (as discussed in Paragraphs 9.07 - 9.19 of this chapter), or for which there is a market mechanism to facilitate net settlement (as discussed in Paragraphs 9.20 - 9.25 of this chapter), the entity also must document the basis for concluding that it is probable that the contract (a) will not settle net and (b) will result in physical delivery.

**Power Purchase or Sales Agreements**

10b.45 In many situations, companies in the electricity industry enter into contracts that permit one party to purchase electricity (also referred to as power) from another party. Such contracts can vary substantially in terms with some requiring delivery of a specific quantity of power, and others providing optionality regarding the quantity to be delivered. A unique characteristic of the industry is that electricity cannot be readily stored in significant quantities. Due to this unique characteristic, the Board provided special provisions for the applicability of the normal purchases and normal sales scope exception to power contracts that meet the definition of a derivative. Contracts to buy and sell electricity are driven by the characteristics of the industry and often contain quantity optionality. The optionality provides the purchaser with a guaranteed supply source since electricity cannot be readily stored. In the case of some electricity producers, the optionality allows the purchaser to meet local, state, or national public utility commission regulatory requirements. The flexibility in power contracts typically allows the buyer to meet fluctuating demand. Another characteristic of the electricity industry is the high level of fixed costs to produce electricity. Electricity contracts typically include a specified charge (sometimes referred to as a capacity or demand charge) to provide for recovery of plant costs. Some contracts also include a variable charge related to the variable cost (the energy charge) of producing electricity.
Paragraphs 10(b)(4) of the Standard (ASC paragraph 815-10-15-45) permits a power purchase or sales agreement (that is, both forward contracts and option contracts or a combination thereof) that is a capacity contract to qualify for the normal purchases and normal sales exception, if the following criteria are met (see DIG Issue C15 for further reference):

(1) Criteria applicable to both parties to the contract:

(a) The terms of the contract require physical delivery of electricity. That is, the contract does not permit net settlement, as described in paragraphs 9(a) and 57(c)(1) of the Standard (ASC paragraphs 815-10-15-100, 815-10-15-103(a) and 15-103(b)) (see Paragraphs 9.07 - 9.19 of this chapter for further information). For an option contract, physical delivery is required if the option contract is exercised. FASB Accounting Standards Update No. 2015-13, Derivatives and Hedging (Topic 815): Application of the Normal Purchases and Normal Sales Scope Exception to Certain Electricity Contracts within Nodal Energy Markets (a consensus of the FASB Emerging Issues Task Force) (ASU 2015-13), addressed certain contracts within the nodal energy markets. More specifically, certain forward contracts to purchase or sell electricity that necessitate transmission through, or delivery to a location within, an electricity grid operated by an independent system operator result in one of the contracting parties incurring charges (or credits) for the transmission of that electricity. These charges or credits in part are based on locational marginal pricing differences payable to (or receivable from) the independent system operator. For example, this occurs when the contractual delivery location is not the same as where the electricity will ultimately be consumed or the point from which the electricity exits the grid for transmission to a customer. Delivery to the ultimate consumption or exit point is facilitated by the independent system operator of the grid. The use of locational marginal pricing to determine the transmission charge (or credit) does not constitute net settlement. This is true even if legal title to the associated electricity is conveyed to the independent system operator during transmission. ASU 2015-13 became effective upon its issuance on August 10, 2015 and is to be applied prospectively.

(b) The power purchase or sales agreement, whether a forward contract, an option contract, or a combination of both, is a capacity contract. Therefore, the contract must meet the definition of a capacity contract included in the Standard. See Paragraph 10b.50 for that definition. Differentiating between an option contract that is a capacity contract and a traditional option contract (that is, a financial option on electricity) is a matter of judgment that depends on the facts and circumstances. See Paragraph 10b.51 below for characteristics to consider in such evaluation for power purchase or sale agreements that contain option features. These characteristics do not need to be considered for a forward contract to be a capacity contract.

(c) The contract is documented as a normal purchases and normal sales contract and includes the basis for concluding that the contract meets the scope exception as
described in paragraph 58(b) of the Standard (ASC paragraph 815-10-15-37). See Paragraphs 10b.02 - 10b.26.

(2) Criterion applicable only to the seller of electricity:
   (a) The electricity that would be deliverable under the contract involves quantities that are expected to be sold by the reporting entity in the normal course of business.

(3) Criteria applicable only to the buyer of electricity:
   (a) The electricity that would be deliverable under the contract involves quantities that are expected to be used or sold by the reporting entity in the normal course of business.
   (b) The buyer of the electricity under the power purchase or sales agreement is an entity that is engaged in selling electricity to retail or wholesale customers and is statutorily or otherwise contractually obligated to maintain sufficient capacity to meet electricity needs of its customer base.
   (c) The contracts are entered into to meet the buyer’s obligation to maintain a sufficient capacity, including a reasonable reserve margin established by or based upon a regulatory commission, local standards, regional reliability councils, or regional transmission organizations.

Physical Delivery of Electricity

10b.47 To qualify for the normal purchases and normal sales scope exception, the capacity contract cannot permit net settlement, as described in Paragraphs 9.07 - 9.19 of this chapter. For example, a capacity contract that contains a market-based liquidating damage provision does not qualify for the normal purchases and normal sales scope exception in paragraph 10(b)(4) of the Standard (ASC paragraph 815-10-15-45). That requirement is stricter than the normal purchases and normal sales scope exception requirements described in paragraphs 10(b)(1) and 10(b)(3) of the Standard (ASC paragraphs 815-10-15-41 and 15-42 through 15-44).

10b.48 Power purchase or sale agreements that require physical delivery qualify for the normal purchases and normal sales scope exception even if the contract is subject to being booked out or are scheduled to be booked out. A bookout is an unplanned netting of physical transactions with the same counterparty or group of counterparties in the electric utility industry and is a common scheduling convenience when two or more utilities have offsetting transactions. As discussed in Paragraph 10b.32 of this chapter, a contract that is subject to a bookout does not qualify for the normal purchases and normal sales scope exception, unless it is a capacity contract and meets the requirements described in Paragraph 10b.46 above.

10b.49 A capacity contract that is an option or a combination of a forward and option is eligible for the normal purchases and normal sales scope exception. However, to qualify for the exception, the contract must require physical delivery if the option or option component is exercised.

10b.49a Companies in the wholesale electricity industry often join Regional Transmission Organizations within which grid operations are managed by an Independent System Operator.
ISOs do not generate, market, or trade electricity for their own account. Rather, their activities are profit neutral and quantity balanced. A unique characteristic of the contracts within this market are that the transmission of the electricity often involves contractual delivery locations that are not the same as where the electricity will ultimately be consumed or the point from which the electricity exits the grid for transmission to a customer. ISOs also generally take title to electricity as it is transmitted through the grid. The ISO assigns prices for electricity at locations (referred to as nodes) on the grid where electricity can be delivered and withdrawn. The price an ISO charges market participants includes the recovery of various costs, but also the difference in locational pricing at the delivery and withdrawal locations. Due to this unique characteristic, the EITF provided a special exemption to the physical delivery criterion of the normal purchases and normal sales scope exception to contracts within the nodal energy markets. Specifically, these contracts are not considered to be net settled even if they (1) require delivery locations that are different from where the electricity will ultimately be consumed or the point from which the electricity exits the grid for transmission to a customer, (2) involve the transfer of title to the ISO, or (3) involve locational pricing differences. In reaching its decision, the Task Force understood that before the evolution of the nodal energy market structure, companies used other means of transmission and applied the normal purchases and normal sales scope exception (assuming all of the other criteria were met). However, with the industry moving to nodal energy markets, disallowing these contracts from applying the normal purchases and normal sales scope exception would result in a significant number of routine physical transactions being accounted for as derivatives. In this instance, the Task Force did not believe that accounting for these transactions at fair value provided decision-useful information.

Agreement Is a Capacity Contract

10b.50 The Standard defines a capacity contract as an agreement by an owner of capacity to sell the right to that capacity to another party so that it can satisfy its obligations. In the electricity industry, capacity (sometimes referred to as installed capacity) is the capability to deliver electric power to the electric transmission system of an operating control area. A control area is a portion of the electric grid that schedules, dispatches, and controls generating resources to serve area load (ultimate users of electricity) and coordinates scheduling of the flow of electric power over the transmission system to neighboring control areas. A control area requires entities that serve load within the control area to demonstrate ownership or contractual rights to capacity sufficient to serve that load at times of peak demand and to provide a reserve margin to protect the integrity of the system against potential generating unit outages in the control area.

10b.51 Deciding whether an option contract is a capacity contract or a traditional option contract is a matter of judgment. The characteristics of an option capacity contract and a traditional option contract are set forth below in Exhibit 2.2 and should be considered in that evaluation for contracts that contain option features; however, other characteristics not listed in the exhibit may also be relevant in that evaluation. (See DIG Issue C15 for further reference.) These contracts must also meet the definition of a capacity contract included in Paragraph 10b.50.
Exhibit 2.2: Characteristics of Both Option Contracts That are Capacity Contracts and Financial Options on Electricity

<table>
<thead>
<tr>
<th>Option Contract That is a Capacity Contract</th>
<th>Financial Option Contract on Electricity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 The contract usually specifies the power plant or group of power plants that will provide the electricity.</td>
<td>The contract does not refer to the generation or origination of the electricity.</td>
</tr>
<tr>
<td>2 The strike price (paid on exercise) includes pricing terms to compensate the plant operator for variable operations and maintenance costs expected during the specified production periods.</td>
<td>The strike price is structured based on the expected forward prices of power.</td>
</tr>
<tr>
<td>3 The specified quantity is based on individual needs of parties to the agreement.</td>
<td>The specified quantity reflects standard amounts of electric energy, which facilitate market liquidity (for example, exercise in increments of 10,000 KwH).</td>
</tr>
<tr>
<td>4 The transfer point is usually at one or a group of specified physical delivery point(s), as opposed to a major market hub.</td>
<td>The transfer point is a major market hub (liquid trading hub), not seller- or buyer-site specific.</td>
</tr>
<tr>
<td>5 The contract usually specifies certain operational performance by the facility (for example, the achievement of a certain heat rate).</td>
<td>No operational performance is specified (not plant specific).</td>
</tr>
<tr>
<td>6 The contract sometimes incorporates requirements for interconnection facilities, physical transmission facilities, or reservations for transmission services.</td>
<td>None specified.</td>
</tr>
<tr>
<td>7 The contract may specify jointly agreed-to plant outages (e.g., for maintenance) and provide for penalties in the event of unexpected outages.</td>
<td>Penalties for outages are not specified (not plant specific).</td>
</tr>
<tr>
<td>8 Damage provisions on default usually are based on a reduction of the capacity payment (which is not market based). If default provisions specify market-liquidating damages, they usually</td>
<td>Damage provisions on default are based on market liquidating damages.</td>
</tr>
</tbody>
</table>
contain some form of floor, ceiling, or both. The characteristics of the default provision usually are tied to the expected generation facility.

<table>
<thead>
<tr>
<th></th>
<th>The contract’s term is usually long (one year or more).</th>
</tr>
</thead>
<tbody>
<tr>
<td>9</td>
<td>The contract’s term is not longer than two years (because financial options on electricity are currently illiquid beyond that period).</td>
</tr>
</tbody>
</table>

**Documentation**

10b.52 As discussed in Paragraph 10b.20 above, an entity is required to document the designation of the contract as a normal purchases and normal sales exception. When performing that documentation, the entity also must document the basis for concluding that the agreement meets all the applicable criteria described in Paragraph 10b.46 in this chapter.

**Quantities Are Expected to Be Sold In the Normal Course of Business**

10b.53 From the perspective of the seller, to qualify for the normal purchases and normal sales exception, the electricity that would be deliverable under the contract must involve quantities that are expected to be sold by the reporting entity in the normal course of its business. There is no requirement that the seller of the electricity must generate the electricity. That is, as long as the quantities that are deliverable under the contract are quantities that are expected to be generated or purchased by the seller, or both, and sold to the buyer in the normal course of its business, the contract is eligible for the scope exception.

**Quantities Are Expected to Be Used or Sold In the Normal Course of Business**

10b.54 From the perspective of the buyer, to qualify for the normal purchases and normal sales exception, the electricity that would be deliverable under the contract must involve quantities that are expected to be used or sold by the reporting entity in the normal course of its business. That is, as long as the quantities that are deliverable under the contract are quantities that are expected to be sold or consumed by the buyer, or both, in the normal course of its business, the contract is eligible for the scope exception.

**Statutory or Contractual Obligation**

10b.55 From the perspective of the buyer, to qualify for the normal purchases and normal sales exception, the buyer of the electricity must be an entity that engages in the sale of electricity to retail or wholesale customers and that buyer of the electricity is statutorily or otherwise contractually obligated to maintain sufficient capacity to meet electricity needs of its customer base (that is, the retail or wholesale customers).

10b.56 Electricity contracts between large retail buyers (e.g., a large retail store or a large manufacturer) and an electricity provider would not meet the requirement related to statutory or contractual obligation. Forward contracts for the purchase or sale of electricity with a fixed quantity that do not meet this criterion are nevertheless eligible to qualify for the normal purchases and normal sales exception by meeting all the requirements in paragraph 10(b)(1) of the Standard (ASC paragraph 815-10-15-41) (as discussed in Paragraphs 10b.28 - 10b.34 of this chapter), and forward contracts with optionality for the purchase or sale of electricity that do not
meet this criterion are nevertheless eligible to qualify for the normal purchases and normal sales exception by meeting all the requirements in paragraph 10(b)(3) of the Standard (ASC paragraphs 815-10-15-42 through 15-44) (as discussed in Paragraphs 10b.36 - 10b.44 of this chapter).

**Buyer’s Obligation to Maintain a Sufficient Capacity**

10b.57 From the perspective of the buyer, to qualify for the normal purchases and normal sales exception, the contract must be entered into to meet the buyer’s obligation to maintain sufficient capacity. That obligation must be established or based on a regulatory commission, local standards, regional reliability councils, or regional transmission organizations.

**HEDGING NORMAL PURCHASES OR NORMAL SALES CONTRACTS**

10b.58 In the previous paragraphs, we discussed the characteristics required to meet the normal purchases and normal sales exception in the Standard. A contract that is not subject to the requirements of the Standard because it qualifies for the normal purchases and normal sales exception may be designated as a hedged item in a fair value or cash flow hedge, provided the criteria in paragraphs 21 or 29 of the Standard (ASC paragraphs 815-20-25-12 and 25-15) are met. A contract that qualifies for the normal purchases and normal sales exception will typically satisfy the criteria for a firm commitment. A transaction underlying a contract that qualifies for the normal purchases and normal sales exception, but does not satisfy the criteria for a firm commitment (typically because it does not have a fixed price), may be the hedged transaction in a cash flow hedge. See Chapters 5 and 6 of this Handbook for a discussion of fair value and cash flow hedging, respectively. (See DIG Issue E17 for further reference.)

**Certain Insurance Contracts**

10c.01 Paragraph 10(c) of the Standard (ASC paragraphs 815-10-15-52 through 15-54) exclude certain insurance contracts in which payment may be affected by the change in a variable but the payment is triggered by the occurrence of an identified insurable event (not the change in the variable) and applies to both parties to the contract.

10c. Certain insurance contracts. Generally, contracts of the type that are within the scope of FASB Statements No. 60, Accounting and Reporting by Insurance Enterprises, No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long Duration Contracts and for Realized Gains and Losses from the Sale of Investments, and No. 113, Accounting and Reporting for Reinsurance of Short Duration and Long Duration Contracts, are not subject to the requirements of this Statement whether or not they are written by insurance enterprises. That is, a contract is not subject to the requirements of this Statement if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. The following types of contracts written by insurance enterprises or held by the insureds are not subject to the requirements of this Statement for the reasons given:
(1) **Traditional life insurance contracts.** The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.

(2) **Traditional property and casualty contracts.** The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.

However, insurance enterprises enter into other types of contracts that may be subject to the provisions of this Statement. In addition, some contracts with insurance or other enterprises combine derivative instruments, as defined in this Statement, with other insurance products or nonderivative contracts, for example, indexed annuity contracts, variable life insurance contracts, and property and casualty contracts that combine traditional coverages with foreign currency options. Contracts that consist of both derivative portions and nonderivative portions are addressed in paragraph 12.

DIG Issues related to this paragraph are B10, B25, B26, B28, B31, B35, and C1. See DIG Issues Index.

**10c.02** The Board decided to exclude the types of traditional contracts discussed in paragraph 10(c) of the Standard (ASC paragraphs 815-10-15-52 through 15-54) because the settlement of the contract is tied to a loss triggered by the occurrence of a specified insurable event (e.g., death of the insured or a property loss). Those contracts should continue to be accounted for under the accounting literature that addresses traditional insurance contracts, that is, FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (ASC Topic 944, Financial Services-Insurance).

**10c.03** The Board initially proposed to exclude insurance contracts from the scope of the Standard but became concerned that the term insurance contracts might be interpreted quite broadly to encompass most agreements or contracts issued by insurance enterprises as part of their ongoing operations. Furthermore, the Board was concerned that contracts that are substantially the same as other derivative instruments might, instead, be accounted for as insurance contracts to avoid the provisions of the Standard. The Board, therefore, decided to require that those contracts be included in, or excluded from, the scope of this Standard based on their characteristics.

**10c.04** Despite having some of the same characteristics as a derivative, insurance contracts often lack one or more of the characteristics that the Board decided were essential in applying the provisions of the Standard to an instrument. As a result, most freestanding insurance contracts will not qualify as derivative instruments, in their entirety, since they will not meet the definition of a derivative instrument in paragraph 6 of the Standard (ASC paragraph 815-10-15-83). However, freestanding insurance contracts that do not meet the definition of a derivative instrument may contain an embedded derivative feature that is required to be separated from the freestanding insurance contract if the provisions of paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) are met. That is, paragraph 12 of the Standard...
(ASC paragraph 815-15-05-1) explicitly states that contracts that do not, in their entirety, meet the definition of a derivative instrument, such as certain insurance policies, may contain embedded derivative instruments that are required to be separated from the contract if the provisions of that paragraph (ASC paragraph 815-15-25-1) are met.

10c.05 Insurance contracts that meet the Standard's definition of a derivative instrument but are explicitly excluded from the scope of the Standard by paragraph 10(c) (ASC paragraphs 815-10-15-52 through 15-54) must be accounted for in accordance with GAAP applicable to insurance contracts. It should be noted that freestanding insurance contracts that meet the definition of a derivative instrument and are explicitly excluded from the scope of the Standard by paragraph 10(c) (ASC paragraphs 815-10-15-52 through 15-54) typically do not contain embedded derivative features that are required to be separated from the freestanding insurance contract. That is, since a freestanding insurance contract that meets the definition of a derivative will meet the exception in paragraph 10(c) of the Standard (ASC paragraphs 815-10-15-52 through 15-54) if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk, the contract typically cannot contain any embedded features that are required to be separated under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1 and ASC paragraphs 815-15-25-1 and 25-14).

10c.06 Contracts that meet the definition of a derivative instrument in paragraph 6 of the Standard (ASC paragraph 815-10-15-83) that are not explicitly excluded by paragraph 10(c) of the Standard (ASC paragraphs 815-10-15-52 through 15-54), however, will be subject to the provisions of this Standard, whether issued by an insurance enterprise or another type of enterprise.

10c.07 As discussed above, while many contracts issued by insurance or other enterprises may not, as a freestanding contract, meet the definition of a derivative instrument, some may include embedded derivative components. Such contracts include, but are not limited to, annuity contracts that promise the policyholder a return based on selected changes in the S&P 500 Index, variable life and annuity contracts, and property and casualty contracts that combine protection for property damage and changes in foreign currency exchange rates, equity indices or other similar underlyings. An entity should use the guidance discussed in Chapter 3 to determine whether the embedded features within the contracts fall within the scope of the Standard.

10c.08 The following example illustrates the application of paragraph 10(c) of the Standard (ASC paragraphs 815-10-15-52 through 15-54): (See DIG Issue B10 for further reference.)

Example 2.11: Equity-Indexed Life Insurance Contract

ABC issues equity-indexed life insurance contracts to its customers. The contracts combine term life insurance coverage with an investment feature, similar to universal life contracts. Death benefit amounts are based on the amount selected by the policyholder plus the account value. Charges for the cost of insurance and administrative costs are assessed periodically against the account. The policyholder’s account value is based on the cumulative deposits credited with positive returns based on an equity index (e.g., S&P 500). The policy’s cash surrender value also is linked to the equity index. The death benefit amount may also depend on the cumulative return on the index. Equity-indexed life insurance contracts are accounted for as...
universal life (UL) insurance contracts under Statement 97 (ASC Topic 944, Financial Services - Insurance) and, accordingly, the customer’s account value is credited with a return indexed to an equity index rather than an interest rate established by the insurer, as is done with typical UL contracts.

Such contracts will not meet the definition of a derivative in paragraphs 6 of the Standard (ASC paragraph 815-10-15-83) because the terms of the contract do not permit net settlement of the entire contract, the entire contract cannot readily be settled net by a means outside the contract, and the entire contract does not provide for delivery of an asset that puts the recipient in a position similar to net settlement. However, these contracts represent a hybrid instrument that would have to be evaluated for an embedded derivative (as further discussed in Chapter 3). Because the policyholder can obtain an equity-indexed return by exercising the surrender option before death, the investment component of the equity-indexed life insurance contract would contain an embedded feature that needs to be analyzed under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14).

If, however, the contract contained an equity-indexed death benefit component that was over and above the cash surrender value that is payable to the policyholder upon surrender of the policy, that death benefit component would not be an embedded derivative subject to the requirements of the Standard since the benefits are payable only on death. The death benefit component would meet the scope exception in paragraph 10(c) of the Standard (ASC paragraphs 815-10-15-52 through 15-54).

10c.09 Dual-trigger property and casualty insurance contracts are used to provide tailored commercial risk coverage at lower premiums. Dual-trigger property and casualty insurance contracts are contracts that pay a benefit/claim on occurrence of both an insurable event and changes in a separate pre-identified variable. Since the likelihood of both events occurring is less than the likelihood of only one of the events occurring, the dual-trigger policy premiums are usually lower than traditional policies that insure only one of the risks. The policyholder usually is purchasing the policy to provide for coverage against a catastrophe since, if both events occur, the combined effect may be disastrous to its business. These insurance contracts may qualify for the exception under paragraph 10(c) of the Standard (ASC paragraphs 815-10-15-52 through 15-54). To qualify, the contract must provide for a legitimate transfer of risk, and not simply constitute a deposit or form of self-insurance. A property and casualty contract that provides for the payment of benefits/claims as a result of both an identifiable insurable event and changes in a variable would qualify in its entirety for the insurance exception in paragraph 10(c) (ASC paragraphs 815-10-15-52 through 15-54) and not require bifurcation of any embedded derivative features provided all of the following conditions are met:

(1) Benefits/claims are paid only if an identifiable insurable event occurs (e.g., theft or fire).

(2) The amount of the payment is limited to the amount of the policyholder’s incurred insured loss.

(3) The contract does not involve essentially assured amounts of cash flows (regardless of the timing of those cash flows) based on insurable events that are highly probable of occurring because the insured would nearly always receive the benefits (or suffer the detriment) of changes in the variable. This also is applicable to actuarially
determined amounts that are the result of insurable events that are highly probable of occurring.

10c.10 The following illustrates the application of paragraph 10(c) of the Standard (ASC paragraphs 815-10-15-52 through 15-54) to dual-trigger property and casualty insurance contracts: (See DIG Issue B26 for further reference.)

Example 2.12: Dual-Trigger Insurance Contracts

ABC issues a dual-trigger policy that pays property damage from hurricanes incurred by a specific golf resort in Florida; however, the losses are covered only if other golf courses in the region incur hurricane-related losses and the claims cannot exceed the average property damages incurred by the other golf resorts in the county. This contract would qualify for the exception in paragraph 10(c) of the Standard (ASC paragraphs 815-10-15-52 through 15-54) since claims are paid only on the occurrence of a hurricane, are limited (capped) at the amount of the policyholder’s incurred insured loss, and do not involve assured cash flows based on a highly probable event.

10c.11 A similar issue relates to contracts that require a payment based on the occurrence of a physical variable. For example, a contract that would pay a fixed amount if a tornado hits Mississippi. As more fully discussed in Paragraphs 10e.03 - 10e.07 of this chapter, the Standard provides a physical variables exception for some of these contracts.

Financial Guarantee Contracts

10d.01 The fourth exception to the scope of this Standard relates to financial guarantee contracts and applies to both parties to the contract.

10d. Financial guarantee contracts. Financial guarantee contracts are not subject to this Statement only if:

(1) They provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations under a nonderivative contract, either at pre-specified payment dates or accelerated payment dates as a result of the occurrence of an event of default (as defined in the financial obligation covered by the guarantee contract) or notice of acceleration being made to the debtor by the creditor.

(2) Payment under the financial guarantee contract is made only if the debtor’s obligation to make payments as a result of conditions as described in (1) above is past due.

(3) The guaranteed party is, as a precondition in the contract (or in the back-to-back arrangement, if applicable) for receiving payment of any claim under the guarantee, exposed to the risk of nonpayment both at inception of the financial guarantee contract and throughout its term either through direct legal ownership of the guaranteed obligation or through a back-to-back arrangement with another party.
that is required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation.

In contrast, financial guarantee contracts are subject to this Statement if they do not meet all of the above three criteria, for example, if they provide for payments to be made in response to changes in another underlying such as a decrease in a specified debtor’s creditworthiness.

DIG Issue related to this paragraph is B27. See DIG Issues Index.

10d.02 For a financial guarantee contract to meet the scope exception of paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58), the contract must:

- Provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations. See Paragraphs 10d.03 - 10d.06.
- Provide payment only if the debtor’s obligation is past due. See Paragraphs 10d.07 10d.09.
- Provide payment only if the guaranteed party is exposed to the risk of nonpayment at inception of the guarantee arrangement and throughout its life. See Paragraphs 10d.10 - 10d.12.

FAILURE OF THE DEBTOR TO SATISFY ITS REQUIRED PAYMENT OBLIGATIONS

10d.03 The events of default specified within a lending agreement between a creditor and a debtor may be either payment based (e.g., payment of principal or interest when due) or nonpayment based (e.g., violation of a covenant or a change in control). In most lending agreements, the creditor has the right to require payment in full, if any event of default occurs. However, this is a right and not an automatic contractual acceleration of payment under the lending agreement. Consequently, if a payment or nonpayment based default occurs, the debtor does not fail to satisfy its required payment obligation unless and until the creditor exercises its right to accelerate payment under the lending agreement.

10d.04 Some creditors will enter into a guarantee agreement with a guarantor that allows the creditor to receive compensation from the guarantor if an event of default occurs with a specified lending agreement. In general, creditors entering into such guarantee arrangements are attempting to mitigate credit risk as well as operational risk. In other words, the creditor is attempting to reduce its risk related to nonpayment by a debtor as well as reduce its risk related to operational or other changes that may occur with the debtor during the life of the lending agreement.

10d.05 The intent for the scope exception for financial guarantee contracts in paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58) is to align that exception with the scope exception in paragraph 10(c) of the Standard (ASC paragraphs 815-10-15-52 through 15-54) for traditional insurance contracts. That is, guarantees eligible for the scope exception are similar to insurance contracts in that they entitle the holder (e.g., a creditor) to compensation only if, as a result of an insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specified asset or liability for which the holder is at risk. Accordingly, for a financial guarantee contract to qualify for the scope exception in paragraph 10(d) of the
Standard (ASC paragraph 815-10-15-58), the guaranteed party (i.e., the creditor) must demand payment from the debtor of the specified and referenced asset (if not already due) and once it is determined that the required payment obligation has not been satisfied by the debtor, the guaranteed party must relinquish to the guarantor its rights to receive payment from the debtor before it receives payment from the guarantor.

10d.06 A guarantee arrangement that protects an entity from the nonpayment of an interest rate swap contract by the counterparty to the swap is not eligible for the financial guarantee scope exclusion as discussed in paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58) since that exclusion only applies to contracts that provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations under a nonderivative contract, such as a loan.

DEBTOR’S OBLIGATION IS PAST DUE

10d.07 For a financial guarantee contract to qualify for the scope exception in paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58), payment under that financial guarantee contract can be made to the guaranteed party by the guarantor only if the guaranteed party was contractually due an amount by the debtor of the specified and referenced asset and that amount is now past due. In addition, the amount of payment the guaranteed party is entitled to receive from the guarantor is limited to the amount that is currently past due by the debtor of the specified and referenced asset.

10d.08 When determining the amount that is past due by a debtor of the specified and referenced asset, any contractual amount that is not paid by the debtor per the lending agreement is considered past due. Consider for example, a situation in which a debtor owes a total principal amount of $10,000 to a lender in principal installments of $100. If a specific payment by the debtor in the amount of $100 is due to the creditor by 1:00pm EST on December 15, 20X0, the payment of $100 is considered past due if it is not received by the creditor by 1:00pm EST on December 15, 20X0. Consequently, the amount the creditor can receive under a qualifying financial guarantee contract from the guarantor is limited to $100, not the full outstanding principal of $10,000.

10d.09 If a creditor has the right to require payment for full satisfaction of the lending agreement from the debtor if an event of default occurs, and the creditor exercises that right by notifying the debtor that payment in full satisfaction of the lending agreement is now contractually required, the amount the creditor can receive under a qualifying financial guarantee contract from the guarantor is limited to the required payment for full satisfaction of the lending agreement from the debtor once it is past due. For example, assume a creditor has the right to demand full payment in the amount of $10,000 in satisfaction of a lending agreement if any contractually scheduled payment is not received. As in Paragraph 10d.08, assume a contractually scheduled payment in the amount of $100 is due to the creditor by 1:00pm EST on December 15, 20X0 and is not received. If the creditor notifies the debtor that it demands payment in the amount of $10,000 in satisfaction of the lending agreement as a result of the missed payment and payment is not made, the amount the creditor can receive under a qualifying financial guarantee contract from the guarantor is limited to $10,000. However, a guaranty arrangement that pays the full outstanding amount of $10,000 or purchases the entire outstanding note for $10,000, regardless
of whether the lender requires full and immediate payment of the note, does not meet the financial guarantee exception.

GUARANTEED PARTY IS EXPOSED TO THE RISK OF NONPAYMENT

10d.10 To qualify for the scope exception in paragraph 10(d) (ASC paragraph 815-10-15-58), a financial guarantee contract must require, as a precondition for payment of a claim, that the guaranteed party be exposed to the risk of nonpayment on the referenced asset, both at the inception of the financial guarantee contract and over its life. If an entity is not exposed to the risk of nonpayment on the referenced asset over the life of the financial guarantee contract and the guarantee contract does not explicitly require an ongoing exposure to such risk, the scope exception in paragraph 10(d) (ASC paragraph 815-10-15-58) does not apply. If the guaranteed party is able to eliminate its risk of nonpayment on the referenced asset by selling the asset, the contract will not qualify for the exception unless the guarantee contract explicitly terminates on the sale of the referenced asset.

10d.11 A guarantor may write a financial guarantee contract that references a specific asset. Concurrently or thereafter, the guarantor may purchase a financial guarantee contract that references the same asset and become the guaranteed party under that purchased contract so that, if payment is required under the written financial guarantee contract, a mirror payment and transfer of rights will occur under the purchased financial guarantee contract. Those arrangements typically are called back-to-back arrangements. The back-to-back purchased financial guarantee contract will meet the scope exception in paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58) if (a) the written financial guarantee contract meets the scope exception in paragraph 10(d) (ASC paragraph 815-10-15-58), (b) all receipts contractually required under the purchased financial guarantee contract mirror the required payments under the written financial guarantee contract, (c) all terms of the purchased financial guarantee contract mirror the terms under the written financial guarantee contract, and (d) the purchased financial guarantee contract requires the guaranteed party to continue to be exposed to the obligations under the written financial guarantee contract.

10d.12 The following illustrates the type of financial guarantee contract that is excluded under paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58):

Example 2.13: Financial Guarantee Contract

Lending Bank has a loan to Borrower X and wants to reduce its credit exposure on this loan. Lending Bank enters into an agreement with Guarantor Bank in which Lending Bank will pay Guarantor Bank a periodic payment of 20 basis points a year. In return, Guarantor Bank agrees to pay Lending Bank any missed scheduled payments if Borrower X fails to make a scheduled payment provided Lending Bank is exposed to the risk of nonpayment on the loan over the life of the agreement. In the event of a missed payment, Guarantor Bank will pay Lending Bank the scheduled payment due on the loan and will receive the rights to that payment in exchange.

Because Guarantor Bank is not required to pay Lending Bank until Borrower X misses a payment on the loan, the payment amount is equal to the scheduled payment due, and Lending Bank is exposed to the risk of nonpayment throughout the life of the agreement with Guarantor Bank, this contract represents a financial guarantee purchased by Lending Bank. As such, the
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10d.13 The following paragraphs discuss the application of the scope exception in paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58) to credit derivatives and dual-triggered financial guarantee contracts.

Credit Derivatives

10d.14 Guarantee contracts that provide for payment or receipt of cash based on a change in the creditworthiness of a designated entity (i.e., underlying) but do not require that the borrower in the financial obligation covered by the guarantee contract fail to satisfy its contractual payment obligations before the guaranteed party is reimbursed, are not excluded by paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58).

10d.15 A credit derivative is a common example of the type of contract that does not meet the financial guarantee exception paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58) as it does not require the borrower to fail to satisfy its contractual payment obligations before the subject credit derivative provides payment. A credit derivative represents a financial instrument, usually a swap, which provides protection to the holder of the derivative in case of a decline in the creditworthiness of the subject of the contract. Many credit derivatives define the underlying as either the credit spread (either sector, obligor’s creditworthiness, or both) of a particular entity’s outstanding debt securities (i.e., credit spread options), or the value of the security when such security has defaulted (i.e., credit default swaps). For example, Insurance Company A executes a credit spread option with Investment Bank B whereby Investment Bank B will pay Insurance Company A the product of the notional amount of the option, $100 million, multiplied by the incremental increase in the yield for Widget Company C’s Series A Debt Securities over 600 basis points above the yield on U.S. Treasuries (the current credit spread for the referenced debt securities). If the yield (i.e., credit spread) for Widget Company C Series A Debt Securities increases to 700 basis points above U.S. Treasuries, Investment Bank B will pay Insurance Company A $1 million (the product of the notional amount of the swap, $100 million, multiplied by the incremental increase above 600 basis points.) Since the option does not require that Widget Company C fail to satisfy its contractual payment obligations related to its Series A Debt Securities before the guaranteed party, Insurance Company A, is reimbursed, the credit derivative would not meet the exception in paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58).

Dual-Trigger Financial Guarantee Contracts

10d.16 Dual-trigger financial guarantee contracts are similar to dual-trigger property and casualty insurance contracts as discussed in Paragraphs 10c.09 - 10c.10 of this chapter. Dual-trigger financial guarantee contracts that meet all the requirements of paragraph 10(d) (ASC paragraph 815-10-15-58), except the amount paid to the guaranteed party is the lesser of the missed payments on the referenced asset or, for example, the missed payments on a referenced

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pool of other assets, typically will qualify for the scope exception. A dual-trigger financial
guarantee contract typically lowers a guaranteed party’s premium on the contract because claims
are limited by external factors and the guarantor is not exposed solely to the guaranteed party’s
underwriting performance. The lesser of payment provision in the dual-trigger financial
guarantee contract, in essence, represents a type of deductible in the contract. (See DIG Issue
B27 for further reference.)

**Certain Contracts That Are Not Traded on an Exchange**

10e.01 Paragraph 10(e) (ASC paragraphs 815-10-15-59 and 15-60) excludes certain contracts
that are not traded on an exchange from the scope of the Standard.

10e. Certain contracts that are not traded on an exchange. Contracts that are not exchange-
traded are not subject to the requirements of this Statement if the underlying on which the
settlement is based is one of the following:

1. A climatic or geological variable or other physical variable

2. The price or value of (a) a nonfinancial asset of one of the parties to the contract
   provided that the asset is not readily convertible to cash or (b) a nonfinancial
   liability of one of the parties to the contract provided that the liability does not
   require delivery of an asset that is readily convertible to cash

3. Specified volumes of sales or service revenues by one of the parties to the contract.

If a contract has more than one underlying and some, but not all, of them qualify for one of the
exceptions in paragraphs 10(e)(1), 10(e)(2), and 10(e)(3), the application of this Statement to
that contract depends on its predominant characteristics. That is, the contract is subject to the
requirements of this Statement if all of its underlyings, considered in combination, behave in a
manner that is highly correlated with the behavior of any of the component variables that do
not qualify for an exception.

DIG Issues related to this paragraph are B26, C1, and C5. See DIG Issues Index.

10e.02 The exceptions in paragraph 10(e) (ASC paragraphs 815-10-15-59 and 15-60) focus on
contracts that are not traded on an exchange and apply to both parties to the contract. The Board
concluded that any instrument or contract traded on an exchange, including those with the
characteristics of an underlying specified in paragraph 10(e) (ASC paragraphs 815-10-15-59 and
15-60), should be subject to the provisions of this Standard if the instrument or contract meets
the definition of a derivative instrument in paragraph 6 of the Standard (ASC paragraph 815-10-
15-83). Thus, paragraph 10(e) of the Standard (ASC paragraphs 815-10-15-59 and 15-60) creates
different accounting for exchange-traded contracts and non-exchange-traded contracts. We
believe this distinction exists because contracts that are exchange-traded provide different
benefits and pose different risks from non-exchange-traded contracts. Based on informal
discussion with the FASB staff, entities should continuously monitor whether instruments or
contracts meet the definition of a derivative instrument because the instrument or contract may
change between exchange-traded and non-exchange traded and, therefore, between inclusion in
and exclusion from the scope of the Standard.
10e.03 The first exception in paragraph 10(e) of the Standard (ASC paragraphs 815-10-15-59 and 15-60) addresses contracts and instruments that are not traded on an exchange and whose underlying is a climatic or geological variable or other physical variable. Paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)) requires the instrument or contract to have one or more underlyings to meet the definition of a derivative instrument in the Standard. In Paragraphs 7.03 and 7.09 of this chapter, an underlying is described as any variable factor whose changes are observable or otherwise objectively verifiable. In concept, any observable variable, including physical as well as financial, may be an underlying for a derivative instrument. For example, a contract or instrument may be settled or valued based on the number of inches of rainfall or snow in a particular area or the severity of an earthquake as measured by the Richter scale. The Board was concerned that constituents had not had sufficient opportunity to consider the implications and potential measurement difficulties of including in the scope of the Standard contracts based on physical variables. The Board believes many contracts for which the underlying is a physical variable are currently accounted for as insurance contracts, and it considers the accounting currently governing insurance contracts to be adequate for these contracts (see discussions in Paragraphs 10c.01 - 10c.11 of this chapter). Contracts related to climatic variables that are non-exchange traded are accounted for under EITF Issue No. 99-2, “Accounting for Weather Derivatives” (EITF 99-2) (ASC Subtopic 815-45, Derivatives and Hedging - Weather Derivatives). Thus, the Board concluded that it would not be appropriate to include in the scope of the Standard contracts that are not exchanged-traded and are settled as a result of a climatic, geological, or other physical variable. The following illustrates this point:

Example 2.14: Contract That Is Not Traded on an Exchange - Geological Variable

Company A and Company B are both insurance companies. Company B, in exchange for $1 million, agrees to pay Company A a specified amount on the occurrence of a triggering event, which is defined as the occurrence of an earthquake in a specified region of Japan during a specified time frame. The payment is $100 million multiplied by the magnitude of the earthquake as measured by the Japan Meteorological Agency (JMA). If an earthquake occurs, Company A neither has to suffer a loss nor be obligated to pay losses under insurance policies written to receive payment from Company B.

Because the underlying on which settlement is based is a geological (i.e., physical) variable and because the contract is not exchange-traded, this contract would be explicitly excluded from the scope of the Standard by paragraph 10(e)(1) (ASC paragraphs 815-10-15-59(a)). That is, even though the contract meets the definition of a derivative instrument pursuant to paragraph 6 of the Standard (ASC paragraph 815-10-15-83) in that it has an underlying (the occurrence of an earthquake in a particular region of Japan as measured by the JMA index), a notional amount ($100 million), the $1 million payment made by Company A is considered to be a small investment relative to the payment of $100 million if an earthquake should occur, and has a payment provision resulting in net settlement, it is not an instrument covered by this Standard due to the exception in paragraph 10(e)(1) (ASC paragraphs 815-10-15-59(a)).

10e.04 However, a contract that contains a payment provision that requires a payment based on both a physical and financial variable is not eligible for exception under paragraph 10(e)(1) of
the Standard (ASC paragraph 815-10-15-59(a)), due to the presence of the financial variable. A dollar amount of climatic-induced damages would be considered a financial variable as illustrated below: (DIG Issue C1 for further reference.)

Example 2.15: Contract That Is Not Exchange-Traded – Physical and Financial Variables

An entity purchases a contract that will pay $1,000,000 if aggregate property damage from all hurricanes in the Bahamas exceeds $20,000,000 during the current year. The payment provision under the contract contains two underlyings – a physical variable (i.e., the occurrence of at least one hurricane) and a financial variable (i.e., aggregate property damage exceeding a specified amount $20,000,000). Because of the presence of the financial variable as an underlying, the derivative contract does not qualify for the scope exception in paragraph 10(e)(1) of the Standard (ASC paragraph 815-10-15-59(a)). If the $1,000,000 payment was based solely on the occurrence of a hurricane in the Bahamas, it would qualify for the exception since it is a climatic underlying.

10e.05 If the contract requires a payment only when the holder incurs a decline in revenue or an increase in expense as a result of an event (e.g., a hurricane) and the amount of the payoff is solely compensation for the amount of the holder’s loss, the contract would be a traditional insurance contract that is excluded from the scope of the Standard under paragraph 10(c) (ASC paragraphs 815-10-15-52 through 15-54). See discussion about the insurance exception in Paragraphs 10c.01 - 10c.11 above.

10e.06 The accounting for non-exchange traded weather derivatives (i.e., contracts indexed to climatic or geological variables), which are excluded from the Standard under paragraph 10(e)(1) (ASC paragraph 815-10-15-59(a)), is set forth in EITF 99-2 (ASC Subtopic 815-45). Non-trading forward-based weather derivatives should be accounted for by applying the intrinsic value method and purchased non-trading option-based weather derivatives are accounted for by amortizing the option premium and then applying the intrinsic value method. The intrinsic value method computes an amount based on the difference between the expected results from an upfront allocation of the cumulative strike and the results during a period, multiplied by the contract price (e.g., dollars per heating degree day). The intrinsic value method first requires that the reporting entity allocate the cumulative strike amount to individual periods within the contract term. That allocation should reflect reasonable expectations at the beginning of the contract term of normal or expected experience under the contract and should be based on data from external statistical sources, such as the National Weather Service. The intrinsic value measure of the contract at interim dates would then be calculated based on cumulative differences between experience and the allocation through that date. The initial allocation of the cumulative strike amount should not be adjusted over the term of the contract to reflect results. Illustrative examples for these types of weather derivatives are provided in EITF 99-2 (ASC Subtopic 815-45). Weather derivatives entered into for trading or speculative purposes should be accounted for at fair value and marked to market through earnings. All entities that sell or write non-exchange-traded option-based weather derivatives should initially recognize the premium as a liability and recognize subsequent changes in fair value currently in earnings (i.e., the premium would not be amortized).
Although the accounting for weather derivatives prescribed by EITF 99-2 (ASC Subtopic 815-45), in particular the accounting for weather derivatives held for trading purposes, is similar to the accounting required by the Standard, it is important to note that such derivatives are outside the scope of the Standard under paragraph 10(e)(1) (ASC paragraph 815-10-15-59(a)). Because weather derivatives are outside the scope of the Standard, such instruments (trading or otherwise) are not eligible to be designated as the hedging instrument in a hedging relationship accounted for under the Standard.

NONFINANCIAL ASSET

The second exception in paragraph 10(e) of the Standard (ASC paragraph 815-10-15-59) addresses contracts and instruments that are not traded on an exchange and whose underlying on which settlement is based is a price or value of a unique nonfinancial asset of one of the parties to the contract that is not readily convertible to cash. Similarly excluded is an instrument that is not exchange-traded and for which the underlying on which settlement is based is the price or value of a nonfinancial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash. We believe this exception was intended to apply to sales contracts of nonfinancial assets that meet the net settlement criterion due to inclusion of a cash settled default provision.

The Board concluded that this exception applies only to nonfinancial assets that are unique and only if the nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the price or value of the nonfinancial asset. Thus, the exception would apply to either forward sales or written call options in which the selling party owns the unique nonfinancial asset (e.g., real estate). Neither contract results in the owner of the asset benefiting under the contract if the asset’s price or value increases. Assume an entity enters into a forward agreement to sell a nonfinancial asset at a fixed price in the future. As the asset’s price or value increases, the entity (as the seller) does not benefit under the forward agreement as it is only entitled to receive the previously agreed on fixed price stated in the forward agreement. Likewise, assume an entity writes a call option that enables the counterparty to call a nonfinancial asset at a fixed price in the future. As the asset’s price or value increases, the writer of the option does not benefit under the option contract as it is only entitled to receive the previously agreed upon fixed price stated in the option contract if the counterparty exercises the option. For the entity that does not own the asset (i.e., the purchaser) to qualify for this exclusion, it will need to verify that the counterparty (i.e., seller) owns the asset associated with the underlying to the contract. In most instances, the counterparty will own the asset since it has obligated itself to deliver a unique asset. (See DIG Issue C5 for further reference.)

Neither the Standard nor the FASB staff provided guidance about the definition of unique. We believe that for nonfinancial assets to be considered unique, they must not have interchangeable (i.e., fungible) units. Further, we believe unique assets should have specific physical attributes or locations. For example, we believe that parcels of real estate, buildings, collectibles, specially manufactured goods and machinery are unique. In contrast, commodities generally are fungible and, therefore, would not be considered unique. The following illustrates the application of paragraph 10(e)(2) of the Standard (ASC paragraphs 815-10-15-59(b) and 15-59(c)):
Example 2.16: Illustrating the Concepts in Paragraph 10(e)(2) of the Standard (ASC paragraphs 815-10-15-59(b) and 15-59(c))

**Scenario 1:** Purchaser Inc. purchased for $100,000 a non-exchange-traded option contract to purchase at any time during the next three years, from Seller Inc. a building for $5 million. This contract would meet the exception requirements in paragraph 10(e)(2) of the Standard (ASC paragraphs 815-10-15-59(b) and 15-59(c)) since the building is a nonfinancial asset that is unique, (i.e., it is not interchangeable (fungible)), and the owner of the nonfinancial asset (Seller) would not benefit under the call option contract from an increase in the value of the building during the three-year option period. For example, if the building’s value increased to $8 million, Seller would not benefit under the contract because Seller can only sell the building to Purchaser for $5 million.

**Scenario 2:** Purchaser enters into a non-exchange-traded forward contract to buy from Seller 100 interchangeable (fungible) units of a nonfinancial asset that are not readily convertible to cash. The contract permits net settlement through its default provisions. This contract would not meet the exception requirements in paragraph 10(e)(2) of the Standard (ASC paragraphs 815-10-15-59(b) and 15-59(c)) since the contract’s settlement is based on an underlying associated with a nonfinancial asset that is not unique (i.e., settlement is based on the price or value of an interchangeable nonfinancial asset).

Residual Value Guarantees

10e.11 Paragraph 5(h) of Statement 13 (ASC paragraph 840-30-35-25) defines the estimated residual value of leased property as “the estimated fair value of the leased property at the end of the lease term.” A lessor may obtain a residual value guarantee from the lessee, from an independent third party, or from both. In some lease arrangements, the lessee may be required to guarantee the residual value of the leased property and provide a third-party guarantee of the residual value. Alternatively, some leases require the lessee to reimburse the lessor for the cost of obtaining a third-party guarantee of the residual value. Under Statement 13 (ASC Topic 840, Leases), the lessor and lessee must account for residual value guarantees based on the stated amount of the guarantee, rather than the estimated deficiency to be made up by the guarantor (lessee or third party, or both). Residual value guarantees may be structured in a variety of ways. However, those guarantees usually are settled on a net basis. Accordingly, many residual value guarantees may meet the definition of a derivative.

10e.12 The Standard did not amend Statement 13 (ASC Topic 840). However, except as provided in paragraph 10(f) (ASC paragraph 815-10-15-63), it also did not exclude residual value guarantees from its scope. As a result, there is a scope overlap between Statement 13 (ASC Topic 840) and the Standard with respect to the accounting for residual value guarantees that (a) are subject to the requirements of Statement 13 (ASC Topic 840), (b) meet the definition of a derivative in the Standard, and (c) either are not explicitly excluded from the scope of the Standard or do not qualify for one of the scope exceptions in the Standard. EITF Issue 01-12, “The Impact of the Requirements of FASB Statement No. 133 on Residual Value Guarantees in Connection with a Lease” (ASC paragraph 815-10-15-80), resolved this issue and indicated that residual value guarantees that are subject to the requirements of the lease accounting literature are not subject to the requirements of the Standard.
10e.13 However, residual value guarantee contracts that are not subject to the lease accounting literature, including residual value guarantee obligations issued by third-party residual value guarantors and those contracts that, although labeled as residual value guarantees, are not in the scope of Statement 13 (ASC Topic 840) (e.g., because there is not a true transfer of risk from the lessor to a third-party guarantor or because the settlement under the contract is not sufficiently specific to the leased property) are not automatically excluded from the scope of the Standard. Thus, all those residual value guarantees must be reviewed to determine whether they are derivatives and whether they qualify for any of the scope exceptions in the Standard.

10e.14 The following illustrates the conclusions of the EITF (ASC paragraph 815-10-15-80) with respect to residual value guarantees:

**Example 2.17: Residual Value Guarantee**

Company A (the lessor) leases a car to a lessee for a period of three years. The lease qualifies as a direct financing lease for Company A based on the requirements of Statement 13 (ASC Topic 840). In accordance with Statement 13 (ASC Topic 840), minimum lease payments include a residual value guarantee purchased by Company A from Company B. The terms of the residual value guarantee provided by Company B call for Company B to pay Company A any shortfall between $5,000 (the expected retail value of the car in three years based on current market conditions) and the Blue Book retail value of the car (based on the retail value for that year, make, and model, assuming the car is in good condition with normal mileage). If the Blue Book retail value of the car in three years is more than $5,000, Company B is not required to pay Company A.

The residual value guarantee contract meets the definition of a derivative because (a) it contains an underlying (the Blue Book retail value of the car) and a payment provisions ($5,000 minus the Blue Book retail value of the car), (b) it requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and (c) its terms require net cash settlement.

Since Company A must account for the residual value guarantee contract under Statement 13 (ASC Topic 840), the contract is not subject to the requirements of the Standard, even though it meets the definition of a derivative. However, since the contract meets the definition of a derivative and Company B does not apply the provisions of Statement 13 (ASC Topic 840) to the contract, Company B must determine whether the contract qualifies for any scope exceptions in the Standard.

**SPECIFIED VOLUMES OF REVENUES**

10e.15 The third exception in paragraph 10(e) of the Standard (ASC paragraphs 815-10-15-59) addresses contracts and instruments that are not traded on an exchange and whose underlying is a specified volume of sales or service revenues by one of the parties to the contract. This exception is intended to apply to contracts with settlements based on the volume of items sold or services rendered (e.g., leases with payments contingent on the level of sales from the leased facility and royalty agreements).
10e.16 Some believe this exception generally applies only to specified volumes of sales or service revenue. Others believe that it also applies to other entity-specific performance measures such as net income, earnings before interest, taxes, depreciation, and amortization (EBITDA), or operating cash flows. Paragraph 58(c)(3) of the Standard states that the 10(e)(3) exception (ASC paragraphs 815-10-15-59(d)) is intended to apply to contracts with settlements based on volumes of items sold or services rendered and further states the exception is not intended to apply to contracts based on changes in sales or revenues due to changes in market prices of the items sold. Those that have a narrower view of the application of this exception state that since net income, EBITDA, or other performance measures are highly affected by transactions other than the volumes of items sold or services rendered (e.g., compensation, cost of goods sold, and rent), such items generally would not meet the exception criterion of paragraph 10(e)(3) (ASC paragraphs 815-10-15-59(d)).

10e.17 However, those that hold a broader view of the application of this exception refer to the status sections of EITF Issue No. 97-8, “Accounting for Contingent Consideration Issued in a Purchase Business Combination” and EITF Issue No. 86-21, “Application of the AICPA Notice to Practitioners regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property” (ASC paragraph 310-10-05-9 and 815-15-55-10). EITF 97-8 discusses contingent consideration in a business combination and whether that consideration would be considered additional purchase price (which is excluded from the Standard pursuant to paragraph 11(c) (ASC paragraph 815-10-15-74(c)) or compensation (which is not explicitly excluded from the Standard). The status section of EITF 97-8 indicates that “because this Issue applies only to contingent consideration that is based on earnings [emphasis added] or on a guaranteed value of the securities to effect the business combination, the issuer would not account for the contingent consideration as a derivative instrument whether a separate financial instrument or an embedded derivative. Specifically, paragraph 10(e) of Statement 133 (ASC paragraph 815-10-15-59(d)) states that if the underlying settlement of the contract is based on specified volumes of sales or service revenues of one of the parties to the contract, the contract is not subject to the requirements of Statement 133.” EITF 86-21 (ASC paragraph 815-15-55-10) discusses equity kickers in real estate loans whereby the lender can participate in the profitability of the underlying property, noting in the status section that “if the equity kicker is based on a share in net earnings or operating cash flows [emphasis added], it would also typically qualify for the scope exception in paragraph 10(e)(2) (ASC paragraphs 815-10-15-59(b) and 15-59(c)).” Although the status section cites paragraph 10(e)(2) (ASC paragraphs 815-10-15-59(b) and 15-59(c)), we believe this statement pertains more appropriately to paragraph 10(e)(3) of the Standard (ASC paragraph 815-10-15-59(d)). However, under this broader view, we believe activity captured in an expense line item of the entity’s income statement (or a component thereof) is not considered an entity-specific performance measure. For example, if an entity entered into a contract and settlement was based upon a percentage or a multiple of the entity’s research and development expense for a specific period or a specific project, it would not meet this scope exception and additional analysis would be required before concluding whether a different scope exception could apply (e.g., paragraph 10(e)(2) (ASC paragraphs 815-10-15-59(b) and 15-59(c))).

10e.18 We believe that either view is acceptable and an entity should select a policy and follow it consistently. Even if an entity selects the narrower view of the application of this exception, the contract may meet the exception in paragraph 10(e)(3) (ASC paragraph 815-10-15-59(d)) of the
Standard if all of its underlyings (i.e., changes in all variables), considered in combination, behave in a manner that is not highly correlated with the behavior of any of the component variables that do not qualify for the 10(e)(3) exception (ASC paragraph 815-10-15-59(d)) – see Paragraphs 10e.19 - 10e.21 for further discussion of this issue.

PREDOMINANT CHARACTERISTICS

10e.19 The final point in paragraph 10(e) of the Standard (ASC paragraphs 815-10-15-59 and 15-60) relates to the Board’s concern that instruments or contracts may have an underlying that combines more than one variable (a combined underlying or multiple underlyings) in which some, but not all underlyings, meet the exceptions cited in paragraph 10(e) (ASC paragraphs 815-10-15-59 and 15-60). Under this guidance, the application of the Standard to that contract depends on the predominant characteristics of the combined variables (underlyings). The contract is subject to the requirements of the Standard if the changes in its combined underlying are highly correlated with changes in one of the component variables that would not qualify for an exception.

10e.20 This discussion was added to the Standard to clarify the application of paragraph 10(e) (ASC paragraphs 815-10-15-59 and 15-60), that is, that the Board did not intend to automatically exclude such instruments or contracts from the scope of the Standard if only one of the variables of a combined underlying met the exceptions in paragraph 10(e) (ASC paragraphs 815-10-15-59 and 15-60). The Board indicated that a contract with a combined underlying is subject to the requirements of this Standard if its settlement is expected to change in a way that is highly correlated with the way it would change if it were based on an underlying that would not be eligible for one of the exceptions in paragraph 10(e) of the Standard (ASC paragraphs 815-10-15-59 and 15-60).

10e.21 It should be noted that the predominant characteristics evaluation under paragraph 10(e) of the Standard (ASC paragraphs 815-10-15-50 and 15-60) is based on whether the combined underlyings behave in a manner that is highly correlated with the behavior of any of the component variables that does not qualify for an exception instead of whether the combined underlyings behave in a manner that is highly correlated with the behavior of any of the component variables that does qualify for an exception. Consequently, as long as the combined underlyings do not behave in a manner that is highly correlated with the behavior of any of the component variables that does not qualify for an exception, there is no requirement that the combined underlyings behave in a manner that is highly correlated with the behavior of any of the component variables that does qualify for an exception.

Derivative Instruments That Serve as Impediments to Sales Accounting

10f.01 Paragraph 10(f) of the Standard (ASC paragraph 815-10-15-63) addresses the exception for certain contracts or components of contracts that, because of their characteristics, do not permit accounting for a related contract as a sale or purchase by one of the parties to the contract.

10f. Derivatives that serve as impediments to sales accounting. A derivative instrument (whether freestanding or embedded in another contract) whose existence serves as an impediment to recognizing a related contract as a sale by one party or a purchase by the counterparty is not subject to this Statement. For example, the existence of a guarantee of the
residual value of a leased asset by the lessor may be an impediment to treating a contract as a sales type lease, in which case the contract would be treated by the lessor as an operating lease. Another example is the existence of a call option enabling a transferor to repurchase transferred assets that is an impediment to sales accounting under FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. DIG Issue related to this paragraph is C6. See DIG Issues Index.

10f.02 Certain derivative instruments when viewed alone or in connection with a related contract prevent the transfer of control of an asset or a pool of assets to the counterparty to the contract. As a result of the inability to transfer control of an asset or pool of assets, accounting for the transfer as a sale is prohibited. By accounting for these contracts as derivative instruments under the provisions of the Standard, an entity may, in certain circumstances, account for essentially the same value twice. First, by retaining the assets subject to the derivative contract on the balance sheet, and second by accounting for the derivative contract as a freestanding derivative instrument (i.e., asset or liability). The Board gives as an example a call option that enables a transferor to repurchase a transferred financial asset that is not readily obtainable. This call option prevents the transferor from accounting for that transfer as a sale. Thus, the holder of the option continues to recognize the asset to which the option relates in its financial statements. Recording the option at fair value would essentially double count the value associated with that asset. As a result, the Board decided to exclude these instruments or contracts from the scope of the Standard.

10f.03 In some cases, a derivative instrument’s existence does not serve as an impediment to recognizing a related contract as a sale by one party or a purchase by the counterparty as the related contract is not permitted to be accounted for as a sale or purchase for reasons other than the existence of that derivative instrument. Consistent with paragraph 284 of the Standard (ASC paragraph 815-10-15-65), those derivative instruments would not be accounted for as a derivative under the Standard if accounting for that derivative would result in double counting the assets. For example, if a transferor transfers financial assets but retains a call option on those assets, the condition in paragraph 9(c) of Statement 140 (ASC paragraph 860-10-40-5(c)) may be satisfied because the assets transferred are readily obtainable; however, the transfer may fail the isolation condition in paragraph 9(a) of Statement 140 (ASC paragraph 860-10-40-5(a)) because of significant continued involvement by the transferor. Because the transferor is required to continue to recognize the assets transferred, recognition of the call option on those assets would effectively result in recording the assets twice. Therefore, the derivative is excluded from the Standard. (See DIG Issue C6 for further reference.)

10f.04 The following illustrates this concept:

Example 2.18: Transfer of Financial Assets With a Retained Call Accounted for as a Financing

A transferor transfers to a third party a financial asset that is readily obtainable but retains a call option on that asset. The transferor also writes an option that allows the transferee to put the financial asset back to the transferor at par. Assume that the transfer fails the isolation criteria in paragraph 9 of Statement 140 (ASC paragraph 860-10-40-5) because of significant continued involvement by the transferor.
involvement by the transferor. Since the transfer fails sales accounting treatment, the transferor accounts for the transfer as a financing (the receipt of cash is recorded as a borrowing/liability). Recognition of the call option held by the transferor would effectively result in recording the associated asset twice; therefore, the call option is not subject to the scope of the Standard. Exercise of the put option by the transferee would result in the transferor repurchasing the asset that it has transferred, but which is still recorded as an asset on its balance sheet. Because the transferor is required to recognize the borrowing, recognition of the put option would result in counting the liability twice; accordingly, the written put option is not subject to the scope of the Standard.

While the put option and the call option are not required to be accounted for as derivatives under the Standard, each option would still be required to be accounted for under other existing GAAP.

Investments in Life Insurance

10g.01 Paragraph 10(g) of the Standard (ASC paragraph 815-10-15-67) addresses an exception for the policyholder of certain investments in life insurance.

10g. Investments in life insurance. A policyholder’s investment in a life insurance contract that is accounted for under FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance, or FASB Staff Position FTB 85-4-1, “Accounting for Life Settlement Contracts by Third Party Investors,” (ASC Subtopic 325-30, Investments - Other -- Investments in Insurance Contracts) is not subject to this Statement. This does not affect the accounting by the issuer of the life insurance contract.

DIG Issue related to this paragraph is B31. See DIG Issues Index.

10g.02 The accounting for purchases of life insurance contracts commonly referred to as COLI (corporate-owned life insurance), BOLI (business-owned life insurance), or key-man insurance is addressed by FASB (ASC Subtopic 325-30, Investments--Other - Investment in Insurance Contracts) Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance (Technical Bulletin 85-4). These contracts, at times, provide for a cash surrender value that is periodically adjusted to reflect the return on a portfolio of equity securities. This feature may be considered an embedded derivative feature under the Standard (see Chapter 3 for a discussion on embedded derivatives). A policyholder’s investment in a life insurance contract that is subject to Technical Bulletin 85-4 (ASC Subtopic 325-30) is reported at net realizable value (cash surrender value), which does not equal fair value (even though the amount may at times be close to fair value). Therefore, the investment in a life insurance contract does not qualify for the embedded derivative scope exception in paragraph 12(b) of the Standard (ASC paragraph 815-15-25-1(b)) applicable to contracts that are carried at fair value with changes in value recorded in earnings. Third-party investors account for life settlement contracts under FASB Staff Position No. FTB 85-4-1, “Accounting for Life Settlement Contracts by Third-Party Investors” (FSP No. FTB 85-4-1) (ASC Subtopic 325-30). These contracts, at times, also provide for a cash surrender value that is adjusted based on an equity securities portfolio. Contracts within the scope of this FSP (ASC Subtopic 325-30) are accounted for using either the investment method or fair value method, as defined in the FSP (ASC Subtopic 325-30).
10g.03 The policyholder cannot apply Technical Bulletin 85-4 (ASC Subtopic 325-30) (or the investor cannot apply FSP No. FTB 85-4-1) to the host contract (the life insurance contract, or life settlement contract, absent the embedded derivative that would be accounted for separately) because the hypothetical host contract has no stated cash surrender value. Accordingly, paragraph 10(g) of the Standard (ASC paragraph 815-10-15-67) indicates that the policyholder/investor should account for its investment in a life insurance contract/life settlement contract in its entirety under the provisions of Technical Bulletin 85-4/FSP No. FTB 85-4-1, (ASC Subtopic 325-30) even if the contract includes derivative-like provisions that would otherwise require separate accounting as a derivative under paragraph 12 of the Standard (ASC paragraphs 815-15-25-1 and 25-14). The policyholder/investor should not apply the embedded derivative provisions of the Standard to a life insurance contract/life settlement contract that is subject to Technical Bulletin 85-4/FSP No. FTB 85-4-1 (ASC Subtopic 325-30).

10g.04 The scope exception in paragraph 10(g) of the Standard (ASC paragraph 815-10-15-67) does not apply to issuers of these insurance contracts or to purchasers of contracts not subject to Technical Bulletin 85-4/FSP No. FTB 85-4-1 (ASC Subtopic 325-30). These entities need to analyze their contracts under paragraph 12 of the Standard (ASC paragraphs 815-15-25-1 and 25-14) and should refer to DIG Issue B10, “Embedded Derivatives: Equity-Indexed Life Insurance Contracts.”

Certain Investment Contracts

10h.01 Paragraph 10(h) of the Standard (ASC paragraph 815-10-15-68) identifies certain investment contracts that are not subject to its provisions.

10h. Certain investment contracts. A contract that is accounted for under paragraph 12 of FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, as amended by Statement 110, is not subject to this Statement. This exception applies only to the party that accounts for the contract under Statement 35 or Statement 110.

10h.02 FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans (Statement 35), and FASB Statement No. 110, Reporting by Defined Benefit Pension Plans of Investment Contracts (Statement 110) (ASC Topic 960, Plan Accounting - Defined Benefit Pension Plans), requires a defined benefit plan to report insurance contracts in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA (i.e., either at fair value or contract value).

10h.03 A potential conflict with the Standard arises because for some insurance contracts with embedded derivatives, such as purchased put options on certain referenced securities, the Standard requires that the contract be bifurcated and the embedded derivative be accounted for separately.

10h.04 Due to the limited scope of those identified conflicts, the Board decided to add paragraph 10(h) of the Standard (ASC paragraph 815-10-15-68) to resolve the potential conflicts so that a contract that is accounted for under either paragraph 4 of Statement 110 or paragraph 12 of Statement 35, as amended by Statement 110 (ASC paragraph 960-325-35-3), is not subject to the
The scope exception in paragraph 10(h) (ASC paragraph 815-10-15-68) does not apply to the contract’s counterparty that does not account for the contract under Statement 35 or Statement 110 (ASC Topic 960).

**Loan Commitments**

10i.01 Paragraph 10(i) of the Standard (ASC paragraph 815-10-15-69) establishes exceptions from its requirements for the holder of a loan origination commitment and the issuer of certain loan origination commitments.

10i. **Loan commitments.** The holder of any commitment to originate a loan (that is the potential borrower) is not subject to the requirements of this Statement. Issuers of commitments to originate mortgage loans that will be held for investment purposes as discussed in paragraphs 21 and 25 of Statement 65 are not subject to this Statement. In addition issuers of loan commitments to originate other types of loans (that is other than mortgage loans) are not subject to the requirements of this Statement.

10i.02 Loan origination commitments are legally binding commitments to extend credit to a counterparty under certain pre-specified terms and conditions. They typically have fixed expiration dates and may be either fixed-rate or variable-rate. Loan origination commitments can either be revolving or non-revolving and can be distributed through syndication arrangements, in which one entity acts as a lead and an agent on behalf of other entities that will each extend credit to a single borrower. Loan origination commitments also generally permit the lender to terminate the arrangement under the terms of the covenants negotiated under the agreement.

10i.03 Loan origination commitments include, but are not limited to, one-to-four-family residential mortgage loan commitments; loan commitments for multifamily properties, commercial real estate, construction, and land development; commercial loan commitments (i.e., commitments to extend credit to commercial or industrial entities); credit card lines (i.e., commitments to extend credit to individuals or commercial or industrial entities through credit cards); home equity lines (i.e., commitments to extend credit under revolving, open-end lines of...
credit secured by one-to-four-family residential property); manufactured housing; automobile financing; and sub-prime lending.

10i.04 The Board noted that requiring an evaluation of whether a particular loan origination commitment meets the definition of a derivative under the Standard would impose a significant operational burden on entities. In addition, the Board noted that there would be significant disagreement among various entities that would result in diversity in practice when deciding whether the loan origination commitment met the conditions required in paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)) for net settlement. As a result and as more fully discussed below, the Board decided to prescribe the accounting for the holder and the issuer of all loan origination commitments.

HOLDERS OF LOAN COMMITMENTS

10i.05 As stated in paragraph 10(i) of the Standard (ASC paragraph 815-10-15-69), the holder of any loan origination commitment (i.e., the potential borrower in the arrangement) is not subject to the requirements of the Standard, even if that loan commitment meets the definition of a derivative.

ISSUERS OF LOAN COMMITMENTS

10i.06 Regardless of whether a loan origination commitment actually meets the definition of a derivative, the issuer (i.e., the potential lender in the arrangement) of a loan commitment that relates to the origination of a mortgage loan that will be held for sale, as discussed in FASB Statement No. 65, Accounting for Mortgage Banking Activities, as amended (Statement 65) (ASC Topic 948, Financial Services - Mortgage Banking), must account for that loan commitment as a derivative. That is, if a loan commitment relates to the origination of a mortgage loan that will be held for sale, the loan commitment must be accounted for as a derivative by the issuer. This is the only automatic inclusion of an instrument as a derivative in the Standard. This is the case regardless of the existence of a material adverse change clause that may be invoked by the issuer to terminate the agreement based either on a subjective evaluation that a material adverse change has occurred or criteria that are objectively determinable, as long as the loan commitment is a legally binding contract.

10i.07 The issuer (i.e., the potential lender in the arrangement) of a loan commitment that relates to the origination of a mortgage loan that will be held for investment purposes, as discussed in Statement 65 (ASC Topic 948), is not subject to the requirements of the Standard, even if that loan commitment meets the definition of a derivative.

10i.08 The issuer (i.e., the potential lender in the arrangement) of a loan commitment that relates to the origination of a loan that is other than a mortgage loan is not subject to the requirements of the Standard, even if that loan commitment meets the definition of a derivative.

10i.09 The accounting by the issuer of loan commitments as prescribed by the Standard recognizes that a distinct accounting model exists in Statement 65 (ASC Topic 948) for mortgage loans originated to be held for sale. In addition, the ability to convert the underlying loan to cash is inherent in the business activity of entering into loan commitments to originate mortgage loans to be held for sale. However, loan commitments that relate to the origination of mortgage loans that will be held for investment, as discussed in paragraph 25 of Statement 65 (ASC paragraph
948-310-25-4), must continue to be accounted for in accordance with the requirements of that paragraph. That is, paragraph 25 of Statement 65 (ASC paragraph 948-310-25-4) requires that fees and costs associated with originating or committing to originate loans for investment should be accounted for as prescribed in FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (Statement 91) (ASC Subtopic 310-20, Receivables - Nonrefundable Fees and Other Costs). Further, commitments that relate to the origination of other types of loans (i.e., other than mortgage loans) that are not within the scope of Statement 65 (ASC Topic 948) must also continue to be accounted for in accordance with the guidance in Statement 91 (ASC Subtopic 310-20). For example, commitments to extend credit to commercial or industrial entities that will not give rise to mortgage loans must be accounted for in accordance with the guidance in Statement 91 (ASC Subtopic 310-20). In those cases, the Standard does not override the existing accounting requirements of Statement 91 (ASC Subtopic 310-20). (See DIG Issue C13 for further reference.)

10i.10 It is important to note that paragraphs 6 and 10(i) of the Standard (ASC paragraph 815-10-15-69 and 815-10-15-83) do not address the accounting by a purchaser or seller of loans under a loan commitment (e.g., a forward commitment to purchase loans or a forward commitment to sell loans). A purchaser or seller of loans under such a commitment needs to determine whether the commitment meets the definition of a derivative as described in paragraph 6 of the Standard (ASC paragraph 815-10-15-83). If the commitment does meet the definition of a derivative, it will require derivative accounting with changes in fair value recorded through earnings. Footnote 8 to paragraph 21(a) of the Standard implies that a mortgage banker’s forward sale commitments (and, consequently, forward purchase commitments) are derivatives that lock in prices at which the mortgage loans will be sold to investors. However, such commitments may qualify as hedging instruments in cash flow hedges of the forecasted sales of mortgage loans.

Certain Registration Payment Arrangements

10j.01 Paragraph 10(j) of the Standard (ASC paragraph 815-10-15-82) establishes exceptions from its requirements for the issuer of, and the counterparty to, certain registration payment arrangements.

10j. Registration Payment Arrangements. Registration payment arrangements within the scope of FSP EITF 00-19-2, “Accounting for Registration Payment Arrangements,” are not subject to the requirements of this Statement. The exception in this subparagraph applies to both (a) the issuer that accounts for the arrangement pursuant to FSP EITF 00-19-2 and (b) the counterparty. From the issuer’s perspective, registration payment arrangements that are within the scope of FSP EITF 00-19-2 (ASC Subtopic 825-20) are exempt from the Standard under paragraph 10(j) (ASC paragraph 815-10-15-82). These registration payment arrangements are also exempt from the perspective of the counterparty. For purposes of applying FSP EITF 00-19-2 (ASC Subtopic 825-20), a registration payment arrangement is an arrangement that specifies that the issuer will endeavor (1) to file a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the
SEC (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period, and/or (2) to maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity). An arrangement that requires the issuer to maintain and/or obtain listed status on a stock exchange, instead of, or in addition to, maintaining and/or obtaining an effective registration statement is also within the scope as long as all the characteristics called for by the FSP (ASC Subtopic 825-20) are met. FSP EITF 00-19-2 (ASC Subtopic 825-20) applies to a registration payment arrangement regardless of whether it is issued as a separate agreement or included as a provision of a financial instrument or other agreement. A company that fails to meet the requirement of a registration payment arrangement within the scope of FSP EITF 00-19-2 (ASC Subtopic 825-20) would be required to transfer consideration to the investor until the registration statement is declared effective or its effectiveness is maintained for the prescribed period. The consideration to be transferred to the investor is often calculated as a percentage of the proceeds from the issuance of the security and may be in the form of cash, equity shares, or as an adjustment to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument). FSP EITF 00-19-2 (ASC Subtopic 825-20) was issued to address diversity in practice that existed in accounting for registration payment arrangements. Some companies treated these arrangements as freestanding derivatives, while others considered them when analyzing the related financial instrument or instruments in accordance with EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock.”(ASC Subtopic 815-40, Derivatives and Hedging - Contracts in Entity's Own Equity). FSP EITF 00-19-2 (ASC Subtopic 825-20) cannot be applied by analogy to the accounting for contracts that are not registration payment arrangements within its scope. For example, a building contract that includes a provision requiring the contractor to obtain a certificate of occupancy by a certain date or pay a penalty every month until the certificate of occupancy is not within the scope of the FSP.

10j.03 FSP EITF 00-19-2 (ASC Subtopic 825-20) does not apply to registration payment arrangements that determine the amount of consideration to be paid by reference to an observable index or market other than the market for the issuer’s own stock. For example, FSP EITF 00-19-2 (ASC Subtopic 825-20) does not apply if the consideration to be transferred if the issuer is unable to obtain an effective registration statement is determined by reference to the price of a commodity. Additionally, FSP EITF 00-19-2 (ASC Subtopic 825-20) does not apply to arrangements in which the financial instrument or instruments subject to the arrangement are settled when the consideration is transferred, such as a warrant that is contingently puttable if an effective registration statement for the resale of the equity shares that are issuable upon exercise of the warrant is not declared effective by the SEC within a specified grace period. The scope of the FSP (ASC Subtopic 825-20) does not include arrangements whereby consideration that would be transferred to the counterparty is an adjustment to the conversion ratio of a convertible instrument. The FSP (ASC Subtopic 825-20) contemplates that the issuer will use best efforts or commercially reasonable efforts to register shares and thus does not apply to arrangements that obligate the issuer to deliver registered shares upon exercise or conversion of the related security as discussed in paragraphs 14-16 of EITF 00-19 (ASC paragraphs 815-40-25-11 through 25-13, 25-17, and 25-18).

10j.04 FSP EITF 00-19-2 (ASC Subtopic 825-20) sets forth the accounting guidance for issuers of registration payment arrangements (the counterparty to registration payment arrangements...
should account for the arrangements based on the provisions of other applicable GAAP) and requires the contingent obligation in a registration payment arrangement to be separately analyzed under FASB Statement No. 5, Accounting For Contingencies (Statement 5) (ASC Topic 450, Contingencies) and FASB Interpretation 14, Reasonable Estimation of the Amount of a Loss (Interpretation 14) (ASC Subtopic 450-20, Contingencies - Loss Contingencies).

Registration payment arrangements should therefore play no part in determining the initial classification and subsequent accounting for the securities they relate to. If payment under a registration payment arrangement is probable and can be reasonably estimated at the inception of the arrangement, a liability should be recorded. The measurement guidance in Statement 5 (ASC Topic 450) and Interpretation 14 (ASC Subtopic 450-20) should be applied to determine the amount to record. The estimated payment should be recorded, or, if a reasonable estimate of the payment is a range and no amount within the range is a better estimate than any other, an amount representing the low end of the range should be recorded. If the arrangement requires payment in shares, the issuer’s share price at the reporting date should be used to measure the contingent liability under Statement 5 (ASC Topic 450). The remaining proceeds would be allocated to the financial instrument or instruments issued in conjunction with the arrangement based on the provisions of other applicable GAAP. For example, if the securities issued concurrently with the arrangement are a debt instrument and an equity-classified warrant, the proceeds remaining after recognizing and measuring a liability for the registration payment arrangement under Statement 5 (ASC Topic 450) would be allocated on a relative fair-value basis between the debt and the warrant. A registration payment arrangement recognized at issuance is a liability separate and apart from a convertible instrument and therefore reduces the proceeds used to determine the effective conversion price for purposes of assessing whether a beneficial conversion feature exists. If penalty payments become probable and reasonably estimable after the inception of a registration payment arrangement, or if the measurement of the liability recognized at inception is changed in a subsequent period, the difference in the recorded value of the liability should be recognized immediately in earnings.

10j.05 FSP EITF 00-19-2 (ASC Subtopic 825-20) and the paragraph 10(j) (ASC paragraph 815-10-15-82) exception are effective for registration payment arrangements entered into or modified subsequent to December 21, 2006. Arrangements that were entered into before December 21, 2006 become subject to their guidance for fiscal years beginning after December 15, 2006 by recognizing a cumulative-effect adjustment in retained earnings as of the beginning of the year of adoption and interim periods within those fiscal years. Adoption may cause some securities to be reclassified from liabilities to equity. The transition guidance is a modified version of the cumulative-effect-of-adoption approach. The following concepts outline the basic approach to transition:

- Outstanding registration payment arrangements as of the date of adoption should be recognized and measured under Statement 5 (ASC Topic 450) and Interpretation 14 (ASC Topic 450-20) as of that date.
- If the registration payment arrangement was previously accounted for separately from the related financial instrument, the accounting for the related financial instrument should remain unchanged.
- If a financial instrument was originally analyzed in combination with a registration payment arrangement, the company should determine how it would have accounted
for the financial instrument under applicable GAAP at the date the instrument was issued, ignoring the effect of the registration payment arrangement, and should roll forward the revised accounting to the date of adoption. Analyzing financial instruments in combination with a registration payment arrangement could have affected the evaluation of an embedded feature under the issuer’s previous accounting policies (for example, requiring bifurcation of an embedded conversion option along with the registration payment arrangement).

No adjustment should be made to the carrying amounts of other instruments that were originally issued together with an instrument that was analyzed in combination with a registration payment arrangement. For example, the carrying amount of debt that was issued with a detachable warrant that included a registration payment arrangement would not be adjusted based on changes to the warrant resulting from the adoption of FSP EITF 00-19-2 (ASC Subtopic 825-20), because the debt was not analyzed with the registration payment arrangement.

OTHER EXCLUSIONS

11.01 The Standard also excludes from its scope certain additional contracts issued by an entity. These exceptions are discussed in paragraph 11 of the Standard (ASC paragraphs 815-10-15-74 and 15-75) that begins with the following:

11. Notwithstanding the conditions of paragraphs 6-10, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Statement:

11.02 Paragraph 11 of the Standard (ASC paragraph 815-10-15-75) ends with the emphasis that the exceptions generally apply only to the entity issuing the contract and not to the entity holding the contract, as follows:

In contrast, the above exceptions do not apply to the counterparty in those contracts. In addition, a contract that an entity either can or must settle by issuing its own equity instruments but that is indexed in part or in full to something other than its own stock can be a derivative instrument for the issuer under paragraphs 6-10, in which case it would be accounted for as a liability or an asset in accordance with the requirements of this Statement.

11.03 Because the exceptions do not apply to the counterparty to the contracts (except for paragraph 11(c) (ASC paragraph 815-10-15-74(c)), as revised by FASB Statement No. 141 (revised 2007), Business Combinations (Statement 141(R) (ASC Topic 805, Business Combinations)), as discussed in the section entitled "Certain Contracts Related to a Business Combination"), the accounting treatments by the parties to the contract are not symmetrical. Paragraph 11’s (ASC paragraph 815-10-15-74) exceptions also do not apply to a third party that may purchase the contract from one of the initial parties to the contract. Finally, the exceptions do not apply if the contract is indexed in part or in full to something other than an entity’s own stock even if the contract can or must be settled in its own stock.

Contracts Indexed to an Entity’s Own Stock and Classified in Equity

11a.01 Paragraph 11(a) (ASC paragraph 815-10-15-74(a)) excludes certain equity instruments that are issued or held by the reporting entity.
11a. Contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders’ equity in its statement of financial position.

DIG Issues related to this paragraph are B37, C2, C8, and G1. See DIG Issues Index.

11a.02 As noted in paragraph 3(a) of the Standard (ASC paragraph 815-10-10-1(a)), derivative instruments are assets or liabilities. Consequently, contracts issued or held by a reporting entity that are indexed to its own stock and appropriately classified in stockholders’ equity in its statement of financial position are not within the scope of the Standard. The Board explicitly excluded the accounting for such instruments from the scope of the Standard with the addition of paragraph 11(a) (ASC paragraph 815-10-15-74(a)).

11a.03 In order for a contract that is issued or held by the reporting entity to meet the requirements of this exception, the contract must be both:

(1) Indexed to the reporting entity's own stock, and

(2) Classified in stockholders' equity in the reporting entity's statement of financial position.

CONTRACTS ISSUED OR HELD BY THE REPORTING ENTITY

11a.04 The exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)) relates only to contracts issued (i.e., written) or held (i.e., purchased) by the reporting entity. When analyzing an equity-linked financial instrument relative to the paragraph 11(a) (ASC paragraph 815-10-15-74(a)) exception, care must be taken to identify both the entity issuing or holding the instrument and the entity’s stock to which the contract is indexed.

11a.05 For a number of business reasons, an entity may write or purchase contracts that are indexed to, and sometimes settled in, its own stock. Examples of these equity-linked financial instruments include written call options (e.g., warrants), purchased put options, purchased call options, and forward sale contracts. These contracts may be settled using a variety of settlement methods, or the issuing entity or counterparty may have a choice of settlement methods. Three common settlement methods are:

- Physical settlement – the party designated in the contract as the buyer delivers the full stated amount of cash to the seller, and the seller delivers the full stated number of shares to the buyer.
- Net-share settlement – the party with a loss delivers to the party with a gain shares with a current fair value equal to the gain.
- Net-cash settlement – the party with a loss delivers to the party with a gain a cash payment equal to the gain, and no shares are exchanged.

11a.06 The contracts described above may be either freestanding or embedded in another financial instrument. A freestanding instrument is entered into separate and apart from any of the entity’s other financial instruments or equity transactions, or it is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.
CONTRACTS INDEXED TO THE REPORTING ENTITY’S OWN STOCK  

11a.07 Determining whether an instrument (or an embedded feature) is indexed to an entity's own stock is the first part of the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)). If an instrument (or an embedded feature) with the characteristics of a derivative instrument under paragraphs 6–9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128) is indexed to an entity's own stock, it is still necessary to evaluate whether it is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument). The term “indexed to the reporting entity’s own stock” has raised practice issues, including issues relating to the evaluation of:

- Contracts containing contingency provisions that affect the timing of settlement, the settlement amount, or both; and
- Contracts for which the settlement amount is determined by reference to an entity’s own stock and another variable or underlying (e.g., interest rates).

Determining Whether an Instrument is Indexed to an Entity's Own Stock Before Adoption of ASU 2017-11 (ASC Subtopic 815-40)

11a.08 ASC Section 815-40-15 establishes a framework for determining whether an instrument (or embedded feature) is indexed to an entity's own stock and applies to any freestanding financial instrument or embedded feature with all the characteristics of a derivative in paragraphs 6–9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128), for purposes of determining whether that instrument or embedded feature qualifies for the first part of the scope exception in paragraph 11(a) of Statement 133 (ASC paragraph 815-10-15-74(a)). ASC Section 815-40-15 also applies to any freestanding financial instrument that is potentially settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative in paragraphs 6–9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128). ASC Section 815-40-15 does not apply to share-based payment awards within the scope of Statement 123(R) (ASC Topic 718, Compensation--Stock Compensation) for purposes of determining whether instruments are classified as liability awards or equity awards under that Statement (ASC Topic 718).

11a.08a ASC Section 815-40-15 specifies that an entity shall evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock using the following two-step approach:

- Step 1: Evaluate the instrument's contingent exercise provisions, if any.
- Step 2: Evaluate the instrument's settlement provisions.

11a.08b Outstanding instruments within the scope of ASC Section 815-40-15 are always considered issued for accounting purposes, except as discussed in the remainder of this paragraph. In some cases, parties to a business combination exchange contingently exercisable options to purchase equity securities of the other entity, at favorable prices, to encourage successful completion of that combination. If the merger is consummated as proposed, the options expire unexercised. If, however, a specified event occurs that interferes with the planned
business combination, the options become exercisable. Such *lock-up options* are not considered issued for accounting purposes unless and until the options become exercisable.

**Evaluation of Contingent Exercise Provisions (Step 1)**

**11a.08c** Under ASC Section 815-40-15, an exercise contingency would not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on (a) an observable market, other than the market for the issuer's stock (if applicable), or (b) an observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer, EBITDA (earnings before interest, taxes, depreciation, and amortization) of the issuer, net income of the issuer, or total equity of the issuer). If the evaluation of Step 1 does not preclude an instrument from being considered indexed to the entity's own stock, the analysis would proceed to Step 2.

**11a.08d** For purposes of applying the guidance in ASC Section 815-40-15, an *exercise contingency* is a provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event. Examples of exercise contingencies include provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable. If an instrument's strike price or the number of shares used to calculate the settlement amount would be adjusted upon the occurrence of an exercise contingency, the exercise contingency would be evaluated under Step 1 and the potential adjustment to the instrument's settlement amount would be evaluated under Step 2.

**Evaluation of Settlement Provisions (Step 2)**

**11a.08e** An instrument (or embedded feature) would be considered indexed to an entity's own stock if its settlement amount will equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount or a fixed amount of a debt instrument issued by the entity. For example, a written call option on the entity's equity shares that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity would be considered indexed to the entity's own stock. An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. If the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) would still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a *fixed-for-fixed* forward or option on equity shares.

**11a.08f** A fixed-for-fixed forward or option on equity shares has a settlement amount that is equal to the difference between the price of a fixed number of equity shares and a fixed strike price. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's stock price and additional variables, including the strike price of the instrument, term of the instrument, expected dividends or other dilutive activities, stock borrow cost, interest rates, stock price volatility, the entity's credit spread, and the ability to maintain a standard hedge position in the underlying shares. Determinations and adjustments related to the settlement of these instruments would be evaluated under the guidance set forth in ASC 815-40-15.
amount (including determining the ability to maintain a standard hedge position) must be commercially reasonable. An instrument (or embedded feature) would not be considered indexed to the entity's own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares. If an instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares, or if the instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed above in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares, the instrument (or embedded feature) would not be considered indexed to the entity's own stock.

11a.08g Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For example, the Black-Scholes-Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs of a fixed-for-fixed option on equity shares include adjustments to neutralize the effects of events that can cause stock price discontinuities. For example, a merger announcement may cause an immediate jump (up or down) in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in (a) the fair value of an equity-linked instrument and (b) the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a merger announcement or similar event do not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity's own stock. Such provisions are contained in the International Swaps and Derivatives Association's master agreements. Consequently, they are incorporated into the terms of many equity-linked financial instruments that are currently outstanding in the marketplace. It should be noted that such terms are intended to adjust for the breakage between the gain or loss on an equity derivative contract and the offsetting gain or loss on a hypothetical offsetting hedge position that would result from an event that causes a significant stock price discontinuity. They are not intended to compensate for a counterparty's actual hedging losses.

11a.08h Some equity-linked financial instruments contain provisions that provide an entity with the ability to unilaterally modify the terms of the instrument at any time, if such modification benefits the counterparty. For example, the terms of a convertible debt instrument may explicitly permit the issuer to reduce the conversion price at any time to induce conversion of the instrument. For purposes of applying Step 2, such provisions do not affect the determination of whether an instrument (or embedded feature) is considered indexed to an entity's own stock.

Evaluation of Settlement Provisions (Step 2) When the Strike Price of an Equity-Linked Financial Instrument Is Denominated In a Foreign Currency

11a.08i The issuer of an equity-linked financial instrument is exposed to changes in currency exchange rates if the instrument's strike price is denominated in a currency other than the functional currency of the issuer. ASC paragraph 815-40-15-71 clarifies that an equity-linked financial instrument (or embedded feature) would not be considered indexed to the entity's own...
stock if the strike price is denominated in a currency other than the issuer's functional currency (including a conversion option embedded in a convertible debt instrument that is denominated in a currency other than the issuer's functional currency). Determining whether an equity-linked financial instrument is indexed to an entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade. Thus, if an entity with the U.S. dollar as its functional currency writes a call option on its own equity shares with a strike price denominated in Canadian dollars, the option is not considered indexed to the entity's own stock. On the other hand, if an entity with the U.S. dollar as its functional currency writes a call option on its own stock that is traded on the London Stock Exchange, the option would not be precluded from being considered indexed to the entity's own stock, if the strike price of the option is denominated in U.S. dollars.

**Market-Based Employee Stock Option Valuation Instruments**

11a.08j Some entities have issued equity-linked financial instruments to investors for purposes of establishing a market-based measure of the grant-date fair value of a grant of employee stock options. Under the terms of a market-based employee stock option valuation instrument, the issuer is typically obligated to make variable quarterly payments to investors that are a function of the net intrinsic value received by a pool of the issuer's employees, based on actual stock option exercises by those employees each period. Those market-based employee stock option valuation instruments are not within the scope of Statement 123(R) (ASC Topic 718) themselves, so the guidance in ASC Section 815-40-15 applies for purposes of determining whether such instruments are considered indexed to an entity's own stock.

11a.08k The settlement amount of market-based employee stock option valuation instruments will not equal the difference between the fair value of a fixed number of the issuer's equity shares and a fixed strike price. Those instruments provide for variable quarterly payments to investors that are based on actual employee stock option exercises for the period. Because a variable that affects the settlement amount is employee stock option exercise behavior, which is not an input to the fair value of a fixed-for-fixed option or forward contract on equity shares, the instrument is not considered indexed to the entity's own stock. Therefore, those instruments do not qualify for the scope exception in paragraph 11a of the Standard (ASC paragraph 815-10-15-74(a)), regardless of whether the issuer has the ability to settle its obligations under the contract by delivering a variable number of its own equity shares each period. Such instruments have underlyings (the entity's share price and employee option exercises) and a notional amount (the number of underlying employee stock options), they requires an initial net investment that is smaller than would be required to invest in the underlying shares directly, and they require periodic net settlements. Consequently, the market-based employee stock option valuation instruments described in this section should be accounted for as derivative liabilities under the Standard.

**Example 2.19: Determining Whether Instruments are Indexed to an Entity's Own Stock - Application of ASC Section 815-40-15 Before Adoption of ASU 2017-11**

**Instrument 1:** ABC Corp. issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms; however, they only become exercisable after ABC accumulates $100 million in sales to third parties.
Analysis under ASC Section 815-40-15: For ABC, those warrants are considered to be indexed to its own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) based on the following evaluation:

Step 1: The exercise contingency (that is, the accumulation of $100 million in sales to third parties) is an observable index. However, it can only be calculated or measured by reference to ABC's sales, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2: Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share).

Instrument 2: ABC issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that if there is an announcement of a merger involving ABC, the strike price of the warrants will be adjusted to offset the effect of the merger announcement on the net change in the fair value of (a) the warrants and (b) an offsetting hedge position in the underlying shares. The strike price adjustment must be determined using commercially reasonable means based on an assumption that the counterparty has entered into a hedge position in the underlying shares to offset the share price exposure from the warrants. That strike price adjustment is not affected by the counterparty's actual hedging position (e.g., the strike price adjustment does not differ in circumstances when the counterparty is actually over-hedged, under-hedged, or un-hedged).

Analysis under ASC Section 815-40-15: For ABC, those warrants are considered to be indexed to its own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share), unless there is a merger announcement. If there is a merger announcement, the strike price would be adjusted to offset the effect of the merger announcement on the net change in the fair value of the warrants and an offsetting hedge position in the underlying shares. In that circumstance, the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed option on equity shares. Refer to paragraph 11a.08g of this Section for additional discussion.

Instrument 3: ABC issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that (a) if the entity sells shares of its common stock for an amount less than $10 per share, the strike price of the warrants is reduced to equal the issuance price of those shares, or (b) if the entity issues an equity-linked financial instrument with a strike price below $10 per share, the strike price of the warrants is reduced to equal the strike price of the newly issued equity-linked financial instrument. Those types of adjustment provisions are sometimes referred to in practice as *down round features*.
Analysis under ASC Section 815-40-15: For ABC, those warrants are not considered to be indexed to its own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. The strike price would be adjusted if ABC (a) sells shares of its common stock for an amount less than $10 per share or (b) issues an equity-linked financial instrument with a strike price below $10 per share. Consequently, the settlement amount of the warrants can be affected by (a) future equity offerings undertaken by ABC at the then-current market price of the related shares or (b) the contractual terms of other equity-linked financial instruments issued in a later period. The occurrence of a sale of common stock by the entity at market is not an input to the fair value of a fixed-for-fixed option on equity shares. Similarly, the occurrence of a sale of an equity-linked financial instrument is not an input to the fair value of a fixed-for-fixed option on equity shares, if the transaction is priced at market.

Instrument 4: ABC enters into a forward contract to sell a variable number of its common shares in one year for $1,000. If ABC's stock price is equal to or less than $10 at maturity, ABC will issue 100 shares of its common stock to the counterparty. If ABC's stock price is greater than $10 but equal to or less than $12 at maturity, ABC will issue a variable number of its common shares worth $1,000. Finally, if the share price is greater than $12 at maturity, ABC will issue 83.33 shares of its common stock.

Analysis under ASC Section 815-40-15: For ABC, the forward contract is considered indexed to its own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price ($1,000). Although the strike price to be received at settlement is fixed, the number of shares to be issued to the counterparty varies based on the entity's stock price on the settlement date. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed forward contract on equity shares, the instrument is considered indexed to the entity's own stock.

Instrument 5: ABC enters into a forward contract to sell 100 shares of its common stock for $10 per share in one year. Under the terms of the forward contract, if ABC (a) distributes a stock dividend or ordinary cash dividend, (b) executes a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend, (c) issues shares for an amount below the then-current market price, or (d) repurchases shares for an amount above the then-current market price, the strike price of the forward contract would be adjusted to offset the resulting dilution (except for issuances and repurchases that occur upon settlement of outstanding option or forward contracts on equity shares). [Note: This term adjusts for the dilution to the forward contract counterparty resulting from the occurrence of specified dilutive events. The adjustment to the strike price of the forward contract is based on a mathematical calculation that determines the direct effect that the occurrence of such dilutive events should
have on the price of the underlying shares; it does not adjust for the actual change in the market price of the underlying shares upon the occurrence of those events, which may increase or decrease for other reasons.]

**Analysis under ASC Section 815-40-15:** For ABC, the forward contract is considered to be indexed to its own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) based on the following evaluation:

**Step 1:** The instrument does not contain an exercise contingency. Proceed to Step 2.

**Step 2:** The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and $1,000 ($10 per share) are upon the (a) distribution of a stock dividend or ordinary cash dividend, (b) execution of a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend, (c) issuance of shares for an amount below the then-current market price, or (d) repurchase of shares for an amount above the then-current market price. An implicit assumption in standard pricing models for equity-linked financial instruments is that such events will not occur (or that the strike price of the instrument will be adjusted to offset the dilution caused by such events). Therefore, the only variables that could affect the settlement amount in this example would be inputs to the fair value of a fixed-for-fixed forward contract on equity shares.

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**Determining Whether an Instrument is Indexed to an Entity’s Own Stock After Adoption of ASU 2017-11 (ASC Subtopic 815-40)**

11a.09 In July 2017, the FASB issued ASU No. 2017-11 Earnings Per Share (ASC Topic 260); Distinguishing Liabilities from Equity (ASC Topic 480); Derivatives and Hedging (ASC Topic 815): (Part I) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception (ASU 2017-11) (ASC Subtopics 260 and 505, ASC paragraphs 815-10-15-75A, 815-40-15D, 40-55-33 to 40-55-3A) to address the accounting for certain financial instruments that contain down round features. Under Part I of ASU 2017-11, for purposes of evaluating whether a financial instrument meets the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)), an entity excludes any down round feature from its consideration of whether the instrument is indexed to the entity’s own stock. As a result, more instruments may meet the requirements in ASC Section 815-40-15 to be considered indexed to an entity's own stock.

11a.09a For public business entities, Part I of ASU 2017-11 is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. For all other entities, it is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted for all entities, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

11a.09b Part I of ASU 2017-11 can be adopted by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the first fiscal year and interim period(s) in which it is effective. The cumulative effect of the change should be recognized as an
adjustment of the opening balance of retained earnings in the fiscal year and interim period of adoption. Alternatively, it can be adopted retrospectively to outstanding financial instruments with a down round feature for each prior reporting period presented.

11a.09c ASC Section 815-40-15, as amended by ASU 2017-11, establishes a framework for determining whether an instrument (or embedded feature) is indexed to an entity's own stock and applies to any freestanding financial instrument or embedded feature with all the characteristics of a derivative in paragraphs 6–9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128), for purposes of determining whether that instrument or embedded feature qualifies for the first part of the scope exception in paragraph 11(a) of Statement 133 (ASC paragraph 815-10-15-74(a)). ASC Section 815-40-15 also applies to any freestanding financial instrument that is potentially settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative in paragraphs 6–9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128). ASC Section 815-40-15 does not apply to share-based payment awards within the scope of Statement 123(R) (ASC Topic 718, Compensation--Stock Compensation) for purposes of determining whether instruments are classified as liability awards or equity awards under that Statement (ASC Topic 718).

11a.09d ASC Section 815-40-15 specifies that an entity shall evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock using the following two-step approach:

- Step 1: Evaluate the instrument's contingent exercise provisions, if any.
- Step 2: Evaluate the instrument's settlement provisions.

11a.09e Outstanding instruments within the scope of ASC Section 815-40-15 are always considered issued for accounting purposes, except as discussed in the remainder of this paragraph. In some cases, parties to a business combination exchange contingently exercisable options to purchase equity securities of the other entity, at favorable prices, to encourage successful completion of that combination. If the merger is consummated as proposed, the options expire unexercised. If, however, a specified event occurs that interferes with the planned business combination, the options become exercisable. Such lock-up options are not considered issued for accounting purposes unless and until the options become exercisable.

Evaluation of Contingent Exercise Provisions (Step 1)

11a.10 Under ASC Section 815-40-15, an exercise contingency would not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on (a) an observable market, other than the market for the issuer's stock (if applicable), or (b) an observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer, EBITDA (earnings before interest, taxes, depreciation, and amortization) of the issuer, net income of the issuer, or total equity of the issuer). If the evaluation of Step 1 does not preclude an instrument from being considered indexed to the entity's own stock, the analysis would proceed to Step 2.

11a.10a For purposes of applying the guidance in ASC Section 815-40-15, an exercise contingency is a provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying, including
the occurrence (or nonoccurrence) of a specified event. Examples of exercise contingencies include provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable. If an instrument's strike price or the number of shares used to calculate the settlement amount would be adjusted upon the occurrence of an exercise contingency, the exercise contingency would be evaluated under Step 1 and the potential adjustment to the instrument's settlement amount would be evaluated under Step 2.

**Evaluation of Settlement Provisions (Step 2)**

11a.11 An instrument (or embedded feature) would be considered indexed to an entity's own stock if its settlement amount will equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount or a fixed amount of a debt instrument issued by the entity. For example, a written call option on the entity's equity shares that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity would be considered indexed to the entity's own stock. An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. If the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) would still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares.

11a.11a A fixed-for-fixed forward or option on equity shares has a settlement amount that is equal to the difference between the price of a fixed number of equity shares and a fixed strike price. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's stock price and additional variables, including the strike price of the instrument, term of the instrument, expected dividends or other dilutive activities, stock borrow cost, interest rates, stock price volatility, the entity's credit spread, and the ability to maintain a standard hedge position in the underlying shares. Determinations and adjustments related to the settlement amount (including determining the ability to maintain a standard hedge position) must be commercially reasonable. An instrument (or embedded feature) would not be considered indexed to the entity's own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares. If an instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares, or if the instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed above in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares, the instrument (or embedded feature) would not be considered indexed to the entity's own stock.

11a.11b Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For example, the Black-Scholes-Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs of a fixed-for-fixed option on equity shares include adjustments to neutralize the effects of events that can cause stock price
discontinuities. For example, a merger announcement may cause an immediate jump (up or down) in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in (a) the fair value of an equity-linked instrument and (b) the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a merger announcement or similar event do not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity's own stock. Such provisions are contained in the International Swaps and Derivatives Association's master agreements. Consequently, they are incorporated into the terms of many equity-linked financial instruments that are currently outstanding in the marketplace. It should be noted that such terms are intended to adjust for the breakage between the gain or loss on an equity derivative contract and the offsetting gain or loss on a hypothetical offsetting hedge position that would result from an event that causes a significant stock price discontinuity. They are not intended to compensate for a counterparty's actual hedging losses.

11a.11c Some equity-linked financial instruments contain provisions that provide an entity with the ability to unilaterally modify the terms of the instrument at any time, if such modification benefits the counterparty. For example, the terms of a convertible debt instrument may explicitly permit the issuer to reduce the conversion price at any time to induce conversion of the instrument. For purposes of applying Step 2, such provisions do not affect the determination of whether an instrument (or embedded feature) is considered indexed to an entity's own stock.

Evaluation of Settlement Provisions (Step 2) When the Equity-Linked Financial Instrument Contains a Down Round Feature

11a.12 ASU 2017-11 (ASC Master Glossary) defines a down round feature as a feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.

11a.12a ASU 2017-11 (ASC Master Glossary) also notes that a down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard anti-dilution provision is not considered a down round feature.

11a.12b ASC paragraph 815-40-15-5D clarifies that when classifying an instrument with a down round feature, the feature is excluded from the consideration of whether the instrument is indexed to the entity's own stock. In effect, the down round feature is ignored when applying the provisions of ASC Section 815-40-15.

Evaluation of Settlement Provisions (Step 2) When the Strike Price of an Equity-Linked Financial Instrument Is Denominated In a Foreign Currency

11a.12c The issuer of an equity-linked financial instrument is exposed to changes in currency exchange rates if the instrument's strike price is denominated in a currency other than the
functional currency of the issuer. ASC paragraph 815-40-15-7I clarifies that an equity-linked financial instrument (or embedded feature) would not be considered indexed to the entity's own stock if the strike price is denominated in a currency other than the issuer's functional currency (including a conversion option embedded in a convertible debt instrument that is denominated in a currency other than the issuer's functional currency). Determining whether an equity-linked financial instrument is indexed to an entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade. Thus, if an entity with the U.S. dollar as its functional currency writes a call option on its own equity shares with a strike price denominated in Canadian dollars, the option is not considered indexed to the entity's own stock. On the other hand, if an entity with the U.S. dollar as its functional currency writes a call option on its own stock that is traded on the London Stock Exchange, the option would not be precluded from being considered indexed to the entity's own stock, if the strike price of the option is denominated in U.S. dollars.

Market-Based Employee Stock Option Valuation Instruments

11a.12d Some entities have issued equity-linked financial instruments to investors for purposes of establishing a market-based measure of the grant-date fair value of a grant of employee stock options. Under the terms of a market-based employee stock option valuation instrument, the issuer is typically obligated to make variable quarterly payments to investors that are a function of the net intrinsic value received by a pool of the issuer's employees, based on actual stock option exercises by those employees each period. Those market-based employee stock option valuation instruments are not within the scope of Statement 123(R) (ASC Topic 718) themselves, so the guidance in ASC Section 815-40-15 applies for purposes of determining whether such instruments are considered indexed to an entity's own stock.

11a.12e The settlement amount of market-based employee stock option valuation instruments will not equal the difference between the fair value of a fixed number of the issuer's equity shares and a fixed strike price. Those instruments provide for variable quarterly payments to investors that are based on actual employee stock option exercises for the period. Because a variable that affects the settlement amount is employee stock option exercise behavior, which is not an input to the fair value of a fixed-for-fixed option or forward contract on equity shares, the instrument is not considered indexed to the entity's own stock. Therefore, those instruments do not qualify for the scope exception in paragraph 11a of the Standard (ASC paragraph 815-10-15-74(a)), regardless of whether the issuer has the ability to settle its obligations under the contract by delivering a variable number of its own equity shares each period. Such instruments have underlyings (the entity's share price and employee option exercises) and a notional amount (the number of underlying employee stock options), they requires an initial net investment that is smaller than would be required to invest in the underlying shares directly, and they require periodic net settlements. Consequently, the market-based employee stock option valuation instruments described in this section should be accounted for as derivative liabilities under the Standard.
Example 2.20: Determining Whether Instruments are Indexed to an Entity's Own Stock - Application of ASC Section 815-40-15 After Adoption of ASU 2017-11

Instrument 1: ABC Corp. issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms; however, they only become exercisable after ABC accumulates $100 million in sales to third parties.

Analysis under ASC Section 815-40-15: For ABC, those warrants are considered to be indexed to its own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) based on the following evaluation:

Step 1: The exercise contingency (that is, the accumulation of $100 million in sales to third parties) is an observable index. However, it can only be calculated or measured by reference to ABC's sales, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2: Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share).

Instrument 2: ABC issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that if there is an announcement of a merger involving ABC, the strike price of the warrants will be adjusted to offset the effect of the merger announcement on the net change in the fair value of (a) the warrants and (b) an offsetting hedge position in the underlying shares. The strike price adjustment must be determined using commercially reasonable means based on an assumption that the counterparty has entered into a hedge position in the underlying shares to offset the share price exposure from the warrants. That strike price adjustment is not affected by the counterparty's actual hedging position (e.g., the strike price adjustment does not differ in circumstances when the counterparty is actually over-hedged, under-hedged, or un-hedged).

Analysis under ASC Section 815-40-15: For ABC, those warrants are considered to be indexed to its own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share), unless there is a merger announcement. If there is a merger announcement, the strike price would be adjusted to offset the effect of the merger announcement on the net change in the fair value of the warrants and an offsetting hedge position in the underlying shares. In that circumstance, the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed option on equity shares. Refer to paragraph 11a.11b of this Section for additional discussion.

Instrument 3: ABC issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms and are exercisable at any time.
However, the terms of the warrants specify that (a) if the entity sells shares of its common stock for an amount less than $10 per share, the strike price of the warrants is reduced to equal the issuance price of those shares, or (b) if the entity issues an equity-linked financial instrument with a strike price below $10 per share, the strike price of the warrants is reduced to equal the strike price of the newly issued equity-linked financial instrument. Those types of adjustment provisions are sometimes referred to in practice as down round features.

**Analysis under ASC Section 815-40-15:** For ABC, those warrants are considered to be indexed to its own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: While the settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price because the strike price would be adjusted if ABC (a) sells shares of its common stock for an amount less than $10 per share or (b) issues an equity-linked financial instrument with a strike price below $10 per share (i.e., the occurrence of a sale of common stock by the entity at market is not an input to the fair value of a fixed-for-fixed option on equity shares and the occurrence of a sale of an equity-linked financial instrument is not an input to the fair value of a fixed-for-fixed option on equity shares, if the transaction is priced at market), ASC paragraph 815-40-15-5D indicates that when classifying an instrument with a down round feature, the feature is excluded from the consideration of whether the instrument is indexed to the entity's own stock. Accordingly, the instrument is considered indexed to the entity's own stock since it does not contain any other features to be assessed under Step 2.

**Instrument 4:** ABC enters into a forward contract to sell a variable number of its common shares in one year for $1,000. If ABC's stock price is equal to or less than $10 at maturity, ABC will issue 100 shares of its common stock to the counterparty. If ABC's stock price is greater than $10 but equal to or less than $12 at maturity, ABC will issue a variable number of its common shares worth $1,000. Finally, if the share price is greater than $12 at maturity, ABC will issue 83.33 shares of its common stock.

**Analysis under ASC Section 815-40-15:** For ABC, the forward contract is considered indexed to its own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price ($1,000). Although the strike price to be received at settlement is fixed, the number of shares to be issued to the counterparty varies based on the entity's stock price on the settlement date. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed forward contract on equity shares, the instrument is considered indexed to the entity's own stock.

**Instrument 5:** ABC enters into a forward contract to sell 100 shares of its common stock for $10 per share in one year. Under the terms of the forward contract, if ABC (a) distributes a stock dividend or ordinary cash dividend, (b) executes a stock split, spinoff, rights offering, or
recapitalization through a large, nonrecurring cash dividend, (c) issues shares for an amount below the then-current market price, or (d) repurchases shares for an amount above the then-current market price, the strike price of the forward contract would be adjusted to offset the resulting dilution (except for issuances and repurchases that occur upon settlement of outstanding option or forward contracts on equity shares). [Note: This term adjusts for the dilution to the forward contract counterparty resulting from the occurrence of specified dilutive events. The adjustment to the strike price of the forward contract is based on a mathematical calculation that determines the direct effect that the occurrence of such dilutive events should have on the price of the underlying shares; it does not adjust for the actual change in the market price of the underlying shares upon the occurrence of those events, which may increase or decrease for other reasons.]

Analysis under ASC Section 815-40-15: For ABC, the forward contract is considered to be indexed to its own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and $1,000 ($10 per share) are upon the (a) distribution of a stock dividend or ordinary cash dividend, (b) execution of a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend, (c) issuance of shares for an amount below the then-current market price, or (d) repurchase of shares for an amount above the then-current market price. An implicit assumption in standard pricing models for equity-linked financial instruments is that such events will not occur (or that the strike price of the instrument will be adjusted to offset the dilution caused by such events). Therefore, the only variables that could affect the settlement amount in this example would be inputs to the fair value of a fixed-for-fixed forward contract on equity shares.


11a.13 Once an entity has concluded that an instrument is indexed to its own (paragraph 11(a)(1) stock (ASC paragraph 815-10-15-74(a))), it must determine whether that instrument is classified in stockholders' equity in its statement of financial position (paragraph 11(a)(2) (ASC paragraph 815-10-15-74(a))) before concluding whether the requirements of the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) have been met. The accounting for instruments held or issued by and indexed to an entity’s own stock is addressed in FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (Statement 150) (ASC Topic 480, Distinguishing Liabilities from Equity), and in EITF 00-19 (ASC Subtopic 815-40). In order to qualify for the exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)), the contract must not be within the scope of Statement 150 (ASC Topic 480) if the instrument is considered a freestanding financial instrument. In addition, the contract must be classified in equity if the instrument is a freestanding financial instrument, and if it is an embedded instrument, that embedded instrument must be classified in equity if it were freestanding.
11a.14 Statement 150 (ASC Topic 480) requires a freestanding financial instrument within its scope to be classified as a liability (or, in some cases, an asset), and accordingly, for those instruments the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) does not apply. Freestanding financial instruments such as written put options and forward purchase contracts on an entity’s own shares (regardless of the settlement options) are within the scope of Statement 150 (ASC Topic 480) and are not eligible for the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)). Further, if such freestanding financial instruments also meet the definition of a derivative in paragraphs 6 - 9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128), the instrument must be accounted for as a derivative unless the instrument meets one of the Standard's scope exceptions (e.g., in paragraph 10 (ASC paragraphs 815-10-15-13 through 15-82) or paragraph 11(d) (ASC paragraph 815-10-15-74(d))). If such freestanding financial instruments are not accounted for under the Standard, the instrument must be accounted for at fair value with changes in fair value reflected currently in earnings, unless Statement 150 (ASC Topic 480) the Standard. If a freestanding financial instrument is indexed to an entity's own stock and is not within the scope of Statement 150 (ASC Topic 480) then EITF 00-19 (ASC Subtopic 815-40) must be applied to determine whether the instrument is classified in stockholders' equity.

11a.15 The EITF addressed the classification of freestanding financial instruments within EITF 00-19 (ASC Subtopic 815-40) and concluded that freestanding financial instruments that are indexed to an entity’s own stock can result in asset, liability, or equity classification depending on the terms of the contract. To qualify for the exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)), an entity with either a freestanding financial instrument that is not within the scope of Statement 150 (ASC Topic 480) (e.g., a freestanding purchased call option on an entity’s own shares) or an embedded financial instrument (e.g., the embedded written put option within a share of the entity’s common stock that is puttable to the entity by the holder by its contractual terms) must analyze the contract under the provisions in EITF 00-19 (ASC Subtopic 815-40) to determine whether the instrument should be classified in equity (or should be classified in equity if the embedded instrument were freestanding). If the contract meets the criteria in EITF 00-19 (ASC Subtopic 815-40) for classification as either temporary or permanent equity, the contract is eligible to meet the paragraph 11(a) (ASC paragraph 815-10-15-74(a)) scope exclusion. If it does not, the contract is required to be measured at fair value with changes in fair value reported currently in earnings. The accounting for contracts classified as an asset or liability pursuant to EITF 00-19 (ASC Subtopic 815-40) is the same as would be required for a derivative under the Standard, except they cannot be used as hedging instruments.

11a.16 It should be noted that the U.S. Securities and Exchange Commission (SEC)’s Accounting Series Release No. 268, Presentation in Financial Statements of Redeemable Preferred Stock (ASR 268), requires certain items to be classified outside of the equity section on the face of the statement of financial position (i.e., in temporary equity). Although classification outside of permanent equity is required for certain ASR 268 instruments, such presentation is considered stockholders’ equity for purposes of applying the paragraph 11(a) (ASC paragraph 815-10-15-74(a)) exception of the Standard. (See DIG Issue C2 for further reference.) However, freestanding warrants and similar instruments on shares that are redeemable (either puttable or mandatorily redeemable) are accounted for as liabilities under Statement 150 (ASC Topic 480) and would not qualify for the scope exception in paragraph...
11(a) of the Standard (ASC paragraph 815-10-15-74(a)). (See FSP FAS 150-5 for additional guidance.)

11a.16a For purposes of determining whether an embedded feature that has the characteristics of a derivative under paragraphs 6 - 9 of the Standard (ASC paragraph 815-10-15-83 through 15-128) qualifies for the scope exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)), the entity must evaluate whether that embedded feature is (1) indexed to the entity's own stock and (2) would be classified in stockholders' equity if it were a freestanding financial instrument. For purposes of making those determinations, the guidance in Statement 150 (ASC Topic 480) would not be applied because that Statement (ASC Topic 480) does not apply to embedded features. However, other accounting guidance that would be applied to freestanding financial instruments (e.g., EITF 00-19 and EITF 07-5 (ASC Subtopic 815-40)) would also apply to embedded features for purposes of evaluating whether they qualify for the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)). If the scope exception paragraph 11(a) (ASC paragraph 815-10-15-74(a)) is met, then an embedded feature would not be separately accounted for as a derivative under the Standard. (Refer to Section 3 for guidance on evaluating embedded derivative features under the Standard.)

APPLICATION ISSUES

11a.17 In determining whether an instrument should be classified in stockholders’ equity, entities face several practical issues. These include:

- Freestanding financial instruments potentially settled in an entity's own stock that do not have all the characteristics of a derivative;
- Meaning of a freestanding financial instrument;
- Accounting for accelerated share repurchase programs;
- Accounting for forward equity sales transactions; and
- Accounting for contracts indexed to a subsidiary’s stock.

Freestanding Financial Instruments Potentially Settled in an Entity’s Own Stock That Do Not Have All the Characteristics of a Derivative

11a.17a Some freestanding financial instruments that are potentially settled in an entity's own stock do not have all the characteristics of a derivative instrument in paragraphs 6 - 9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128). For example, a forward contract to issue an entity's own equity shares in exchange for cash (physical settlement) would not meet the net-settlement characteristic of a derivative instrument, as described in paragraphs 6c and 9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128), if there is no market mechanism to facilitate net settlement and the underlying equity shares are not readily convertible to cash. Regardless of whether such instruments have the characteristics of a derivative under the Standard, they must (a) be considered indexed to the reporting entity's own stock and (b) meet the conditions for equity classification under applicable U.S. GAAP to be classified as equity instruments. However, embedded derivative features that are potentially settled in an entity's own stock but do not have all the characteristics of a derivative in paragraphs 6 - 9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128) should not be separately accounted for as
derivatives, regardless of whether they would meet the conditions for the scope exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)).

11a.17b If a freestanding instrument does not have the characteristics of a derivative under the standard, is potentially settled in an entity's own stock, and is not considered indexed to the entity's own stock under applicable U.S. GAAP (for example, EITF 07-5 ASC Subtopic 815-40), it would be classified as an asset or a liability. Some instruments with those characteristics are within the scope of Statement 150 (ASC Topic 480) and should be accounted for as liabilities (or assets in some circumstances) based on the recognition and measurement guidance in that Statement (ASC Topic 480). However, for other instruments with those characteristics, U.S. GAAP may not contain specific measurement guidance. SEC registrants should consider whether the financial instrument embodies a written option that should be measured at fair value each period with changes in fair value reported in earnings.3 In many cases, it may be appropriate for non-SEC registrants to report written options at fair value and recognize changes in fair value through earnings as well.

11a.17c If a freestanding instrument does not have the characteristics of a derivative under the Standard, is potentially settled in an entity's own stock, and is considered indexed to the entity's own stock under applicable guidance (for example, EITF 07-5 (ASC Subtopic 815-40)), additional analysis is required to determine whether it would be classified as an asset or liability or as an equity instrument. If an instrument with those characteristics is within the scope of Statement 150 (ASC Topic 480), it should be accounted for as a liability (or an asset in some circumstances) based on the recognition and measurement guidance in Statement (ASC Topic 480). If an instrument with those characteristics is not within the scope of Statement 150 (ASC Topic 480), the guidance in EITF 00-19 (ASC Subtopic 815-40) should be applied to determine whether it qualifies for equity classification. If the instrument does not meet the conditions for equity classification in EITF 00-19 (ASC Subtopic 815-40), it should be reported as an asset or liability and measured at fair value each period with changes in fair value reported in earnings.

Meaning of a Freestanding Financial Instrument

11a.18 Statement 150 (ASC Topic 480) and EITF 00-19 (ASC Subtopic 815-40) define a freestanding financial instrument as a financial instrument that is entered into separately and apart from any of the entity’s other financial instruments or equity transactions, or that is entered into in conjunction with some other transaction and is legally detachable and separately exercisable. Deciding whether an instrument is considered freestanding is important, among other reasons, because:

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3 In a speech given at the 2003 AICPA National Conference on Current SEC Developments, an SEC staff member clarified that the SEC’s historical position on measurement of written options at fair value each period with changes in fair value reported in earnings was not intended to apply to guarantees within the scope of FASB Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees (ASC Subtopic 460-10, Guarantees - Overall), Including Indirect Guarantees of Indebtedness of Others. Refer to FSP FIN 45-2, Whether FASB Interpretation No. 45 Provides Support for Subsequently Accounting for a Guarantor’s Liability at Fair Value (ASC paragraph 460-10-35-2) for additional guidance on subsequent measurement of guarantees within the scope of Interpretation 45 (ASC Subtopic 460-10).
• The classification guidance in Statement 150 (ASC Topic 480) applies only to freestanding financial instruments; consequently, a freestanding instrument and an embedded instrument are subject to different classification rules under GAAP;

• Instruments within equity typically do not need to be adjusted to current fair value through earnings; and

• The exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) only applies to instruments that are classified in equity (or, for an embedded derivative, that would be classified in equity if it were a freestanding instrument).

11a.19 Although there is no comprehensive guidance relative to when an instrument is considered freestanding, we believe all transactions should be analyzed thoroughly to determine whether the instrument is considered freestanding. In addition, separate financial instruments with the same counterparty that were entered into in contemplation of each other, have terms based on the same underlying, and have collective settlement/termination provisions should be reviewed to determine whether their separation fulfills a substantive business and economic purpose. Paragraphs 9.45 - 9.47 of this chapter explain when two instruments may need to be considered in the aggregate as a derivative.

Accounting for Accelerated Share Repurchase Programs

11a.20 Accounting for accelerated share repurchase programs is the subject of EITF Issue No. 99-7, “Accounting for an Accelerated Share Repurchase Program” (EITF 99-7) (ASC paragraph 505-30-25-5 and 55-6). Generally, an accelerated share repurchase program is a combination of transactions that permits an entity to purchase a targeted number of shares immediately with the final purchase price of those shares determined by an average market price over a fixed period of time in the future. For example, to facilitate an accelerated share repurchase program, an investment bank might borrow shares and sell them short to an entity at the current market value. The shares are held in treasury; the entity has legal title to the shares; and no other party can vote the shares. Simultaneously the entity enters into a forward contract (a net-settled forward sales contract) with the same investment bank with a notional amount equal to the number of shares the entity just purchased. The forward will settle based on the difference between the average share price over a period of time and the initial share repurchase price. If the forward contract is in a loss position to the entity (i.e., the average share price is greater than the initial share purchase price), the entity has the choice to settle the amount net cash or net shares. If it is in a gain position (i.e., the average share price is less than the initial share purchase price), the entity will receive net cash. According to EITF 99-7 (ASC paragraph 505-30-55-6), the treasury stock transaction and forward contract should be recorded separately. The specific terms of accelerated share repurchase contracts may vary (e.g., the forward contract may contain caps and/or floors on the gain or loss at settlement). If the forward contract is not within the scope of Statement 150 (ASC Topic 480), the entity should determine whether the contract should be accounted for as an equity instrument or as an asset or liability based on applicable U.S. GAAP (e.g., Statement 133, EITF 00-19 and EITF 07-5 (ASC Subtopic 815-40)).
Forward Equity Sale Transactions

11a.21 A common transaction executed by entities involving their own stock involves forward contracts to sell equity shares. Most forward equity sale transactions involve an agreement to sell a fixed or variable number of equity shares at a specified price in a future period. EITF 00-19 and EITF 07-5 (ASC Subtopic 815-40) typically govern the classification and accounting for such transactions. However, the guidance in Statement 150 (ASC Topic 480) must also be considered. For example, a freestanding forward contract to sell equity shares that are redeemable, including contingently redeemable shares, would be within the scope of Statement 150 (ASC Topic 480). If the forward contract also meets the definition of a derivative, it must be accounted for in accordance with the Standard. (See FSP FAS 150-5 (ASC paragraphs 480-10-25-9, 25-13, and ASC paragraph 480-10-55-33) for additional guidance.)

11a.21a Another type of transaction involves simultaneously executing (1) a contract to sell equity shares currently and (2) a forward purchase contract to repurchase the same number of shares in a future period. In these types of transactions, an entity will sell a certain number of its shares at the current market price to a counterparty, usually an investment bank. Simultaneously, the entity enters into a forward purchase contract with the same investment bank with a notional amount equal to the number of shares that they just sold. The forward will settle based on a set price above the sale price to generate a fixed yield for the investment bank. The forward is settled at the entity’s discretion (i.e., physical shares are repurchased, net-share settlement, or net-cash settlement). A freestanding financial instrument within the scope of Statement 150 (ASC Topic 480) cannot be combined with another freestanding financial instrument, unless combination is specifically required under the provisions of the Standard and its related guidance. Statement 150 (ASC Topic 480) requires that a freestanding forward purchase contract for the issuer’s equity shares, such as the forward transaction described above, be classified as a liability (or an asset in some cases), regardless of the form of settlement. If the forward purchase contract also meets the definition of a derivative, it must be accounted for in accordance with the Standard unless it qualifies for the scope exception in paragraph 11(d) (ASC paragraph 815-10-15-74(d)), which is discussed later in this Section.

Contracts Indexed to a Subsidiary’s Stock

11a.22 The EITF has addressed accounting for financial instruments indexed to and/or settled in a consolidated subsidiary’s stock and whether these contracts would be eligible for the exception afforded by paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)). In general, freestanding contracts held or issued by an entity involving another entity’s common stock are not eligible for the exception. For example, a forward sale or written call option contract issued by a publicly traded holding company that is indexed to a consolidated publicly traded subsidiary would be classified as a liability (or an asset in some circumstances). In addition, a purchased option contract entered into by a publicly traded holding company that is indexed to a majority owned publicly traded subsidiary is not considered indexed to the reporting entity’s own stock. If a contract involving another entity’s common stock also meets the definition of a derivative pursuant to the guidance in paragraphs 6 - 9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128), it will require derivative accounting. The relevant EITF issues are:
- EITF Issue No. 00-6, “Accounting for Freestanding Derivative Financial Instruments Indexed to, and Potentially Settled in, the Stock of a Consolidated Subsidiary” (EITF 00-6) (ASC Topic 810, Consolidation)
- EITF Issue No. 08-8, "Accounting for an Instrument (or an Embedded Feature) With a Settlement Amount that is Based on the Stock of an Entity's Own Consolidated Subsidiary" (EITF 08-8); and
- EITF Issue No. 00-4, “Majority Owner’s Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Indexed to the Minority Interest in That Subsidiary” (EITF 00-4) (ASC paragraphs 480-10-55-53 through 55-62).

**EITF 00-6 (ASC Topic 810) (Applicable Prior to Adoption of EITF 08-8)**

11a.23 A parent company may enter into freestanding contracts indexed to, and potentially settled in, the stock of a consolidated subsidiary. Examples of these contracts include written put options, written call options (e.g., warrants), purchased put options, purchased call options, forward sales contracts, and forward purchase contracts. These contracts may be settled in a variety of methods (e.g., physical, net-share and net-cash settlement). The consensuses reached in EITF 00-6 (ASC Topic 810) were affected by the subsequent issuance of Statement 150 (ASC Topic 480). A freestanding instrument within the scope of Statement 150 (ASC Topic 480) is required to be classified as a liability (or an asset in some cases), regardless of the settlement methods permitted in the instrument and regardless of whether that instrument is considered indexed to the issuer’s equity shares. (ASC paragraph 480-10-05-6) states that for freestanding financial instruments within its scope that are issued by members of a consolidated group of entities, the issuer’s equity shares include the equity shares of any entity whose financial statements are included in the consolidated financial statements.) Freestanding written put options and forward purchase contracts on an issuer’s equity shares are within the scope of Statement 150 (ASC Topic 480). Accordingly, freestanding written put options and freestanding forward purchase contracts that are within the scope of EITF 00-6 (ASC Topic 810)(that is, they are indexed to, and potentially settled in, the stock of a consolidated subsidiary) do not meet the scope exclusion in ASC paragraph 815-10-15-74(a)) because Statement 150 (ASC Topic 480) requires such instruments to be classified as a liability (or an asset in some cases). Such instruments that also meet the Standard’s definition of a derivative instrument are required to be accounted for as a derivative unless the instrument meets one of the Standard’s scope exceptions (e.g., in paragraph 10 (ASC paragraphs 815-10-15-13 through 15-82) or in paragraph 11(d) (ASC paragraph 815-10-15-74(d))).

11a.24 All other freestanding financial instruments within the scope of EITF 00-6 (ASC Topic 810) are not within the scope of Statement 150 (ASC Topic 480) and, therefore, the consensuses reached by the EITF (ASC Topic 810) were not affected. Entities that have instruments such as written call options (e.g., warrants), purchased put options, purchased call options and forward sales contracts that are within the scope of EITF 00-6 (ASC Topic 810) that are indexed to, and potentially settled in, the stock of a consolidated subsidiary must continue to follow the consensuses in EITF 00-6 (ASC Topic 810) (prior to adoption of EITF 08-8). EITF 00-6 (ASC Topic 810) requires all such contracts to be accounted for under the Standard if they meet the definition of a derivative. Further, the EITF, for the purpose of the instruments in EITF 00-6 (ASC Topic 810), concluded that the stock of a subsidiary is not considered equity of the parent
(reporting entity), thus eliminating the exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) for these contracts. It is important to note that the consensus in EITF 00-6 (ASC Topic 810) differs from guidance in EITF Issue No. 99-1, “Accounting for Debt Convertible into the Stock of a Consolidated Subsidiary” (EITF 99-1) (ASC paragraphs 470-20-25-14 and 25-15). EITF 99-1 (ASC paragraphs 470-20-25-14 and 25-15) specifies that the embedded conversion option in a debt instrument issued by a parent company that is convertible into the stock of a consolidated subsidiary would not be separated by the issuer and accounted for as a derivative because the conversion option meets the paragraph 11(a) (ASC paragraph 815-10-15-74(a)) scope exception. See Paragraph A3.27 of Chapter 3. [Note: As described below, EITF 00-6 (ASC Topic 810) will be nullified by EITF 08-8 (ASC paragraphs 815-40-15-5(c), 15-77, 815-10-45-17(a), and 65-4), which is effective for fiscal years beginning on or after December 15, 2008 and interim periods within those years. After adoption of EITF 08-8 (ASC paragraphs 815-40-15-5(c), 15-77, 815-10-45-17(a), and 65-4), contracts for which the payoff is based, in whole or in part, on the shares of a consolidated subsidiary are not precluded from being considered indexed to the entity's own stock in the consolidated financial statements. Rather, the consensus in EITF 07-5ASC Subtopic 815-40) should be applied to make that evaluation.]

11a.24a Some contracts within the scope of EITF 00-6 (ASC Topic 810) will not meet the Standard definition of a derivative. Contracts within EITF 00-6’s (ASC Topic 810) scope that meet the Standard definition of a derivative could be excluded from the Standard if they meet one of the paragraph 10 (ASC paragraphs 815-10-15-13 through 15-82) exceptions. An example of a contract that would not meet the definition of a derivative is a freestanding instrument that is only physically settled by issuing subsidiary shares and receiving cash and the subsidiary’s stock is “not readily convertible into cash.” For a forward sale contract that is within the scope of EITF 00-6 (ASC Topic 810) that does not meet the definition of a derivative, the parent should not record the disposition of the shares until the forward is settled and the shares are transferred. For such contracts, the parent should continue to recognize subsidiary income or loss in consolidation as if no forward contract was outstanding. However, if there is an excess of carrying amount of the parent’s investment in the shares to be sold over the strike price of the forward contract, an impairment loss may exist. For a purchased option contract that is within the scope of EITF 00-6 (ASC Topic 810) that does not meet the definition of a derivative, the parent should not record the acquisition or disposition of shares until it exercises the option and purchases or sells the shares. For a written option contract that is within the scope of EITF 00-6 (ASC Topic 810) but not within the scope of Statement 150ASC Topic 480) (e.g., a written call option) that does not meet the definition of a derivative, the SEC staff has a longstanding position that the written option should initially be reported at fair value and subsequently marked to fair value through earnings.

EITF 08-8 (Supersedes the guidance in EITF 99-1 and EITF 00-6) (ASC paragraphs 815-40-15-5(c), 15-77, 815-10-45-17(a), and 65-4)

11a.24b At the November 13, 2008 EITF meeting, the Task Force reached a consensus on EITF 08-8 (ASC paragraphs 815-40-15-5(c), 15-77, 815-10-45-17(a), and 65-4). That Issue applies to freestanding financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary. EITF 08-8 (ASC paragraphs 815-40-15-5(c), 15-77, 815-10-45-17(a), and 65-4) applies to those instruments
(and embedded features) in the consolidated financial statements of the parent, regardless of whether the instrument was entered into by the parent or the subsidiary. That Issue is effective for fiscal years beginning on or after December 15, 2008 and interim periods within those years and it supersedes the guidance in EITF 99-1 (ASC paragraphs 470-20-25-14 and 25-15) and EITF 00-6 (ASC Topic 810). EITF 08-8 (ASC paragraphs 815-40-15-5(c), 15-77, 815-10-45-17(a), and 65-4) does not apply to instruments that are not eligible for equity classification under other applicable U.S. GAAP (for example, Statement 150 (ASC Topic 480)). Additionally, that Issue does not apply to a written put option and a purchased call option embedded in the shares of a noncontrolling interest in a consolidated subsidiary if the arrangement is accounted for as a financing under the consensus in EITF 00-4 (ASC paragraphs 480-10-55-53 through 55-62), which is discussed below. EITF 08-8 (ASC paragraphs 815-40-15-5(c), 15-77, 815-10-45-17(a), and 65-4) eliminates the inconsistency between the evaluation of freestanding financial instruments and embedded features indexed to the stock of a consolidated subsidiary that currently results from the conflicting guidance in EITF 99-1 (ASC paragraphs 470-20-25-14 and 25-15) and EITF 00-6 (ASC Topic 810), as described.

11a.24c EITF 08-8 (ASC paragraphs 815-40-15-5(c), 15-77, 815-10-45-17(a), and 65-4) specifies that freestanding financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary are not precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent if the subsidiary is a substantive entity. In that circumstance, the consensus in EITF 07-5 (ASC Subtopic 815-40) must be applied to the freestanding financial instrument (or embedded feature) within the scope of EITF 08-8 (ASC paragraphs 815-40-15-5(c), 15-77, 815-10-45-17(a), and 65-4) to determine whether it is indexed to the entity's own stock and should be considered in connection with other applicable U.S. GAAP (for example, EITF 00-19 (ASC Subtopic 815-40)) to determine the classification of the freestanding instrument (or embedded feature) in the consolidated financial statements. However, if the subsidiary is not a substantive entity, the instrument or embedded feature would not be considered indexed to the entity's own stock. In connection with EITF 08-8 (ASC paragraphs 815-40-15-5(c), 15-77, 815-10-45-17(a), and 65-4), the SEC Observer reiterated the SEC staff's longstanding position that written options that do not qualify for equity classification should be reported at fair value each reporting period with changes in fair value recognized in earnings.

11a.24d EITF 08-8 (ASC paragraphs 815-40-15-5(c), 15-77, 815-10-45-17(a), and 65-4) specifies that an equity-classified instrument within its scope, including an embedded feature that is separately recorded in equity under applicable U.S. GAAP (for example, FSP APB 14-1, Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)) (ASC Subtopic 470-20, Debt - Debt with Conversion and Other Options), must be presented as a component of noncontrolling interest in the consolidated financial statements, regardless of whether the instrument was entered into by the parent or the subsidiary. However, if an equity-classified instrument within the scope of EITF 08-8 (ASC paragraphs 815-40-15-5(c), 15-77, 815-10-45-17(a), and 65-4) was entered into by the parent and expires unexercised, the carrying amount of the instrument must be reclassified from the noncontrolling interest to the controlling interest.
EITF 00-4 (ASC paragraphs 480-10-55-53 through 55-62)

11a.25 EITF 00-4 (ASC paragraphs 480-10-55-53 through 55-62) address situations where a controlling majority owner (parent) sells a noncontrolling interest or buys a controlling interest and at the same time enters into certain derivatives, including a physically settled forward contract and a combination of a put and call option with the noncontrolling interest holder to facilitate purchasing all or part of the noncontrolling interest. The consensus on that Issue specified circumstances where the derivatives should be accounted for as an in-substance financing of the parent’s purchase of the noncontrolling interest. The consensuses reached in EITF 00-4 (ASC paragraphs 480-10-55-53 through 55-62) were affected by the subsequent issuance of Statement 150 (ASC Topic 480). If an entity enters into a freestanding, fixed-price forward contract to purchase the noncontrolling interest holder’s shares, the instrument is within the scope of Statement 150 (ASC Topic 480) and must be classified as a liability (or an asset in some cases); therefore, the instrument would not be eligible for the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)). If the entity enters into a single freestanding instrument that combines a written put option and purchased call option for the noncontrolling interest holder’s shares, the instrument is within the scope of Statement 150 (ASC Topic 480) and must be classified as a liability; therefore, the instrument would not be eligible for the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)). The original consensus in EITF 00-4 (ASC paragraphs 480-10-55-53 through 55-62) would be applied to arrangements within the scope of that Issue if the guidance in Statement 150 (ASC Topic 480) is not applied because the put option (or the combined put and call option) is embedded in the shares held by the noncontrolling interest.

Contracts Issued for Stock-Based Compensation Arrangements

11b.01 Paragraph 11(b) of the Standard (ASC paragraph 815-10-15-74(b)) extends the concept of paragraph 11(a) (ASC paragraph 815-10-15-74(a)) to exclude contracts issued in the entity’s own equity securities for share-based compensation arrangements.

11b. Contracts issued by the entity that are subject to FASB Statement No. 123 (revised 2004), Share-Based Payment Compensation--Stock Compensation. If any such contract ceases to be subject to Statement 123(R) in accordance with paragraph A231 of that Statement, the terms of that contract shall then be analyzed to determine whether the contract is subject to this Statement.

55a FASB Staff Position FAS 123(R)-1, “Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R),” defers the guidance in paragraph A231 of Statement 123(R) for employee awards under certain circumstances and provides additional guidance about when those awards cease to be subject to Statement 123(R). An award that ceases to be subject to Statement 123(R) in accordance with that FSP should be analyzed to determine whether it is subject to this Statement.

DIG Issue related to this paragraph is C3. See DIG Issues Index.

11b.02 Contracts issued by the entity that are subject to FASB Statement No. 123 (revised 2004), Share-Based Payment (Statement 123(R)) (ASC Topic 718), are not considered to be derivative instruments under the Standard so long as they are within the scope of Statement 123(R) (ASC Topic 718). This exception relates only to the issuer of the share-based payment, not to the...
holder. Statement 123(R) (ASC Topic 718) applies to employee share-based compensation arrangements and issuances of equity instruments to acquire goods or services from nonemployees. Equity instruments granted in share-based payment transactions subject to Statement 123(R) (ASC Topic 718) may cease being subject to that Statement (ASC Topic 718) due to certain events or circumstances such as performance by a nonemployee.

11b.03 Statement 133 Implementation Issue No. C3, “Scope Exceptions: Exception Related to Stock-Based Compensation Arrangements,” as revised on December 15, 2004, highlights a framework for evaluating equity instruments granted in share-based payment transactions from the issuer’s perspective. The resolution specifically addresses equity instruments granted to nonemployees. Absent FASB Staff Position No. FAS 123(R)-1, “Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R),”(ASC paragraphs 718-10-35-9 through 35-11), we believe the framework would also be applicable to equity instruments granted to employees. FSP FAS 123(R)-1 (ASC paragraphs 718-10-35-9 through 35-11) deferred the requirement of Statement 123(R) (ASC Topic 718) that a freestanding financial instrument issued to an employee in exchange for past or future employee services originally subject to Statement 123(R) (ASC Topic 718) becomes subject to the recognition and measurement requirements of other applicable GAAP when the rights conveyed by the instrument are no longer dependent on the holder being an employee of the entity. Accordingly, equity instruments granted to employees that are subject to Statement 123(R) (ASC Topic 718) continue to be subject to the recognition and measurement provisions of that Statement (ASC Topic 718) throughout the life of the instruments, unless their terms are modified when the holders are no longer employees. FASB Staff Position No. FAS 123(R)-5 states that a modification, for the purpose of FSP FAS 123(R)-1 (ASC paragraphs 718-10-35-9 through 35-11), does not include a change to the terms of an award if the change is made solely to reflect an equity restructuring provided that (a) there is no increase in the fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, i.e., the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring and (b) all holders of the same class of equity instrument (e.g., stock options) are treated in the same manner. The Statement 123(R) (ASC Topic 718) deferral does not apply to equity instruments granted to nonemployees, nor to instruments issued, in whole or in part, as consideration for goods and services other than employee service, irrespective of the employment status of the recipient of the award on the grant date.

11b.04 When evaluating the issuer’s accounting for equity instruments granted to nonemployees, the issuer must first determine whether performance has occurred. In making that determination, performance commitments and conditions should be evaluated under the provisions of EITF Issue 96-18, “Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.” (ASC Subtopic 505-50, Equity - Equity-Based Payments to Non-Employees). Until performance has occurred, the share-based payment transaction would be within the scope of Statement 123(R) (ASC Topic 718) and therefore would be excluded from the scope of Statement 133 pursuant to paragraph 11(b) of the Standard (ASC paragraph 815-10-15-74(b)). Once performance has occurred, equity instruments issued to nonemployees would be outside the scope of Statement 123(R) (ASC Topic 718) and would thereby be subject to other authoritative literature such as Statement 133, Statement 150 (ASC Topic 480), and EITF 00-19 (ASC Subtopic 815-40). Consideration should be given to the
scope exception in paragraph 11(a) of Statement 133 (ASC paragraph 815-10-15-74(a)) in determining whether those instruments are within the scope of the Standard. In evaluating whether the instruments are both (1) indexed to the issuer’s own stock and (2) classified in stockholders’ equity pursuant to that paragraph (ASC paragraph 815-10-15-74(a)), it is important to understand all of the terms of the instruments. For example, in order to obtain equity classification for equity instruments under EITF 00-19 (ASC Subtopic 815-40) by public companies, the instruments must, with limited exceptions, permit the issuer to settle the instruments with unregistered shares. Otherwise, it is assumed that the instruments will be net-cash settled and thereby classified as liabilities.

**11b.05** Issuers should consider the impact of the change on equity instruments that previously qualified for the scope exception in paragraph 11(b) (ASC paragraph 815-10-15-74(b)), both upon the initial adoption of Statement 123(R) (ASC Topic 718) and on an ongoing basis. The general guidance for transition issues in Statement 133 (i.e., Statement 133 Implementation Issue No. K5, “Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues”) does not specifically address situations in which an instrument is subject to one section of authoritative GAAP for a portion of its term (e.g., Statement 123(R) (ASC Topic 718) and another section for the remainder of its term (e.g., Statement 133, EITF 00-19 (ASC Subtopic 815-40), or Statement 150 (ASC Topic 480)). Therefore, we believe issuers should analogize to paragraph 10 of EITF 00-19 (ASC paragraphs 815-40-38-8 through 38-10), which provides guidance on how to account for changes in classification of contracts. Under EITF 00-19 (ASC Subtopic 815-40), if a contract is reclassified from permanent or temporary equity to an asset or a liability, the change in fair value prior to the date of reclassification is accounted for as an adjustment to stockholders’ equity. Thus, we believe that, both at initial adoption of revised DIG Issue C3, which coincides with the initial adoption of Statement 123(R) (ASC Topic 718), and on an ongoing basis, when an equity instrument granted in a share-based payment transaction is reclassified from equity to a liability, the change in fair value of the instrument during the period of equity classification (i.e., prior to liability classification) should be reflected in stockholders’ equity upon reclassification of the instrument.

**11b.06** Holders of equity instruments granted in share-based payment transactions should evaluate the terms of those instruments under Statement 133 given that paragraph 11(b) of the Statement (ASC paragraph 815-10-15-74(b)) does not apply to holders of Statement 123(R) (ASC Topic 718) share-based payment transactions, regardless of whether performance has occurred. The accounting for these instruments is described in EITF Issue No. 00-8, “Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services.” (ASC Subtopic 505-50, Equity - Equity-based Payments to Non-employees). Changes in the fair value of such instruments after the measurement date, as defined in that EITF Issue (ASC Subtopic 505-50), should be accounted for in accordance with Statement 133 if the instruments are determined to be derivatives and those changes are unrelated to the achievement of performance conditions.

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4 Statement 123(R) (ASC Topic 718), as modified by SEC rule-making, was effective for public entities that do not file as small business issuers as of the beginning of the first annual reporting period beginning after June 15, 2005 (i.e., January 1, 2006 for calendar-year-end public entities). Small business issuers and nonpublic entities were required to adopt Statement 123(R) (ASC Topic 718) as of the beginning of the first annual period beginning after December 15, 2005.
11b.07 The following example illustrates the types of contracts explicitly excluded from the scope by paragraph 11(b) of the Standard (ASC paragraph 815-10-15-74(b)):

Example 2.21: Contracts Issued in a Share-Based Payment Transaction

ABC Corp. issues options to Company XYZ for services related to the installation of a new computer system. The options permit XYZ to buy 1,000 shares of ABC’s stock (a company whose shares are publicly traded). The strike price of the options is at a 5% premium over the market price of ABC’s stock price at the date the options were issued. The fair value of the options is equal to the fair value of the services rendered.

ABC, as the issuing company, would not evaluate the options under the Standard prior to performance by XYZ because contracts subject to Statement 123(R) (ASC Topic 718) are explicitly excluded by paragraph 11(b) (ASC paragraph 815-10-15-74(b)). However, ABC would evaluate the options under the Standard and other authoritative literature once performance by XYZ occurred. When evaluating the options under the Standard, ABC should consider the scope exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)).

Certain Contracts Related to a Business Combination

11b.08 Certain contracts related to a business combination are excluded from the Standard under paragraph 11(c) (ASC paragraph 815-10-15-74(c)). This exclusion is different before and after the adoption of Statement 141(R) (ASC Topic 850, Business Combinations).

CONTINGENT CONSIDERATION FROM A BUSINESS COMBINATION ACCOUNTED FOR UNDER STATEMENT 141 OR 141(R)

11c.01 Paragraph 26 of FASB Statement No. 141, Business Combinations (Statement 141), discusses contingent consideration as being “consideration that is issued or issuable at the expiration of the contingency period or that is held in escrow pending the outcome of the contingency.” Paragraph 11(c) of the Standard (ASC paragraph 815-10-15-74(c)) explicitly excludes contingent consideration arrangements related to a business combination from the scope of the Standard by the issuer:

11c. Contracts issued by the entity as contingent consideration from a business combination. The accounting for contingent consideration issued in a business combination is addressed in FASB Statement No. 141, Business Combinations. In applying this paragraph the issuer is considered to be the entity that is accounting for the combination using the purchase method.

11c.02 Paragraph 11(c) (ASC paragraph 815-10-15-74(c)) explicitly excludes from the scope of the Standard the issuer’s accounting for instruments issued as contingent consideration arrangements in a purchase business combination because the issuer’s accounting for such arrangements is set forth in Statement 141. The exception does not apply to the holder (i.e., the seller of the business). The effect of a contingent consideration arrangement on the accounting for a business combination often is significant and depends on the terms and conditions of both the business combination and the contingent consideration arrangement. Although contingent consideration arrangements may share some or all of the characteristics of derivative instruments.
addressed by the Standard, the Board determined it was inappropriate to change the accounting by the entity that accounts for the business combination.

11c.03 The Standard does, however, apply to similar contracts that are not accounted for as contingent consideration arrangements under the provisions of Statement 141, if those contracts meet the Standard’s definition of a derivative instrument. Generally, contingent consideration in connection with a business combination described in the purchase agreement, is either in the form of a separate financial instrument or embedded in a security, and is usually based on earnings of the acquired entity or on a guaranteed value of securities issued to effect the purchase. These types of contingent consideration arrangements would be accounted for under Statement 141. Other types of contingent consideration arrangements not based on earnings or on the market price of the specified security issued to effect the business combination should be analyzed to determine whether the entire contract or an embedded feature within the contract should be accounted for under the Standard. For example, if an entity’s security issued as consideration in a business combination includes a contingent payment feature indexed to LIBOR, the instrument would be accounted for under Statement 141 at fair value for initial purchase price allocation purposes. However, the subsequent accounting related to the embedded LIBOR payment feature is not covered by Statement 141 and would be accounted for under the Standard. The Standard also applies to a holder’s accounting for contingent consideration that meets the Standard definition of a derivative instrument. The following example illustrates this concept.

Example 2.22: Contingent Consideration Issued in a Purchase Business Combination

SWM Co. issues to DJM Co. a freestanding financial instrument in a purchase business combination that provides contingent consideration that is indexed to changes in the price of the purchased company’s stock. SWM Co. accounts for the instrument under Statement 141 (as addressed in EITF Issue No. 97-8, “Accounting for Contingent Consideration Issued in a Purchase Business Combination”). From the perspective of the purchaser of the business (i.e., the issuer of the instrument-SWM Co.), the instrument is explicitly excluded from the scope of the Standard by paragraph 11(c) (ASC paragraph 815-10-15-74(c)). DJM Co., the seller of the business and holder of the instrument, would be required to account for that instrument under the provisions of the Standard if it meets the definition of a derivative. If DJM Co. subsequently sells the freestanding financial instrument (contingent consideration arrangement) to a third party, the new holder also would be required to account for that instrument under the provisions of the Standard.

CONTRACTS TO ENTER INTO A BUSINESS COMBINATION ACCOUNTED FOR UNDER STATEMENT 141(R) (ASC TOPIC 805)

11c.04 Statement 141(R) (ASC Topic 805), which amended Statement 141, was issued in December 2007 and is effective prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Statement 141(R) (ASC Topic 805) replaced the guidance in paragraph 11(c) of the Standard (ASC paragraph 815-10-15-74(c)) that explicitly excluded contingent consideration arrangements related to a business combination from the scope of the Standard by
the issuer with a provision that excludes from the scope of the Standard contracts to enter into a business combination at a future date:

11c. Contracts between an acquirer and a seller to enter into a business combination at a future date.

11c.05 The revision to paragraph 11(c) of the Standard (ASC paragraph 815-10-15-74(c)) is a result of the change in the guidance related to the accounting for contingent consideration under Statement 141(R) (ASC Topic 805). Statement 141(R) (ASC Topic 805) requires that upon the effective date, an acquirer must initially measure contingent consideration at fair value and remeasure contingent consideration that is classified as an asset or a liability to fair value at each reporting date until the contingency is resolved. Statement 141(R) (ASC Topic 805) requires that the changes in fair value are recognized in earnings, except in the less likely scenario where the contingent consideration is a qualifying hedging instrument in a cash flow hedge, in which case Statement 133 requires the changes to be initially recognized in OCI to the extent it is effective. Therefore, contingent consideration related to a business combination with an acquisition date after the effective date of Statement 141(R) (ASC Topic 805) that is classified as an asset or a liability would be within the scope of Statement 133 if it meets the definition of a derivative and may be designated as a hedging instrument.

11c.06 Contingent consideration related to a business combination with an acquisition date before the effective date of Statement 141(R) (ASC Topic 805) would continue to be excluded from the scope of Statement 133 by the issuer until the contingency is resolved.

Forward Contracts That Require Physical Settlement

11d.01 Paragraph 11(d) of the Standard (ASC paragraph 815-10-15-74(d)) provides a scope exception for physically settled forward contracts for an entity’s own shares as follows:

11d. Forward contracts that require settlement by the reporting entity’s delivery of cash in exchange for the acquisition of a fixed number of its equity shares (forward purchase contracts for the reporting entity’s shares that require physical settlement) that are accounted for under paragraphs 21 and 22 of FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.

11d.02 According to Statement 150 (ASC Topic 480), a forward contract to purchase an entity’s own shares must be classified as a liability (or in some cases, an asset) by the issuer. As a result, any such forward contract does not meet the scope exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)) since the contract cannot be classified in stockholder’s equity. Forward contracts to purchase an entity’s own shares that have a choice of settlement methods as described in Paragraph 11a.04 of this chapter (regardless of which entity has the choice), or such contracts that require either net share or net cash settlement, must initially and subsequently be measured at fair value in accordance with the Standard (if it meets the definition of a derivative) or in accordance with Statement 150ASC Topic 480 (if it does not meet the definition of a derivative).

11d.03 The scope exception in paragraph 11(d) of the Standard (ASC paragraph 815-10-15-74(d)) was introduced when Statement 150 (ASC Topic 480) was issued in order to override the
initial and subsequent measurement provisions of the Standard for forward contracts to purchase
a fixed number of an entity’s own shares that must be physically (i.e., gross) settled by the entity
by delivering cash (in any currency) in exchange for those fixed number of shares. For such a
contract that meets the definition of a derivative, the initial and subsequent measurement would
have been at fair value. However, Statement 150 (ASC Topic 480) requires a different initial and
subsequent measurement for such instruments and, accordingly, such contracts are not within the
scope of the Standard.

11d.04 In accordance with Statement 150 (ASC Topic 480), forward contracts that require
physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for
cash should be measured initially at the fair value of the shares at inception, adjusted for any
consideration or unstated rights or privileges and equity should be reduced by an amount equal to
the fair value of the shares at inception. If both the amount to be paid and the settlement date are
fixed, the instruments should be measured subsequently at the present value of the amount to be
paid at settlement, accruing interest cost using the rate implicit at inception. If either the amount
to be paid or the settlement date varies based on specific conditions, the instruments should be
measured subsequently at the amount of cash that would be paid under the conditions specified
in the contract if settlement occurred at the reporting date, recognizing the resulting change in
that amount from the previous reporting date as interest cost.

QUESTIONS & ANSWERS

What Is a Derivative Instrument?

All Criteria (Paragraphs 6 - 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-128))

1. ABC purchases an option for $100 that will expire in six months to acquire 1,000 shares of
XYZ’s common stock at a fixed price. XYZ’s shares are publicly traded, and the option
provides for net cash settlement.

Q. Should ABC account for the purchased option as a derivative instrument under the Standard?

A. Yes. Paragraph 6 of the Standard (ASC paragraph 815-10-15-83) sets forth the definition of a
derivative instrument. The purchased option has an underlying (XYZ’s share price), a notional
amount (1,000 XYZ shares), requires no, or a small, initial investment at inception of the
contract, and settles in net cash; therefore, ABC should account for the purchased option as a
derivative instrument because it meets the definition of a derivative instrument pursuant to
paragraph 6 of the Standard (ASC paragraph 815-10-15-83) and is not explicitly excluded from
the scope by paragraphs 10 (ASC paragraphs 815-10-15-13 through 15-82) or 11 of the

2. A wheat farmer enters into a futures contract to deliver 80,000 bushels of wheat in two
months at a specified price per bushel. A market mechanism exists to settle the contract on a net
basis and the wheat farmer intends to settle the contract net.

Q. Should the wheat farmer account for the futures contract as a derivative instrument under the
Standard?
A. Yes. The futures contract has an underlying (price of wheat), a notional amount (80,000 bushels), requires no, or a small, initial investment at inception of the contract, and will be settled net; therefore, the wheat farmer should account for the wheat futures contract as a derivative instrument because it meets the definition of a derivative instrument pursuant to paragraph 6 of the Standard (ASC paragraph 815-10-15-83) and is not explicitly excluded from the scope of the Standard by paragraphs 10 or 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82 or ASC paragraphs 815-10-15-74 and 15-75). Even if this futures contract were considered a normal sale by the wheat farmer it would not qualify to be excluded from the scope of the Standard pursuant to paragraph 10(b) (ASC paragraphs 815-10-15-22, 15-30, 15-37, 15-38, and 15-40 through 15-45) because contracts that require cash settlements of gains or losses or are otherwise settled net on a periodic basis do not qualify for the normal purchases and normal sales exclusion.

What Is a Derivative Instrument?

3. LAB Corp. enters into a six-month forward contract to purchase 10,000 ounces of gold. The contract may be settled in net cash, net gold, or through delivery of a quantity of a unique metal sufficient to settle the contract. LAB pays a small premium to enter into this contract.

Q. What is the underlying in this contract?

A. Paragraphs 6(a) and (7) of the Standard (ASC paragraph 815-10-15-83(a) and ASC paragraphs 815-10-15-88 through 15-93) define the characteristics of an underlying. Because the value of and amount of settlement in this contract are determined by the price of gold, we believe the underlying in this contract is the price of gold. The fact that a unique metal may be delivered in lieu of cash or gold affects only the manner in which the contract will be settled, not the value or amount of the settlement.

What Is a Derivative Instrument?

4. ABC has purchased a financial instrument for $250,000 that requires $5,000,000 to be paid to ABC if LIBOR exceeds 10% during the next two years. Assume the $250,000 initial payment is smaller than would be required for other types of contracts that would have a similar response to an increase in LIBOR over 10%.

Q. Does the financial instrument meet the requirements of paragraph 6(a) of the Standard (ASC paragraph 815-10-15-83(a)) to qualify as a derivative instrument under the Standard?

A. Yes. Paragraph 6 of the Standard (ASC paragraph 815-10-15-83) sets forth the definition of a derivative instrument. Paragraph 6(a) of the Standard (ASC paragraph 815-10-15-83(a)) requires the instrument or contract to have, “one or more notional amounts or payment provisions or both” (emphasis added). While the instrument does not have a notional amount, it does include a payment provision (as defined by the Standard). As such, we believe the financial instrument meets the requirements of paragraph 6(a) of the Standard (ASC paragraph
What Is a Derivative Instrument?

Initial Investment (Paragraphs 6(b) and 8 of the Standard (ASC paragraph 815-10-15-83(b), and 815-10-15-92 through 15-96))

5. DEF enters into an interest rate swap with XYZ Bank. The terms of the interest rate swap require DEF to receive a fixed rate of interest at 8.5% and pay a variable rate of interest at LIBOR plus 1% on a notional amount of $50,000,000 for a five-year term. The terms of the interest rate swap also require DEF to receive $10,000 at the inception of the transaction. Assume the $10,000 payment made to DEF represents compensation for the fact that the interest rate swap is off-market in that DEF is only receiving a fixed rate of 8.5% whereas an interest rate swap with comparable terms would be receiving a fixed rate of 8.55% in today’s market.

Q. Does the interest rate swap meet the no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would have a similar response to changes in LIBOR (smaller than) criterion of paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)) to qualify as a derivative instrument under the Standard?

A. Yes. Paragraph 6 of the Standard (ASC paragraph 815-10-15-83) sets forth the definition of a derivative instrument. Paragraph 8 of the Standard (ASC paragraphs 815-10-15-92 through 15-96), which expands on no or smaller than initial net investment criterion of paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)), states that many derivative instruments will require an initial investment to compensate for terms that are more or less favorable than market conditions and that, “a derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount), or that is determined by applying the notional amount to the underlying.” Because the initial investment on the interest rate swap was not equal to the notional amount (or the notional amount plus a premium or minus a discount), or was determined by applying the notional amount to the underlying, we believe the interest rate swap meets the no or smaller than initial net investment criterion of a derivative instrument specified in paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)).

6. A foreign currency swap is an agreement that generally requires the exchange of principal amounts denominated in two different currencies at the inception of the contract at the current (spot) rate and an agreement to re-exchange the currencies at a specified future date at an agreed-upon rate.

Q. Does a foreign currency swap meet the no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would have a similar response to changes in the exchange rates (smaller than) criterion of paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)) to qualify as a derivative instrument under the Standard?

A. Yes. While the requirement to exchange notional amounts at the inception of the contract would, on the surface, appear to exclude these instruments as derivative instruments under the
Standard, the Board specifically permitted the definition of a derivative instrument pursuant to paragraph 6 of the Standard (ASC paragraph 815-10-15-83) to include currency swaps. It is the Board’s observation that the initial exchange of currencies does not constitute an initial investment equal to the notional amount of the contract, but is instead the exchange of one kind of cash for another kind of cash. The forward contract that obligates and entitles both parties to exchange specified currencies, on specified dates, at specified prices is a derivative instrument if it meets the definition in paragraph 6 of the Standard (ASC paragraph 815-10-15-83).

Because the foreign currency swap requires no initial investment, we believe a foreign currency swap meets the no or smaller than initial net investment criterion of a derivative instrument pursuant to paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)).

7. Company A owns 1,000 shares of Company B that it plans to sell at the end of a one-month restriction period. These shares of Company B cost Company A $10 per share and they are now trading at $20 per share. Company A is concerned that Company B’s share price will decline in the coming month and wants to hedge this exposure. To do so, Company A borrows 1,000 shares of Company B from Bank C for a one-month period. Company A immediately sells these shares in the open market for $20 per share. At the end of the month, Company A satisfies its obligation to Bank A using the 1,000 shares of Company B that it owns.

Q. Does the arrangement between Bank C and Company A (i.e., the borrowing of Company B shares for one month) meet the no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would have a similar response to changes in the price of Company B shares (smaller than) criterion of paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)) to qualify as a derivative instrument under the Standard?

A. No. The seller (Company A) is required to receive the 1,000 shares of Company B at the inception of the contract, which is the notional amount; therefore, we believe this arrangement does not meet the no or smaller than initial net investment criterion pursuant to paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)) and, as such, does not meet the definition of a derivative instrument pursuant to paragraph 6 of the Standard (ASC paragraph 815-10-15-83).

Company A’s arrangement with Bank C is a short sale arrangement. The Board intentionally did not address whether short sales arrangements would always (or never) meet the definition of a derivative instrument pursuant to paragraph 6 of the Standard (ASC paragraph 815-10-15-83) because the terms and related customary practices of the contracts vary. Instead, the specific terms of the contract must be evaluated to determine whether it meets the Standard’s definition of a derivative instrument.

Paragraph 59(d) of the Standard (ASC paragraphs 815-10-55-57 through 55-59) addresses this specific situation. Paragraph 59(d) of the Standard (ASC paragraphs 815-10-55-57 through 55-59) also addresses other activities typically involved in a short sale arrangement such as (1) the short seller selling a security to the purchaser, (2) the short seller delivering a borrowed security to the purchaser, and (3) the short seller purchasing a security from the market, all of which the Board indicates do not generally involve derivative instruments. Paragraph 59(d) of the Standard (ASC paragraphs 815-10-55-57 through 55-59) does state, however, that if a forward purchase or sale is involved, and the contract does not qualify for the exception of paragraph...
What Is a Derivative Instrument?

Net Settlement (Paragraphs 6(c) (ASC paragraph 815-10-15-83(c)) and 9 of the Standard (ASC paragraphs 815-10-15-99, 15-100, 15-110, 15-119, 15-120 and 15-128))

8. Bear Co. has a commitment to purchase raw material inventory at £30,000 in three months. Bear Co.’s functional currency is the U.S. dollar. In order to have adequate pounds sterling on hand for the purchase, Bear Co. enters into a forward contract with Aggies Co. to acquire £30,000 in three months at a rate of US$1.60/£1.00.

Q. Is the foreign currency forward contract a derivative instrument under the Standard?

A. Yes. Because the contract is settled in an asset that, while being associated with the underlying and in a denomination equal to the notional amount (£30,000), is readily convertible to cash, we believe the foreign currency forward contract meets the net settlement criterion pursuant to paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)).

9. In conjunction with the issuance of debt, ABC a non-public company, issues an option that allows XYZ to acquire 100 shares of ABC’s stock at a specified price for a period of two years. The option requires physical settlement; that is, if the options are exercised, settlement is accomplished through physical delivery of the full stated amount of the shares (i.e., not net shares or cash).

Q. From XYZ’s perspective, does the purchased option meet the net settlement criterion of paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)) to qualify as a derivative instrument under the Standard?

A. No. This contract requires physical settlement; that is, the asset being delivered in settlement of the contract (ABC shares) is associated with both the underlying and in a denomination equal to the notional amount. Because ABC’s shares are not publicly traded, the stock is not considered to be readily convertible to cash. In addition, there is no market mechanism that permits net settlement of the contract; therefore, we believe the contract does not meet the net settlement criterion of paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)) and, as such, the contract does not meet the definition of a derivative instrument pursuant to paragraph 6 of the Standard (ASC paragraph 815-10-15-83).

10. ABC enters into a contract to purchase 100 units of a unique metal in 60 days at a fixed price. The contract requires physical settlement.

Q(a). Does the contract meet the net settlement criterion of paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)) to qualify as a derivative instrument under the Standard?

A. No. Settlement of the contract is through delivery of an asset that is associated with the underlying and denominated in an amount equal to the notional amount. Furthermore, the asset being delivered in settlement of the contract (unique metal) is not readily convertible to cash. Finally, there is no market mechanism to facilitate net settlement of the contract. Thus, we believe the contract does not meet the net settlement criterion in paragraph 6(c) of the Standard.
Q(b). Would the same contract (for 100 units of a unique metal) meet the net settlement criterion of paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)) if settlement of the contract was for the delivery of gold instead of a unique metal?

A. Yes. Because the contract can be settled with the physical delivery of gold, we believe such a contract meets the net settlement criterion of paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)). Specifically, the contract settles in an asset that is neither associated with the underlying nor in a denomination equal to the notional amount.

What Instruments or Contracts Are Excluded from the Standard?

(Paragraph 10 of the Standard (ASC paragraphs 815-10-15-13 through 15-82))

11. TGK Corporation enters into a three-day forward to acquire 30,000 existing shares of Z Company stock (Z Company is a high-volume, publicly traded company). TGK Corporation pays a small commission to enter into this contract. The contract settles through physical delivery of Z Company stock.

Q(a). Should TGK Corporation account for the forward purchase contract as a derivative instrument under the Standard?

A. No. Paragraph 10(a) of the Standard (ASC paragraphs 815-10-15-15 and 15-16) specifically excludes regular-way security trades from the scope of the Standard. Because this contract does not provide for net settlement, nor does a market mechanism exist to facilitate net settlement, and because security trades involving equity securities are readily convertible to cash and customarily settle in three days, we believe this transaction meets the regular-way exception of paragraph 10(a) of the Standard (ASC paragraphs 815-10-15-15 and 15-16). Therefore, the contract is explicitly excluded from the scope of the Standard. As such, TGK Corporation should not account for the forward purchase contract as a derivative instrument under the Standard.

Q(b). If the contract instead permitted settlement in an equivalent value of Company Y stock, which is a public equity investee of Company Z with high-volume trading (the forward would continue to be valued based on Company Z stock), should TGK Corporation account for the forward purchase contract as a derivative instrument under the Standard?

A. Yes. A regular-way security trade arises from the trade of a specified security, which is settled through physical delivery of that specified security. The Standard's scope exception in paragraph 10(a) (ASC paragraphs 815-10-15-15 and 15-16) relating to regular-way security trades for existing securities refers only to securities delivered that are readily convertible to cash. Despite the fact that the contract may be settled in three days, it is not for the security specified in the contract (i.e., Company Z stock). The contract has an underlying (Company Z stock), a notional amount (30,000 shares), requires no, or a small, initial investment at inception of the contract and is settled in Company Y stock (an asset that is associated with neither the underlying nor in a denomination equal to the notional amount); therefore, we believe TGK Corporation should account for the contract as a derivative instrument because it meets the definition of a derivative instrument pursuant to paragraph 6 of the Standard (ASC paragraph 815-10-15-83(c)).
12. ABC enters into a one-year contract to purchase 34,000 gallons of fuel oil at a fixed price from an oil company to satisfy its normal requirements for fuel oil. The contract provides that as an alternative to taking physical delivery of fuel oil, during any given month, either party may elect to settle the contract net cash for the difference between the fixed price in the contract and the market price of the fuel oil. However, ABC has concluded at the inception of the contract that it is probable at inception and throughout the term of the contract that it will not be settled net and that ABC will take physical delivery of the 34,000 gallons of fuel oil. In addition, ABC has documented its basis for this conclusion.

Q. Should ABC account for the contract as a derivative instrument under the Standard?

A. No. Paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22, 15-30, 15-37, 15-38, and 15-40 through 15-45) addresses contracts that are considered normal purchases and normal sales and are excluded from the scope of the Standard if the contract is for the purchase or sale of something other than a financial asset or derivative instrument to be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period of time. The contract entered into by ABC, which allows for net settlement, can still meet the normal purchases and normal sales exception if it is probable at inception of the contract and throughout the contract term that the contract will not be settled net and will result in physical delivery.

Since ABC’s purchase of 34,000 gallons of fuel oil is in a quantity that will meet its requirements over a reasonable period of time in the normal course of business, and ABC has concluded at the inception of the contract, and throughout the term of the contract, that it is probable that it will not settle the contract net and will take physical delivery and has documented its basis for such conclusion, the contract meets the normal purchases and normal sales exception of the Standard.

13. Q. Does a contract that meets the definition of a derivative and that provides payment to the holder in the event that a debtor files for bankruptcy meet the scope exception for financial guarantee contracts contained in paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58)?

A. No. Paragraph 10(d) (ASC paragraph 815-10-15-58) provides an exception for certain financial guarantee contracts if, among other things, they only reimburse the guaranteed party because the debtor fails to pay when payment is due, which is an identifiable insurable event. Filing for bankruptcy does not meet this criterion since payment is made under the contract before payment by the debtor is due and the debtor fails to make the payment.

14. Bank A has a two-year, $50 million, 15% fixed-rate loan with Company Z and wants to hedge its credit exposure on this loan. To hedge the credit exposure associated with this loan, Bank A enters into an arrangement with Bank B. The terms of the arrangement provide that Bank A will pay Bank B all principal and interest collected from Company Z on the loan. In return, Bank B will pay Bank A interest at an annual rate of 9% (on a notional amount of $50 million) plus a $50 million payment in two years. This contract settles on a net basis at the end...
of each of the next two years. At the end of year two, Bank A transfers legal title on the loan to Bank B.

Q. Assuming the arrangement meets the definition of a derivative, does it meet the exception for financial guarantee contracts in paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58)?

A. No. Paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58) excludes only those financial guarantees that, among other things, represent payments to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations when the debtor’s obligation is past due. Although this contract is similar to a financial guarantee contract because no matter how Company Z performs on the loan, Bank A will receive the principal plus a 9% return, the contract does not explicitly require nonpayment by Company Z before Bank B will reimburse Bank A and, therefore, does not meet the exclusion in paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58).

15. LAK Co. enters into a contract that is an option to purchase a piece of artwork owned by ALB Co. for a specified price in six months. LAK Co. pays ALB Co. a premium for this purchased option.

Q. Should LAK Co. account for the arrangement as a derivative instrument under the Standard?

A. No. Paragraph 10(e)(2) of the Standard (ASC paragraphs 815-10-15-59(b) and 15-59(c)) specifically from the scope of the Standard contracts that are not exchange-traded if the underlying on which settlement is based is the price or value of a nonfinancial asset of one of the parties to the contract provided that the nonfinancial asset is not readily convertible to cash. The nonfinancial asset must be unique (i.e., not an interchangeable unit) and the nonfinancial asset related to the underlying must be owned by the party that would not benefit under the contract from an increase in the price or value of the nonfinancial asset.

This arrangement represents an option to purchase a nonfinancial asset (i.e., a piece of artwork), which generally would be considered a unique nonfinancial asset (i.e., it is not an interchangeable unit). In addition, the artwork is a nonfinancial asset of one of the parties to the contract and is not readily convertible to cash. ALB Co., the owner of the nonfinancial asset (i.e., the art work) will not benefit under an option contract from an increase in the price or value of the work of art since the option contract is for a specified price.

Therefore, we believe this arrangement is explicitly excluded from the scope of the Standard by paragraph 10(e)(2) (ASC paragraphs 815-10-15-59(b) and 15-59(c)). As such, LAK should not account for the arrangement as a derivative instrument under the Standard.

16. Retail Company is the lessee of retail space that is used to house their retail outlet. The terms of the lease require Retail Company to pay 25% of its net profit each month as the lease payment.

Q. Assuming the arrangement meets the definition of a derivative, does it meet the exception for certain contracts that are not exchange-traded in paragraph 10(e)(3) of the Standard (ASC paragraph 815-10-15-59(d))?

A. It depends. Paragraph 10(e)(3) of the Standard (ASC paragraph 815-10-15-59(d)) specifically excludes from the scope contracts that are not exchange-traded if the underlying on
which settlement is based is specified volumes of sales or service revenues of one of the parties to the contract. Some believe this exception applies only to specified volumes of sales or service revenue. Others believe that it also applies to other entity-specific performance measures such as net profit. Paragraph 58(c)(3) of the Standard (ASC paragraph 815-10-15-59(d)) further clarifies this exception by indicating that paragraph 10(e)(3) (ASC paragraph 815-10-15-59(d)) is intended to apply to contracts with settlements based on the volume of items sold or services rendered, for example, royalty agreements. It is not intended to apply to contracts based on changes in sales or revenues due to changes in market prices. Therefore, those that have a narrower view of the application of the exception believe that since an entity’s net profit includes items other than retail sales (e.g., compensation and other costs) that are market driven, the contract does not meet the scope exception set forth in paragraph 10(e)(3) of the Standard (ASC paragraph 815-10-15-59(d)). Those that hold a broader view of the application of the exception believe that the contract satisfies the exception based on discussion included in the status sections of EITF 97-8 and EITF 86-21 (ASC paragraph 815-15-55-10). We believe that either view is acceptable as long as the underlying in the contract does not change due to changes in market prices or indices. Retail Company should select a policy and follow it consistently.

Even if Retail Company selects the narrower view of the application of the exception, as per paragraph 10(e) of the Standard (ASC paragraph 815-10-15-59(d)), if net profit does not behave in a manner that is highly correlated with the behavior of any of the components of net profit except the volume of items sold, the arrangement would still be excluded from the Standard.

17. ABC enters into a loan commitment with XYZ bank paying a 50 basis point fee to lock into a 7% rate today for a working capital loan that will be made in three months.

Q. Does the loan commitment qualify as a derivative instrument under the Standard?

A. No. Per paragraph 10(i) of the Standard (ASC paragraph 815-10-15-69), neither the holder nor the issuer of the commitment accounts for the commitment as a derivative. Commitments to originate mortgage loans that management intends to hold for investment purposes and all other types of loans are excluded from the Standard. A working capital loan is an example of other types of loans (non-mortgage).

18. XYZ Co. is the holder of a commitment from ABC Bank to originate to XYZ a $200,000 commercial mortgage loan at an interest rate of 6.5%. ABC Bank intends to sell the loan once originated.

Q. Does the commitment to originate the mortgage loan that will be sold qualify as a derivative instrument under the Standard?

A. It depends. Per paragraphs 6 (ASC paragraph 815-10-15-83) and 10(i) of the Standard (ASC paragraph 815-10-15-69), the determination of whether a commitment to originate a mortgage loan that will be sold is excluded under the Standard depends on which role an entity plays in the contract. From the holder’s (XYZ Co.) perspective, the commitment is excluded from the Standard because holders of any loan commitment to borrow are precluded from applying the Standard. However, from the issuer’s (ABC Bank) perspective, since it is the issuer’s intention
to sell the loan in the future, the commitment is automatically included as a derivative under the Standard.

19. XYZ Bank commits to sell at par to ABC Bank a $1,000,000 pool of conforming 1-4 family conventional mortgage loans with a weighted average rate of 6.5%. ABC Bank intends to eventually resell these mortgage loans.

Q. Does the commitment to sell a pool of mortgage loans that will be resold qualify as a derivative instrument under the Standard?

A. It depends. Paragraph 6 and 10(i) of the Standard (ASC paragraph 815-10-15-83 and ASC paragraph 815-10-15-69) do not address commitments to sell or buy loans. Thus the contract must be evaluated by both parties to ascertain whether it meets the characteristics of a derivative under the Standard.

Other Exceptions

(Paragraph 11 of the Standard (ASC paragraphs 815-10-15-74 and 15-75))

20. MG Corp. enters into a contract to sell 10,000 shares of its own common stock at $350 per share to Rascal Co. in six months. The contract may be settled through physical settlement (i.e., delivery of MG Corp. common stock) or in net cash at the option of Rascal Co.

Q(a). Should MG Corp. account for the contract as a derivative instrument under the Standard?

A. Yes. Paragraph 11 of the Standard (ASC paragraphs 815-10-15-74 and 15-75) address contracts that are excluded from the scope of the Standard. Paragraph 11(a) of the Standard (ASC paragraphs 815-10-15-74 and 15-75) specifically exclude contracts that are issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in its stockholders’ equity. EITF 00-19 (ASC Subtopic 815-40) sets forth the accounting for forward sale contracts that are indexed to and potentially settled in a company’s own stock. Pursuant to EITF 00-19 (ASC Subtopic 815-40), this contract would be accounted for as an asset or liability because it can be settled through physical delivery of MG Corp. stock, or in net cash at the option of Rascal Co. Thus, the contract would not be included in stockholders’ equity of MG Corp.

The contract has an underlying (the price of MG Corp. stock), a notional amount (10,000 shares of MG Corp. stock), requires no initial investment at inception of the contract, and is settled in net cash or MG Corp. stock, which is readily convertible to cash; therefore, we believe MG Corp. should account for the arrangement as a derivative instrument because it meets the definition of a derivative instrument pursuant to paragraph 6 of the Standard (ASC paragraph 815-10-15-83) and is not explicitly excluded from the scope by paragraphs 10 (ASC paragraphs 815-10-15-13 through 15-82) or 11 of the Standard (ASC paragraphs 815-10-15-74 and 15-75).

Q(b). Would MG Corp. account for the contract as a derivative instrument under the Standard if the contract permitted settlement through physical settlement or net cash at the option of MG Corp. and the additional conditions of paragraphs 12 - 32 of EITF 00-19 (ASC paragraphs 815-40-25-7 through 25-35) were met?

A. No. If the contract permitted settlement in net cash or physical settlement at the option of MG Corp. and the additional conditions of paragraphs 12 - 32 of EITF 00-19 (ASC paragraphs
815-40-25-7 through 25-35) were met, the contract would be classified as permanent equity. We believe the contract would be explicitly excluded as a derivative instrument pursuant to paragraph 11(a) of the Standard (ASC Topic 815-10-15-74(a)). Therefore, MG Corp. should not account for the arrangement as a derivative instrument under the Standard. Note, however, that Rascal Co. would account for the instrument as a derivative instrument.

21. In connection with a purchase business combination JEE Co. issues a certificate to selling shareholders. The value of the certificate is indexed to the acquired company’s earnings over the next five years.

Q. Should JEE Co. account for the certificate as a derivative instrument under the Standard?

A. No. Paragraph 11(c) of the Standard (ASC paragraph 815-10-15-74(c)) specifically excludes from the scope of the Standard contracts issued by an entity as contingent consideration in a business combination. The certificate represents a contingent consideration arrangement in a business combination and is explicitly excluded from the scope of the Standard by paragraph 11(c) (ASC paragraph 815-10-15-74(c)) and, as such, JEE Co. should not account for this arrangement as a derivative instrument under the Standard. However, the seller of the business (and holder of the agreement) is not explicitly excluded from the Standard by paragraph 11(c) (ASC paragraph 815-10-15-74(c)) and would be subject to the provisions of the Standard if the agreement meets the definition of a derivative instrument under paragraph 6 of the Standard (ASC paragraph 815-10-15-83) and is not explicitly excluded from the scope by paragraphs 10 (ASC paragraphs 815-10-15-13 through 15-82) or 11 of the Standard (ASC paragraphs 815-10-15-74 and 15-75).
Section Three: Embedded Derivative Instruments (updated July 2019)

INTRODUCTION

Until this point, the definition of a derivative instrument has focused on types of freestanding instruments and arrangements that would be considered derivative instruments under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (Statement 133 or Standard). The Standard, as amended applies not only to freestanding derivative instruments, but also to certain components of nonderivative instruments or contracts that have characteristics that are similar to characteristics of a derivative instrument. These nonderivative instruments and contracts, referred to as hybrid instruments, often contain embedded derivatives.

This chapter discusses the nature of an embedded derivative component, how to identify and analyze embedded derivative components, and how to account for that embedded derivative component. The identification and analysis procedures discussed in this chapter should be applied when the instrument is acquired or created and, in certain circumstances, periodically thereafter.

Appendix A analyzes the embedded derivative provisions of the Standard as they relate to hybrid instruments that contain debt, equity, or lease host contracts. Appendix B analyzes the embedded derivative provisions and other provisions of the Standard as they relate to certain insurance contracts.

FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments (Statement 155), was issued in February 2006, and FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (Statement 159) (ASC Subtopic 825-10, Financial Instruments - Overall), was issued in February 2007. For certain hybrid financial instruments containing an embedded derivative that would otherwise require bifurcation, Statement 155 permits entities to irrevocably elect to initially and subsequently measure that hybrid instrument in its entirety at fair value (with changes in fair value recognized in earnings).1 Statement 159 (ASC Subtopic 825-10) permits a similar fair value election for most financial assets and liabilities (and certain other eligible items), whether they contain an embedded derivative or not. These fair value elections may be chosen on an instrument-by-instrument basis upon initial recognition of an instrument (or upon another qualifying event). Instruments subject to a fair value election could be assets or liabilities and could be acquired or issued by the entity. An instrument for which fair value measurement has been elected is not separated into a host and embedded derivatives (because the entire instrument is carried at fair value through earnings), and may not be designated as a hedging instrument under Statement 133 (ASC Topic 815).

In addition to its fair value measurement election, Statement 155 modifies the existing accounting for certain hybrid financial instruments by:

1 This election may not be applied to the hybrid instruments described in paragraph 8 of Statement 107 (ASC paragraph 825-10-50-8) (for example, equity instruments issued by the entity and classified in stockholders' equity in the statement of financial position).

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(a) Clarifying which interest-only strips and principal-only strips are not subject to the requirements of the Standard,

(b) Establishing a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid instruments that contain an embedded derivative requiring bifurcation (interpreted by DIG Issue B40 "Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets"), and

(c) Clarifying that concentrations of credit risk in subordinated interests in securitized financial assets should not be considered embedded derivatives.

The impact of Statement 155 and DIG Issue B40 is discussed in more detail later in this chapter. Statement 155 is effective for all financial instruments acquired, issued, or subject to a new basis remeasurement event occurring after the beginning of an entity’s first fiscal year that begins after September 15, 2006. DIG Issue D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets" remains effective for instruments recognized prior to the effective date of Statement 155.

Statement 159 (ASC Subtopic 825-10) is effective at the beginning of an entity's first fiscal year that begins after November 15, 2007.

FASB Statement No. 157, Fair Value Measurements (ASC Subtopic 820-10) is effective for fiscal years beginning after November 15, 2007. Statement 157 provides guidance on making fair value measurements, including fair value measurements associated with embedded derivatives. Further, Statement 157 amends EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" (EITF 02-3) (ASC paragraph 815-10-45-9) to remove the prohibition on recognizing certain day-one gains and losses at the inception of a derivative instrument when the transaction price does not equal the initial fair value of the instrument, for instance because the transaction contains an element of dealer profit. Nevertheless, even after adoption of Statement 157, we expect the situations in which day-one gains and losses will be recognized at the inception of derivative instruments or hybrid financial instruments will be limited. See Paragraph 16.02.

Statements 155, 157 (ASC Subtopic 820-10), and 159 (ASC Subtopic 825-10) are only discussed in this chapter to the extent they are relevant to the evaluation of embedded derivatives. This chapter does not contain detailed guidance on making fair value elections or fair value measurements. See additional discussion of these topics in other KPMG guidance.

DEFINING CHARACTERISTICS OF AN EMBEDDED DERIVATIVE COMPONENT

12.01 Paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) discusses the defining characteristics of, and the accounting requirements for, embedded derivative instruments as follows:
12. Contracts that do not in their entirety meet the definition of a derivative instrument (refer to paragraphs 6-9), such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the host contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this Statement if and only if all of the following criteria are met:

(a) The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract. Additional guidance on applying this criterion to various contracts containing embedded derivative instruments is included in Appendix A of this Statement.

(b) The contract (“the hybrid instrument”) that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.

(c) A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6-11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.) However, this criterion is not met if the separate instrument with the same terms as the embedded derivative instrument would be classified as a liability (or an asset in some circumstances) under the provisions of Statement 150, but would be classified in stockholders’ equity absent the provisions in Statement 150.*

* For purposes of analyzing the application of paragraph 11(a) of this Statement to an embedded derivative instrument as though it were a separate instrument, paragraphs 9-12 of Statement 150 should be disregarded. Those embedded features are analyzed by applying other applicable guidance.

Derivatives Implementation Group (DIG) Issues related to this paragraph are A1, B1, B6, B7, B8, B10, B11, B13, B14, B15, B16, B17, B18, B19, B20, B22, B23, B24, B25, B26, B27, B28, B29, B30, B31, B35, B36, B37, B38, C6, C8, D1, K2, and K3 See DIG Issues Index.

12.02 To achieve the Standard’s objective of measuring all derivative instruments at fair value, it is necessary to identify derivatives that are embedded in certain nonderivative instruments and other contracts, and to define the circumstances in which that embedded derivative should be accounted for separately from the host contract. Thus, the Standard explicitly anticipated situations in which entities could circumvent the recognition and measurement requirements of
the Standard by embedding a derivative instrument into a nonderivative instrument or other contract.

12.03 One of the challenges faced by the Financial Accounting Standards Board (FASB or Board) in developing the provisions for embedded derivative instruments was to ensure that situations where significant derivative instruments were embedded in nonderivative instruments or contracts were captured within the scope of this Standard. On the other hand, the Board wanted to ensure that certain conventional instruments containing embedded derivative instruments were excluded from the scope of the Standard (e.g., a conventional mortgage loan containing an embedded prepayment or call option). To meet these challenges, the Board developed defining characteristics to help identify derivative instruments that are embedded in other nonderivative instruments or contracts as well as instances when those embedded derivatives warrant separate accounting.

Identification and Analysis of Embedded Components

12.04 Identifying and analyzing embedded derivative instruments can be a complex process. This section of the chapter discusses the characteristics of embedded derivative instruments and identifies situations in which the embedded derivative warrants accounting separate from the nonderivative instrument or contract (referred to as the host contract) in which the derivative component is embedded. A flowchart is presented toward the end of this chapter (in Paragraph 16.03 as Exhibit 3.2) to illustrate the decision-making process needed to determine the accounting for an embedded derivative instrument. The critical steps relative to the identification and analysis of embedded derivative components are as follows:

- Identification of a contract as a hybrid instrument;
- Determination of the nature of the host contract;
- Identification of the embedded component;
- Determination of whether the embedded component meets the definition of a derivative; and
- Determination of whether the embedded derivative warrants accounting separate from the host contract.

Identification of a Contract as a Hybrid Instrument

12.05 A hybrid instrument is a contract that does not in its entirety meet the definition of a derivative instrument in paragraphs 6 - 9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128), but contains explicit or implicit terms that affect some or all of the cash flows under the contract in a manner similar to the way in which the terms of a derivative instrument affect its cash flows. A hybrid instrument comprises a host contract and one or more embedded components. A common example of a hybrid instrument is a debt instrument that contains a put option, call option, conversion option, or a combination thereof.

12.06 A hybrid instrument is a contract that does not, in its entirety, meet the definition of a derivative instrument. In general, an instrument cannot be a hybrid instrument if it meets the definition of a derivative in its entirety but is explicitly excluded from the scope of the Standard.
by paragraphs 10 or 11 (ASC paragraphs 815-10-15-13 through 15-82). See Paragraph 10b.17 in Chapter 2 for a discussion of this with respect to a normal purchases and normal sales contract. Also see Paragraph B3.19 in Appendix B to this chapter for a discussion of an exception to this with respect to a variable annuity insurance contract.

12.07 If the hybrid instrument is remeasured at fair value through earnings, the hybrid instrument is not subject to the embedded derivative provisions of the Standard because the entire instrument is carried at fair value through earnings, including the embedded components. When the entire hybrid instrument is measured at fair value, the embedded derivative component should not be accounted for separately from the host contract. Thus, for example, a hybrid instrument that qualifies for, and for which an entity has selected, the fair value option in Statement 159 (ASC Subtopic 825-10), would not be subject to the embedded derivative provisions of the Standard. For all other hybrid instruments, an entity should understand and analyze the economic characteristics and nature of the risks of the components of the hybrid instrument to determine whether an embedded derivative exists and whether the embedded derivative should be accounted for separately from the host contract. For certain hybrid financial instruments containing an embedded derivative that would otherwise require bifurcation from the host contract, Statement 155 permits entities to irrevocably elect to initially and subsequently measure the hybrid instrument in its entirety at fair value (with changes in fair value recognized in earnings). In circumstances where fair value measurement is elected for an entire hybrid financial instrument pursuant to the guidance in Statement 155 or Statement 159 (ASC Subtopic 825-10), the embedded derivative component should not be accounted for separately from the host contract.

12.08 For a hybrid instrument to be remeasured at fair value through earnings, the entire hybrid instrument must be remeasured at fair value, and the changes in that fair value must be reported currently in earnings. If the entire hybrid instrument is remeasured at something other than fair value or only a component of the hybrid instrument is remeasured at fair value, the hybrid instrument must be evaluated under the provisions of paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) to determine whether the embedded derivative must be accounted for separately from the host. For example, an instrument that is remeasured, in whole or in part, at redemption value or contract value must be evaluated under the provisions of paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14). (See DIG Issue B24 for further reference.)

12.09 The Standard also requires the application of the embedded derivative provisions to available-for-sale hybrid instruments, which are otherwise reported at fair value with changes in other comprehensive income (OCI). Applying the embedded derivative provisions to available-for-sale hybrid instruments (e.g., available-for-sale securities) so that any embedded derivative instruments that are not clearly and closely related to the host contract receive accounting as derivative instruments (rather than as available-for-sale securities) is more consistent with the overall goal of the Standard.

12.10 The following fact pattern is used throughout this section to illustrate the steps necessary to identify and analyze embedded components. Assume Company A issues a five-year financial instrument with a principal amount of $1,000,000 indexed to the stock of Company B (an unrelated public entity whose common shares are actively traded). At inception, Company A receives $1,000,000 from the holder of the instrument; at maturity the holder will receive
$1,000,000 plus or minus any appreciation or depreciation, respectively, in the fair value of 10,000 shares of Company B. Assume that the market price of Company B stock to which the debt instrument is indexed is $100 per share at the issuance date. Also assume no separate interest payments are made. Because the instrument requires an initial net investment equal to the notional amount ($1,000,000), the instrument itself is not a derivative instrument. However, because the cash flows required by the instrument are affected by changes in the equity price of Company B in a manner similar to the cash flows of a derivative instrument (the cash flows of the debt instrument will vary based upon the changes in value of another entity’s equity), the instrument is a hybrid. Company A did not elect to account for the entire instrument at fair value through earnings under Statement 159 (ASC Subtopic 825-10). In addition, U.S. GAAP does not require that the issuer account for such indexed debt instruments at fair value with changes in fair value recognized in earnings. For indexed debt instruments that do not contain an embedded derivative, EITF Issue No. 86-28, “Accounting Implications of Indexed Debt Instruments,” (EITF 86-28) (ASC Subtopic 470-10) provides the applicable guidance under U.S. GAAP. Under that Issue, Company A would have recorded changes in the liability resulting from a change in the index (market price of Company B’s stock) as an adjustment of the carrying amount of the debt obligation that is recognized in earnings currently. Remeasuring at the index is not the same as remeasuring at fair value. Thus, the hybrid instrument must be further analyzed to determine whether its components must be accounted for separately from the host. (See DIG Issues B1) and DIG Issue B24 for additional information.) If an indexing feature in a debt instrument is separately accounted for by the issuer as a derivative under the Standard, the guidance in EITF 86-28 would not apply. However, if an indexing feature in a debt instrument does not require separate accounting by the issuer as a derivative under the Standard, the consensuses in EITF 86-28 would be applied to the hybrid instrument.

**Determination of the Nature of the Host Contract**

12.11 After identifying a contract as a hybrid instrument, it is necessary to identify the nature of the host contract. A host contract is the nonderivative instrument or contract component in a hybrid instrument. The most common types of host contracts are debt, equity, and leasing contracts. Identifying the nature of the host contract is critical to analyzing whether an embedded component of the hybrid requires separate accounting. The type of host contract will provide a reference point to evaluate whether the host and embedded component are clearly and closely related as discussed below. In certain circumstances the identity of the host contract is evident from the nature of the hybrid instrument. For example, if a financial instrument host contract encompasses a residual interest in an entity, the economic characteristics and risks may be considered that of an equity instrument (equity host). If, however, the financial instrument host contract does not embody a claim on the residual interest in an entity, the economic characteristics and risks may be considered that of a debt instrument (debt host).

12.11a The Standard requires the determination of the nature of a host contract (e.g., more like debt or more like equity) to be made based on an evaluation of the overall nature and substance of the hybrid instrument. Although the Standard does not provide comprehensive guidance for making this determination, guidance has developed on the evaluation of the host contract in a hybrid instrument issued in the form of share through SEC staff speeches and announcements. That guidance requires the evaluation of the nature of a host contract to consider all of the terms and features of the hybrid (i.e., it is inappropriate to exclude terms and features in coming to this
conclusion). For instance, an instrument issued in the form of a share may contain a debt host if the overall characteristics of the share instrument make it more debt-like than equity-like (for instance, if it contains a fixed dividend rate and a mandatory redemption date). The fact that the share may be classified in permanent or temporary equity under other GAAP is not determinative for this purpose. Because many preferred share instruments with debt-like characteristics (such as fixed price redemption features) are classified in stockholders' equity under other GAAP, this substance-based analysis can be particularly challenging for preferred share instruments. A more detailed discussion of determining the nature of a host contract for a share (which may also be applicable in many cases for evaluating non-share instruments) is included in Appendix A to this chapter starting at paragraph A3.31.

12.12 Using the example from Paragraph 12.10 above, we believe the host contract is a debt instrument because the instrument has a stated maturity date and the holder has none of the rights of a shareholder, for example, the ability to vote the shares or receive distributions to shareholders.

Identification of the Embedded Component

12.13 The Standard does not provide specific guidance about how to identify the components that are embedded in a hybrid instrument. We believe that if a hybrid instrument or contract is valued in a manner other than the manner that would be applied to similar non-hybrid instruments or contracts, it may contain an embedded component. In the example in Paragraph 12.10 above, the embedded component has an equity-based underlying (the fair value of the stock of Company B). In that example, the host contract may be considered a debt instrument and the embedded component may be considered an equity-based component in general terms. However, to analyze whether the embedded component needs to be accounted for separately from the host under the Standard, the entity needs to identify the specific terms of both the host contract and the embedded component. Based on the information in Paragraph 12.10 above, from the perspective of Company A, we believe a reasonable approach would be to view the embedded component as a total return equity swap in which Company A receives a fixed or floating rate of interest based on $1,000,000 notional amount and pays or receives the return on 10,000 shares of the stock of Company B. The fixed or floating rate of interest would be set so that the fair value of the equity swap would be zero at the issuance date of the instrument. The debt host would contain an implied interest rate equal to that of the receive leg of the equity swap.

12.14 Certain terms are added to contracts by a third party either contemporaneously or subsequent to the issuance of an instrument and are not considered embedded in the hybrid instrument. For example, if a third party adds a put or call option to a debt instrument contemporaneously with or subsequent to the issuance of a debt instrument, that put or call option is not considered an embedded component of the debt host, but instead, must be analyzed as a freestanding instrument under the provisions of the Standard. (See DIG Issue B3 for further reference.)

12.15 Some terms are added to a contract contemporaneously with its issuance whereby those terms are explicitly transferable independent of the contract and, thus, potentially exercisable by a party other than the issuer or holder of the contract and are not considered embedded in the hybrid instrument. For example, a call option that is transferable by the debtor or investor to a
third party based on the legal agreements governing the debt issuance can result in having different counterparties for the option and the original debt instrument. Accordingly, even when such an option is incorporated into the terms of the original debt agreement, it must be analyzed as a freestanding instrument under the provisions of the Standard because it can be separated from the debt instrument and effectively sold to a third party. (See DIG Issue K2 for further reference.)

**Determination of Whether the Embedded Component Meets the Definition of a Derivative**

**12.16** For an embedded component to be accounted for separately from the host contract, it must meet the definition of a derivative instrument in paragraph 6 of the Standard (ASC paragraph 815-10-15-83) as if it were a freestanding instrument. In addition, it must not be excluded from the scope of the Standard under paragraphs 10 and 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82). In applying the provisions of paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)) to determine whether the embedded component meets the definition of a derivative instrument, paragraph 12(c) of the Standard indicates (ASC paragraphs 815-15-25-1(c) and 25-14) indicate that the initial investment for the hybrid instrument should not be considered to be the initial net investment for the embedded component. Rather, conceptually the initial investment in the embedded feature is the fair value of that feature at the evaluation date (i.e. how much one would pay or receive to enter into the feature if it were a freestanding derivative). See Paragraphs 16.07-16.12 for further discussion. If the embedded component meets the definition of a derivative under paragraph 6 of the Standard (ASC paragraph 815-10-15-83), it may be excluded from the scope of the Standard (ASC Topic 815) based on the exclusions discussed in paragraphs 10 and 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82). Therefore, the embedded component would not need to be separated from the host contract and accounted for separately. (Refer to Chapter 2 for a discussion of the defining characteristics of a derivative instrument subject to the provisions of the Standard as well as the situations in which an instrument is excluded from the scope of the Standard.)

**12.17** Entities must be careful when analyzing embedded components to ascertain if they meet the net settlement criterion. At times, the hybrid instrument may not meet the net settlement criterion but the embedded component does. For example, a forward contract to sell a ship in six months that includes a pricing feature that changes the final price of the ship based on changes in silver would not meet the net settlement criterion as follows: (1) the seller is required to deliver an asset (the ship) that is associated with the underlying of the contract (the price of the ship) and that has the same denomination (one ship) as the contract, thus the criterion of paragraph 9(a) (ASC paragraph 815-10-15-100) is not met; (2) there is no market mechanism that facilitates net settlement of the forward contract, thus the criterion of paragraph 9(b) (ASC paragraph 815-10-15-110) is not met; and (3) the ship being delivered under the contract is not readily convertible to cash or a derivative instrument, thus the criterion of paragraph 9(c) (ASC paragraphs 815-10-15-119 and 15-120) is not met. However, the embedded component, a forward silver contract, does meet net settlement under paragraph 9(a) (ASC paragraph 815-10-15-100): neither party is required to deliver silver, the asset associated with the underlying of the embedded component. One party delivers a ship and the other cash. If all other criteria for bifurcation in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) are met, the forward silver contract would be separated and accounted for as a derivative instrument.
12.18 Paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) addresses an exclusion from the scope of the Standard for contracts that are indexed to the reporting entity’s own stock and classified in stockholders’ equity. FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (Statement 150) (ASC Topic 480), requires issuers to classify specified freestanding financial instruments that embody obligations for the issuer as liabilities (or assets in some circumstances). However, Statement 150 (ASC Topic 480) does not address the classification of embedded features within hybrid instruments. Thus, an entity should not consider the provisions of Statement 150 (ASC Topic 480) when it determines whether the embedded features within hybrid instruments are required to be separated from the instrument under paragraph 12(c) of the Standard (ASC paragraphs 815-15-25-1(c) and 25-14). Rather, the entity should apply other generally accepted accounting principles (GAAP) (e.g., EITF Issues No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock,” (EITF 00-19) (ASC Subtopic 815-40). As discussed in Section 2 of this Handbook, EITF 07-5 establishes a framework for determining whether an instrument (or embedded feature) is indexed to an entity's own stock, which is the first part of the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)). That Issue is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years.

12.18a Also as discussed in Section 2 of this Handbook, in July 2017, the FASB issued ASU No. 2017-11 Earnings Per Share (ASC Topic 260); Distinguishing Liabilities from Equity (ASC Topic 480); Derivatives and Hedging (ASC Topic 815): (Part I) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception (ASU 2017-11) (ASC Subtopics 260 and 505, ASC paragraphs 815-10-15-75A, 815-40-15D, 40-55-33 to 40-55-3A) to address the accounting for certain financial instruments that contain down round features. Under Part 1 of ASU 2017-11, for purposes of evaluating whether a financial instrument meets the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)), an entity excludes any down round feature from its consideration of whether the instrument is indexed to the entity’s own stock. As a result, more instruments may meet the requirements in ASC 815-40-15 to be considered indexed to an entity's own stock.

12.18b ASU 2017-11 (ASC Master Glossary) defines a down round feature as a feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.

12.19 Using the example from Paragraph 12.10 above, the embedded component is considered a total return equity swap. Because the embedded component has two underlyings (the market price of a share of Company B common shares and interest rates) and two notional amounts (10,000 shares and $1,000,000), it meets the characteristic in paragraph 6(a) of the Standard (ASC paragraph 815-10-15-83(a)). The embedded component meets the characteristic in paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)) because it has no initial net investment (fair value of zero). Because neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value,
number of shares, or other denomination that is equal to the notional amount (i.e., the embedded total return equity swap is net-cash-settled at maturity of the instrument), the embedded component meets the characteristic in paragraph 6(c) of the Standard (ASC paragraph 815-10-15-83(c)). As a result, the embedded component meets the definition of a derivative if it is freestanding. In addition, the exclusions discussed in paragraphs 10 and 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82) are not applicable to this embedded derivative.

Determination of Whether the Embedded Derivative Warrants Accounting Separate from the Host Contract

12.20 Deciding whether the identified embedded derivative component should be accounted for separately from the host contract will be the most difficult task in accounting for embedded derivative instruments. After an entity determines that a separate instrument with the same terms would be a derivative instrument under paragraphs 6 - 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-128), the entity must determine whether the economic characteristics and risks of the embedded derivative component are clearly and closely related to the host contract. If they are clearly and closely related, the embedded derivative component would not be separated from the host contract. However, if they are not, the embedded derivative component must be separated from the host contract and accounted for as a derivative instrument.

12.21 As a practical matter, the Board decided that not all embedded derivative components should be required to be accounted for separately from their host contract. Many instruments with embedded derivative components that generally bear a close economic relationship to the host contract have been used for many years and were not developed to achieve a desired accounting result. Variable-rate debt instruments, and mortgage loans and other prepayable debt instruments are examples of such familiar hybrid instruments with embedded derivative components. The accounting for such hybrid instruments with embedded derivative components is well established and generally has not been questioned.

12.22 The Board noted that other instruments, however, such as securities that contain both an interest rate element and an equity or commodity-based element, include derivatives that may cause the value of the entire instrument to vary inversely with changes in interest rates (i.e., in a manner that does not bear a close economic relationship to an interest-bearing debt host contract). The Board decided that those derivative components should be accounted for separately from their host contracts. Thus, whether the embedded derivative components bear a close economic relationship (i.e., are clearly and closely related) to the host contract determines whether they are accounted for separately from the host contract.

12.23 Determining whether an embedded derivative component and the host contract are clearly and closely related will require judgment. The interdependency between the embedded derivative component and the host contract may indicate whether the embedded derivative component is clearly and closely related to its host contract. An embedded derivative component whose fair value is commonly associated with the fair value of the host contract often will be clearly and closely related to that host contract. For example, the fair value of the prepayment option embedded in callable debt is directly affected by the fair value of the debt instrument in which it is embedded. Therefore, the embedded prepayment option generally is clearly and closely related to the interest rate on the debt host instrument. In contrast, the fair value of the derivative component in an equity-indexed debt instrument that pays the holder a return based on increases
in the Standard & Poor’s (S&P) 500 Index is not directly affected by the interest rate on the debt host instrument in which it is embedded. Therefore, the derivative component generally is not considered to be clearly and closely related to the interest rate on the debt host instrument. Several reasonable approaches have developed in practice for determining whether the economic characteristics and risks of an embedded derivative component are not clearly and closely related to the economic characteristics and risks of the host contract in an instrument containing multiple embedded derivatives. We believe the most common approach is one where each embedded component is evaluated against a host contract that does not contain other embedded components that are not integral to the basic nature of the host. In other words, the host includes only features that are critical to its basic nature. See Paragraphs 12.27a-12.27c for further discussion of integral features.

12.23a Appendix A of this chapter provides an analysis and examples of three common host contracts and the application of the clearly and closely related concept. Appendix B of this chapter provides an analysis of the embedded derivative provisions and other provisions of the Standard as they relate to certain insurance contracts.

12.24 Using the example from Paragraph 12.10 above, the embedded derivative is considered a total return equity swap and the host contract is a debt instrument with an implied interest rate equal to the interest rate leg of the total return equity swap and a maturity date on the settlement date for the hybrid instrument. Because the issuer pays a return based on the changes in market value of another entity’s common shares (via the embedded derivative), the embedded derivative component is not considered clearly and closely related to the interest rate on the debt instrument. Thus, Company A would be required to account for that embedded derivative separately from the host contract unless it irrevocably elects, at issuance or upon another qualifying event, to measure the hybrid instrument in its entirety at fair value, with changes in fair value reported in earnings, pursuant to the guidance in Statement 155 or Statement 159 (ASC Subtopic 825-10).

Terms of the Embedded Component

12.25 Paragraphs 176 - 200 of the Standard (ASC paragraphs 815-15-55-54 through 55-56 and 55-165 through 55-221) address several examples of the application of paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1, and 25-14) to hybrid instruments with one embedded component. In practice, many hybrid instruments contain more than one embedded component (e.g., a debt instrument may contain a put option and a call option). Because the Standard does not provide comprehensive guidance about how to identify embedded components, when multiple embedded components are present in a single hybrid instrument, an application issue arises as to how to determine the terms of the embedded components.

12.26 When a hybrid instrument contains more than one embedded component, each is independent and interdependent on one another and may relate to the same risk. In addition, when determining the fair value of a hybrid instrument, the relationship between the host and all components typically is taken into account. That is, although each embedded component within a hybrid instrument that contains multiple embedded components may be thought of on an individual basis, the value of any individual component should somehow take into consideration the other components when valuing the hybrid instrument. For example, if an entity issues a debt instrument that is callable by the issuer and puttable by the holder, the embedded call option and
the embedded put option are independent of each other because each can be exercised by a different party. However, the embedded call option and the embedded put option also depend on each other because the exercise of one effectively cancels the other. For these reasons, identifying the specific characteristics of each embedded component within a hybrid instrument often requires judgment.

12.27 Regardless of the approach taken by an entity in identifying the terms of each embedded component, we believe that the entity must use a consistent approach to determine the characteristics of embedded components within all hybrid instruments. That is, the methodology an entity uses to accumulate embedded components for purposes of determining whether the nonderivative instrument or contract contains an embedded derivative that warrants separate accounting should be consistent for all instruments regardless of the host contract.

Terms of the Host Contract

12.27a While the basic nature of the host (e.g. more akin to debt or equity) considers all of the substantive terms and conditions of the hybrid instrument as discussed at Paragraph 12.11, the Standard provides no guidance for constructing the specific terms of the host once a basic evaluation of the nature has been made. In many cases, there will be no need to identify the specific terms of the host contract because qualitative factors will be determinative in concluding whether an embedded feature is clearly and closely related. For example, a feature that allows the holder to convert the instrument into equity shares of the issuer would not be considered clearly and closely related to the economic characteristics and risks of a debt host but generally would be considered clearly and closely related to the characteristics of an equity host. In this context, the guidance in paragraphs 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) should be considered, as well as the guidance in the appendices to this chapter and any relevant DIG Issues. In other cases, however, determining whether a feature is clearly and closely related to the host will require quantitative analysis that considers specific terms of the host contract. For example, in evaluating whether an interest rate feature (for instance, an embedded written put option) is clearly and closely related to a debt host under paragraph 13 of Statement 133 (ASC paragraphs 815-15-25-26 through 25-29), it may be necessary to determine the initial rate of return on the debt host. However, the initial rate of return on the debt host may be impacted by other embedded features in the hybrid instrument. As such, a question arises as to whether the host contract should include any other embedded features (and if so, which ones) in determining whether an individual feature is clearly and closely related to the host contract.

12.27b There is limited guidance on identifying the terms of a debt or equity host in the Standard. DIG Issue B19 notes that the terms of the host generally should be determined based on the stated or implied substantive terms of the hybrid instrument, but notes that this determination may require judgment in many circumstances. In the absence of more detailed guidance, we believe there may be several possible reasonable approaches. However, we believe an integral features approach is used most commonly in practice. Under an integral features approach, all embedded features that must be evaluated as possible derivatives are excluded from the host contract in determining the specific terms of the host contract. However, features of the hybrid instrument that are clearly integral to the basic nature of the host are included in the terms of the host.
For example, consider a mandatorily redeemable convertible preferred share with a cumulative fixed rate dividend and several put and call features that has been determined to be a debt host using the guidance beginning at Paragraph A3.31 in Appendix A of this chapter. In determining the specific terms of the host, the host would be a debt instrument with a fixed rate of interest, a maturity date on the mandatory redemption date, and a par value equal to the redemption price. The conversion feature, as well as the various puts and calls, would be excluded from the host because they are not integral to the basic nature of the debt host. Under this approach, the mandatory redemption feature is considered integral to the debt host (indeed, it is likely the primary reason that the host is considered debt) and therefore is included as a term of the debt host when determining whether embedded derivative features are clearly and closely related to the host. Including the redemption feature as a term of the debt host is consistent with DIG Issue B19, which states that the terms of the host "should be based on the stated or implied substantive terms of the hybrid instrument". Identifying an integral feature requires judgment. At a minimum, we would expect a feature to be clearly and closely related to the host in order to qualify as integral. Note that while under this approach non-integral embedded features are excluded in determining the terms of the host, the determination of the nature of the host (akin to debt or equity) must consider all features of the hybrid as discussed in Paragraph 12.11a.

Separating Multiple Embedded Derivatives

As indicated above, after the terms of each embedded component are identified and the entity concludes that a component individually warrants separate accounting as a derivative instrument under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14), the entity must separate that embedded derivative from the host contract. If an entity identifies more than one component, each of which would individually warrant separate accounting as a derivative instrument under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14), those individual embedded derivatives must be bundled together as a single, compound embedded derivative instrument and be bifurcated and accounted for separately from the host contract under the Standard. Thus, an entity cannot embed a compound derivative in a hybrid instrument and separate that compound derivative into multiple derivatives based on the dissimilar components.

It is important to note that if some, but not all, of the embedded derivatives in a hybrid instrument are clearly and closely related to the economic characteristics and risks of the host contract, those embedded derivatives that are clearly and closely related should not be included in the compound derivative that is bifurcated from the host contract. See DIG Issue B15 for further reference. Further, as discussed above, we believe that features that are not bifurcated should not be included in determining the specific terms of the host contract (for purposes of determining whether individual features are clearly and closely related to the host) unless they are integral to the basic nature of the host contract.

EMBEDDED DERIVATIVE COMPONENTS RELATING TO INTEREST-BEARING CONTRACTS

Paragraphs 13 and 14 of the Standard (ASC paragraphs 815-15-25-26 through 25-29 and 815-10-15-72 and 15-73) address the clearly and closely related concept as it relates to interest-bearing contracts. Those paragraphs discuss common relationships between interest rate features
and interest-bearing contracts and provide guidance about determining whether those types of contracts include embedded derivative components that should be accounted for separately.

**13.02** Paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) addresses specific contract terms as follows:

13. For purposes of applying the provisions of paragraph 12, an embedded derivative instrument in which the only underlying is an interest rate or interest rate index\(^6\) that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following conditions exist:

(a) The hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover *substantially* all of its initial recorded investment.\(^*\)

(b) The embedded derivative meets both of the following conditions:

(1) There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor’s initial rate of return on the host contract.

(2) For any of the possible interest rate scenarios under which the investor’s initial rate of return on the host contract would be doubled (as discussed under paragraph 13(b)(1)), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under the relevant future interest rate scenario) for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer’s credit quality at inception.

Even though the above conditions focus on the investor’s rate of return and the investor’s recovery of its investment, the existence of either of those conditions would result in the embedded derivative instrument not being considered clearly and closely related to the host contract by both parties to the hybrid instrument. Because the existence of those conditions is assessed at the date that the hybrid instrument is acquired (or incurred) by the reporting entity, the acquirer of a hybrid instrument in the secondary market could potentially reach a different conclusion than could the issuer of the hybrid instrument due to applying the conditions in this paragraph at different points in time.

\(^6\) Examples are an interest rate cap or an interest rate collar. An embedded derivative instrument that alters net interest payments based on changes in a stock price index (or another non-interest-rate index) is not addressed in paragraph 13.

\(^*\) The condition in paragraph 13(a) does not apply to a situation in which the terms of the hybrid instrument permit, but do not require, the investor to settle the hybrid instrument in a manner that causes it not to recover substantially all of its initial recorded investment, provided that the issuer does not have the contractual right to demand a settlement that causes the investor not to recover substantially all of its initial net investment.
DIG Issues related to this paragraph are A23, B2, B5, B6, B9, B13, B16, B39, B40, C6 and D1 (for instruments recognized prior to adoption of Statement 155). See DIG Issues Index.

13.03 Paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) applies to embedded derivatives with a single interest rate or interest rate index underlying for which the embedded derivative can potentially change the amount or timing of an interest payment that otherwise would be paid or received on the host contract. Examples of embedded derivatives that can potentially cause that change include interest rate caps, interest rate floors, interest rate collars, call options and put options within debt host contracts. An embedded derivative that alters net interest payments based on changes in an underlying that is not an interest rate or interest rate index, such as a stock price, inflation or credit index, is not addressed in paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29). In addition, an embedded derivative that alters net interest payments based on changes in an interest rate underlying in combination with another index such as a stock price, inflation, or credit index (or another interest rate or interest rate index underlying) is not addressed in paragraph 13 (ASC paragraphs 815-15-25-26 through 25-29). Neither is an embedded call nor put option that is contingent on the occurrence of an event such as a change in control. The feature has two underlyings: the contingency occurring or not occurring and the interest rate. For example, an embedded call or put option containing multiple underlyings that can accelerate the settlement of debt instruments is addressed in paragraph 61(d) (ASC paragraphs 815-15-25-40 and 25-41), as interpreted by DIG Issue B16 rather than paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29). See further discussion in paragraphs A3.12-A3.13 of Appendix A to this chapter.

13.04 Most embedded derivative components that are interest rate related would be considered clearly and closely related to a debt host. However, an embedded derivative that introduces leverage would not be considered clearly and closely related. Paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) provides a test to determine whether the embedded derivative introduces leverage and, therefore, is not considered clearly and closely related to the debt host. The Standard discusses two situations in which this leveraging could occur:

- The hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover substantially all of its initial recorded investment.

- The following two conditions are met: (1) there is a possible future interest rate scenario under which the embedded derivative would at least double the investor’s initial rate of return on the host contract, and (2) for any of those scenarios, the embedded derivative also would result in a rate of return that is at least twice what otherwise would be the then-current market return for a contract that has the same terms as the host contract.

13.05 If there is a possibility, regardless of how remote, that either one of the situations in paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) could be met, the embedded interest rate derivative would not be considered clearly and closely related to the debt host. The condition of paragraph 13(b) (ASC paragraph 815-15-25-26(b)) is met if one of the situations that meets the condition of paragraph 13(b)(1) (ASC paragraph 815-15-25-26(b)(1)) also meets the condition of paragraph 13(b)(2) (ASC paragraph 815-15-25-26(b)(2)). Paragraph 13(b) is not meant to be read to say that the condition is met only if all of the situations that meet
the condition of paragraph 13(b)(1) also meet the condition of paragraph 13(b)(2). This reading would result in an embedded derivative rarely considered as not clearly and closely related.

13.06 The analysis of the two situations of paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) in which an interest rate embedded derivative may not be considered clearly and closely related to a debt host is applicable to both parties (issuer and investor) at inception of the instrument. As such, one would expect symmetry in the treatment of the instrument by both the issuer and the investor. However, because many instruments trade in secondary markets and the analysis also must be performed at acquisition of the instruments, an entity that acquires the instrument in the secondary market analyzes whether the conditions of paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) are met at a later date than the issuer. Thus, the secondary market purchaser may arrive at a conclusion about whether the embedded derivative feature is clearly and closely related to the debt host that is different from the issuer’s or original purchaser’s conclusion.

**Investor Could Not Recover Substantially All of Its Initial Recorded Investment**

13.07 An embedded derivative component may have a leveraged effect on the return on a hybrid instrument if a change in interest rates could cause the investor not to recover substantially all of its initial recorded investment based on its contractual terms. Paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) does not define when an investor is considered not to “recover substantially all of its initial recorded investment.” However, we believe that the investor would not recover substantially all of its initial recorded investment if it is possible that the investor would not recover 10% or more of its initial recorded investment.

13.08 When determining whether substantially all of an initial recorded investment is not recovered based on contractual terms, an entity should evaluate whether the undiscounted net cash inflows over the life of the instrument would be sufficient for the investor to recover substantially all of its initial recorded investment in the hybrid instrument. This is typically a concern with instruments, for example, structured notes or residual interests in certain transactions that have been issued with leveraged interest rate derivative components. The following illustrates this concept:

**Example 3.1: Structured Note**

Company A purchases for $10,000,000 a structured note with a face amount of $10,000,000, a coupon of 9% and a term of two years. The terms of the structured note require that if the interest rate for single-A-rated debt decreases to 5% while the note is outstanding, the principal amount on the note is reduced to $7,500,000. While the embedded derivative component is interest rate related and the host contract is a debt instrument, it is possible for the hybrid instrument to contractually settle in such a way that the investor might not recover substantially all of its initial recorded investment. For example, if the interest rate for single-A-rated debt decreased to 5% immediately after issuance of the structured note, the undiscounted net cash inflows received by the investor over the two-year life of the instrument would be $8,850,000 ($7,500,000 principal and $1,350,000 interest) and the investor would not recover 11.5% ($1,150,000) of its $10,000,000 initial recorded investment. As such, the embedded
derivative instrument is not considered to be clearly and closely related to the host contract under paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a)), based on the guidance in paragraph 13 (ASC paragraphs 815-15-25-26 through 25-29), and Company A is required to analyze the embedded component under paragraphs 12(b) and 12(c) of the Standard (ASC paragraphs 815-15-25-1(b), 25-1(c) and 25-14) to determine whether it is required to separate that component from the host contract. The structured note is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur, so the criterion for separation in paragraph 12(b) (ASC paragraph 815-15-25-1(b)) is met. If the host contract was identified as a $10,000,000, 12% fixed-rate debt instrument and the embedded component was identified as a written floor contract with a strike price of 5% and a settlement amount of $2,500,000, that written floor contract would meet the requirements of paragraphs 6 - 9 of the Standard (ASC paragraphs 815-15-83 through 15-128) (and would not be excluded by paragraphs 10 or 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82)), so the criterion for separation in paragraph 12(c) (ASC paragraph 815-15-25-1(c) and 25-14) is met. Because the criteria in paragraphs 12(a) – 12(c) (ASC paragraphs 815-15-25-1(a) through 25-1(c) and 25-14) are met, the embedded derivative would be separated from the host contract and accounted for as a derivative instrument pursuant to the Standard unless the entity irrevocably elects, at issuance or in connection with another qualifying event, to measure the hybrid instrument in its entirety at fair value, with changes in fair value reported in earnings, pursuant to the guidance in Statement 155 or Statement 159 (ASC Subtopic 825-10). (See DIG Issue B2 for further reference.)

13.09 Some instruments allow the investor to choose whether the instrument will settle in such a way that allows the investor not to recover substantially all of its initial recorded investment. For example, assume that at issuance an investor purchased for $1,250 a 10-year debt instrument with a principal amount of $1,000. Also assume that the debt instrument contains an embedded put option that permits the investor immediately to put the debt instrument back to the issuer at $1,000. If the investor chooses immediately to put the debt instrument back to the issuer at $1,000, the investor would not recover $250 of its initial recorded investment of $1,250. That $250 represents 20% of the investor’s initial recorded investment; therefore, the investor would not recover substantially all of its initial recorded investment.

13.10 Provided that the issuer does not have the contractual right to demand a settlement that causes the investor to not recover substantially all of its initial recorded investment, the requirement in paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) that an investor would not recover substantially all of its initial recorded investment does not apply to a situation in which the terms of a hybrid instrument permit, but do not require, the investor to settle the hybrid instrument so that it does not recover substantially all of its initial recorded investment. Thus, in the Paragraph 13.09 example, the condition in paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) would not be met and the embedded put option would be considered clearly and closely related to the debt host, even though the investor could potentially end up not recovering substantially all of its initial recorded investment. (See DIG Issue B5 for further reference.) The guidance in paragraph 13(a) (ASC paragraphs 815-15-25-26(a)) and DIG Issue B5 applies to embedded derivatives with a single interest rate or interest rate index underlying that can alter net interest payments that would otherwise be paid or
received on a debt host contract. However, that guidance does not apply to embedded derivatives containing an underlying other than a single interest rate or interest rate index underlying or multiple underlyings (e.g., dual-indexed options) that can accelerate the settlement of debt instruments. For example, embedded call or put options that contain multiple underlyings related to (1) an interest rate or interest rate index and (2) the occurrence or nonoccurrence of a contingent event require application of the guidance in paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-40 and 25-41) and DIG Issue B16, rather than paragraph 13 (ASC paragraphs 815-15-25-26 through 25-29). See further discussion in Paragraphs A3.12 – A3.13 of Appendix A to this chapter.

13.11 If the investor could be forced by the contractual terms of the hybrid instrument to accept settlement at an amount that causes the investor not to recover substantially all of its initial recorded investment, the embedded derivative would not be considered clearly and closely related to the host contract. To illustrate, assume the investor purchased from a single-A-rated issuer for $10 million a structured note with a $10 million principal, a 9.5% interest coupon, and a term of 10 years when the current market rate for 10-year single-A-rated debt is 7%. Assume further that the terms of the note require that, at the beginning of the third year of its term, the principal on the note is reduced to $7.1 million and the coupon interest rate is reduced to zero for the remaining term to maturity if interest rates for single-A-rated debt have increased to at least 8% by that date. That structured note would meet the condition in paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) for both the issuer and the investor because the investor could be forced to accept settlement that causes the investor not to recover substantially all of its initial recorded investment. That is, if increases in the interest rate for single-A-rated debt triggers the modification of terms, the investor would receive a total of $9 million ($1.9 million in interest payments for the first two years and $7.1 million in principal repayment), thus not recovering substantially all of its $10 million initial recorded investment (the $1 million short-fall represents 10% of the initial recorded investment). Therefore, in this example, the embedded derivative would not be considered clearly and closely related.

**Embedded Derivative Component Could Double an Investor’s Initial Rate of Return and Result in a Rate of Return That Is at Least Twice What Otherwise Would Be the Then-Current Market Return for the Host Contract**

13.12 The other situation in which the embedded derivative component may have a leveraged effect on the instrument’s return exists when the embedded derivative: (1) could possibly at least double the investor’s initial rate of return on the host contract and (2) could result in a rate of return that is at least twice what otherwise would be the then-current market return for a contract that has the same terms as the host contract and that involves a debtor with credit quality similar to the issuer’s credit quality at inception. The second part of this test compares the effect of the embedded derivative on the host contract’s return at any of the possible future interest rate scenarios under which the investor’s rate of return on the host contract, combined with the effect of the embedded derivative component, would be double the adjusted rate of return of the host contract at the date of the rate adjustment, not at the date the hybrid instrument is executed, keeping credit quality constant.

13.13 It is important to note that the tests described in paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) (the double-double test) compare the return on the host contract,
combined with the effect of the embedded derivative component, to the return on the host contract. Thus, the entity must first identify the host contract and the features of that contract, including its rate of return. Identifying the terms of the host contract and embedded components requires judgment.

13.14 The FASB staff issued DIG Issue B39 in June 2005, which clarifies that the conditions in paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) do not apply to an embedded call option in a hybrid instrument containing a debt host contract if the right to accelerate the settlement of the debt can be exercised only by the debtor (issuer/borrower). DIG Issue B39 created more consistency in the evaluation of embedded derivative components related to interest-bearing contracts under paragraphs 13(a) and 13(b) of Statement 133 (ASC paragraphs 815-15-26(a) and 25-26(b)). Prior to DIG Issue B39 a call option held by the debtor embedded in a debt instrument could meet the conditions in paragraphs 13(b)(1) (ASC paragraph 815-15-25-26(b)(1)) and 13(b)(2) (ASC paragraph 815-15-25-26(b)(2)), even if the terms of the instrument permit, but do not require, the debtor to settle the hybrid instrument in a manner that would double the investor’s initial rate of return and would result in a rate of return that is at least twice what otherwise would be the then-current market return. This differed from the evaluation of an embedded derivative under paragraph 13(a) (ASC paragraph 815-15-26(a)), as interpreted by DIG Issue B5, which would not apply to a situation in which the terms of a hybrid instrument permit, but do not require, the investor to settle the hybrid instrument in a manner that causes the investor not to recover substantially all of its initial recorded investment (see further discussion in Paragraph 13.10). DIG Issue B39 specifies that the conditions in paragraph 13(b) (ASC paragraph 815-15-25-26(b)) only apply to situations that meet the two conditions specified in paragraphs 13(b)(1) (ASC paragraphs 815-15-25-26(b)(1)) and 13(b)(2) (ASC paragraph 815-15-25-26(b)(2)) and for which the investor has the unilateral ability to obtain the right to receive the high rate of return specified in those paragraphs.

13.14a The guidance in paragraph 13(b) (ASC paragraph 815-15-25-26(b)) applies and DIG Issue B39 applies to embedded derivatives with a single interest rate or interest rate index underlying that can alter net interest payments that would otherwise be paid or received on a debt host contract. However, that guidance does not apply to embedded derivatives containing an underlying other than a single interest rate or interest rate index underlying or multiple underlyings (e.g., dual-indexed options) that can accelerate the settlement of debt instruments. For example, embedded call or put options that contain multiple underlyings related to (1) an interest rate or interest rate index and (2) the occurrence or nonoccurrence of a contingent event require application of the guidance in paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-40 and 25-41) and DIG Issue B16 rather than paragraph 13 (ASC paragraphs 815-15-25-26 through 25-29). See further discussion in Paragraphs A3.12 – A3.13 of Appendix A to this chapter. Further, the guidance in DIG Issue B39 does not apply to prepayment features relating to call options embedded within the underlying assets of a securitized interest, such as a mortgage-backed security, because the call option is embedded in the underlying financial assets, not the securitized interest itself. For prepayable securitized financial assets where the rate of return could double because of a call option in the underlying financial assets, a different analysis is required under DIG Issue B40. See Paragraphs 14.12 - 14.16.

13.15 The following illustrates the application of paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29):
Example 3.2: Variable-Rate Debt with a Floor – An investor holds a bond with a coupon rate of interest that varies with changes in an interest rate index. If the variable rate decreases below a specified rate, the bond pays that specified rate.

Assume the investor receives interest based on the London Interbank Offered Rate (LIBOR); however, if the LIBOR rate falls below 5% at any reset date, the investor receives 5%. A bond could have been issued at par by the entity without an embedded floor at LIBOR plus 2%. At the date of issuance, LIBOR is 4%. The bonds are issued at par and the investor paid par.

Because there are no contractual provisions that would allow the debt to be settled so that the investor would not recover substantially all of its initial recorded investment, the provisions of paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) are not met. To apply the provisions of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)), it must be noted that debt without a floor could have been issued at par for LIBOR plus 2%; consequently, the initial rate of return on the host contract is LIBOR plus 2%. An analysis must be performed to determine whether the embedded derivative (which provides a minimum return of 5% to the investor) could at least double the investor’s initial rate of return on the host contract, which was 6% (LIBOR plus 2%), in any of the possible interest rate environments. Because the initial rate of return on the host contract is 6% and the investor is guaranteed a rate of return throughout the life of the hybrid instrument of at least 5%, there is no possibility that the embedded floor would double the investor’s initial rate of return on the host contract (the embedded floor would have to guarantee a rate of return of at least 12% to meet this criterion). Because the provisions of paragraphs 13(a) and 13(b) of the Standard (ASC paragraphs 815-15-25-26(a) and 25-26(b)) are not met, the embedded floor is considered clearly and closely related to the debt host. Therefore, the embedded derivative should not be separated from the host contract even though in a falling interest rate environment, the hybrid instrument may have a return to the investor that is a significant amount above the current market return of the host contract. That is, if LIBOR were to decrease to 0.25%, the embedded floor provision of the hybrid would return 5% to the investor, which is more than double the then-current market return for the host contract of 2.25% (LIBOR plus 2%).

Example 3.3: Range Floater – An investor holds a bond with a coupon rate that depends on the number of days that a reference rate stays within a pre-established collar; otherwise, the bond pays zero percent interest or a below-market rate.

Assume the investor receives 8% if LIBOR is at or between 3 and 3.99%. The coupon will be zero percent for each day that LIBOR is outside the range. A variable-rate bond could have been issued at par by the entity without a collar at LIBOR plus 1%. At the date of issuance, LIBOR is 3%. The bonds are issued at par and the investor paid par.

Because there are no contractual provisions that would allow the debt to be settled so that the investor would not recover substantially all of its initial recorded investment, the provisions of paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) are not met. To apply the provisions of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)), it must be
noted that debt without a collar could have been issued at par for LIBOR plus 1%; consequently, the initial rate of return on the host contract is LIBOR plus 1%. An analysis must be performed to determine whether the embedded derivative could at least double the investor’s initial rate of return on the host contract, which was 4% (LIBOR plus 1%), in any of all the possible interest rate environments. The following summarizes the potential LIBOR rates and the return to the investor with the effects of the embedded collar for the hybrid instrument:

<table>
<thead>
<tr>
<th>Potential LIBOR Rates</th>
<th>Effects of Collar</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.00% - 0.99%</td>
<td>Return of 0%</td>
</tr>
<tr>
<td>1.00% - 1.99%</td>
<td>Return of 0%</td>
</tr>
<tr>
<td>2.00% - 2.99%</td>
<td>Return of 0%</td>
</tr>
<tr>
<td>3.00% - 3.99%</td>
<td>Return of 8%</td>
</tr>
<tr>
<td>4.00% - 4.99%</td>
<td>Return of 0%</td>
</tr>
<tr>
<td>5.00% - 5.99%</td>
<td>Return of 0%</td>
</tr>
<tr>
<td>6.00% - 6.99%</td>
<td>Return of 0%</td>
</tr>
<tr>
<td>7.00% - above</td>
<td>Return of 0%</td>
</tr>
</tbody>
</table>

When LIBOR is at or between 3.00 and 3.99%, the embedded collar provides the holder with a return of 8%. Because 8% is double the investor’s initial rate of return on the host contract, which was 4%, the provisions of the first part of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) are met. To apply the provisions of the second part of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)), an analysis must be performed to determine whether the embedded derivative results in a rate of return that is at least twice what otherwise would be the then-current market return for the host contract when LIBOR is at, or between 3.00 and 3.99%. The following summarizes those potential LIBOR rates, the return on the hypothetical host contract, and the return to the investor with the effects of the embedded collar for the hybrid instrument:

<table>
<thead>
<tr>
<th>Potential LIBOR Rates</th>
<th>Return on Host (LIBOR + 1%)</th>
<th>Effects of Collar</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.00%</td>
<td>4.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>3.01%</td>
<td>4.01%</td>
<td>8.00%</td>
</tr>
<tr>
<td>3.02%</td>
<td>4.02%</td>
<td>8.00%</td>
</tr>
<tr>
<td>3.03%</td>
<td>4.03%</td>
<td>8.00%</td>
</tr>
<tr>
<td>3.04%</td>
<td>4.04%</td>
<td>8.00%</td>
</tr>
<tr>
<td>3.05%</td>
<td>4.05%</td>
<td>8.00%</td>
</tr>
<tr>
<td>3.06%</td>
<td>4.06%</td>
<td>8.00%</td>
</tr>
<tr>
<td>3.07% - 3.99%</td>
<td>4.07% - 4.99%</td>
<td>8.00%</td>
</tr>
</tbody>
</table>

When LIBOR is 3.00%, the return on the hybrid instrument is 8% and the return on the host contract would have been 4%. Because the hybrid provides a return of 8% when LIBOR is 3.00% and the host contract would have provided a return of only 4.00%, the embedded derivative provides a return that is at least twice the then-current market return for the host. As a result, the provisions of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) are met. Because the provisions of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) are met, the embedded collar is not considered clearly and closely related to the debt host. Accordingly, the embedded collar must be separated from the hybrid instrument if the
Example 3.4: Variable-Rate Debt with a Cap – An investor holds a bond with a coupon rate of interest that varies with changes in an interest rate index. If the variable rate increases above a specified rate, the bond pays a specified rate.

Assume the investor receives LIBOR; however, if LIBOR is at or above 10% at any reset date, the investor receives 12%. A variable-rate bond could have been issued at par by the entity without a cap at LIBOR minus 2%. At the date of issuance, LIBOR is 8%. The bonds are issued at par and the investor paid par.

Because there are no contractual provisions that would allow the debt to be settled so that the investor would not recover substantially all of its initial recorded investment, the provisions of paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) are not met. To apply the provisions of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)), it must be noted that debt without a cap could have been issued at par for LIBOR minus 2%; consequently, the initial rate of return on the host contract is LIBOR minus 2%. An analysis must be performed to determine whether the embedded derivative could at least double the investor’s initial rate of return on the host contract, which was 6% (LIBOR minus 2%), in any of all the possible interest rate environments. When LIBOR is at or above 10%, the embedded cap provides the holder with a return of 12%. Because 12% is double the investor’s initial rate of return on the host contract, which was 6%, the provisions of the first part of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) are met. To apply the provisions of the second part of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)), an analysis must be performed to determine whether the embedded derivative results in a rate of return that is at least twice what otherwise would be the then-current market return for the host contract when LIBOR is at or above 10%. The following summarizes those potential LIBOR rates, the return on the hypothetical host contract, and the return to the investor with the effects of the embedded cap for the hybrid instrument:

<table>
<thead>
<tr>
<th>Potential LIBOR Rates</th>
<th>Return on Host (LIBOR - 3%)</th>
<th>Effects of Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>10.00% - 10.99%</td>
<td>8.00% - 8.99%</td>
<td>12.00%</td>
</tr>
<tr>
<td>11.00% - 11.99%</td>
<td>9.00% - 9.99%</td>
<td>12.00%</td>
</tr>
<tr>
<td>12.00% - 12.99%</td>
<td>10.00% - 10.99%</td>
<td>12.00%</td>
</tr>
<tr>
<td>13.00% - 13.99%</td>
<td>11.00% - 11.99%</td>
<td>12.00%</td>
</tr>
<tr>
<td>14.00% and above</td>
<td>12.00% and above</td>
<td>12.00%</td>
</tr>
</tbody>
</table>

As can be seen in the above analysis, when LIBOR is at or above 10.00%, the embedded derivative does not provide a return that is at least twice the then-current return for the host. For example, when LIBOR is at 10%, the return on the hybrid instrument is 12%, and the return on the host contract would have been 8.00%. Because the hybrid provides a return of 12% when LIBOR is 10% and the host contract would have provided a return of 8%, the
embedded derivative does not provide a return that is at least twice the then-current market return for the host. As a result, the provisions of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) are not met. Because the provisions of paragraphs 13(a) and 13(b) of the Standard (ASC paragraphs 815-15-25-26(a) and 25-26(b)) are not met, the embedded cap is considered clearly and closely related to the debt host.

Example 3.5: Callable Fixed-Rate Debt – An investor holds a bond with a fixed coupon rate that is callable by the issuer.

Assume the investor purchases a four-year, 5% fixed-rate debt instrument for its par amount of $1,000 on the day it is issued. Also assume the debt instrument is callable by the issuer at $1,050 at any time. A four-year fixed-rate debt instrument that was not callable by the issuer could have been issued at par with a rate of 4% and a four-year variable-rate debt instrument that was not callable by the issuer could have been issued at par by the entity at LIBOR. At the date of issuance, LIBOR is 4%. The hybrid instrument can be viewed as containing a 4%, fixed-rate host with an embedded call option.

Because there are no contractual provisions that would allow the debt to be settled so that the investor would not recover substantially all of its initial recorded investment, the provisions of paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) are not met. Additionally, the embedded call option has a single interest rate underlying and is exercisable only by the issuer, so DIG Issue B39 specifies that the feature is not subject to the provisions in paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)). Because the provisions of paragraphs 13(a) and 13(b) of the Standard (ASC paragraphs 815-15-25-26(a) and 25-26(b)) are not met, the embedded call option with a single interest rate underlying is considered clearly and closely related to the debt host.

It should be noted that, prior to DIG Issue B39, it would have been necessary to perform an analysis of the embedded call option under paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)), to determine whether there are any circumstances in which the embedded call option could at least double the investor’s initial rate of return on the host contract and result in a rate of return that is at least twice the then-current market return for the host contract. In this example, prior to the guidance in DIG Issue B39, the criteria in paragraph 13(b) (ASC paragraph 815-15-25-26(b)) would have been met and the embedded call option would be considered not clearly and closely related to the host contract because the issuer could call the bond shortly after issuance (e.g., if interest rates decreased dramatically in a short period of time), resulting in a rate of return that would at least double the investor’s 4% initial rate of return on the host contract and result in a rate of return that is at least twice the 4% then-current market return for the host contract. For example, the investor’s annualized rate of return would be 1,825% if the bond were called the day after issuance. However, the guidance in DIG Issue B39, which was issued in June 2005, clarifies that the conditions in paragraph 13(b) (ASC paragraph 815-15-25-26(b)) do not apply to an embedded call option with a single interest rate or interest rate index underlying in a hybrid instrument containing a debt host contract if the right to accelerate settlement of the debt can be exercised only by the debtor.
Example 3.6: Fixed-to-Floating Note – A bond that pays a varying coupon (first-year coupon is fixed; second- and third-year coupons are based on LIBOR).

Assume the investor receives 8.5% for the first year and LIBOR for the second and third years. A three-year fixed-rate bond could have been issued at par by the entity at 8.5% and a three-year variable-rate bond could have been issued at par by the entity at LIBOR. At the date of issuance, LIBOR is 8.5%. The bonds are issued at par and the investor paid par. The hybrid instrument can be viewed as containing an 8.5%, fixed-rate host with an embedded forward starting interest rate swap that requires the investor to pay fixed at 8.5% and receive LIBOR.

Because there are no contractual provisions that would allow the debt to be settled so that the investor would not recover substantially all of its initial recorded investment, the provisions of paragraph 13(a) of the Standard (ASC paragraph 815-15-25-25(a)) are not met. To apply the provisions of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-25(b)), it must be noted that a three-year fixed-rate bond could have been issued at par for 8.5%; consequently, the initial rate of return on the host contract is 8.5%. An analysis must be performed to determine whether the embedded derivative could at least double the investor’s initial rate of return on the host contract, which was 8.5%, in any of all the possible interest rate environments when the forward starting interest rate swap becomes active (in one year’s time). The following summarizes the potential LIBOR rates and the return to the investor with the effects of the embedded derivative for the hybrid instrument:

<table>
<thead>
<tr>
<th>Potential Future LIBOR Rates</th>
<th>Effects of Forward Starting Interest Rate Swap</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.00% - 14.99%</td>
<td>Return of 0.00% - 14.99%</td>
</tr>
<tr>
<td>15.00% - 15.99%</td>
<td>Return of 15.00% - 15.99%</td>
</tr>
<tr>
<td>16.00% - 16.99%</td>
<td>Return of 16.00% - 16.99%</td>
</tr>
<tr>
<td>17.00% - 17.99%</td>
<td>Return of 17.00% - 17.99%</td>
</tr>
<tr>
<td>18.00% - 18.99%</td>
<td>Return of 18.00% - 18.99%</td>
</tr>
<tr>
<td>19.00% - above</td>
<td>Return of 19.00% - above</td>
</tr>
</tbody>
</table>

When LIBOR is at or above 17%, the embedded derivative provides the holder with a return of LIBOR, and because that return is at least double the investor’s initial rate of return on the host contract, which was 8.5%, the provisions of the first part of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-25(b)) are met. To apply the provisions of the second part of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-25(b)), an analysis must be performed to determine whether the embedded derivative results in a rate of return that is at least twice what otherwise would be the then-current market return for the host contract when LIBOR is at or above 17%. The following summarizes those potential LIBOR rates, the return on the hypothetical host contract, and the return to the investor with the effects of the embedded derivative for the hybrid instrument:

<table>
<thead>
<tr>
<th>Potential LIBOR Rates</th>
<th>Return on Host</th>
<th>Effects of Forward Starting Interest Rate Swap</th>
</tr>
</thead>
<tbody>
<tr>
<td>17.00%</td>
<td>17.00%</td>
<td>17.00%</td>
</tr>
<tr>
<td>18.00%</td>
<td>18.00%</td>
<td>18.00%</td>
</tr>
<tr>
<td>19.00%</td>
<td>19.00%</td>
<td>19.00%</td>
</tr>
</tbody>
</table>
Since the host contract’s fixed rate of interest equaled LIBOR at the date of issuance, the market return for a contract that has the same terms as the host contract and that involves a debtor with credit quality similar to the issuer’s credit quality at inception would be at or near the potential LIBOR rate in the future. That is, if the debtor issued new fixed-rate debt at the time the LIBOR rate increased, the debtor would issue the new fixed-rate debt at that new LIBOR rate (assuming the same credit quality at inception of the original instrument).

As can be seen in the above analysis, when LIBOR is at or above 17%, the embedded derivative does not provide a return that is at least twice the then-current return for the host. As a result, the provisions of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) are not met. Because the provisions of paragraphs 13(a) and 13(b) of the Standard (ASC paragraphs 815-15-25-26(a) and 25-26(b)) are not met, the embedded forward starting swap is considered clearly and closely related to the debt host.

**13.15a** The application of the guidance on whether interest rate features are clearly and closely related to an interest-bearing host can be complicated and should be evaluated in a linear fashion. First, if the financial instrument qualifies for the principal-only and interest-only scope exception from Statement 133 in paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73) (which was amended with the issuance of Statement 155 and is discussed below) evaluation of embedded features in that instrument is unnecessary. Second, if the feature is indexed to interest rates and another underlying (such as a contingency), the analysis of the embedded feature must be performed relative to other guidance (e.g., DIG Issue B16 for call and put options) and not paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29). Finally, the paragraph 13 (ASC paragraphs 815-15-25-26 through 25-29) analysis itself is based on two different tests for leverage as described in Paragraphs 13.07-13.14a. Further, particular types of features are exempt from certain tests if certain conditions are met as discussed in DIG Issues B5 (investor-controlled features and paragraph 13a) (ASC paragraphs 815-15-25-26(a)), B39 (issuer-controlled call options and paragraph 13b (ASC paragraphs 815-15-25-26(b))), B40 (qualified prepayment features in securitized financial assets and paragraph 13b (ASC paragraph 815-15-25-26(b)). There are specific criteria that must be evaluated in determining whether the exemptions in those DIG Issues are applicable to a particular feature.

**13.15b** The logic for determining whether an interest rate feature is clearly and closely related (C&CR) to an interest-bearing host is outlined in the flowchart below, along with references to the guidance in this chapter applicable to each step:
Exhibit 3.1: Analyzing Embedded Interest Rate Features in an Interest-Bearing Host

14.01 Because the holder of an interest- or principal-only strip may not recover substantially all of its initial recorded investment or could obtain a significantly higher return than initially expected, the Board recognized that questions might arise as to whether an interest- or principal-

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14. However, interest-only strips and principal-only strips are not subject to the requirements of this Statement provided they (a) initially resulted from separating the rights to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative that otherwise would have been accounted for separately as a derivative pursuant to the provisions of paragraphs 12 and 13 and (b) do not incorporate any terms not present in the original financial instrument described above.

DIG Issues related to this paragraph are B6, C4, and D1. See DIG Issues Index.

14.02 The issues related to returns on investment addressed in paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) can arise when analyzing the appropriate accounting for interest-only and principal-only strips originated from debt instruments that are prepayable. These issues also surround accounting for beneficial interests in securitizations that are covered under the provisions of FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (Statement 140) (ASC Topic 860, Transfers and Servicing). Accordingly, the Board decided to exclude from the scope of the Standard those interest-only and principal-only strips that do not incorporate embedded derivative component features. Therefore, prior to being amended by Statement 155, excluded from the scope of the Standard are interest-only and principal-only strips that (1) initially resulted from separating the rights to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative component that would be accounted for separately under the Standard and (2) do not incorporate any terms not present in the original financial instrument. As a result, unaltered interest-only and principal-only strips that originated from instruments that do not contain embedded derivative components that would be required to be separated are excluded from the scope of the Standard.

14.03 Prior to being amended by Statement 155, the first issue to focus on in applying the exception in paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73) is whether the original financial instrument (or instruments) that was used to create the interest-only and principal-only strips was a derivative or contained an embedded derivative component that would be accounted for separately from the host under the Standard. To determine whether this is the case, the entity would need to refer to the original instrument. If the original financial instrument is a derivative in its entirety or contains an embedded derivative that is required to be accounted for separately, the exclusion in paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73) would not apply and the strips would need to be evaluated to see whether they include an embedded derivative instrument that must be separated in accordance with paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14).

14.04 The second issue to focus on in applying the exception in paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73) is whether the interest-only and the principal-only strips contain any additional terms that were not present in the original financial instrument (or instruments). To determine whether this is the case, one would need to refer to the original instrument and compare its terms to the terms of the interest only and principal-only strips. If any
term exists in the interest-only or principal-only strips that was not part of the terms of the original financial instrument, paragraph 14 (ASC paragraphs 815-10-15-72 and 15-73) does not apply and the entity must evaluate the strips to determine whether they include an embedded derivative instrument that must be separated in accordance with paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14).

14.05a To illustrate, assume the original instrument was an 8% fixed-rate bond with a principal amount of $1,000 and the interest-only strip that was created from the bond was 100% of those interest payments plus 10% of those principal payments and the principal-only strip that was created from the bond was 90% of those principal payments. In this situation, neither the interest-only strip nor the principal-only strip would be subject to the Standard because they would qualify for the exception in paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73) (prior to being amended by Statement 155). That is, both strips (1) initially resulted from separating the rights to receive the contractual cash flows of the 8% fixed-rate bond with a principal amount of $1,000 and that bond was not a derivative under the Standard nor did it contain an embedded derivative that would be accounted for separately under the Standard and (2) do not contain any terms that are not present in the original bond. (See DIG Issue C4 for further reference.)

14.06 In contrast, assume the original instrument was an 8% fixed-rate bond with a principal amount of $1,000. The interest-only strip that was created from the bond was 100% of those interest payments. Furthermore, if interest rates decline by 200 basis points, the interest-only strip will also receive 10% of the principal payments of the bond. The principal-only strip that was created from the bond was 100% of those principal payments. Furthermore, if interest rates decline by 200 basis points, the principal-only strip will receive 90% of those principal payments. In this situation, both the interest-only strip and the principal-only strip would be subject to the Standard because they would not qualify for the exception in paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73). That is, while both strips initially resulted from separating the rights to receive the contractual cash flows of the 8% fixed-rate bond with a principal amount of $1,000 and that bond was not a derivative under the Standard nor did it contain an embedded derivative that would be accounted for separately under the Standard, both strips contain terms that are not present in the original bond (the contingent feature requires a reallocation if interest rates decline by 200 basis points).

14.06a Statement 155 amends the guidance in paragraph 14 (ASC paragraphs 815-10-15-72 and 15-73) to limit the applicability of the scope exception for interest-only strips and principal-only strips. During its deliberations for Statement 155, the Board affirmed that it intends the interest-only strip and principal-only strip exception to apply to only the simplest separations of interest payments from principal payments. The revised paragraph 14 (ASC paragraphs 815-10-15-72 and 15-73), effective upon adoption of Statement 155, is presented below.

14. However, interest-only strips and principal-only strips are not subject to the requirements of this Statement provided those strips (a) represent the right to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument or a specified proportion of the contractual principal cash flows of that debt instrument and (b) do not incorporate any terms not present in the original debt instrument. An allocation of a portion of the interest or principal cash flows of a specific debt instrument as reasonable compensation for stripping the instrument or to provide adequate compensation to a servicer (as defined in
Statement 140) would meet the intended narrow scope of the exception provided in this paragraph. However, an allocation of a portion of the interest or principal cash flows of a specific debt instrument to provide for a guarantee of payments, for servicing in excess of adequate compensation, or for any other purpose would not meet the intended narrow scope of the exception.

14.06b After being amended by Statement 155, the first issue to focus on in applying the exception in paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73) is whether the strips represent rights to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument or a specified proportion of the contractual principal cash flows of that instrument. To determine whether this is the case, the entity would need to refer to the original instrument. An allocation of a portion of the interest or principal cash flows of a specific debt instrument as reasonable compensation for stripping the instrument or to provide adequate compensation to the servicer does not disqualify an interest-only strip or a principal-only strip from the scope exception in paragraph 14 (ASC paragraphs 815-10-15-72 and 15-73), provided that the allocation does not provide for a guarantee of payments, for servicing in excess of adequate compensation, or for any other purpose. After being amended by Statement 155, the second issue to focus on in applying the exception in paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73) continues to be whether the interest-only and the principal-only strips contain any additional terms that were not present in the original debt instrument, as discussed in Paragraph 14.04) above.

14.06c To illustrate, assume the original instrument was an 8% fixed-rate bond with a principal amount of $1,000 and the interest-only strip that was created from the bond was 100% of those interest payments plus 10% of those principal payments and the principal-only strip that was created from the bond was 90% of those principal payments. In this situation, the interest-only strip would be subject to the Standard because it would not qualify for the exception in paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73) after being amended by Statement 155. The first part of that scope exception specifies that the strip represents rights to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument or a specified portion of the contractual principal cash flows. In this example, the holders of the interest-only strip are entitled to receive both a proportion of contractual interest cash flows and a proportion of contractual principal cash flows. Accordingly, the interest-only strip would not qualify for the narrow scope exception in paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73), as amended by Statement 155. In contrast, the principal-only strip would not be subject to the Standard because it would qualify for the exception in paragraph 14 (ASC paragraphs 815-10-15-72 and 15-73), as amended by Statement 155. That is, the principal-only strip (1) represents rights to receive only a specified proportion of the contractual principal cash flows of the debt instrument and (2) does not contain any terms that are not present in the original bond.

14.06d Interest-only and principal-only strips that do not qualify for the scope exception in paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73) and are not derivatives in their entirety should be analyzed under paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) to determine if embedded prepayment features require bifurcation. While securitized strips may be eligible for an exception from the paragraph 13(b)(ASC paragraph 815-15-25-26(b)) analysis via DIG Issue B40 (see Paragraph 14.12) prepayment
features will often be bifurcated because they fail the criterion in paragraph 13(a) (ASC paragraph 815-15-25-26(a)) (i.e., there are possible scenarios in which exercise of the call would result in the strip investor not receiving a return of substantially all of its initial investment).

**SECURITIZATIONS AND EMBEDDED CREDIT-DERIVATIVE SCOPE EXCEPTION**

14.07 Interests in securitized financial assets refers to any interest that a stakeholder would have in a securitization vehicle relative to the underlying assets. Examples of such interests include guarantee fees, servicing fees, interest-only strips, principal-only strips, mortgage-backed securities (MBS), collateralized debt obligations (CDOs), as well as certificates of the trust or any other form of ownership in a trust. When determining the accounting for interests in securitized financial assets, including interest-only and principal-only strips that do not qualify for the scope exception described in paragraph 14 of Statement 133 (ASC paragraphs 815-10-15-72 and 15-73), as amended by Statement 155, paragraphs 14A (ASC paragraphs 815-15-25-11 through 25-13) and 14B of the Standard (ASC paragraphs 815-15-15-8 and 15-9) must be considered (in addition to other guidance on embedded features, such as paragraph 13 (ASC paragraphs 815-15-25-26 through 25-29)).

14.07a Paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73) was written to cover a narrow set of interest-only and principal-only strips. Following the release of Statement 133, the FASB staff received a number of inquiries about the application of this paragraph to other beneficial interests in securitized financial assets; specifically whether the exception applied to beneficial interests issued in a securitization that were not interest-only or principal-only strips and whether those beneficial interests meet the definition of a freestanding derivative or contain an embedded derivative. In response to these inquiries, DIG Issue D1 was released, which until amended by Statement 155, allowed entities to make a policy election in determining whether to apply Statement 133 (ASC Topic 815) to beneficial interests in securitized financial assets.

14.08 Prior to being amended by Statement 155, DIG Issue D1 allowed entities to continue to apply the guidance in paragraphs 14 and 362 of Statement 140 (ASC paragraph 860-20-35-2 and 320-10-25-5(a) instead of the Standard for a beneficial interest, either purchased or retained, resulting from securitized financial assets. That is, an entity was not required to evaluate securitized interests to determine whether they constitute derivatives in their entirety or contain embedded derivatives if a policy election was made by the entity upon adoption of DIG Issue D1. Instead, securitized interests were accounted for as either available-for-sale or trading investments. This interim guidance, which is nullified for all financial instruments acquired, issued, or subject to a new basis remeasurement event after an entity’s adoption of Statement 155, was not limited to securitizations involving QSPEs, and was required to be applied consistently to all securitized financial interests.

14.09 For financial instruments subject to the interim guidance in DIG Issue D1 (i.e., prior to adoption of Statement 155), the majority of beneficial interests in securitized financial assets were accounted for as investments in securities classified as either available-for-sale or trading. That is, entities may account for all beneficial interests in securitized financial assets, whether retained or purchased, by applying the guidance in paragraphs 14 and 362 of Statement 140 (ASC paragraph 860-20-35-2 and 320-10-25-5(a)). That guidance allowed for interest-only and...
principal-only strips, retained interests in securitizations, loans, other receivables or other financial assets that can be contractually prepaid or settled in such a way that a holder would not recover substantially all of its recorded investment to be measured like investments in debt securities classified as available-for-sale or trading under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (Statement 115) (ASC Subtopic 320-10). Further, we believe that the guidance in DIG Issue D1 applied to both parties to a beneficial interest.

**14.10** Statement 155 adds subparagraph 14A to the Standard (ASC paragraphs 815-15-25-11 through 25-13), which establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial interests that contain an embedded derivative requiring bifurcation. Additionally, Statement 155 added subparagraph 14B to the Standard (ASC paragraphs 815-15-15-8 and 15-9), which included guidance that concentrations of credit risk in the form of subordination were not embedded derivatives (see additional discussion of amendments made to paragraph 14B by Accounting Standards Update No. 2010-11, *Scope Exception Related to Embedded Credit Derivatives*, (ASU 2010-11) in Paragraphs 14.17 through 14.28 and Paragraph A3.06a). Subparagraphs 14A (ASC paragraphs 815-15-25-11 through 25-13) and 14B of the Standard (ASC paragraphs 815-15-15-8 and 15-9), which are effective upon adoption of Statement 155, are presented below.

**14A.** The holder of an interest in securitized financial assets (other than those identified in paragraph 14) shall determine whether the interest is a freestanding derivative or contains an embedded derivative that under paragraphs 12 and 13 would be required to be separated from the host contract and accounted for separately. That determination shall be based on an analysis of the contractual terms of the interest in securitized financial assets, which requires understanding the nature and amount of assets, liabilities, and other financial instruments that compose the entire securitization transaction. A holder of an interest in securitized financial assets should obtain sufficient information about the payoff structure and the payment priority of the interest to determine whether an embedded derivative exists.

**14B.** Changes in cash flows attributable to changes in the creditworthiness of an interest resulting from securitized financial assets and liabilities (including derivative contracts) that represent the assets or liabilities that are held by the issuing entity shall not be considered an embedded derivative under this Statement. Paragraph superseded by Accounting Standards Update No. 2010-11, *Scope Exception Related to Embedded Credit Derivatives*.²

The concentration-transfer-of credit risk that is only in the form of subordination of one financial instrument to another (such as the subordination of one beneficial interest to another tranche of a securitization, thereby redistributing credit risk) shall not be considered is an embedded derivative feature that shall not be subject to the application of paragraph 815-10-15-11 and Section 815-15-25 under this Statement. Only the embedded credit derivative feature created by subordination between the financial instruments is not subject to the application of paragraph 815-10-15-11 and Section 815-15-25. However, other embedded credit derivative features (for example, those related to credit default swaps on a referenced credit) would be subject to the application of paragraph 815-10-15-11 and Section 815-15-25 even if their

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² The following guidance was added to ASC paragraph 815-15-15-9 by ASU 2010-11. ASC paragraph 815-15-15-9 refers to the guidance in paragraph 14B of the historical Standard that was effectively revised by ASU 2010-11.
effects are allocated to interests in tranches of securitized financial instruments in accordance with those subordination provisions. Consequently, the following circumstances (among others) would not qualify for the scope exception and are subject to the application of paragraph 815-10-15-11 and Section 815-15-25 for potential bifurcation:

(a) An embedded derivative feature relating to another type of risk (including another type of credit risk) is present in the securitized financial instruments.

(b) The holder of an interest in a tranche of that securitized financial instrument is exposed to the possibility (however remote) of being required to make potential future payments (not merely receive reduced cash inflows) because the possibility of those future payments is not created by subordination. (Note, however, that the securitized financial instrument may involve other tranches that are not exposed to potential future payments and, thus, those other tranches might qualify for the scope exception.)

(c) The holder owns an interest in a single-tranche securitization vehicle; therefore, the subordination of one tranche to another is not relevant.

14.11 Statement 155 resolves the issues addressed in DIG Issue D1 by eliminating the exemption from applying Statement 133 (ASC Topic 815) to beneficial interests in securitized financial assets. Accordingly, the holder of a beneficial interest in securitized financial assets (other than the narrow set of interest-only strips and principal-only strips that are identified in amended paragraph 14 of Statement 133 (ASC paragraphs 815-10-15-72 and 15-73)) would be required to determine whether the interest is a freestanding derivative or contains an embedded derivative that, under paragraphs 12 and 13 of Statement 133 (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14, and 815-15-25-26 through 25-29), should be separated into a host contract and a derivative instrument. This determination should be based on the contractual terms of the beneficial interest. As such, a holder of a beneficial interest in securitized financial assets (other than those subject to the limited scope exception in amended paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73)) would be required to obtain sufficient information about the payoff structure and the payment priority of the instrument to determine whether an embedded derivative exists, regardless of whether the holder of an interest in a securitized financial asset is a purchaser of that interest or whether the holder is a transferor that retains the interest in transferred assets in the securitization transaction. This analysis will require an understanding of the nature and amount of assets and liabilities and the nature and amount of other financial instruments making up a securitization transaction. For resecuritisations of tranches from previous transactions, this analysis might require an understanding of each securitization making up the resecuritization. The guidance in Statement 155 nullifies DIG Issue D1, although the interim guidance in DIG Issue D1 remains effective for instruments recognized prior to the effective date of Statement 155.

14.11a The following examples illustrate the embedded features analysis for a securitized interest in underlying financial assets.
Example 3.7: Securitized Interest with no Embedded Derivative

A SPE holds fixed rate loans with a principal amount of $100,000 and issues variable rate notes with a principal amount of $100,000 to investors. The SPE enters into a pay-fixed, receive variable interest rate swap with a counterparty. The variable payments received under the swap are sufficient to provide the variable interest payments due to the noteholders. The loans are subject to scheduled amortization and the notional amount of the swap is amortized based on the scheduled amortization.

**Analysis:** The beneficial interests do not contain an embedded derivative. As the contractual repayment terms of the assets are such that the holders of the notes will always receive the amounts that are contractually due (without considering possible credit losses), the notes do not have an embedded derivative under paragraph 13(a) of Statement 133 (ASC paragraph 815-15-25-26(a)).

Example 3.8: Securitized Interest with an Embedded Derivative

A SPE holds fixed rate loans with a principal amount of $100,000 and issues variable rate notes with a principal amount of $100,000 to investors. The SPE enters into a pay-fixed, receive variable interest rate swap with a counterparty. The loans are subject to prepayment and the notional amount of the swap is amortized based on the prepayment expectation as of the securitization date. The variable payments received under the swap are sufficient to provide the variable interest payments due to the noteholders if the loans prepay no more quickly than expected.

**Analysis:** The loans contain an embedded derivative feature. In the event that prepayments on the fixed rate loans occur at a faster rate than the amortization of the notional of the interest rate swap such that the notional of the swap is greater than the principal of the underlying loans, it is possible that the investor may not recover substantially all of its recorded investment in the notes, as the fixed rate loans will not have the necessary cash flows to provide the investor its expected return if the swap is in a pay position (i.e., if interest rates drop).

14.12 Call Options in Underlying Financial Assets. Following the release of Statement 155, questions were raised about the application of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) to securitized financial assets that contain issuer call options. The guidance in DIG Issue B39 does not apply to prepayment features relating to call options embedded within the underlying assets of a securitized interest, such as a mortgage-backed security, because the call option is embedded in the underlying financial assets, not the securitized interest itself. While Statement 155 had amended DIG Issue B39 to provide a scope exception for securitized interests that simply proportionately pass through the cash flows on underlying assets (including the impact of the call options), that scope exception was perceived as too narrow given that many securitized interests do not pass through cash flows in a proportional manner. In response, the FASB issued DIG Issue B40. Under DIG Issue B40, a securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of Statement 133 (ASC paragraph 815-15-25-26(b)) if a) the investor cannot control the right to accelerate the settlement...
of the securitized interest, and b) the securitized interest itself has no embedded derivative (including an interest rate-related derivative) that would be required to be accounted for separately other than an embedded derivative that results solely from the embedded call options in the underlying financial assets. It is important to note that DIG Issue B40 does not provide a scope exception from paragraph 13(a) of Statement 133 (ASC paragraph 815-15-25-26(a)) (whether the investor may not recover substantially all of its initial investment).

14.13 The result of DIG Issue B40 is a narrow scope exception from paragraph 13(b) of Statement 133 (ASC paragraph 815-15-25-26(b)) for securitized interests that contain only an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets. If a securitized interest contains any other features that require separation under Statement 133, even features unrelated to the prepayment feature or features with minimal fair values (such as paragraph 13(a) (ASC paragraph 815-15-25-26(a)) derivatives with de minimis value), the prepayment feature would not be eligible for the scope exception and would require further analysis using the double-double test in paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)). Unlike the previous exception in DIG Issue B39, proportionality of cash flows is not a consideration in DIG Issue B40. That is, the cash flows of the securitized underlying assets may be allocated disproportionately among interest holders (for example, because some securitized interests are more exposed to credit or prepayment risk than others) without affecting whether a prepayment feature requires analysis under paragraph 13(b) (ASC paragraph 815-15-25-26(b)). However, the new guidance is more restrictive than the previous exception in that any other derivative embedded in the securitized interest disqualifies that interest from the scope exception. Whether a securitized interest contains an embedded derivative, other than an embedded derivative that results solely from the embedded call options in the underlying financial assets, should be determined by analyzing the features and cash flows associated with the securitized interest, which in turn requires an understanding of the nature and amount of assets, liabilities, and other instruments that compose the securitization transaction.

14.14 DIG Issue B40 applies to securitized interests in prepayable financial assets acquired or retained (or subject to a new basis event) after the adoption of Statement 155 and will generally not affect the accounting for previously acquired or retained securitized interests. With respect to securitized interests acquired or retained after the adoption of Statement 155, DIG Issue B40 applies in full to all instruments originally issued after June 30, 2007. DIG Issue B40 applies in modified form to securitized interests issued prior to June 30, 2007 and acquired or retained after the adoption of Statement 155. Such securities may include other embedded derivatives that require separation and still be exempt from analysis under paragraph 13(b) of Statement 133 (ASC paragraph 815-15-25-26(b)) if the fair value of those other derivatives has only an extremely remote probability of being more than trivial throughout the life of the security, as determined on the date of adoption of Statement 155 or the purchase of the instrument, whichever occurs later. For this purpose a fair value at or near zero is trivial. We expect this guidance to apply primarily to securitized interests in circumstances where the investor might not receive a full return of its initial investment, but the probability of such an outcome is extremely remote. In that case, the embedded features would require separation under paragraph 13(a) of Statement 133 (ASC paragraph 815-15-25-26(a)), but would not have a fair value appreciably higher than zero, because the interest-rate environments necessary to result in the feature paying off (i.e., the investor losing a portion of its initial investment), though theoretically possible, have not historically occurred and almost certainly will not occur in the future. The FASB staff
included this delay in full transition to DIG Issue B40 in order to provide issuers of securitized interests time to adapt the structure of new deals in a way that conforms to the new scope exception.

**14.15** Because Statement 155 applies to instruments acquired after a certain date and the full requirements of DIG Issue B40 apply to instruments originally issued after a certain date, companies will need to track three types of securities that are subject to different accounting requirements: a) securities acquired before the date that Statement 155 was adopted (apply policy elected under DIG Issue D1), b) securities acquired after Statement 155 was adopted, but originally issued prior to June 30, 2007 (apply modified DIG Issue B40), and c) securities acquired after Statement 155 was adopted and originally issued after June 30, 2007 (apply DIG Issue B40 fully). Given that securities issued before June 30, 2007 may continue to be held or acquired for years subsequent to adoption, this tracking effort will need to be continued indefinitely.

**14.16** Most companies adopted Statement 155 and DIG Issue B40 at the same time. However, some companies may have adopted Statement 155 for financial statements released prior to the release of DIG Issue B40. Those companies should have adopted DIG Issue B40 in the first reporting period beginning after December 31, 2006. A company that adopted Statement 155 prior to the release of DIG Issue B40, and in doing so had treated derivatives embedded in a securitized interest in prepayable financial assets in a manner consistent with the guidance in DIG Issue B40, would continue to apply that accounting policy. A company that adopted Statement 155 prior to release of DIG Issue B40 and had instead treated derivatives embedded in a securitized interest in prepayable financial assets consistent with the guidance in DIG Issue B39 example 6, as amended by Statement 155 but prior to amendment by DIG Issue B40, should apply the guidance in DIG Issue B40 retrospectively to the date Statement 155 was adopted. If the company must recombine a host instrument with a previously separated embedded derivative, or reverse a Statement 155 fair-value election that would not have been available, any changes in the fair value of the previously separated derivative or fair value hybrid that were recorded in income should be reversed and the following accounting should be applied:

(a) Entities that elected to measure the entire hybrid financial instrument at fair value under Statement 155 may elect any appropriate classification in accordance with Statement 115 (ASC Subtopic 320-10) for the hybrid financial instrument.

(b) Financial instruments not carried at fair value through earnings under the Statement 155 fair-value election should be initially and subsequently recorded based on the Statement 115 (ASC Subtopic 320-10) classification previously elected for the host instrument.

**14.17 Embedded Credit-Derivative Scope Exception.** Statement 155 included guidance in paragraph 14B of Statement 133 that changes in the cash flows of beneficial interests attributable to changes in the creditworthiness of the securitized financial assets and liabilities (including derivative contracts) were not considered embedded derivatives under the Standard and concentrations of credit risk (for example, concentrations of credit risk in subordinated interests in securitized financial assets) should not be considered embedded derivatives under the Standard, regardless of how they arise. This guidance did not affect other aspects of the Standard regarding credit risk and the identification of credit risk as an embedded derivative. For instance, the examples relating to modified coinsurance and similar arrangements in DIG Issue B36...
continue to represent credit risk that is not clearly and closely related to the host contract (see discussion in Paragraphs B3.34 – B3.37 in Appendix B of this chapter).

14.18 However, after issuing Statement 155, the FASB determined that it was necessary to reevaluate this guidance because it believed that the embedded credit-derivative scope exception provided in paragraph 14B had been applied more broadly than originally intended. ASU 2010-11 clarifies how embedded credit-derivative features should be analyzed to determine whether those features should be accounted for separately. It is important to note that the ASU applies to not only interests in securitized financial assets, but to all interests that may have embedded credit derivative features such as interests in senior/subordinated loan participation structures that have cash flow priority features. For simplicity, the guidance in this section is presented in the context of interests in securitized financial assets. The ASU states that the embedded credit-derivative scope exception applies to embedded derivative features related to the transfer of credit risk that is only in the form of subordination of one financial instrument to another (such as between tranches of beneficial interests issued by a securitization entity). Any other embedded derivative features relating to another type of risk (including another type of credit risk) must be evaluated for separation as an embedded derivative. This guidance narrows the application of the embedded credit-derivative scope exception to embedded derivative features related only to subordination; therefore, other embedded derivative features related to another type of credit risk, such as those introduced through a written credit default swap, are not eligible for the scope exception and must be analyzed to determine whether they must be accounted for separately.

14.19 ASU 2010-11 also states that if the holder of an interest in a tranche of a securitized financial instrument may be required to make additional payments to the issuing entity (however remote the possibility), the tranche holder must evaluate all embedded credit-derivative features for separation because the possibility of those future payments is not created by subordination. It also clarifies that if a company holds an interest in a single-tranche securitization structure, an embedded-credit derivative feature would have to be evaluated for separation because subordination is not relevant.

14.20 In addition to providing guidance on the application of the scope exception, ASU 2010-11 describes how certain embedded credit-derivative features should be evaluated under the Standard’s clearly and closely related criteria. It states that the following features are considered to be not clearly and closely related to the host contract:

- An embedded credit-derivative feature that exposes the tranche holder to the possibility (however remote) of being required to make future payments; and
- An embedded credit-derivative feature that arises from the addition of a new credit risk to a securitization structure (e.g., by a written credit default swap).

14.21 ASU 2010-11 provides examples to illustrate the application of the scope exception to interests in common financing structures. Certain of the examples’ conclusions are not clear that the interests being analyzed contain more than one embedded credit-derivative feature, only one of which (or neither of which) meets the embedded credit-derivative scope exception. Due to concerns that the conclusions reached in those examples may be subject to different interpretations, we informally discussed the application of the guidance in the ASU with the FASB staff. Based on our discussion, we understand that the FASB intended the ASU to clarify that an embedded credit-derivative feature related to subordination would always meet the
embedded credit-derivative scope exception, except in circumstances where a holder of an interest in a tranche of a securitized financial instrument may be required to make additional payments to the issuing entity. If there is no possibility that a tranche holder could be required to make additional payments to the issuing entity and the instrument includes both an embedded credit-derivative feature created by subordination and an embedded credit-derivative feature related to another type of credit risk (such as a written credit default swap), the embedded credit-derivative feature created by subordination meets the embedded credit-derivative scope exception and is not required to be evaluated for separation. The embedded credit-derivative feature related to another type of credit risk must be evaluated for separation.

14.22 The following examples illustrate the evaluation of embedded credit-derivative features in interests in common financing structures and are consistent with the FASB’s intended interpretation of ASU 2010-11. The examples assume that the beneficial interests and embedded credit-derivative features meet all the other criteria for separation of the host contract and derivative feature.

Example 3.8a: Securitization with Subordination

A SPE holds prepayable fixed-rate loans and issues multiple tranches of fixed-rate debt instruments to investors with differing levels of subordination. No tranche holder paid a significant premium for its interest.

Analysis: Each of the tranches would be a hybrid instrument with an embedded credit-derivative feature. However, because the embedded derivative feature involves only the transfer of credit risk that is in the form of subordination of one financial instrument to another, it would meet the embedded credit-derivative scope exception and would not be evaluated for separation.

Example 3.8b: Fully Funded Synthetic Collateralized Debt Obligations (CDO)

A SPE holds debt securities issued by AA-rated Company A and a written credit default swap on a referenced credit (BBB-rated Company B) and issues multiple tranches of credit-linked debt instruments to investors with differing levels of subordination. The tranche holders are not required to make additional payments to the entity if losses under the credit default swap exceed the value of securities held by the SPE.

Analysis: Each of the tranches would be a hybrid financial instrument with two embedded credit-derivative features: one related to the allocation of credit risk associated with the instruments held by the SPE and one related to the credit risk of Company B introduced by the credit default swap.

The embedded credit-derivative feature related to the allocation of credit risk associated with the instruments held by the SPE would meet the embedded credit-derivative scope exception and would not be evaluated for separation because the feature involves only the transfer of credit risk that is in the form of subordination of one financial instrument to another. However, the embedded credit-derivative feature related to the credit risk of Company B introduced by the credit default swap would not meet the embedded credit-derivative scope exception and
would be evaluated for separation because the credit risk is not related only to subordination. 
Because a new credit risk was added to the beneficial interests by a written credit default swap,
the associated embedded credit-derivative feature is considered to be not clearly and closely
related to the host contract and would be required to be separated and accounted for as a
derivative instrument.

The fair value of the separated embedded credit-derivative feature related to the written credit
default swap would be based on the feature’s expected cash flows as affected by the
subordination provisions even though no separate derivative is recognized for the embedded
credit-derivative feature related only to subordination.

**Example 3.8c: Partially Funded Synthetic CDO**

A SPE holds debt securities issued by AA-rated Company A and a written credit default swap
on a referenced credit (BBB-rated Company B) and issues multiple tranches of credit-linked
debt instruments to investors with differing levels of subordination. Certain tranche holders
may be required to make additional payments to the entity if losses under the credit default
swap exceed the value of securities held by the entity.

**Analysis:** Each of the tranches would be a hybrid financial instrument with two embedded
credit-derivative features: one related to the allocation of credit risk associated with the
instruments held by the SPE and one related to the credit risk of Company B introduced by the
credit default swap.

Tranche holders that may be required to make future payments to the SPE would be required
to evaluate all embedded credit-derivative features (related to subordination and the written
credit default swap) for separation because the tranche holders’ potential future payments are
related to credit risk not related only to subordination. The compound embedded credit-
derivative (composed of the credit default swap and subordination features) is considered to be
not clearly and closely related to the host contract and would be required to be separated and
accounted for as a derivative instrument by tranche holders that may be required to make
future payments to the issuing entity.

Tranche holders that are not exposed to potential future payments would evaluate the
embedded credit-derivative features similarly to **Example 3.8b.** The embedded credit-
derivative feature related to the allocation of credit risk associated with the instruments held by
the SPE would meet the embedded credit-derivative scope exception and would not be
evaluated for separation because the feature involves only the transfer of credit risk that is in
the form of subordination of one financial instrument to another. However, the embedded
credit-derivative feature related to the credit risk of Company B introduced by the credit
default swap would not meet the embedded credit-derivative scope exception and would be
evaluated for separation because the credit risk is not related only to subordination. Because a
new credit risk was added to the beneficial interests by a written credit default swap, the
associated embedded credit-derivative feature is considered to be not clearly and closely
related to the host contract and would be required to be separated and accounted for as a
derivative instrument.
Example 3.8d: Fully Funded Synthetic CDO with a Single-Tranche Structure

A SPE holds debt securities issued by AA-rated Company A and a written credit default swap on a referenced credit (BBB-rated Company B) and uses a single-tranche structure to issue credit-linked debt instruments to investors. The investors are not required to make additional payments to the entity if losses under the credit default swap exceed the value of securities held by the SPE.

Analysis: Because a new credit risk was added to the beneficial interests by a written credit default swap, the associated embedded credit-derivative feature is considered to be not clearly and closely related to the host contract and would be required to be separated and accounted for as a derivative instrument.

14.23 ASU 2010-11 affected investors in fully funded synthetic CDOs that applied the embedded credit-derivative scope exception to their interests in securitized assets and liabilities and did not evaluate the embedded credit-derivative feature for separation. Those investors are required to bifurcate and separately account for the embedded credit-derivative feature related to the written credit default swap as a derivative after the effective date of the ASU.

14.24 ASU 2010-11 is effective at the beginning of a company’s first fiscal quarter beginning after June 15, 2010.

14.25 On initial adoption of ASU 2010-11, companies could have irrevocably elected to apply the fair value option to any investment in a beneficial interest in securitized financial assets. The election did not require companies to evaluate whether the hybrid financial instrument otherwise would be separated into a host contract and a derivative instrument upon adoption of the ASU. Companies were able to make this election on an instrument-by-instrument basis and had to support the election with documentation completed by the beginning of the fiscal quarter of initial adoption. If a company early adopted the guidance and elected to apply the fair value option, it was required to make the election at the beginning of that fiscal quarter. All changes in the fair value of the investment going forward will be recognized in earnings.

14.26 If the fair-value option is not elected, companies must determine whether all currently recognized financial instruments that were acquired, issued, or subject to a remeasurement event on or after Statement 155 became effective (January 1, 2007 for calendar-year-end companies) contain embedded credit derivatives for which the provisions of ASU 2010-11 would change the conclusion about whether the embedded derivative qualifies for the embedded credit-derivative scope exception. If a hybrid instrument must be separated into a host contract and a derivative instrument, the carrying amount of the host contract at adoption must be based on a pro forma bifurcation as of the inception of the hybrid contract and the host contract’s subsequent accounting to the date of adoption.

EMBEDDED DERIVATIVE COMPONENTS THAT ARE NOT ACCOUNTED FOR SEPARATELY

15.01 In limited circumstances, the embedded derivative component is not accounted for separately from the host contract even if it otherwise meets the requirements for doing so in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14). Those
limited circumstances may exist when (a) a contract involves qualifying interest-only or principal-only strips as discussed in paragraph 14 of the Standard (ASC paragraphs 815-10-15-72 and 15-73), (b) a contract involves certain embedded foreign currency derivative instruments, or (c) when the embedded derivative instrument cannot reliably be separated from the host contract. The last two circumstances are discussed in paragraphs 15 (ASC paragraphs 815-15-15-5, 15-6, and 15-10) and 16 of the Standard (ASC paragraphs 815-15-25-53).

15.02 Paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10) exclude from the separation requirements of paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) certain embedded foreign currency derivative instruments, as follows:

15. An embedded foreign currency derivative instrument shall not be separated from the host contract and considered a derivative instrument under paragraph 12 if the host contract is not a financial instrument and it requires payment(s) denominated in (a) the functional currency of any substantial party to that contract, (b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions),* (c) the local currency of any substantial party to the contract, or (d) the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary (as discussed in paragraph 11 of Statement 52). The evaluation of whether a contract qualifies for the exception in this paragraph should be performed only at inception of the contract. Unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both denominated in a foreign currency are subject to the requirement in Statement 5 to recognize any foreign currency transaction gain or loss in earnings and shall not be considered to contain embedded foreign currency derivative instruments under this Statement. The same proscription applies to available-for-sale or trading securities that have cash flows denominated in a foreign currency.

* If similar transactions for a certain product or service are routinely denominated in international commerce in various different currencies, the transaction does not qualify for the exception.

DIG Issues related to this paragraph are B4, B6, B21, B28, B32, B33, and B37. See DIG Issues Index.

Nonfinancial Instrument as the Host Contract

15.03 The first exclusion in paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10) from the separation requirements deals with nonfinancial host contracts. This exclusion applies to an embedded foreign currency derivative only if it is integral to the hybrid instrument. To be considered integral to the hybrid instrument, the contractual payments must be denominated in one of the following currencies: (a) the functional currency of a substantial party to the contract, (b) the currency in which the price of the related goods or services is routinely denominated in international commerce, (c) the local currency of a substantial party to the contract, or (d) the currency used by a substantial party as if it were the functional currency because the primary economic environment in which that party operates is highly inflationary. (See DIG Issue B21 for further reference.) It should be noted that the evaluation of whether a
contract qualifies for the exception in paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10) is performed only at inception of the contract.

15.04 When determining who is a substantial party to the contract for purposes of applying the provisions of paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10), the entity needs to consider all facts and circumstances related to that contract including whether the contracting party possesses the requisite knowledge, resources, and technology to fulfill the contract without relying on related parties. To make this assessment, an entity should look through the legal form of the contract to evaluate the substance of the underlying relationships.

15.05 We believe that only one entity within a consolidated group can be deemed a substantial party to the contract with respect to providing the majority of the resources to fulfill a contract. Identifying the entity that will provide the majority of the resources is subjective, and should be based on both quantitative and qualitative factors. Certain resources, for example, employees and material costs specifically used to fulfill the contract, can be quantified. Qualitative factors that may not be easily measured include developed technology, knowledge, experience, and infrastructure. (See DIG Issue B32 for further reference.)

15.06 The following illustrates the determination of the substantial parties to a contract:

**Example 3.9: Substantial Parties to a Lease**

A U.S. parent company has a French subsidiary. The French subsidiary is a substantive operating entity. The subsidiary enters into a lease with a Canadian company. Even though the French subsidiary has the resources to make the majority of the lease payments as a result of its operations, the parent company guarantees the lease payments.

The French subsidiary should be considered a substantial party to the contract because it will provide a majority of the payments required under the contract. The parent is a third-party guarantor and is not a substantial party to the contract, even though it is a related party. Based on the information presented, the Canadian company is the other substantial party to the contract.

**Example 3.10: Substantial Parties to a Construction Contract**

A U.S.-based construction company (the Parent) pursues business in a foreign country on a major construction contract. The Parent has an operating subsidiary (the Subsidiary) in that foreign country. Primarily for tax and political reasons, the Parent causes its Subsidiary to enter into a contract with the customer (i.e., the contract is legally between the Subsidiary and the customer). The Subsidiary, by itself, does not possess the requisite financial, human and other resources, technology, and knowledge to execute the construction contract on its own. The Parent provides the majority of the resources required under the contract, including direct involvement in negotiating the terms of the contract, managing, and executing the contract throughout its duration, and maintaining all contract supporting functions, such as legal, tax, insurance, and risk management. Because the Parent controls it, the Subsidiary does not have a choice of subcontractor for these resources and services and will always integrate the Parent into all phases of the contract. Without the Parent, the Subsidiary and the customer would
probably never have entered into the construction contract because the Subsidiary could not perform under this contract without the help of the Parent.

The Parent should be considered a substantial party to the contract because the Parent will provide a majority of resources required under the contract on behalf of the Subsidiary. The Subsidiary is not considered a substantial party to the contract even though it is the legal party to the contract. Based on the information presented, the customer is the other substantial party to the contract.

15.07 If a contract is denominated in the functional currency of an entity that is a substantial party to a contract, the condition in paragraph 15(a) of the Standard (ASC paragraph 815-15-15-10(b)(1)) is met. An entity will be able to determine easily when that condition is met if the contract is denominated in its own functional currency. However, if the contract is not denominated in its own functional currency, the entity must determine whether the contract is denominated in the functional currency of the other substantial party to the contract in order to meet the condition in paragraph 15(a) of the Standard (ASC paragraph 815-15-15-10(b)(1)). We believe such a determination should be based on verifiable facts, not by conjecture.

15.08 To meet the condition in paragraph 15(b) of the Standard (ASC paragraph 815-15-15-10(b)(2)), the contract must be denominated in the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce. That assessment should be based on how similar transactions for a certain product or service are routinely denominated around the world, not just in one local area. Therefore, if transactions for a product or service were routinely denominated in one currency in one region of the world, but in other currencies in other parts of the world, the transactions would not meet the condition in paragraph 15(b) of the Standard (ASC paragraph 815-15-15-10(b)(2)). The following illustrates this provision:

**Example 3.11: Routinely Denominated in International Commerce**

In general, a real estate lease negotiated between companies involved in international commerce in certain South American economies would routinely require U.S. dollar payments, while real estate leases negotiated between companies involved in international commerce in European economies would not routinely require U.S. dollar payments. Assume the lessee is a Canadian company that uses the Canadian dollar as its functional currency and the property being leased is located in Venezuela. Also assume the lessor is a Venezuelan company whose functional currency is the Mexican Peso and the lease is denominated in U.S. dollars.

If similar transactions for a certain product or service are routinely denominated in international commerce in various different currencies, the exception in paragraph 15(b) of the Standard (ASC paragraph 815-15-15-10(b)(2)) does not apply to any of those similar transactions. In this example, because real estate leases around the world are not routinely denominated in U.S. dollars, the leasing transaction would not qualify for the exception in paragraph 15(b) of the Standard (ASC paragraph 815-15-15-10(b)(2)).

15.09 An entity will be able to determine readily whether the contract is denominated in the local currency of any substantial party to the contract based on the location of each party and thus
determine whether the condition in paragraph 15(c) of the Standard (ASC paragraph 815-15-15-10(b)(3)) is met. For example, if one substantial party is located in Japan and the other substantial party is located in Germany, a contract that requires payments in yen or euros would be denominated in the local currency of any substantial party to the contract, regardless of whether it is the functional currency of any substantial party to the contract.

15.10 To meet the condition in paragraph 15(d) of the Standard (ASC paragraph 815-15-15-10(b)(4)), the contract must be denominated in the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary. When making that determination, an entity will need to evaluate the conditions in paragraph 11 of FASB Statement No. 52, Foreign Currency Translation (Statement 52) (ASC paragraph 830-10-45-11 of ASC Topic 830, Foreign Currency Matters). We believe that that determination should be based on verifiable facts and not conjecture.

Application Issues

15.11 As previously indicated, the Standard requires that the payments be denominated in a currency that is integral to the arrangement. It follows that the exception in paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10) implicitly requires that the other aspects of the embedded foreign currency derivative also must be integral to the arrangement. The following illustrates these requirements:

**Example 3.12: Embedded Foreign Currency Derivative Instrument**

Company A, whose functional currency is the U.S. dollar, leases a warehouse in London for £8,000 per month. The lease agreement gives Company A the alternative to make lease payments on this warehouse in U.S. dollars using the exchange rate in effect at the end of the respective month.

This provision would not be considered an embedded derivative component that is required to be separated from the host contract and considered a derivative instrument for purposes of this Standard. The provision serves only to convert payments that would otherwise be paid in one currency to the functional currency of one of the parties with a substantial interest in the contract (i.e., it serves to convert sterling payments to U.S. dollars, which is the functional currency of the lessee).

**Example 3.13: Embedded Foreign Currency Derivative Instrument**

Two entities enter into a long-term service contract whereby Entity A agrees to provide a service to Entity B at market rates over a three-year period. Entity B forecasts that it will pay 1,000 euros to Entity A at the end of the 3-year period for all services rendered under the contract. Entity A’s functional currency is the euro and Entity B’s functional currency is the U.S. dollar. In addition to providing the terms under which the service will be provided, the contract includes a foreign currency exchange provision. The provision requires that over the term of the contract, Entity B will pay or receive an amount equal to the fluctuation in the exchange rate of the U.S. dollars and the euro applied to a notional amount of 100,000 euro
(i.e., if the U.S. dollar appreciates versus the euro, Entity B will pay the appreciation, and if the U.S. dollar depreciates versus the euro, Entity B will receive the depreciation amount).

Because the contract is leveraged by requiring the computation of the payment based on a 100,000 euro notional amount, the embedded foreign currency instrument is not clearly and closely related to the service contract and would not qualify for the exception provided by paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10). Thus, the contract is a hybrid instrument that contains an embedded derivative – a foreign currency swap with a notional amount of 99,000 euro, which should be separated from the host if the conditions in paragraph 12 of the Standard (ASC paragraph 815-15-25-1) are met. (See DIG Issue B4 for further reference.)

### 15.12 Embedded Foreign Currency Derivatives

Embedded foreign currency options that merely introduce a cap, floor or combination of both on the functional-currency-equivalent price under a nonfinancial purchase contract are common in international trade. These features protect the parties from foreign exchange risk at various levels of exchange rates. The discussion in paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10) related to embedded foreign currency derivatives within nonfinancial contracts includes option features. Thus, those option features would be considered to be clearly and closely related under paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10) as long as those features do not contain leverage or do not represent a written or net written option. (See DIG Issue B33) for further reference.)

### Financial Instrument as the Host Contract

15.13 Paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10) also indicates that financial instruments that are monetary and have principal payments, interest payments, or both that are denominated in a foreign currency should not be considered to include embedded derivative components. Those instruments are subject to the provisions of Statement 52 (ASC Topic 830) and require the entity to recognize a foreign currency transaction gain or loss in earnings. The Board also stated that the same proscription applies to available-for-sale or trading securities that have cash flows denominated in a foreign currency. Thus, a financial instrument in which the principal payments are denominated in the functional currency of the borrower, but the interest payments are denominated in another currency, contains an embedded derivative component that cannot be accounted for separately from the host contract under paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10). The following illustrates this provision:

#### Example 3.14: Embedded Foreign Currency Derivative Instrument

Company B issues a $100,000 debt obligation that matures in five years. The principal is denominated in U.S. dollars and the interest is denominated in yen. Assume the functional currency of Company B is the U.S. dollar.

Because the portion of the instrument related to the periodic interest payments denominated in yen is subject to the requirement in Statement 52 (ASC Topic 830) to recognize the foreign currency transaction gain or loss in earnings, the instrument should not be considered to contain an embedded foreign currency derivative instrument under paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10). In this example, Company B has...
the U.S. dollar as the functional currency and is making interest payments in yen. Remeasurement of the liability is required using future equivalent dollar interest payments determined by the current spot exchange rate and discounted at the historical effective interest rate.

Example 3.15: Embedded Foreign Currency Derivative Instrument

Company A issues a loan at an above-market interest rate. The loan is made in U.S. dollars, which is Company A’s and the borrower’s functional currency, and the borrower has the option to repay the loan in U.S. dollars or in a fixed amount of a specified foreign currency. This instrument can be viewed as combining a loan at prevailing market interest rates and a foreign currency option. The lender has written a foreign currency option that exposes it to changes in foreign currency exchange rates during the outstanding period of the loan. The premium for the option is being paid as part of the interest rate. Because the borrower has the option to repay the loan in U.S. dollars or in a fixed amount of a specified foreign currency, the provisions of paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10) are not relevant to this example. Paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10) addresses foreign-currency-denominated interest or principal payments but does not apply to foreign currency options embedded in a functional-currency-denominated debt host contract. Because the foreign currency option is not clearly and closely related to issuing the loan, the embedded option should be separated from the host contract and accounted for as a derivative by both parties, unless the entities irrevocably elect, at issuance or upon a remeasurement (new basis) event, to measure the hybrid instrument in its entirety at fair value, with changes in fair value reported in earnings, pursuant to the guidance in Statement 155. In contrast, if both the principal payment and interest payments on the loan were payable in only a fixed amount of a specified foreign currency, there would be no embedded foreign currency derivative under paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10).

ACCOUNTING FOR EMBEDDED DERIVATIVE INSTRUMENTS, HOST CONTRACTS, AND HYBRID INSTRUMENTS

16.01 Paragraph 16 of the Standard (ASC paragraphs 815-10-15-84 and 815-15-25-53 and 25-54) summarizes the instruments and features that are included in the scope of the Standard, and the accounting for those instruments and components as follows prior to being amended by Statement 155:

16. In subsequent provisions of this Statement, both (a) a derivative instrument included within the scope of this Statement by paragraphs 6-11 and (b) an embedded derivative instrument that has been separated from a host contract as required by paragraph 12 are collectively referred to as derivative instruments. If an embedded derivative instrument is separated from its host contract, the host contract shall be accounted for based on generally accepted accounting principles applicable to instruments of that type that do not contain embedded derivative instruments. If an entity cannot reliably identify and measure the
embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement.

DIG Issues related to this paragraph are B6, B8, B11, B27, B29, and B30. See DIG Issues Index.

16.01a Statement 155 amends paragraph 16 of the Standard (ASC paragraph 815-15-25-4 through 25-6) to permit an entity that initially recognizes a hybrid financial instrument that would otherwise be required to be separated into a host contract and a derivative instrument to irrevocably elect to subsequently measure that hybrid financial instrument at fair value (with changes in fair value reported in earnings). Further, paragraph 16 (ASC paragraphs 815-10-15-84 and 815-15-25-53 and 25-54, and 815-15-25-4 through 25-6) (both before and after Statement 155) requires fair value measurement for the hybrid in the rare circumstance when an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 (ASC paragraph 815-15-05-1, 815-15-25-1 and 25-14) requires be separated from the host contract. Paragraph 16 of the Standard (ASC paragraphs 815-10-15-84 and 815-15-25-53 and 25-54, and 815-15-25-4 through 25-6), as amended for Statement 155, is presented below:

16. In subsequent provisions of this Statement, both (a) a derivative instrument included within the scope of this Statement by paragraphs 6-11 and (b) an embedded derivative instrument that has been separated from a host contract as required by paragraph 12 are collectively referred to as derivative instruments. If an embedded derivative instrument is separated from its host contract, the host contract shall be accounted for based on generally accepted accounting principles applicable to instruments of that type that do not contain embedded derivative instruments. If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement. An entity that initially recognizes a hybrid financial instrument that under paragraph 12 would be required to be separated into a host contract and a derivative instrument may irrevocably elect to initially and subsequently measure that hybrid financial instrument\(^{6bb}\) in its entirety at fair value (with changes in fair value recognized in earnings). The fair value election shall be supported by concurrent documentation or a preexisting documented policy for automatic election. That recognized hybrid financial instrument could be an asset or a liability and it could be acquired or issued by the entity. That election is also available when a previously recognized financial instrument is subject to a remeasurement (new basis) event\(^{6bbb}\) and the separate recognition of an embedded derivative. However, that recognized hybrid instrument may not be designated as a hedging instrument pursuant to this Statement. This election may be made on an instrument-by-instrument basis.

\(^{6bb}\) This election shall not be applied to the hybrid instruments described in paragraph 8 of FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments.

\(^{6bbb}\) For purposes of this Statement, a remeasurement (new basis) event is an event identified in other authoritative literature, other than the recognition of an other-than-temporary impairment, that requires a financial instrument to be remeasured to its fair value at the time of the event but does not require that instrument to be reported at fair value on a continuous basis with the change in fair value recognized in earnings. Examples of remeasurement events are business combinations and significant modifications of...
16.01b Fair Value Election Under Statement 155. Once an entity has completed its analysis of a hybrid financial instrument comprising a host and an embedded derivative that Statement 133 (ASC Topic 815) would otherwise require be bifurcated and accounted for separately from the host, the entity may elect to carry the entire financial instrument at fair value. The Statement 155 fair value election is irrevocable and must be made on an instrument-by-instrument basis, applied to the entire hybrid financial instrument and supported by concurrent documentation or by a previously established documented policy for automatic election. If the fair value option is elected, changes in fair value would be recognized in earnings. Companies may elect fair-value measurement when the hybrid financial instrument is acquired or issued or when a previously recognized hybrid financial instrument is subject to a remeasurement (i.e., new basis) event. For purposes of Statement 155, a remeasurement event is an event, excluding an other-than-temporary impairment, that triggers a GAAP requirement to remeasure the financial instrument to its fair value at the time of the event. Business combinations and significant modifications of debt are examples of remeasurement events. See further discussion in other KPMG guidance.

16.01c The fair value election in Statement 155 only applies to hybrid financial instruments. Statement 133, paragraph 540 (ASC Section 815-10-20) defines financial instrument as:

"Cash, evidence of an ownership interest in an entity, or a contract that both:

(a) Imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity

(b) Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

A hybrid instrument is the term used to describe an overall instrument in which a derivative feature (or various derivative features) is embedded into a host contract.

16.01d Further, footnote 6bb in paragraph 16 of Statement 133 (ASC paragraph 815-15-25-6), as amended by Statement 155, states the fair value option can not be applied to the hybrid instruments described in paragraph 8 of FASB Statement No. 107, Disclosures About Fair Value of Financial Instruments (Statement 107) (ASC paragraph 825-10-50-8). Paragraph 8 of Statement 107 (ASC paragraph 825-10-50-8) includes the following instruments:

(a) Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in FASB Statements No. 35, Accounting and Reporting by
Substantively extinguished debt subject to the disclosure requirements of Statement 140, Liabilities- Extinguishments of Liabilities

Insurance contracts, other than financial guarantees and investment contracts, as discussed in FASB Statements No. 60, Accounting and Reporting by Insurance Enterprises - Insurance Activities and No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments

Lease contracts as defined in FASB Statement No. 13, Accounting for Leases (a contingent obligation arising out of a cancelled lease and a guarantee of a third-party lease obligation are not lease contracts and are included in the scope of Statement 155) (Statement 13)

Warranty obligations and rights

Unconditional purchase obligations as defined in paragraph 6 of FASB Statement No. 47, Disclosure of Long-Term Obligations

Investments accounted for under the equity method in accordance with the requirements of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock

Minority interests in consolidated subsidiaries

Equity investments in consolidated subsidiaries

Equity instruments issued by the entity and classified in stockholders' equity in the statement of financial position. (In the context of Statement 155, we believe that an instrument that is classified within stockholders' equity, whether in whole or part, is not eligible for the fair value election. As such, similar to Statement, convertible debt with a non-contingent beneficial conversion feature that results in a component of the issuance proceeds being allocated to equity would not be eligible for a fair value election.)

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3 At the June 2007 EITF meeting, the SEC staff announced revisions to EITF D-98, "Classification and Measurement of Redeemable Securities" (ASC paragraph 480-10-S99-3) related to the release of Statement 159 (ASC Subtopic 825-10). The SEC announced that it will no longer accept liability classification for financial instruments that meet the conditions for temporary equity classification under ASR 268, Presentation in Financial Statements of "Redeemable Preferred Stocks" and EITF D-98 (ASC paragraph 480-10-S99-3). As a consequence, the fair value option under Statement 159 (ASC Subtopic 825-10) may not be applied to any financial instrument (or host contract) that qualifies as temporary equity. Registrants that do not choose retrospective application should...
16.01 Difference between Fair Value Election and Statement 133 (ASC Topic 815). The fair value option contained in Statement 155 differs from the fair value hedging model of the Standard where the fair value recorded on the balance sheet for the hedged item relates only to the specific hedged risk (such as interest), with changes in fair value recognized in earnings, which may or may not represent all of the factors that affect the entire fair value of the hedged financial instrument. Another difference between the fair value option in Statement 155 and fair value hedge accounting is that the fair value option, as an election, is irrevocable. This contrasts to fair value hedge accounting, which can be stopped (i.e., de-designated) in the future. In addition, since a company's financial instruments include its debt, Statement 155's fair value election gives companies the opportunity to carry their debt at fair value if that debt includes an embedded derivative that otherwise would require separate accounting under Statement 133.

16.02 Day-One Gains and Losses. Additionally, Statement 155 added subparagraph 16A to the Standard, which required that a difference between the transaction price and the estimated fair value at inception of a hybrid financial instrument for which fair value measurement has been elected should not be recognized in earnings unless that estimated fair value is (a) obtained from a quoted market price in an active market, (b) is evidenced by comparison to other observable current market transactions, or (c) is based on a valuation technique incorporating observable market data. That proscription, similar to prohibition on initial recognition of certain day-one gains for freestanding derivative contracts in EITF 02-3 (ASC paragraph 815-10-45-9), was eliminated by Statement 157 (ASC Subtopic 820-10) and therefore does not apply after adoption of Statement 157.4

16.02a Note that the SEC staff has historically expressed the view that day-one gains should not be recognized for the host contract or embedded derivative that is bifurcated from a hybrid under the rationale that DIG Issue B6 "Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative", requires the residual proceeds or purchase price to be allocated to the host (see Paragraph 16.07). That view continues to be applicable upon adoption of Statement 157 (ASC Subtopic 820-10) for hybrid instruments that are bifurcated between a host contract and a derivative instrument.

16.02b For example, assume a bank issued a structured note to a customer that included an embedded derivative that would be required to be separated pursuant to Statement 133 (ASC Topic 815). In addition, the embedded derivative in the structured note has a fair value of $4 at issuance. Under GAAP, nonderivative financial instrument liabilities are carried at historical/amortized cost except where specifically allowed under the literature. In this instance, assume the structured note is carried at amortized cost and is not carried at fair value. Assume the proceeds received by the bank from the customer for issuing the structured note were $100 but the fair value of the note under Statement 157 (ASC Subtopic 820-10) is $99. Given this situation the SEC staff believes that the derivative should be recorded at its fair value of $4 and the structured note (i.e., the host contract) recorded at $96. This conclusion effectively results in apply the announcement prospectively to all affected instruments that are entered into, modified, or otherwise subject to a remeasurement event in the registrant's first fiscal quarter beginning after September 15, 2007.

4 Statement 157 (ASC Subtopic 820-10) is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year.
the day-one gain being embedded in the host contract and amortized as a yield adjustment over the life of the host contract.

**16.02c** In contrast, if the issuer had adopted Statement 157 (ASC Subtopic 820-10) and elected to account for the structured note at fair value upon issuance pursuant to the fair value election in Statement 155 or Statement 159 (ASC Subtopic 825-10), the bank would have recorded the note at $99 and recognized a dealer profit of $1 at issuance. If the issuer had elected to account for the structured note at fair value upon issuance pursuant to Statement 155 and had not yet adopted Statement 157, the gain would only be recognized if the estimated fair value ($99) was (a) obtained from a quoted market price in an active market, (b) evidenced by comparison to other observable current market transactions, or (c) based on a valuation technique incorporating observable market data.

**16.03** Although after adoption of Statement 157 (ASC Subtopic 820-10), there is no prohibition on recognizing day-one gains upon issuance of a hybrid financial instrument that is carried at fair value (e.g., under Statement 155 or Statement 159 (ASC Subtopic 825-10)) if the fair value of the hybrid is determined to be other than the transaction price, in general the transaction price will equal the fair value of the transaction. In order to support a conclusion that a fair value measurement based on unobservable inputs is an amount different than the transaction price, the subject asset or liability should fall into one of the following categories:

- The transaction to purchase the asset or liability was entered into in a market other than the entity's principal or most advantageous market (in the case where a principal market does not exist) for the sale or transfer of the asset or liability; or
- A transaction to sell the asset or liability is expected to occur at a different point within the bid/ask spread from where the asset or liability was acquired.

**16.04** Although additional examples of when a difference may exist between an entity's measurement of fair value and the transaction price for a specific asset or liability are discussed in Statement 157 (ASC Subtopic 820-10), we believe such instances will be uncommon. To recognize an asset acquired or liability assumed at an amount different from the transaction price, the reporting entity should identify the specific attributes of the transaction that generate the difference between the transaction price and the entity's estimate of fair value and reconcile those attributes with the guidance given in paragraph 17 of Statement 157 (ASC paragraph 820-10-30-3). See paragraphs 17.24-17.24c of Section 4 for additional discussion of this issue.

**Embedded Derivative Components to Be Accounted for Separately from the Host Contract**

**16.05** Paragraph 16 of the Standard (ASC paragraphs 815-10-15-84 and 815-15-25-53 and 25-54) discusses the accounting required for a hybrid instrument that includes an embedded derivative component that qualifies for separate accounting under the Standard. If an embedded derivative qualifies for separate accounting from the hybrid instrument, the Standard requires that the embedded derivative instrument be accounted for in the same manner that a freestanding derivative instrument would be accounted for under the Standard. The remaining host contract should be accounted for under GAAP applicable to the respective instruments. For example, if the embedded conversion option in a convertible debt security is separated from a non-trading debt security, the non-trading debt security would be accounted for under Statement 115 (ASC...
Subtopic 320-10) by the investor. For certain hybrid financial instruments containing an 
embedded derivative that would otherwise require bifurcation from the host contract, Statement 
155 permits entities to irrevocably elect to initially and subsequently measure the hybrid 
instrument in its entirety at fair value (with changes in fair value recognized in earnings). The 
election can be made upon initial recognition of an instrument or upon another qualifying event. 
Further, Statement 159 (ASC Subtopic 825-10) permits a fair value election to be made for most 
financial assets or financial liabilities (and certain other qualifying items), whether or not they 
contain an embedded derivative that would require separation, if an election is made at initial 
recognition of the instrument (or upon another qualifying event). In circumstances where fair 
value measurement is elected for an entire hybrid instrument pursuant to the guidance in 
Statement 155 or Statement 159, the embedded derivative component should not be accounted 
for separately from the host contract because the criterion in paragraph 12(b) of the Standard 
(ASC paragraph 815-15-25-1(b)) would not be satisfied.

16.06 The following flowchart may be used as a guide in determining whether an embedded 
derivative component is considered a derivative instrument that requires accounting separate 
from the host contract under the Standard.

**Exhibit 3.2: How to Account for an Embedded Derivative Component (1, 2)**

![Flowchart](chart.png)

(1) This flowchart does not include certain interest-only and principal-only strips or embedded foreign currency 
derivative instruments that are explicitly excluded from being separated from the host contract and accounted for 
separately pursuant to paragraphs 14 (ASC paragraphs 815-10-15-72 and 15-73) and 15 of the Standard (ASC 
paragraphs 815-15-15-5, 15-6, and 15-10), respectively.

(2) Note that if the entire hybrid instrument is designated at fair value through earnings under Statement 159 (ASC 
Subtopic 825-10), it would fail step 2 of the analysis and no embedded features would require bifurcation.
(3) At this point in the analysis an entity could irrevocably elect to initially and subsequently measure at fair value (with changes in fair value recognized in earnings) a qualifying hybrid financial instrument that is recognized or subject to a new basis remeasurement event after the adoption of Statement 155.

Separating an Embedded Derivative Instrument from a Host Contract

16.07 When allocating the basis of a hybrid instrument between the host contract and the embedded derivative that is required to be separated, DIG Issue B6 "Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative" requires an entity to use an allocation method that initially measures the embedded derivative at fair value and the host contract at the difference between the basis of the hybrid instrument (before bifurcating the embedded derivative) and the fair value of the embedded derivative (i.e., a with-and-without method). After initial measurement, the host contract would be accounted for under generally accepted accounting principles applicable to that type of instrument without an embedded derivative. After initial measurement, the embedded derivative must continue to be measured at fair value. After separation from the host contract, the embedded derivative may be designated prospectively as a hedging instrument provided that all the hedging criteria are met. However, when the embedded derivative is not separately accounted for because fair value measurement is elected for the entire hybrid instrument under Statement 155 or Statement 159 (ASC Subtopic 825-10), that hybrid instrument may not be designated as a hedging instrument under the Standard.

16.08 If the host contract component of the hybrid instrument is measured at fair value with changes in fair value recognized in other comprehensive income, then the sum of the fair values of the host contract component and the embedded derivative should not exceed the overall fair value of the hybrid instrument. After initial separation, entities must track the fair values of the separately recorded components of the hybrid instrument to ensure that the sum of the recognized values of the components does not exceed the fair value of the hybrid instrument. If the sum of the fair value of the components exceeds the fair value of the hybrid instrument, we would expect entities to allocate the excess to the component that is reported at fair value with changes in fair value recognized in other comprehensive income. In other words, the component that is reported at fair value with changes in fair value recognized in earnings (i.e., the separated embedded derivative) would continue to be reported at its fair value.

16.09 The intent of the with-and-without allocation method discussed above is to avoid the recognition of an immediate gain or loss in earnings that would occur if another method, such as a relative-fair-value method, were used when the embedded derivative that is separated from the host contract continues to be reported at fair value through earnings. Further, as discussed in paragraph 16.02a, the with-and-without allocation method prescribed in DIG Issue results in the entire residual transaction value being ascribed to the host and accounted for using the literature applicable to the host contract.

Terms of the Embedded Derivative Instrument

16.10 While the Standard did not provide comprehensive guidance on the mechanics of separating an embedded derivative from a hybrid instrument, it did provide general guidance about the terms of the separated embedded derivative when the embedded derivative component is a nonoption or option contract.
16.11 When separating a nonoption-based embedded derivative from a host contract, the terms of the nonoption-based embedded derivative should be determined in a manner that results in its fair value generally being equal to zero. At inception of the hybrid instrument, the issuer and the original investor would base that determination on the issuance date of the instrument. However, an investor that purchases the instrument after the issuance date of the instrument would base that determination on the date of purchase (and not the issuance date) of the hybrid instrument. The nonoption-based embedded derivative should contain a notional amount and an underlying consistent with the terms of the hybrid instrument. Artificial terms should not be created to introduce leverage, asymmetry, or some other risk exposure not already present in the hybrid instrument. Generally, the appropriate terms for the nonoption embedded derivative will be readily apparent. Often, simply adjusting the reference forward price to be at-the-market for the purposes of separately accounting for the embedded derivative will result in that non-option embedded derivative having a fair value of zero. As a result, entities need to maintain two sets of documentation. One set will be the legal contract terms of the hybrid instrument. The other set will be the terms of the host contract and embedded derivative as modified to attain a zero value for the derivative. These modified terms will need to be followed for subsequent accounting of the host and derivative. See DIG Issues B20 and B23 for further reference.

16.12 When separating an option-based embedded derivative from the host contract, the strike price of the embedded derivative should be based on the stated terms documented in the hybrid instrument. As a result, the option-based embedded derivative may have a strike price that does not equal the market price of the asset associated with the underlying and, therefore, a fair value that is other than zero. There are substantive, fundamental differences between forward-based and option-based contracts. Adjusting the strike price of an option-based embedded derivative fundamentally alters the economics of the hybrid instrument, whereas adjusting the strike price of a forward-based embedded derivative does not necessarily fundamentally alter the economics of the hybrid instrument. See DIG Issue B22 for further reference.

An Entity Cannot Reliably Identify and Measure an Embedded Derivative Component

16.13 Paragraph 16 of the Standard (ASC paragraph 815-15-25-53) addresses the accounting when an entity cannot reliably identify and measure an embedded derivative component. In that situation, the entire contract, including both the derivative and nonderivative portions, should be measured at fair value with changes in fair value reported in earnings each reporting period.

16.14 The Standard presumes that entities entering into sophisticated investment and funding strategies such as structured notes or other complex contracts with embedded derivative components should be able to obtain the information necessary to identify and measure the separate components. Accordingly, it should be unusual for an entity to conclude that it cannot separate an embedded derivative component from its host contract in a reliable manner. In practice, we have found that it has been rare for an entity to conclude that it cannot reliably separate an embedded derivative component from its host contract. As a result, entities rarely, if ever, should conclude that they cannot separate an embedded derivative component from its host contract.

16.15 In the unlikely event that an instrument includes an embedded derivative component that is not accounted for separately from the host contract because the entity is unable to reliably...
identify and measure the embedded derivative component, the entity may not designate that instrument as a hedging instrument. The Standard prohibits an entire contract with an embedded derivative component from being designated as a hedging instrument to avoid the inappropriate use of nonderivative instruments as hedging instruments.

**Appendix A Embedded Derivatives**

**INTRODUCTION**

Deciding whether the identified embedded derivative component should be accounted for separately from its host contract will be the most difficult task in accounting for embedded derivative instruments. After an entity determines that a separate instrument with the same terms would, under paragraphs 6 - 9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128), be a derivative instrument, and would not be excluded from the scope of the Standard under paragraphs 10 and 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82), the entity must determine whether the economic characteristics and risks of the embedded derivative component are clearly and closely related to the host contract. If they are, the embedded derivative component would not be separated from the host contract.

Determining whether an embedded derivative component and the host contract are clearly and closely related will require judgment. The interdependency between the embedded derivative component and the host contract may help to indicate whether the embedded derivative component is clearly and closely related to its host contract. An embedded derivative component that has a fair value commonly associated with the fair value of the host contract often will be clearly and closely related to that host contract.

This appendix explains the key characteristics of the three most common types of host contracts to help entities assess the nature of the embedded derivative component and whether the embedded derivative component is clearly and closely related to the host contract. This appendix also provides examples of how certain hybrid instruments would be analyzed to determine whether the embedded derivative is clearly and closely related to the host contract. If the embedded derivative is not clearly and closely related to the host contract, further analysis is required under paragraphs 12(b) and 12(c) of the Standard (ASC paragraphs 815-15-25-1(b), 25-1(c) and 25-14) to determine whether the embedded derivative should be separated from the host contract and accounted for as a derivative instrument under the Standard. This appendix addresses debt, equity, and lease host contracts.

For certain hybrid financial instruments containing an embedded derivative that would otherwise require bifurcation from the host contract, Statement 155 permits entities to irrevocably elect to initially and subsequently measure the hybrid instrument in its entirety at fair value (with changes in fair value recognized in earnings). A similar election is permitted for most financial assets and financial liabilities (and certain other eligible items), whether or not they contain an embedded derivative that would require separation, under Statement 159 (ASC Subtopic 825-10). In circumstances where fair value measurement is elected for an entire hybrid financial instrument pursuant to the guidance in Statement 155 or Statement 159, the embedded derivative component should not be accounted for separately from the host contract.
DEBT HOST CONTRACT

A3.01 The Standard does not provide a comprehensive list of all instruments that contain a debt host. However, paragraph 60 of the Standard (ASC paragraph 815-15-25-16 and 55-119) provides general guidance for determining whether the host contract is a debt or equity instrument. If the host contract encompasses a residual interest in an entity, its economic characteristics and risks should be considered that of an equity instrument and an embedded derivative would need to possess principally equity characteristics (related to the same entity) to be considered clearly and closely related to the host contract. However, most financial instrument host contracts will not embody a claim to the residual interest in an entity and, thus, the economic characteristics and risks of the host contract may be considered that of a debt instrument. For example, even though the overall hybrid instrument that provides for repayment of principal may include a return based on the market price of an unrelated entity’s common stock, the host contract does not involve any existing or potential residual interest rights. The host contract would instead be considered a debt instrument, and the embedded derivative that incorporates the equity-based return would not be clearly and closely related to the host contract. If the embedded derivative meets the other conditions in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14), it must be separated from the host contract and accounted for as a derivative instrument under the Standard. The evaluation of whether an instrument contains a debt host or an equity host is often most difficult when evaluating a preferred share instrument with characteristics of both debt (e.g., redemption provisions, cumulative fixed rate dividends, etc.) and equity (e.g. voting rights, participation in earnings, etc.). A more detailed discussion of determining the nature of a host contract for a share (which may also be applicable in many cases for evaluating non-share instruments) is included in this appendix starting at Paragraph A3.31.

A3.02 After an entity determines that a hybrid instrument contains a debt host, the entity needs to identify the exact terms of the host contract. While there may be some flexibility in identifying the exact terms of the debt host contract (see Paragraph 12.27b), an entity is not permitted to identify characteristics that are inconsistent with either the stated or implied substantive terms of the hybrid instrument. In the absence of these terms, entities would use judgment to determine whether to account for the debt host as a fixed-rate, floating-rate, or zero-coupon bond. That is, in the absence of stated or implied terms, it is appropriate to consider, among other things, the features of the hybrid instrument, the issuer, and the market in which the instrument is issued, to determine the characteristics of the debt host contract. Judgment is required because the circumstances surrounding each hybrid instrument containing an embedded derivative may be different. However, the use of judgment does not allow entities to express the characteristics of a debt host contract in a manner that would result in identifying an embedded derivative that is not already clearly present in the hybrid instrument. For example, it would not be appropriate for an entity that has a debt obligation with stated terms of fixed interest payments adjusted for changes in the S&P 500 Index to identify a LIBOR-based-floating-rate debt host contract and a compound derivative that incorporates changes in the S&P 500 Index and a floating-to-fixed interest rate swap component. (See DIG Issue B19 for further reference.)

A3.03 The value of a debt instrument is driven by the associated interest rate. The interest rate of a debt instrument comprises a risk-free rate adjusted for expectations and risks related to (1) future inflation during the term of the debt instrument (i.e., possible changes in the purchasing
power of money); (2) the possibility that the invested funds may not be fully recovered (i.e.,
credithworthiness of the debtor); and (3) liquidity preference (i.e., longer term maturities are
viewed to have more liquidity risk than shorter term maturities). Thus, as a general rule, the
interest rate on a debt instrument is viewed to be clearly and closely related to an embedded
derivative component in which the underlying is linked to interest, inflation, the credithworthiness
of the host contract’s issuer (i.e., the debtor or borrower), or the accelerated prepayment of debt
principal. There are, however, exceptions to this general rule and those exceptions are included
in paragraphs 13 (ASC paragraphs 815-15-25-26 through 25-29) and 14 of the Standard (ASC
paragraphs 815-10-15-72 and 15-73) and are discussed in Paragraphs 13.01 - 13.15 and 14.01 -
14.12 of this chapter. The following discusses the most common embedded features within a
debt host contract and whether those embedded features are considered clearly and closely
related to the debt host.

Interest Rate Indices

A3.04 An embedded feature with a single underlying that is an interest rate or interest rate index
is considered to be clearly and closely related to a host contract that is considered a debt
instrument unless the conditions in paragraph 13 of the Standard (ASC paragraphs 815-15-25-26
through 25-29) are met. Notwithstanding this, the Standard indicates that plain-vanilla servicing
rights, which involve an obligation to perform servicing and the right to receive fees for
performing that servicing, do not contain an embedded derivative that would be separated from
those servicing rights and accounted for as a derivative.5

Inflation-Indexed Interest Payments

A3.05 The interest rate and the rate of inflation in the economic environment for the currency in
which a debt instrument is denominated are considered clearly and closely related. Thus, the
inflation-related embedded derivative in a nonleveraged inflation-indexed contract would not be
separated from the host contract. It is important to note that the leverage guidance related to
interest rate underlyings discussed in paragraph 13 of the Standard (ASC paragraphs 815-15-25-
26 through 25-29) and Paragraphs 13.01 - 13.15 of this chapter does not apply for inflation-
related embedded derivatives. Entities with inflation-related embedded derivatives should apply
the general guidance under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-
25-1, and 25-14) and judgment when evaluating whether an inflation-indexed contract is
leveraged.

5 FASB Statement No. 156, Accounting for Servicing of Financial Assets, (ASC Subtopic 860-50, Transfers and
Servicing - Servicing Assets and Liabilities), was issued in March 2006 and provides guidance on accounting for all
separately recognized servicing assets and servicing liabilities. Statement 156 (ASC Subtopic 860-50) amends
Statement 140 (ASC Topic 860) to require that all separately recognized servicing assets and servicing liabilities be
initially measured at fair value, if practicable. Additionally, Statement 156 permits, but does not require, the
subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value.

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**Example A3.1: Inflation-Indexed Interest Payments on a Debt Instrument**

Company A issues a bond with a contractual principal amount that is indexed to the inflation rate but cannot decrease below par. The bond contains a coupon rate that is below that of a traditional bond of similar maturity for credit quality similar to the issuer’s credit quality.

The instrument can be viewed as a fixed-rate bond for which a portion of the coupon interest rate has been exchanged for a conditional exchange contract (or option) indexed to the consumer price index, or other index of inflation in the economic environment for the currency in which the bond is denominated, that entitles the investor to payment of additional principal based on increases in the referenced index. In addition, the instrument has no terms that create leverage. The rates of inflation and interest rates on the debt instrument are considered to be clearly and closely related. Therefore, the embedded derivative should not be separated from the host contract.

**Credit-Sensitive Payments**

A3.06 The creditworthiness of the debtor and the interest rate on a debt instrument are considered to be clearly and closely related. Thus, the embedded derivative would not be separated from the host contract for debt instruments that have the interest rate reset in the event of (1) debtor’s default, (2) a change in the debtor’s published credit rating, or (3) a change in the debtor’s creditworthiness indicated by a change in its spread over Treasury bonds. However, if the embedded feature incorporates credit risk exposures that are unrelated or only partially related to the creditworthiness of the issuer of the instrument, the feature is not clearly and closely related. (See DIG Issue B36 for further reference.) Certain debt arrangements include collateral that is pledged to the creditors. If the debtor does not make payments due under the arrangement, the creditor has recourse solely to that collateral and not to the debtor (i.e., nonrecourse debt arrangements). Those arrangements are not considered to include credit risk exposure unrelated to, or only partially related to, the debt’s issuer.

**Example A3.2: Credit-Sensitive Bond**

Company B issues a bond that has a coupon rate of interest that resets based on changes in the issuer’s credit rating.

The instrument can be viewed as combining a fixed-rate bond with a conditional exchange contract (or an option) that entitles the investor to a higher rate of interest if the credit rating of the issuer declines. Because the creditworthiness of the debtor and the interest rate on a debt instrument are clearly and closely related, the embedded derivative should not be separated from the host contract. However, if the credit risk exposure embedded is different from the risk exposure arising from the issuer’s creditworthiness and a change in creditworthiness of an entity other than the issuer affects the value of the instrument, the embedded derivative component would not be considered clearly and closely related to the host contract.
Example A3.3: Credit-Sensitive Bond

Company A issues a fixed-rate, 10-year, $10 million credit-linked note to an investor that provides for periodic interest payments and the repayment of principal at maturity. However, on default of a specified reference security (a Company X subordinated debt obligation) the redemption value of the note may be zero or there may be some claim to the recovery value of the reference security (depending on the terms of the specific arrangement). In an event of default of the specified reference security, there is no recourse to the general credit of the obligor (Company A). In exchange for accepting the default risk of the reference security, the note entitles the investor to an enhanced yield. The transaction results in the investor selling credit protection and Company A buying credit protection.

The credit risk exposure of the reference security (Company X) and the risk exposure arising from the creditworthiness of the obligor (Company A) are not clearly and closely related. Thus, the economic characteristics and risks of the embedded derivative feature are not clearly and closely related to the economic characteristics and risks of the debt host contract. Consideration also should be given to whether the embedded derivative feature may be a financial guarantee under paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58).

A3.06a Credit Risk and Embedded Credit-Derivative Scope Exception. Statement 155 amended Statement 133 (ASC Topic 815) to clarify the accounting for credit risks that result from the assets and liabilities held by the issuing entity. Statement 155 stated that changes in cash flows attributable to changes in the creditworthiness of an interest resulting from securitized financial assets and liabilities (including derivative contracts) that represent the assets or liabilities that are held by the issuing entity should not be considered an embedded derivative under Statement 133 (ASC Topic 815). Further, it stated that the concentration of credit risk in the form of subordination of one financial instrument to another is not considered an embedded derivative under Statement 133. However, ASU 2010-11 limits the embedded credit-derivative scope exception to embedded credit-derivative features in the form of subordination of one financial instrument to another. Refer to Paragraphs 14.17 through 14.28 for a discussion of how embedded credit-derivative features in financial instruments such as beneficial interests in securitized financial assets should be evaluated under ASU 2010-11.

Contingent Interest

A3.06b Contingent interest provisions in a debt instrument must be analyzed to determine if their terms are clearly and closely related to the host contract. Provisions that require additional interest payments based on inflation or creditworthiness of the issuer are considered clearly and closely related as long as they are not leveraged. In contrast, provisions that require additional interest payments based on commodity prices or the price of the issuer's stock are not considered clearly and closely related. However, contingent interest that is related to company earnings may qualify for the paragraph 10(e)(3) scope exception in the Standard related to certain contracts that are not traded on an exchange (ASC paragraphs 815-10-15-59d).
Calls and Puts

A3.07 Prepayment options (call options and put options) on a debt instrument involve the accelerated redemption of the debt instrument. Because interest rates include an adjustment for expectations and risks related to liquidity, call options (or put options) on debt instruments that can accelerate the redemption of a debt instrument are typically considered clearly and closely related to the interest rate on the debt instrument. That is, although call or put options sometimes are exercised without regard to actual changes in interest rates, the embedded provisions within the Standard require the underlying in all call or put options embedded within debt hosts to be considered an interest rate underlying. Because changes in interest rates are considered clearly and closely related to debt hosts, the embedded call or put option typically would be considered clearly and closely related to the debt host. However, as discussed in paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29), there are circumstances in which a call or put option with a single interest rate or interest rate index underlying would not be considered clearly and closely related to the debt host. Additionally, the discussion beginning at Paragraph A3.12 below describes the evaluation for determining whether embedded call or put options with multiple underlyings would not be considered clearly and closely related to the debt host.

A3.08 As described in Paragraphs 12.16 – 12.19 of this chapter, for an embedded component (including a call or put option) to be accounted for separately from the host contract, it must meet the definition of a derivative instrument in paragraphs 6 – 9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128) as if it were a freestanding instrument. The determination of whether a prepayment option (call option or put option) embedded in a debt instrument would meet the definition of a derivative if it were freestanding is relevant when the embedded prepayment option is not considered clearly and closely related to the debt host under paragraphs 13 (ASC paragraphs 815-15-25-26 through 25-29) or 61(d) of the Standard (ASC paragraphs 815-15-25-41). Prior to DIG Issue B38, which was issued in June 2005, there was diversity in practice with respect to whether the potential settlement of the debtor’s obligation to the creditor that would occur upon exercise of the prepayment option would meet the net settlement criterion in paragraph 9 of the Standard (ASC paragraphs 815-10-15-99 through 15-120). Prior to DIG B38, some believed that the net settlement criterion would be met for substantially all prepayment options embedded in debt instruments; however, others believed that the net settlement criterion would not be met unless the underlying debt instrument itself were readily convertible to cash (e.g., publicly traded debt).

A3.09 DIG Issue B38 specifies that the potential settlement of the debtor’s obligation to the creditor upon exercise of a put option or call option meets the net settlement criterion in paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100). Upon exercise of a prepayment option, the debtor settles its own liability and that settlement should not be considered to involve the delivery of an asset. This conclusion applies regardless of whether the creditor returns evidence of the debtor’s indebtedness (e.g., the creditor returns a note payable marked paid to the debtor), even though some may believe that the creditor is delivering an asset (i.e., the note receivable due from the debtor). Also, the cash paid to the creditor in settling the debtor’s obligation is not associated with the underlying (e.g., interest rates) because cash is not related to any underlying for the embedded put option or call option. Therefore, neither party is required to deliver an asset that is associated with the underlying, so the net settlement criterion in paragraph 9(a) (ASC paragraph 815-10-15-100) is met. This conclusion makes the issue of whether the
debt instrument is readily convertible to cash irrelevant to the net settlement criterion analysis. If all of the criteria in paragraph 12 (ASC paragraph 815-15-25-1) are met, the embedded put or call option should be bifurcated from the debt host contract and accounted for separately as a derivative instrument under the Standard.

A3.10 The guidance in DIG Issue B38 applies when analyzing the net settlement criterion under paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100) for a freestanding call option held by the debtor on its own debt instrument and for a freestanding put option issued by the debtor on its own debt instrument. That guidance does not apply to put or call options that are added by a third party contemporaneously with or subsequent to the issuance of a debt instrument (DIG Issue B3 provides guidance on accounting for put or call options that are attached to a debt instrument). In situations where a put or call option is attached by a third party (for example, an investment banker) and physical settlement is required upon exercise of the option, we believe that the net settlement requirements in paragraph 9(a) and 9(b) (ASC paragraphs 815-10-15-100 and 15-110) (existence of a market mechanism for the net settlement of the derivative) are not met; therefore, the debt instrument itself (i.e., the asset required to be delivered upon exercise of the option) would need to be readily convertible to cash as described in paragraph 9(c) of the Standard (ASC paragraphs 815-10-15-119 and 15-120) in order to meet the net settlement criterion. This evaluation would need to be performed by both the third party who attached the option to the debt instrument and the investor who acquired the debt instrument with the attached option. Therefore, it is important for investors/creditors to understand the terms of a put or call option on a debt instrument (i.e., who is the counterparty to the option) to be able to properly evaluate whether the option should be accounted for as a derivative instrument under the Standard. See further discussion of freestanding prepayment options in Paragraphs 9.18 – 9.19 (including footnote 1 thereto) of Chapter 2.

A3.11 Entities are not permitted to analogize to the guidance in DIG Issue B38 when evaluating an embedded put or call option in a hybrid instrument that does not contain a debt host contract. Thus, the conclusions in DIG Issue B38 would not apply when evaluating a put or call option on a share of preferred stock (whether embedded or freestanding) unless the host contract is deemed to be more akin to a debt instrument than an equity instrument.7 In addition, the guidance in DIG Issue B38 should not be applied by analogy when evaluating a freestanding or embedded put or call option on a nonfinancial asset or liability (e.g., a physical asset). For example, when physical settlement is required upon exercise of a prepayment option, we believe the net settlement requirements in paragraph 9(a) and 9(b) (ASC paragraphs 815-10-15-100 and 15-110) would not be met if the option applies to (1) a share of preferred stock that contains a host contract deemed more akin to equity than debt or (2) a nonfinancial asset or liability. As such, the underlying share of preferred stock or the nonfinancial asset or liability would need to be readily convertible to cash, as specified in paragraph 9(c) (ASC paragraphs 815-10-15-119 and 15-120), in order to meet the net settlement criterion in those circumstances. Entities must be careful when analyzing

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6 In this fact pattern, the prepayment option is attached by a third party, so the underlying debt instrument is considered an asset subject to the guidance in Paragraph 9(a) (ASC paragraph 815-10-15-100), rather than a liability of the holder or writer of the option as contemplated for prepayment options that are subject to the guidance in DIG Issue B38.

7 Paragraph 61(l) of the Standard (ASC paragraph 815-15-25-17) provides guidance for determining whether a preferred stock host contract is more akin to debt or equity. Additionally, the SEC staff has provided guidance on this issue in speeches and in EITF D-109 (ASC paragraph 815-10-S99-3). See discussion at paragraph A3.31.
embedded components to ascertain if they meet the net settlement criterion. At times, the hybrid instrument may not meet the net settlement criterion but the embedded component does. See Paragraph 12.17 for further discussion.

A3.12 In many instances, call or put options embedded in debt instruments contain a single underlying that is an interest rate or interest rate index. However, other call or put options embedded in debt instruments may contain multiple underlyings and include features such as indexed payoffs (instead of a simple acceleration of the redemption amount) or may be contingently exercisable such as upon the occurrence of a change in control (instead of exercisable after a period of time). To determine whether call or put options are considered clearly and closely related to a debt host, the following decision sequence should be evaluated: (See DIG Issue B16 for further reference (ASC paragraph 815-15-25-42).

1. Is the amount paid on settlement (the payoff) adjusted based on changes in an index? If yes, continue to Step 2. If no, go to Step 3.

2. Is the payoff indexed to an underlying other than interest rates or credit risk? If yes, that embedded feature is not clearly and closely related to the debt host contract and further analysis under Steps 3 and 4 is not required. If no, that embedded feature should be analyzed further under Steps 3 and 4.

3. Does the debt involve a substantial premium or discount? We believe that a substantial premium or discount should be interpreted as a premium or discount that is 10% or greater of the amount allocated to the hybrid instrument when the instrument is originally recognized. In addition, a substantial premium or discount may arise at a time other than when the debt is issued. For example, debt issued at par but puttable at 115% of par involves a substantial discount. However, we do not believe that a discount created solely through the separate accounting for an embedded derivative or a beneficial conversion feature would be considered in the evaluation. Under this view, the assessment of whether or not the debt has a substantial premium or discount is effectively evaluated before separating the hybrid into different units of account. If the debt involves a substantial premium or discount, continue to Step 4. If not, further analysis of the contract under ASC paragraph 815-15-25-26 is required, if applicable.

4. Does a contingently exercisable call or put accelerate the repayment of the contractual principal amount (e.g., debt with a put option that is exercisable only after a stated index increases by 20%)? If yes, the call or put is not clearly and closely related to the debt instrument. If not contingently exercisable, the contract should be further analyzed under ASC paragraph 815-15-25-26, if applicable.

A3.12a The above decision sequence focuses on call or put options embedded in debt instruments that contain multiple underlyings (i.e., dual-indexed call and put options, such as contingently exercisable options). As such, the decision sequence noted above would not result in a conclusion that a plain-vanilla embedded call or put option is not clearly and closely related to the debt host contract. However, Steps 3 and 4 from the decision sequence specify that further analysis is required under paragraph 13 of the Standard (ASC paragraph 815-15-25-26) to determine whether an embedded call or put option is clearly and closely related to the debt host contract, if applicable. The wording in Steps 3 and 4 implies that any embedded call or put
A3.12b When evaluating whether an embedded contingent put or call is clearly and closely related to a debt host, we believe that the four-step decision sequence in Paragraph A3.12 provides the entire framework for determining whether a contingent call or put is clearly and closely related to its debt host. In other words, there is no need to separately evaluate whether the contingency itself is indexed only to interest rates or credit risk, and not some extraneous factor. Example A3.11 illustrates the application of this concept. The EITF also reached that same conclusion in ASU No. 2016-06, Derivatives and Hedging (Topic 815), Contingent Put and Call Options in Debt Instruments, which was issued in March 2016 to address diversity in practice. Before the issuance of this ASU, some believed that the four-step decision sequence was only one step in assessing whether a put or call option is clearly and closely related to its debt host. The ASU will also amend ASC paragraph 815-15-25-42 to further clarify the guidance on the four-step decision sequence. The ASU is effective for public business entities for fiscal years beginning after December 15, 2016 with early adoption permitted, and includes specific transition provisions for entities that previously bifurcated embedded derivatives but are no longer required to do so as a result of applying the ASU.

A3.12c When analyzing an embedded call or put option under paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) (i.e., an embedded call or put option containing a single, interest-rate or interest-rate-index underlying), the guidance in DIG Issues B5 and B39 would apply. DIG Issue B5 specifies that the condition in paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) that an investor would not recover substantially all of its initial recorded investment does not apply to a situation in which the terms of a hybrid instrument
permit, but do not require, the investor to settle the hybrid instrument so that it does not recover substantially all of its initial recorded investment (see discussion of DIG Issue B5 in paragraph 13.10 of this chapter). Similarly, DIG Issue B39 specifies that the conditions in paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) do not apply to an embedded call option in a hybrid instrument containing a debt host contract if the right to accelerate the settlement of the debt can be exercised only by the issuer (see discussion of DIG Issue B39 in Paragraph 13.14 of this chapter). As noted earlier, prepayment features in securitized interests that relate to call options in the underlying assets of the trust are not eligible for the scope exception in DIG Issue B39 (because the call options are embedded in the underlying financial assets, not the securitized interests themselves) and must be subjected to the test in paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) unless they meet the criteria in DIG issue B40. See discussion beginning at Paragraph 14.12.

**A3.13** As illustrated in the preceding paragraphs, certain call or put options may not be considered clearly and closely related to a debt host. The following illustrates the steps for making this determination as described above:

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**Example A3.4: Puttable Debt**

Company C issues debt at a substantial premium that is puttable by the investor at any time for its par value.

The embedded put option in this example contains a single interest-rate underlying, so the guidance in paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-41), as interpreted by DIG Issue B16 (ASC paragraph 815-15-25-42), would not result in a conclusion that the put option is not clearly and closely related to the debt host contract. The amount paid on settlement is the par value of the debt, so the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1, above, is no and the analysis must proceed to Step 3. The debt involves a substantial premium, so the answer to Step 3, above, is yes and the analysis must proceed to Step 4. Because the put option is not contingently exercisable, further analysis is required under paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29).

The debt could be settled in a manner such that the investor would not recover substantially all of its initial recorded investment (i.e., if the debt, which was issued at a substantial premium, is put back to the issuer for par shortly after issuance). However, the provisions of paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) do not apply because the terms of the hybrid instrument permit, but do not require, the investor to settle in a manner that it does not recover substantially all of its initial recorded investment. Additionally, there are no contractual provisions that would allow the debt to be settled so that the investor’s initial rate of return would be doubled and would result in a rate of return that is at least twice the then-current market rate, so the provisions of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) are not met. As a result, the embedded put option is clearly and closely related to the debt host contract.
Example A3.5: Callable Debt

Company C issues debt at a substantial discount that is callable by the issuer at any time for its par value.

The embedded call option in this example contains a single interest-rate underlying, so the guidance in paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-41), as interpreted by DIG Issue B16 (ASC paragraph 815-15-25-42), would not result in a conclusion that the call option is not clearly and closely related to the debt host contract. The amount paid on settlement is the par value of the debt, so the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1, above, is no and the analysis must proceed to Step 3. The debt involves a substantial discount, so the answer to Step 3, above, is yes and the analysis must proceed to Step 4. Because the put option is not contingently exercisable, further analysis is required under paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29).

There are no contractual provisions that would allow the debt to be settled so that the investor would not recover substantially all of its initial recorded investment, so the provisions of paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) are not met. Additionally, the embedded call option is exercisable only by the issuer, so DIG Issue B39 specifies that the feature is not subject to the provisions of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)). As a result, the embedded put option is clearly and closely related to the debt host contract.

It should be noted that, prior to DIG Issue B39, it would have been necessary to perform an analysis of the embedded call option under paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)), to determine whether there are any circumstances in which the embedded call option could at least double the investor’s initial rate of return on the host contract and result in a rate of return that is at least twice the then-current market return for the host contract. In this example, prior to the guidance in DIG Issue B39, the criteria in paragraph 13(b) (ASC paragraph 815-15-25-26(b)) would have been met and the embedded call option would be considered not clearly and closely related to the host contract because the issuer could call the bond shortly after issuance (e.g., if interest rates decreased dramatically in a short period of time), resulting in a rate of return that would at least double the investor’s initial rate of return on the host contract and result in a rate of return that is at least twice the then-current market return for the host contract. However, the guidance in DIG Issue B39, which was issued in June 2005, clarifies that the conditions in paragraph 13(b) (ASC paragraph 815-15-25-26(b)) do not apply to an embedded call option with a single interest rate or interest rate index underlying in a hybrid instrument containing a debt host contract if the right to accelerate settlement of the debt can be exercised only by the debtor.
Example A3.6: Contingently Puttable Debt

Company C issues debt at a substantial discount that is puttable at par if LIBOR either increases or decreases by 150 basis points.

The embedded put option in this example has multiple underlyings (interest rates and the occurrence or nonoccurrence of a specified change in an interest rate index) and must be evaluated under paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-41), as interpreted by DIG Issue B16 (ASC paragraph 815-15-25-42). The amount paid on settlement is par and, therefore, the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1, above, is no and the analysis must proceed to Step 3. Because the debt involves a substantial discount, the analysis must proceed to Step 4. Because the put option is contingently exercisable, the embedded put option is not considered clearly and closely related to the debt host.

Example A3.7: Contingently Callable Debt

Company C issues debt at a substantial discount that is callable at par if LIBOR either increases or decreases by 150 basis points.

The embedded call option in this example has multiple underlyings (interest rates and the occurrence or nonoccurrence of a specified change in an interest rate index) and must be evaluated under paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-41), as interpreted by DIG Issue B16 (ASC paragraph 815-15-25-42). The amount paid on settlement is par and, therefore, the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1, above, is no and the analysis must proceed to Step 3. Because the debt involves a substantial discount, the analysis must proceed to Step 4. Because the call option is contingently exercisable, the call option is not considered clearly and closely related to the debt host. In this example, the investor does not have the unilateral ability to obtain the right to receive the increased rate of return because exercise of the call option is solely at the option of Company C (the debtor). However, the embedded call option in this example is not clearly and closely related to the debt host based on the provisions of DIG Issue B16 (ASC paragraph 815-15-25-42), so it is not relevant whether the right to accelerate settlement of the debt can be exercised only by the debtor (i.e., the guidance in DIG Issue B39 does not apply because the embedded call option in this example has multiple underlyings).
Example A3.8: Contingently Callable Zero-Coupon Debt

Company C issues zero-coupon debt that is callable in the event of a change in control. If the debt is called, the issuer pays the accreted value (calculated per an amortization table based on the effective interest rate method).

The embedded call option has multiple underlyings (interest rates and the occurrence or nonoccurrence of a change in control) and must be evaluated under paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-41), as interpreted by DIG Issue B16 (ASC paragraph 815-15-25-42). The amount paid on settlement is the accreted value, therefore, the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1, above, is no and the analysis must proceed to Step 3. Because the debt involves a substantial discount, the analysis must proceed to Step 4. Although the call option is contingently exercisable, the call option does not accelerate the repayment of the contractual principal amount because the debt is callable at the accreted value. As a result, the embedded call option is clearly and closely related to the debt host under paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-41).

Example A3.9: Debt with Indexed Call Option

Company C issues debt at par that is callable at any time during its term. If the debt is called, the investor receives the greater of the par value of the debt or the market value of 100,000 shares of Company X common stock (an unrelated company).

The embedded call option in this example has multiple underlyings (interest rates and Company X’s stock price) and must be evaluated under paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-41), as interpreted by DIG Issue B16 (ASC paragraph 815-15-25-42). The amount paid on settlement may be adjusted based on changes in an equity price (Company X common stock). As a result, the call option is not considered clearly and closely related to the debt host. In this example, the investor does not have the unilateral ability to obtain the right to receive the increased rate of return because exercise of the call option is solely at the option of Company C (the debtor). However, the embedded call option in this example is not clearly and closely related to the debt host based on the provisions of paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-41), as interpreted by DIG Issue B16 (ASC paragraph 815-15-25-42), so it is not relevant whether the right to accelerate settlement of the debt can be exercised only by the debtor (i.e., the guidance in DIG Issue B39 does not apply because the embedded call option in this example has multiple underlyings).
**Example A3.10: Debt with Indexed Put Option**

Company C issues debt at par that is puttable at any time during its term. If the debt is put, the investor receives the lesser of (1) the par value of the debt adjusted for the percentage change in the S&P 500 or (2) the par value of the debt.

The embedded put option in this example has multiple underlyings (interest rates and the S&P 500, an equity index) and must be evaluated under paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-41), as interpreted by DIG Issue B16 (ASC paragraph 815-15-25-42). The amount paid on settlement may be adjusted based on changes in an equity index (S&P 500). As a result, the put option is not considered clearly and closely related to the debt host. In this example, the exercise of the put option is solely at the option of the investor. However, the embedded put option in this example is not clearly and closely related to the debt host based on the provisions of paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-41), as interpreted by DIG Issue B16 (ASC paragraph 815-15-25-42), so it is not relevant whether the right to accelerate settlement of the debt can be exercised only by the investor (i.e., the guidance in DIG Issue B5 does not apply because the embedded put option in this example has multiple underlyings).

**Example A3.11: Debt That Becomes Callable Upon the Price of Gold Exceeding a Pre-Set Price**

Company C issues debt at par that is callable at $107 if the price of gold is greater than $1,400/oz. The embedded call option in this example has multiple underlyings (interest rates and the price of gold) and therefore must be evaluated using the guidance in ASC paragraph 815-15-25-42. The amount paid by Company C on settlement includes a premium above par, however the amount of the premium is not adjusted based on changes in the price of gold. As a result, the answer to Step 1 is no and the analysis proceeds to Step 3. Because the payoff of the debt under the call does not involve a substantial discount or premium (in this instance, the $7 difference between the call price at the par amount of the debt is not considered to be a substantial premium), the analysis does not proceed to Step 4 and further consideration under ASC paragraph 815-15-25-26 is not required. There is also no need to separately evaluate whether the contingency itself is indexed only to interest rates or credit risk, and not some extraneous factor.

Paragraph 13 (ASC paragraphs 815-15-25-26 through 25-29) is not intended to apply to call or put options that contain multiple underlyings (e.g., contingently exercisable options and options containing an indexed payoff). As the embedded call option in this example has multiple underlyings, the evaluation of whether it is clearly and closely related to a debt host contract would be completed after the above decision sequence from DIG Issue B16 (ASC paragraph 815-15-25-42).

**A3.14** Certain debt structures involve the packaging or repackaging of a debt instrument by an intermediary. Put or call options added to debt instruments by a third party, either contemporaneously with or subsequent to the debt issuance, are not considered embedded. Those features are typical in remarketable bond structures. These options are freestanding instruments.
That is, an option that is added or attached to an existing debt instrument by another party results in the investor having different counterparties for the option and the debt instrument and, thus, the option should not be considered an embedded derivative. The concept of an embedded derivative in a hybrid instrument refers to provisions incorporated into a single contract, and not to provisions in separate contracts between different counterparties. Because attached options are considered freestanding, the criteria for separation of an embedded derivative would not apply and an attached option should be accounted for separately as a freestanding derivative under the Standard if the definition of a derivative instrument in paragraphs 6 – 9 of the Standard (ASC paragraphs 815-10-15-83 through 15-128) is met. (See DIG Issues B3 and B13 for further reference.)

A3.15 Certain instruments contain an embedded call and put option executed contemporaneously with the same counterparty as part of a single hybrid instrument. The call and put have the same terms (strike price, notional amount, and exercise date) and the same underlying and cannot be separated from the hybrid instrument. When those conditions exist, the embedded options should be considered as a single forward contract for purposes of applying the Standard. Those embedded call and put options are in substance an embedded forward contract because they (a) convey rights and obligations that are equivalent from an economic and risk perspective to an embedded forward contract, and (b) cannot be separated from the hybrid instrument in which they are embedded. Even though neither party is required to exercise its option, the result of the overall structure is a hybrid instrument that will likely be redeemed earlier than its stated maturity. That result is expected by both the hybrid instrument’s issuer and investor regardless of whether the embedded features that trigger redemption are in the form of two options or a single forward contract. However, if either party is required to exercise its purchased option prior to the stated maturity date of the hybrid instrument, the hybrid instrument should not be viewed as containing an embedded forward contract or embedded put and call options. In that circumstance, the counterparties to the hybrid instrument have agreed to terms that accelerate the stated maturity of the instrument so that the exercise date of the option is essentially the hybrid’s actual maturity date for accounting purposes. (See DIG Issue K3 for further reference.)

Example A3.11a Debt Instruments Issued with Put and Call Options

ABC Corp. issues fixed-rate debt that has a stated maturity of 12/31/X5. The debt contains an option that allows the holder to put the debt to the issuer, at par, on 12/31/X3. The debt also contains an option that allows the issuer to call the debt from the holder, at par, on 12/31/X3. Since the combination of options are embedded within the debt instrument, have the same terms (the strike price is par, the notional amount is equal to the par amount of the debt and the exercise date is 12/31/X3) and the same underlying (changes in interest rates), the combination of embedded options is considered a single forward contract for purposes applying the provisions of the Standard.

Interest Rate Floors, Caps, and Collars

A3.16 Floors, caps, or collars on interest rates and the interest rate on a debt instrument are considered to be clearly and closely related unless the conditions in paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) are met.
Term-Extending Options

A3.17 An embedded derivative provision that either (1) unilaterally enables one party to extend significantly the remaining term to maturity or (2) automatically extends significantly the remaining term triggered by specific events or conditions is not clearly and closely related to the interest rate on a debt instrument, unless the interest rate is concurrently reset to the approximate current market rate for the extended term and the debt instrument initially involved no significant discount. If there is no reset of interest rates, an embedded term extending option is not clearly and closely related to the debt host contract. When an embedded term-extending option is not clearly and closely related to the debt host contract, that embedded feature should be accounted for separately as a derivative if: (1) the hybrid instrument is not remeasured at fair value through earnings under otherwise applicable generally accepted accounting principles (such as through a fair value election under Statement 155 or Statement 159 (ASC Subtopic 825-10) and (2) a separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6 – 11 (ASC paragraphs 815-10-15-13 through 15-128), be a derivative under the Standard. In some cases, a term-extending option in a debt host contract may embody a loan commitment. Under paragraph 10(i) of the Standard (ASC paragraph 815-10-15-69), a loan commitment generally would not be considered to be a derivative instrument for either the issuer or the holder (the potential borrower); however, loan commitments that relate to the origination of mortgage loans that will be held for resale are considered derivatives by the issuer. Further, in considering whether a feature must be bifurcated, one must also consider whether the feature can be net settled as discussed in paragraph 9 of Statement 133 and DIG Issue A13. If the only way the value of the feature can be realized is through the extension of the borrowing contemplated by the option (i.e., the issuer cannot capture the value of the option through some type of settlement or offset provision), that method of realization would generally not qualify as net settlement. See DIG Issue A13 for further reference. The following example illustrates the evaluation of whether a term-extending option is clearly and closely related to the debt instrument in which it is embedded:

Example A3.12: Term Extending Options

ABC Corp. issues five-year floating-rate debt with an interest rate established as a spread to LIBOR, based on the credit risk of the issuer at inception. Embedded in the instrument is the issuer’s option to extend the debt instrument for an additional five-year period. The interest rate on the extended term would be LIBOR plus the original credit spread. The term extending option is not considered clearly and closely related to the host contract because the rate is not reset to approximate market. Market, in this instance, would have taken into account the changes in ABC’s credit spread between inception and the date of the extension. However, the term extension option must be further analyzed to determine whether it would qualify as a derivative if freestanding.

Equity-Indexed Interest Payment

A3.18 The change in fair value of an equity instrument and the interest yield on a debt instrument are not considered clearly and closely related. Thus, an equity-related derivative embedded in an equity-indexed debt instrument is not considered clearly and closely related to
the debt host. Certain hybrid instruments that are considered debt hosts may contain an embedded equity-indexed component for which the embedded equity-indexed component is not clearly and closely related but, if it were freestanding, would qualify for the exclusion in paragraph 11(a) of the Standard (ASC paragraphs 815-10-15-74(a)) related to contracts indexed to the reporting entity’s own stock and classified, if freestanding, in stockholders’ equity. In that case, even though the embedded equity-indexed component is not clearly and closely related to the debt host, it would not be separately accounted for because the condition in paragraph 12(c) of the Standard (ASC paragraph 815-15-25-1(c) and 25-14) was not met.

Commodity-Indexed Interest or Principal Payments

A3.19 The changes in fair value of a commodity and the interest yield on a debt instrument are not considered clearly and closely related. Thus, a commodity-related derivative embedded in a commodity-indexed debt instrument is not clearly and closely related to the debt host. Certain hybrid instruments that are considered debt hosts may contain an embedded commodity contract for which the embedded commodity contract is not clearly and closely related but, if it were freestanding, may be eligible to qualify for the normal purchases and normal sales exception in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-45) provided all requirements have been met, including contemporaneous documentation. In that case, even though the embedded commodity contract is not clearly and closely related to the debt host, it would not need to be separately accounted for by the party to whom it is a normal purchase or normal sale. (See DIG Issue B11 for further reference.)

Convertible Debt

A3.20 Convertible debt instruments are those debt instruments that are convertible into common stock of the issuer. The conversion feature of such instruments is an embedded call option that permits the investor to call the issuer’s stock by relinquishing the debt. That embedded conversion option must be evaluated under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) to determine whether it is required to be separated from the host contract and accounted for as a derivative instrument. Changes in the fair value of an equity interest are not clearly and closely related to a debt host contract (paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a))). Additionally, a convertible debt instrument is not generally remeasured at fair value with changes in fair value recorded currently in earnings by the issuer, unless a fair value election has been made under Statement 155 or Statement 159 (ASC Subtopic 825-10) paragraph 12(b) of the Standard (ASC paragraph 815-15-25-1(b)). [Note: Convertible debt instruments are not eligible for the fair value election in circumstances where applicable U.S. GAAP requires that the conversion option be separately recorded in equity.] Accordingly, the embedded conversion option would be separated from a debt host contract and accounted for as a derivative instrument if the conversion option would be a derivative instrument subject to the requirements of the Standard if it were freestanding (paragraph 12(c) of the Standard (ASC paragraph 815-15-25-1(c) and 25-14)). Provided that the embedded conversion option (1) is indexed to the issuer’s own stock and (2) would be classified in stockholders’ equity if it were freestanding, the embedded conversion option would not be separated and accounted for as a derivative instrument by the issuer based on the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)), as discussed in the following paragraphs. It should be noted that, from the investor’s perspective, the exception in
paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) does not apply. Consequently, the investor would need to separate the conversion option and account for it as a derivative instrument if the remaining conditions in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) are met (unless the investor elects to measure the entire hybrid instrument at fair value with changes in fair value recognized in earnings under Statement 155 or Statement 159).

A3.20a An embedded conversion option contains one or more underlyings (the issuer’s stock price, the issuer’s credit, and interest rates – see further discussion in Paragraph A3.21 of this appendix) and a notional amount (the number of shares into which the instrument is convertible), so an embedded conversion option would meet the characteristic of a derivative in paragraph 6(a) of Statement 133 (ASC paragraph 815-10-15-83(a)) if it were a freestanding instrument. For purposes of assessing the characteristic in paragraph 6(b) of Statement 133 (ASC paragraph 815-10-15-83(b)), the initial net investment for the convertible instrument should not be considered the initial net investment for the embedded conversion option. Accordingly, an embedded conversion option would meet the characteristic of a derivative in paragraph 6(b) (ASC paragraph 815-10-15-83(b)) if it were a freestanding instrument. An embedded conversion option may require physical settlement such that, upon conversion, the issuer is required to deliver its own equity shares in settlement of the convertible instrument. An embedded conversion option that requires physical settlement would meet the characteristic of a derivative in paragraph 6(c) of Statement 133 (ASC paragraph 815-10-15-83(c)) if the shares to be delivered upon conversion are readily convertible to cash as discussed in paragraph 9(c) of Statement 133 (ASC paragraphs 815-10-15-119 and 15-120). Paragraph 83(a) of Concepts Statement 5 states that assets that are readily convertible to cash “have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.” This definition includes, for example, an equity security traded in an active market. A share of stock that is publicly traded but for which the market is not very active is readily convertible to cash if the number of shares to be exchanged is small relative to the daily transaction volume. That same share would not be readily convertible to cash if the number of shares to be exchanged is large relative to the daily transaction volume. If the sale of the shares of an issuer’s actively traded common stock to be received upon exercise of an embedded conversion option is restricted for 31 days or less from their receipt, DIG Issue A14 specifies that such initial sales restriction is not an impediment to considering those shares as being readily convertible to cash. If the shares issuable upon exercise of an embedded conversion option that requires physical settlement are readily convertible to cash, the embedded conversion option would meet the characteristic in paragraph 6(c) (ASC paragraph 815-10-15-83(c)) if it were a freestanding instrument.

A3.20b In some cases, a convertible debt instrument may provide for contractual net settlement of the embedded conversion option. For example, upon conversion, an issuer may be required or permitted to settle the accreted value or principal amount of the instrument in cash and may satisfy the conversion spread (i.e., the intrinsic value of the conversion option) in cash or shares.Convertible debt instruments that require or permit repayment of the principal amount in cash upon conversion are often referred to in practice as Instrument C or Instrument X. In circumstances in which the terms of a convertible instrument provide for net share settlement of the conversion spread as an alternative, the embedded conversion option would meet the characteristic in paragraph 6(c) (ASC paragraph 815-10-15-83(c)) if it were a freestanding instrument.
instrument, regardless of whether the net shares issuable at conversion are readily convertible to cash. In May 2008, the FASB issued FSP APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (FSP APB 14-1) (ASC Subtopic 470-20). For convertible debt instruments that may be settled in cash upon conversion, including instruments that require or permit cash repayment of the principal amount upon conversion, FSP APB 14-1 requires that those instruments be separated into their liability and equity components. However, FSP APB 14-1 does not apply to instruments for which the embedded conversion option is required to be separately accounted for as a derivative under the Standard. Additionally, for instruments within the scope of FSP APB 14-1 that contain embedded features other than the embedded conversion option (e.g., embedded prepayment options or contingent interest features), the guidance in the Standard must be applied to determine whether those features should be separately accounted for as derivatives. The evaluation of whether a convertible debt instrument within the scope of FSP APB 14-1 contains embedded features that must be separately accounted for as derivatives under the Standard is performed before separating the liability and equity components based on the guidance in that FSP. Consequently, the guidance in FSP APB 14-1 does not affect an issuer's determination of whether an embedded feature should be separately accounted for as a derivative under the Standard. For example, a convertible debt instrument that is issued for par and contains embedded prepayment options that are exercisable for an amount equal to that par value would not be considered to involve a substantial discount for purposes of evaluating those embedded prepayment features under DIG Issue B16, even though a significant debt discount may arise upon separation of the instrument's liability and equity components based on the guidance in FSP APB 14-1.

**A3.20c** FSP APB 14-1 (ASC Subtopic 470-20) is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years.

**A3.20d** If a separate instrument with the same terms as the embedded conversion option would meet all the characteristics of a derivative instrument in paragraphs 6 – 9 of Statement 133 (ASC paragraphs 815-10-15-83 through 15-128), the next step in the evaluation of whether the conversion option must be separated from the host contract and accounted for as a derivative instrument is to determine whether the conversion option would qualify for the scope exception in paragraph 11(a) of Statement 133 (ASC paragraph 815-10-15-74(a)).

**A3.21** As described above, an embedded conversion option would not be separated and accounted for as a derivative instrument by the issuer of convertible debt if the conversion option (1) is indexed to the issuer’s own stock and (2) would be classified in stockholders’ equity if it were freestanding. EITF 07-5 (ASC Subtopic 815-40) establishes a framework for determining whether an instrument (or embedded feature) is indexed to an entity's own stock, which is the first part of the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)). That Issue is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Before the effective date of EITF 07-5, EITF 01-6 (ASC Subtopic 815-40) provided guidance for evaluating whether an instrument (or embedded feature) is indexed to an entity's own stock. Although EITF 07-5 nullified EITF 01-6, it brought forward important concepts unchanged to EITF 07-5 that are discussed in this Section of the DHH. In addition, in July 2017, the FASB issued ASU 2017-11 (ASC Subtopics 260 and 505, ASC paragraphs 815-10-15-75A, 815-40-15D, 815-40-55-33 to
55-3A), which addresses the accounting for certain financial instruments that contain down round features. Under ASU 2017-11, for purposes of evaluating whether a financial instrument meets the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)), an entity excludes any down round feature from its consideration of whether the instrument is indexed to the entity’s own stock. ASU 2017-11 (ASC Master Glossary) defined a down round feature as a feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument. A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard anti-dilution provision is not considered a down round feature. Refer to paragraphs 11a.08 – 11a.12e and their related examples in Section 2 of this Handbook for a detailed discussion of the guidance in EITF 07-5 and ASU 2017-11.

A3.21a The fair value of a conversion option embedded in a debt instrument is affected by changes in the fair value of the debt instrument in which it resides, because the holder exchanges that debt instrument for the issuer's equity shares upon conversion. Because the fair value of a debt instrument is affected by interest rates and the issuer's credit spread, questions have arisen regarding the evaluation of whether embedded conversion options should be considered indexed to the issuer's own stock for purposes of evaluating the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)). However, paragraphs 61(k) (ASC paragraphs 815-15-25-51) and 199 of the Standard (ASC paragraphs 815-15-55-217 through 55-221) indicate that a conversion option within simple convertible debt should not be separated from the debt host because a separate option with the same terms would not be considered a derivative for the issuer under paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)). Based on discussions with the FASB staff, the Board wanted to create an exception so that issuers of simple convertible debt would not need to separately account for the conversion option as a derivative. Accordingly, an embedded conversion option that permits the investor to relinquish a debt instrument in exchange for stock of the issuer should be considered indexed to the issuer's stock. Thus, the first criterion of the paragraph 11(a) (ASC paragraph 815-10-15-74(a)) exception would be met by the issuer of simple convertible debt (although further analysis of whether the conversion option is indexed to the issuer's own stock is necessary for more complex convertible instruments, such as debt that becomes convertible only upon the occurrence of specified contingent events). This evaluation was subsequently affirmed by the guidance in EITF 07-5 (ASC Subtopic 815-40), which states "an instrument (or embedded feature) would be considered indexed to an entity's own stock if its settlement amount will equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount or a fixed amount of a debt instrument issued by the entity. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity would be considered indexed to the entity's own stock."

A3.22 For purposes of evaluating an embedded conversion option in a debt instrument under the second criterion in the paragraph 11(a) (ASC paragraph 815-10-15-74(a)) exception, whether the
conversion option would be classified in stockholders’ equity if freestanding, the extent of the analysis depends on whether the instrument is conventional convertible debt or nonconventional convertible debt. The guidance in EITF Issue No. 00-19 (ASC Subtopic 815-40), must be applied to determine whether the embedded conversion option would be classified in stockholders’ equity if freestanding. For example, an embedded conversion option that may permit the investor to require the issuer to net-cash settle upon exercise would not be classified in stockholders’ equity if it were a freestanding instrument. Accordingly, a debt instrument containing an embedded conversion option that may permit the investor to require the issuer to net-cash-settle the conversion option upon exercise would not qualify for the scope exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)), and would be separated from the debt host and accounted for as a derivative instrument under the Standard (ASC Topic 815).

A3.23 Under EITF 00-19 (ASC Subtopic 815-40), contracts that include any provision that could require net-cash settlement cannot be accounted for as equity of the company, except in those limited circumstances in which holders of the underlying shares would also receive cash. Paragraphs 12 – 32 of EITF 00-19 (ASC paragraphs 815-40-25-7 through 25-35) describe additional requirements for equity classification for derivative financial instruments indexed to, and potentially settled in, an entity’s own stock. If any of the conditions described in paragraphs 12 – 32 of EITF 00-19 (ASC paragraphs 815-40-25-7 through 25-35) are not met, it is assumed that the issuer will net-cash settle the contract, even in circumstances where the contract does not specify any circumstances under which net-cash settlement would be permitted or required. However, EITF 00-19 provides an exception to the additional requirements for equity classification in paragraphs 12 – 32 of that Issue (ASC paragraphs 815-40-25-7 through 25-35) for conventional convertible debt. Specifically, the Task Force reached a consensus that for purposes of evaluating under the Standard whether an embedded derivative indexed to a company’s own stock would be classified in stockholders’ equity if freestanding, the requirements of paragraphs 12 – 32 of EITF 00-19 (ASC paragraphs 815-40-25-7 through 25-35) do not apply if the hybrid contract is a conventional convertible debt instrument in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer). At the June 2005 EITF meeting, the Task Force reached a consensus on EITF Issue No. 05-2, "The Meaning of “Conventional Convertible Debt Instrument” in EITF Issue No. 00-19 “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”" (EITF 05-2) (ASC paragraphs 815-40-25-41 and 25-42). That consensus clarified the exception to the requirements in paragraphs 12 – 32 of EITF 00-19 (ASC paragraphs 815-40-25-7 through 25-35) for purposes of evaluating whether an embedded conversion option would be classified in stockholders’ equity if freestanding for conventional convertible debt instruments. EITF 05-2 (ASC paragraphs 815-40-25-41 and 25-42) specifies that instruments that provide the holder with an option to convert into a fixed number of shares (or equivalent amount of cash at the discretion of the issuer) for which the ability to exercise the option is based on the passage of time or a contingent event should be considered conventional for purposes of applying EITF 00-19 (ASC Subtopic 815-40). Standard antidilution provisions in an instrument that adjust the conversion ratio in the event of an equity restructuring that are designed to maintain the value of the conversion option would not preclude a conclusion that an instrument is convertible into a fixed number of shares. For purposes of applying this guidance, an equity restructuring is a nonreciprocal transaction between an issuer and its shareholders that
causes the per-share fair value of the shares underlying the option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend. Accordingly, a provision that reduces the conversion price (i.e., increases the conversion ratio) of a convertible security based on all cash dividends would not be considered a standard antidilution provision under that guidance, so convertible instruments containing such features are not conventional convertible debt instruments. Additionally, EITF 05-2 (ASC paragraphs 815-40-25-41 and 25-42) clarifies that convertible preferred stock with a mandatory redemption date may qualify for this conventional convertible debt exception from applying paragraphs 12 – 32 of EITF 00-19 if the economic characteristics indicate that the instrument is more akin to debt than equity (see discussion of convertible preferred stock in Paragraphs A3.31 – A3.33 of this appendix).

**Example A3.13: Conventional Convertible Debt**

ABC Corp. issues fixed-rate debt instruments with a 20-year maturity for their par value of $1,000 per bond. The holder has the ability to convert each bond at any time into ten shares of ABC’s common stock (i.e., resulting in an effective conversion price of $100 per share). Upon initial issuance of the debt, the market price of ABC’s common stock is $80 per share.

Upon conversion, ABC is required to settle the instrument through the issuance of a fixed number of shares. Accordingly, the instrument is considered conventional convertible debt and the requirements in paragraphs 12 – 32 of EITF 00-19 (ASC paragraphs 815-40-25-7 through 25-35) do not apply for purposes of determining whether the embedded conversion option would be classified in stockholders’ equity if freestanding. In this example, the embedded conversion option that requires settlement in a fixed number of shares would be classified in stockholders’ equity if it were freestanding, so the exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)) applies and the embedded conversion option would not be separated from the debt host by the issuer. The exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)) does not apply to the investor’s accounting, so the investor should separate the embedded conversion option from the debt host and account for that option as a derivative instrument if the remaining criteria in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) are met (unless the investor elects to measure the entire hybrid instrument at fair value with changes in fair value recognized in earnings under Statement 155).

**Example A3.13a: Conventional Convertible Debt That Contains Embedded Prepayment Options**

ABC Corp. issues fixed-rate debt instruments with a 20-year maturity for their par value of $1,000 per bond. The holder has the ability to convert each bond at any time into 10 shares of ABC’s common stock (i.e., resulting in an effective conversion price of $100 per share). On initial issuance of the debt, the market price of ABC’s common stock is $80 per share. ABC can call the debt for its $1,000 par value any time after 3 years from the issuance date. The investor can elect to put the instrument back to ABC for its $1,000 par value at the end of years 5, 10, and 15. Additionally, the investor can elect to put the instrument back to ABC for its $1,000 par value if ABC experiences a change of control.
Analysis of the Embedded Conversion Option under the Standard

On conversion, ABC is required to settle the instrument through the issuance of a fixed number of shares. Accordingly, the instrument is considered conventional convertible debt and the requirements in paragraphs 12 – 32 of EITF 00-19 (ASC paragraphs 815-40-25-7 through 25-35) do not apply for purposes of determining whether the embedded conversion option would be classified in stockholders’ equity if freestanding. In this example, the embedded conversion option that requires settlement in a fixed number of shares would be classified in stockholders’ equity if it were freestanding, so the exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)) applies and the embedded conversion option would not be separated from the debt host by the issuer. The exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)) does not apply to the investor’s accounting, so the investor should separate the embedded conversion option from the debt host and account for that option as a derivative instrument if the remaining criteria in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) are met (unless the investor elects to measure the entire hybrid instrument at fair value with changes in fair value recognized in earnings under Statement 155).

Analysis of the Embedded Prepayment Options under the Standard

The convertible debt instrument contains a noncontingent call option that can be exercised any time after year three and it contains a noncontingent put option that can be exercised on three specified dates (at the end of years 5, 10, and 15). The noncontingent call and put options have a $1,000 fixed exercise price that is equal to the initial proceeds received from issuing the convertible bonds. The noncontingent call and put options in this example contain a single interest-rate underlying, so the guidance in paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-40 and 25-41), as interpreted by DIG Issue B16, would not result in a conclusion that the call and put option are not clearly and closely related to the debt host contract. The amount paid on settlement is the par value of the debt, so the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1 of DIG Issue B16 is no and the analysis must proceed to Step 3. The debt does not involve a substantial premium or discount, so the answer to Step 3 of DIG Issue B16 is no and further analysis is required under paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) to determine whether the call and put options are clearly and closely related to the debt host contract if paragraph 13 is applicable. The debt could not be settled in a manner such that the investor would not recover substantially all of its initial recorded investment on exercise of the noncontingent call and put options, so the provisions of paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) are not met. Additionally, exercise of the noncontingent call and put options would not double the investor’s initial rate of return, so the provisions of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) are not met. As a result, the noncontingent call and put options are clearly and closely related to the debt host contract.

The convertible debt instrument also contains a contingent put option that can be exercised on a change in control of ABC. That contingent put option has multiple underlyings (interest rates and the occurrence or nonoccurrence of a change in control) and must be evaluated under paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-40 and 25-41), as interpreted by DIG Issue B16. The amount paid on settlement is the $1,000 par value, therefore, the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1 in DIG Issue B16 is no and the analysis must proceed to Step 3. Because the debt does not involve a
substantial premium or discount, the answer to Step 3 is no and the contingent put option is clearly and closely related to the debt host under paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-40 and 25-41). That embedded feature is not evaluated under the provisions of paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) because the guidance in that paragraph only applies to embedded features with a single, interest-rate underlying (refer to Paragraph A3.12a of this Section for additional discussion).

Example A3.14: Convertible Debt That May Be Settled in a Combination of Cash and Shares upon Conversion

ABC Corp. issues fixed-rate debt instruments with a 20-year maturity for their par value of $1,000 per bond. The holder has the ability to convert each bond at any time into the equivalent of ten shares of ABC’s common stock (i.e., resulting in an effective conversion price of $100 per share). Upon conversion, ABC has the ability to settle by delivering any combination of cash or common shares with an aggregate value equal to the current market price of ten shares of ABC’s common stock. Upon initial issuance of the debt, the market price of ABC’s common stock is $80 per share.

Upon conversion, ABC is not required to settle the instrument through the issuance of a fixed number of shares. Rather, ABC has the ability to settle investor conversions in any combination of shares or cash. Accordingly, the instrument is not considered conventional convertible debt and the conversion option must meet all the conditions in EITF 00-19 (ASC Subtopic 815-40), including the conditions in paragraphs 12 – 32 of that Issue (ASC paragraphs 815-40-25-7 through 25-35), to determine whether the embedded conversion option would be classified in stockholders’ equity if freestanding. If those conditions for equity classification are met, the exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) would apply and the embedded conversion option would not be separated from the debt host by the issuer. If the conditions for equity classification are not met, the embedded conversion option would be separated from the debt host and accounted for as a derivative instrument, provided that the remaining criteria in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) are met (unless the issuer elects to measure the entire hybrid instrument at fair value with changes in fair value recognized in earnings under Statement 155). The exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)) does not apply to the investor’s accounting, so the investor should separate the embedded conversion option from the debt host and account for that option as a derivative instrument under the Standard if the remaining criteria in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) are met (unless the investor elects to measure the entire hybrid instrument at fair value with changes in fair value recognized in earnings under Statement 155), regardless of whether the conditions for equity classification in EITF 00-19 are met.

Applicability of FSP APB 14-1 (ASC Subtopic 470-20)

Because the convertible debt instrument in this example may be settled in cash upon conversion, the instrument is subject to the guidance in FSP APB 14-1 (ASC Subtopic 470-20) unless the embedded conversion option is required to be separately accounted for as a derivative under the Standard. The liability and equity components of convertible debt
instruments within the scope of FSP APB 14-1 must be separately accounted for in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. The guidance in FSP APB 14-1 does not affect an issuer's determination of whether an embedded feature should be separately accounted for as a derivative under the Standard.

FSP APB 14-1 (ASC Subtopic 470-20) is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years.

Example A3.14a: Convertible Debt That May Be Settled in a Combination of Cash and Shares upon Conversion and Also Contains Embedded Prepayment Options

ABC Corp. issues fixed-rate debt instruments with a 20-year maturity for their par value of $1,000 per bond. The holder has the ability to convert each bond at any time into the equivalent of ten shares of ABC’s common stock (i.e., resulting in an effective conversion price of $100 per share). Upon conversion, ABC has the ability to settle by delivering any combination of cash or common shares with an aggregate value equal to the current market price of ten shares of ABC’s common stock. Upon initial issuance of the debt, the market price of ABC’s common stock is $80 per share. ABC can call the debt for its $1,000 par value any time after 3 years from the issuance date. The investor can elect to put the instrument back to ABC for its $1,000 par value at the end of years 5, 10, and 15. Additionally, the investor can elect to put the instrument back to ABC for its $1,000 par value if ABC experiences a change of control.

Analysis of the Embedded Conversion Option under the Standard

Upon conversion, ABC is not required to settle the instrument through the issuance of a fixed number of shares. Rather, ABC has the ability to settle investor conversions in any combination of shares or cash. Accordingly, the instrument is not considered conventional convertible debt and the conversion option must meet all the conditions in EITF 00-19 (ASC Subtopic 815-40), including the conditions in paragraphs 12 – 32 of that Issue (ASC paragraphs 815-40-25-7 through 25-35), to determine whether the embedded conversion option would be classified in stockholders’ equity if freestanding. If those conditions for equity classification are met, the exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) would apply and the embedded conversion option would not be separated from the debt host by the issuer. If the conditions for equity classification are not met, the embedded conversion option would be separated from the debt host and accounted for as a derivative instrument, provided that the remaining criteria in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) are met (unless the issuer elects to measure the entire hybrid instrument at fair value with changes in fair value recognized in earnings under Statement 155). The exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)) does not apply to the investor’s accounting, so the investor should separate the embedded conversion option from the debt host and account for that option as a derivative instrument under the Standard if the remaining criteria in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) are met (unless the investor elects to measure the entire hybrid instrument at fair value with changes in fair value recognized in earnings under Statement 155)
earnings under Statement 155), regardless of whether the conditions for equity classification in EITF 00-19 are met.

Analysis of the Embedded Prepayment Options under the Standard

The convertible debt instrument contains a noncontingent call option that can be exercised any time after year three and it contains a noncontingent put option that can be exercised on three specified dates (at the end of years 5, 10, and 15). The noncontingent call and put options have a $1,000 fixed exercise price that is equal to the initial proceeds received from issuing the convertible bonds. The noncontingent call and put options in this example contain a single interest-rate underlying, so the guidance in paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-40 and 25-41), as interpreted by DIG Issue B16, would not result in a conclusion that the call and put option are not clearly and closely related to the debt host contract. The amount paid on settlement is the par value of the debt, so the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1 of DIG Issue B16 is no and the analysis must proceed to Step 3. The debt does not involve a substantial premium or discount, so the answer to Step 3 of DIG Issue B16 is no and further analysis is required under paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) to determine whether the call and put options are clearly and closely related to the debt host contract if paragraph 13 is applicable. The debt could not be settled in a manner such that the investor would not recover substantially all of its initial recorded investment upon exercise of the noncontingent call and put options, so the provisions of paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) are not met. Additionally, exercise of the noncontingent call and put options would not double the investor's initial rate of return, so the provisions of paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b)) are not met. As a result, the noncontingent call and put options are clearly and closely related to the debt host contract.

The convertible debt instrument also contains a contingent put option that can be exercised on a change in control of ABC. That contingent put option has multiple underlyings (interest rates and the occurrence or nonoccurrence of a change in control) and must be evaluated under paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-40 and 25-41), as interpreted by DIG Issue B16. The amount paid on settlement is the $1,000 par value, therefore, the payoff amount is not adjusted based on changes in an index. As a result, the answer to Step 1 in DIG Issue B16 is no and the analysis must proceed to Step 3. Because the debt does not involve a substantial premium or discount, the answer to Step 3 is no and the contingent put option is clearly and closely related to the debt host under paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-40 and 25-41). That embedded feature is not evaluated under the provisions of paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) because the guidance in that paragraph only applies to embedded features with a single, interest-rate underlying (refer to Paragraph A3.12a of this Section for additional discussion).

Applicability of FSP APB 14-1 (ASC Subtopic 470-20)

Because the convertible debt instrument in this example may be settled in cash upon conversion and the embedded conversion option is not separately accounted for as a derivative under the Standard, the instrument is subject to the guidance in FSP APB 14-1 (ASC Subtopic 470-20). The liability and equity components of convertible debt instruments within the scope of FSP APB 14-1 must be separately accounted for in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods.
The guidance in FSP APB 14-1 does not affect an issuer's determination of whether an embedded feature should be separately accounted for as a derivative under the Standard. Consequently, for purposes of evaluating whether the embedded prepayment options in this example are clearly and closely related to the debt host, a debt discount arising solely from the separation of the liability and equity components of the instrument under the guidance in FSP APB 14-1 is not considered when evaluating those embedded features under DIG Issue B16.

FSP APB 14-1 (ASC Subtopic 470-20) is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years.

A3.24 It is important to note that the Standard does not provide a blanket exception for the issuer from separating the embedded conversion option as a derivative in all convertible debt instruments. Rather, it is necessary for the issuer to analyze the terms of the conversion option before concluding whether the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) applies. As described above, the conditions that must be evaluated in this analysis are more extensive for instruments that are not considered to be conventional convertible debt. In circumstances where an embedded conversion option meets the scope exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)) and is not separated from the debt host and accounted for as a derivative under the Standard by the issuer, it is still necessary to evaluate whether other embedded derivatives may require separation under the Standard. Additionally, other accounting literature provides guidance on circumstances where a convertible debt issuer may be required to record amounts relating to the embedded conversion option in equity (for example, convertible debt that may be settled in cash upon conversion (including partial cash settlement), convertible debt with a beneficial conversion feature or convertible debt issued at a significant premium). Refer to FSP APB 14-1, EITF 98-5, EITF 00-27 (ASC Subtopic 470-20), and paragraph 18 of APB 14 (ASC paragraph 470-20-25-13), for additional guidance on circumstances where an issuer would be required to allocate amounts to equity relating to an embedded conversion feature. Also note that if any portion of the proceeds for issuing a convertible debt instrument must be classified in stockholders' equity, that instrument is not eligible for a fair value election under Statement 155 or Statement 159 (ASC Subtopic 825-10) because those elections are only available for financial assets and financial liabilities, not for equity.

A3.25 Convertible debt instruments typically contain a number of embedded features in addition to the embedded conversion option. Those embedded features must each be evaluated under the Standard to determine whether they should be separated from the debt host and accounted for as derivative instruments. Such embedded features may be freely exercisable by either the issuer or the investor or they may be exercisable only upon the occurrence of a contingent event. The discussion throughout this chapter and appendix provides guidance for evaluating whether such embedded features are required to be accounted for separately. As described in Paragraphs 12.28 – 12.29 of this chapter, if multiple embedded derivatives are required to be separated from the debt host, those individual embedded derivatives (including, when applicable, the embedded conversion option) must be bundled together as a single, compound embedded derivative instrument and accounted for separately from the debt host under the Standard (unless fair value measurement of the entire hybrid instrument, with changes in fair value recognized in earnings, is elected under Statement 155). [Note: Convertible debt instruments are not eligible for the fair value election in circumstances where applicable U.S. GAAP requires that the conversion option
be separately recorded in equity.] The following are examples of embedded features commonly found in convertible debt instruments (the following examples are not meant to be all-inclusive):

- Call options;
- Put options;
- Contingent interest payments; and
- *Make-whole* payments that provide the investor with additional consideration, which may be payable in cash or shares, if certain events occur before specified dates (e.g., issuer calls the debt or there is a change in control).

A3.25a Certain registration payment arrangements are excluded from the scope of the Standard (ASC Topic 815) and should be analyzed separately under FSP EITF 00-19-2 “Accounting for Registration Payment Arrangements” (ASC Subtopic 825-20, Financial Instruments - Registration Payment Arrangements), (see Chapter 2, Paragraphs 10j.01-10j.05). Under FSP EITF 00-19-2 (ASC Subtopic 825-20), a registration payment arrangement is analyzed separately from the instrument to which it relates whether the registration payment arrangement is contained in the convertible debt instrument (or similar instruments, such as equity shares, preferred shares or warrants) or is freestanding. A registration payment arrangement does not impact the evaluation of any embedded derivative contained in the instrument that it relates to. Any probable and estimable payments to be made under the registration payment arrangement are accrued at issuance and are treated as a reduction in proceeds attributable to the convertible debt using the measurement criteria in FASB Statement No. 5, *Accounting For Contingencies*, (ASC Topic 450, Contingencies) and FASB Interpretation 14, *Reasonable Estimation of the Amount of a Loss* (ASC paragraphs 450-20-30-1, 450-20-25-5, and 450-20-55-23 through 55-35). Subsequent changes in measurement (up or down) are included in earnings.

A3.26 The discussion in the preceding paragraphs should provide entities with a foundation for deciding when embedded components are required to be separated in convertible debt instruments, as well as for deciding whether the requirements for hedge accounting for convertible debt (including convertible debt that contains embedded features that were not required to be separated and convertible debt with embedded derivatives that are required to be separated) have been met (see Chapters 5 and 6 for fair value and cash flow hedging strategies). However, the topic of convertible debt encompasses a number of relevant considerations and a broad array of accounting literature. Entities issuing convertible debt should consider that literature and other resources specifically directed at evaluating convertible debt, such as the KPMG Accounting and Reporting Guide Chapter on *Convertible Debt*.

A3.26a EITF 06-7, "Issuer’s Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133, Accounting for Derivative Instruments and hedging Activities" (ASC paragraphs 815-15-35-4; 815-15-40-1 through 40-4; and 815-15-50-3) addresses how an issuer should account for a previously bifurcated conversion option in a convertible debt instrument if that conversion option no longer meets the bifurcation criteria in Statement 133 (ASC Topic 815). The carrying amount of the conversion option (that is, its fair value on the date of reclassification), should be reclassified to stockholders' equity. The debt host is unaffected and continues to be accounted for on an amortized cost basis. Subsequently, if the
instrument is converted, EITF 06-7 (ASC paragraph 815-15-40-1) requires any unamortized discount on the debt to be recorded as interest expense prior to reclassification of the debt to equity similar to the accounting for debt with a beneficial conversion feature upon conversion. Further, if this type of debt is extinguished for cash or other assets prior to maturity rather than converted, an amount equal to the fair value of the conversion feature at the date of settlement is allocated to equity and the residual is allocated to the debt in determining the extinguishment gain or loss. EITF 06-7 (ASC paragraphs 815-15-35-4; 815-15-40-1 through 40-4; and 815-15-50-3) should be applied to previously bifurcated conversion options in convertible debt instruments that cease to meet the bifurcation criteria in Statement 133 in interim or annual periods beginning after December 15, 2006, irrespective of whether the debt instrument was entered into prior or subsequent to the effective date of this Issue.

A3.26b At times an embedded derivative that was previously bifurcated from a hybrid instrument no longer meets the criteria for separate accounting. In these instances, we believe the derivative value should generally be recombined with the value of the host at the date the separation criteria are no longer met. We believe the model in EITF 06-7 (ASC paragraphs 815-15-35-4; 815-15-40-1 through 40-4; and 815-15-50-3) represents a special case because convertible debt is a compound financial instrument that has characteristics of both an equity instrument and a debt obligation. In general, the guidance in EITF 06-7 (ASC paragraphs 815-15-35-4; 815-15-40-1 through 40-4; and 815-15-50-3) should not be analogized to for other issues.

Debt Convertible into Subsidiary Stock

A3.27 Deleted.

A3.27a Sometimes an entity will issue freestanding financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary. ASC paragraph 815-40-15-5C specifies that freestanding financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary are not precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent if the subsidiary is a substantive entity. ASC paragraph 815-40-15-5C applies to those instruments (and embedded features) in the consolidated financial statements of the parent, regardless of whether the instrument was entered into by the parent or the subsidiary. That guidance does not apply to instruments that are not eligible for equity classification under other applicable U.S. GAAP (e.g., under ASC Topic 480). Additionally, that guidance does not apply to a written put option and a purchased call option embedded in the shares of a noncontrolling interest in a consolidated subsidiary if the arrangement is accounted for as a financing under ASC paragraphs 480-10-55-53 through 55-62.

A3.27b When evaluating whether an embedded conversion option (or other embedded feature) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary qualifies for the scope exception in ASC paragraph 815-10-15-74(a), the guidance in ASC Section 815-40-15 (including ASU 2017-11 (ASC paragraphs 815-40-15-5D, 55-33 to 55-34A when effective)) must first be applied to determine whether the embedded feature is indexed to the entity's own stock. If, based on that guidance, the entity concludes that the embedded feature is indexed to its own stock, it must then evaluate the embedded feature
under ASC Section 815-40-25 to determine whether the feature would be classified in stockholders' equity if it were freestanding (unless the embedded feature is a conversion option in conventional convertible debt, as discussed in paragraph A3.23 of this Section, whereby the requirements for equity classification in ASC paragraphs 815-40-25-7 through 25-35 would not be applied). However, in circumstances in which the subsidiary whose shares would be issued on exercise or conversion of the embedded feature is not considered to be a substantive entity, the embedded feature would not be considered indexed to the entity's own stock when evaluating the scope exception in ASC paragraph 815-10-15-74(a).

**A3.27c** ASC paragraph 810-10-45-17A specifies that an equity-classified instrument (including an embedded feature that is separately recorded in equity under applicable U.S. GAAP) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary that is within the scope of ASC paragraph 815-40-15-5C, must be presented as a component of noncontrolling interest in the consolidated financial statements, regardless of whether the instrument was entered into by the parent or the subsidiary. For example, convertible debt instruments that must or may be settled in cash on conversion, including instruments that require or permit cash repayment of the principal amount on conversion, will be separated into their liability and equity components. Therefore, if an entity issues convertible debt within the scope of ASC paragraph 815-40-15-5C that is convertible into the shares of a consolidated subsidiary, or if a consolidated subsidiary issues convertible debt within the scope of ASC paragraph 815-40-15-5C that is convertible into its own shares, ASC paragraph 810-10-45-17A requires that the equity component be presented as a component of noncontrolling interest in the consolidated financial statements. A similar presentation would result in other circumstances in which a conversion option related to a subsidiary's shares is required to be separately accounted for in equity under other applicable U.S. GAAP (e.g., under ASC Subtopic 470-20, ASC paragraphs 815-15-35-4, 815-15-40-1 through 40-4, and 815-15-50-3). However, if a parent issues debt that is convertible into the stock of a consolidated subsidiary and the conversion option is presented as a component of noncontrolling interest under the guidance in ASC paragraph 810-10-45-17A, then any amount that remains in equity after either the exercise of the conversion option or the maturity of the convertible debt (in both instances reflected either as an increase or decrease to equity, as may be required by the guidance in ASC Subtopic 470-20 or other applicable U.S. GAAP) would be reclassified from the noncontrolling interest to the controlling interest at that time.

**A3.27d** Although not explicitly addressed in ASC paragraph 815-40-15-5C, we believe that debt issued by a consolidated subsidiary that is convertible into the parent’s stock also would not be precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent if the subsidiary is a substantive entity.

**Convertible Debt That Is Denominated in a Foreign Currency**

**A3.27e** EITF 07-5 (ASC Subtopic 815-40) clarifies that a conversion option embedded in a convertible debt instrument that is denominated in a currency other than the issuer's functional currency would not be considered indexed to the entity's own stock for purposes of evaluating the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)). The determination of whether an embedded conversion option is indexed to an entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade. Thus, if an
entity with the U.S. dollar as its functional currency issues a convertible debt instrument that is denominated in Canadian dollars, the embedded conversion option is not considered indexed to the entity's own stock. On the other hand, if an entity with the U.S. dollar as its functional currency issues debt that is convertible into its own stock that is traded on the London Stock Exchange, the embedded conversion option would not be precluded from being considered indexed to the entity's own stock provided that the convertible debt instrument is denominated in U.S. dollars.

**Convertible Instruments That Contain Down Round Features Before Adoption of ASU 2017-11**

**A3.27f** Many convertible debt instruments and convertible preferred shares contain provisions that adjust the conversion price when an entity subsequently issues (a) equity shares for a per share amount that is less than the conversion price of those instruments or (b) another equity-related contract (e.g., preferred stock or warrants) with an exercise price that is lower than the conversion price of those instruments. Such protective features are often referred to in practice as *down round* features. The EITF discussed those features in connection with EITF 07-5 (ASC Subtopic 815-40) and concluded that such features preclude an instrument from being considered indexed to the entity's own stock for purposes of evaluating the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-15-10-74(a)). As a result, conversion options containing down round features are required to be separated and accounted for as derivatives upon an entity's adoption of EITF 07-5, provided that the remaining conditions for separation in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) are met. For example, if a convertible preferred share with a down-round provision contains an equity host contract, the embedded conversion option would be considered clearly and closely related to the host contract under paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a)) and bifurcation of the conversion option would not be required. Additionally, if a conversion option with a down round provision is embedded in a debt host contract but does not meet the net settlement characteristic of a derivative, the conversion option would not be separated as a derivative under paragraph 12(c) of the Standard (ASC paragraph 815-15-25-1(c) and 25-14). EITF 07-5 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years.

**Example A3.14b: Convertible Debt With a Down Round Feature Before the Adoption of ASU 2017-11**

ABC Corp. issues fixed-rate debt instruments with a twenty-year maturity for their par value of $1,000 per bond. The holder has the ability to convert those instruments at any time at an initial conversion ratio of ten shares of ABC’s common stock per bond (i.e., resulting in an effective conversion price of $100 per share). However, the terms of the convertible debt instrument specify that (a) if ABC sells shares of its common stock for an amount less than $100 per share, the conversion price is reduced to equal the issuance price of those shares or (b) if ABC issues an equity-linked financial instrument with a strike price below $10 per share, the conversion price is reduced to equal the strike price of the newly issued equity-linked financial instrument. The common shares that are issuable upon conversion of the debt
instruments are considered to be readily convertible to cash for purposes of evaluating whether the embedded conversion feature meets the net settlement characteristic of a derivative.

Analysis of the Embedded Conversion Option under the Standard (Before adoption of ASU 2017-11)

Before adoption of ASU 2017-11, the embedded conversion option would not be considered to be indexed to the entity's own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) based on the following analysis:

Step 1: The instruments do not contain an exercise contingency, proceed to Step 2.

Step 2: The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. The number of shares issuable on conversion of the debt instruments is not fixed because the conversion price would be adjusted if ABC (a) sells shares of its common stock for an amount less than $100 per share or (b) issues an equity-linked financial instrument with a strike price below $100 per share. Consequently, the settlement amount of the embedded conversion option can be affected by (a) future equity offerings undertaken by ABC at the then-current market price of the related shares or (b) the contractual terms of other equity-linked financial instruments issued in a subsequent period. The occurrence of a sale of common stock by the entity at market is not an input to the fair value of a fixed-for-fixed option on equity shares. Similarly, the occurrence of a sale of an equity-linked financial instrument is not an input to the fair value of a fixed-for-fixed option on equity shares, if the transaction is priced at market. Because the scope exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)) is not met, the embedded conversion option would be separated from the debt host and accounted for as a derivative instrument, provided that the remaining criteria in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) are met (unless the issuer elects to measure the entire hybrid instrument at fair value with changes in fair value recognized in earnings under Statement 155).

Convertible Instruments That Contain Down Round Features After Adoption of ASU 2017-11

A3.27g(1) Many convertible debt instruments and convertible preferred shares contain provisions that adjust the conversion price when an entity subsequently issues (a) equity shares for a per share amount that is less than the conversion price of those instruments or (b) another equity-related contract (e.g., preferred stock or warrants) with an exercise price that is lower than the conversion price of those instruments. Such protective features are often referred to in practice as down round features.

A3.27g(2) In July 2017, the FASB issued ASU 2017-11 (ASC Subtopics 260 and 505, ASC paragraphs 815-10-15-75A, 815-40-15D, 815-40-55-33 to 55-3A) to address the accounting for certain financial instruments that contain down round features. Under Part I of ASU 2017-11, for purposes of evaluating whether a financial instrument meets the scope exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)), an entity excludes any down round feature from its consideration of whether an instrument is indexed to the entity’s own stock.
A3.27g(3) ASU 2017-11 (ASC Master Glossary) defines a down round feature as a feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.

A3.27g(4) ASU 2017-11 (ASC Master Glossary) also notes that a down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard anti-dilution provision is not considered a down round feature.

A3.27g(5) For public business entities, Part I of ASU 2017-11 is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. For all other entities, it is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted for all entities, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

A3.27g(6) Part I of ASU 2017-11 can be adopted by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the first fiscal year and interim period(s) in which it is effective. The cumulative effect of the change shall be recognized as an adjustment of the opening balance of retained earnings in the fiscal year and interim period of adoption. Alternatively, it can be adopted retrospectively to outstanding financial instruments with a down round feature for each prior reporting period presented.

Example A3.14c: Convertible Debt With a Down Round Feature After the Adoption of ASU 2017-11

ABC Corp. issues fixed-rate debt instruments with a twenty-year maturity for their par value of $1,000 per bond. The holder has the ability to convert those instruments at any time at an initial conversion ratio of ten shares of ABC’s common stock per bond (i.e., resulting in an effective conversion price of $100 per share). However, the terms of the convertible debt instrument specify that (a) if ABC sells shares of its common stock for an amount less than $100 per share, the conversion price is reduced to equal the issuance price of those shares or (b) if ABC issues an equity-linked financial instrument with a strike price below $10 per share, the conversion price is reduced to equal the strike price of the newly issued equity-linked financial instrument.

Analysis of the Embedded Conversion Option under the Standard (After Adoption of ASU 2017-11 (ASC Subtopic 815-40))

After adoption of ASU 2017-11 (ASC Subtopic 815-40), the embedded conversion option would be considered to be indexed to the entity's own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) based on the following analysis:
Step 1: The instruments do not contain an exercise contingency, proceed to Step 2.

Step 2: In accordance with ASC paragraph 815-10-15-75A, for purposes of evaluating whether a financial instrument meets the scope exception in paragraph 815-10-15-74(a)(1), a down round feature is excluded from the consideration of whether the instrument is indexed to the entity’s own stock. The instrument does not contain any other features to be assessed under Step 2.

Thus, the embedded conversion option would be considered to be indexed to the ABC’s own stock within the meaning of paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)). However to meet the scope exception in paragraph 11(a), in addition to determining that the embedded conversion option is indexed to ABC’s own stock, ABC would need to determine that the embedded conversion option would be classified in stockholders’ equity if it were a freestanding instrument. For purposes of that determination, other accounting guidance that would be applied to freestanding financial instruments (e.g., EITF 00-19 and EITF 07-5 (ASC Subtopic 815-40)) would also apply to the embedded conversion option. If the scope exception in paragraph 11(a) (ASC paragraph 815-10-15-74(a)) is met, then an embedded feature would not be separately accounted for as a derivative under the Standard.

**Trust-Preferred Securities**

A3.28 A trust-preferred structure generally involves the establishment by an enterprise, such as a bank, of a limited purpose trust (the trust) to issue the trust-preferred securities. The trust issues preferred securities to outside investors and uses the proceeds of the issuance to purchase from the enterprise an equivalent amount of junior subordinated debentures or other loans having stated maturities. The debentures or other loans are the only assets of the trust. When the enterprise makes its payments of interest on the debentures or other loans, the trust distributes the cash to the holders of the trust-preferred securities. The trust-preferred securities must be redeemed upon maturity of the debentures or other loans. In some structures, the trust writes a fixed-price call option to the enterprise that is embedded in the debt obligation of the enterprise to the trust and permits the enterprise to call the loan, for example at par.

A3.29 Prior to adoption of FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities* (ASC Topic 810, *Consolidation - Overall*), (revised December 2003), the sponsoring enterprise consolidated the trust in such trust-preferred structures as a result of holding all the common equity of the trust. However, under the provisions of FIN 46R (ASC Topic 810), the enterprise should not consolidate the trust in structures such as the one described in the previous paragraph because the enterprise does not have a significant variable interest in the trust (any common equity held by the enterprise may be a variable interest, but would not be able to receive a sufficient portion of the variability of the trust to require consolidation by the enterprise). Accordingly, the enterprise would report the junior subordinated debentures held by the trust as debt instruments in its consolidated financial statements. Any derivatives embedded in those debt instruments, such as an embedded call option, would need to be evaluated to determine if they are required to be separated from the debt host and accounted for as derivatives under the Standard.
EQUITY HOST CONTRACT

A3.30 The value of an equity host contract is driven by the equity index or price of the equity of the entity issuing the hybrid instrument that includes the equity host contract. Thus, if the underlying of the embedded derivative component is associated with the index or price of a different entity's equity, the embedded derivative component would not be considered clearly and closely related to the equity host contract. This section discusses the more common embedded features within an equity host contract and whether those embedded features are considered clearly and closely related to the equity host.

A3.30a However, prior to determining whether a feature is clearly and closely related to its host contract it is necessary to determine whether the host is more akin to debt or equity. The Standard does not rely on the GAAP classification of a hybrid to determine the nature of its host. Instead, the analysis focuses on the overall substance of the instrument. This can be particularly judgmental with preferred stock that often contains both debt-like and equity-life features. As such, this section begins with a more detailed discussion of determining whether an instrument is an equity host or debt host.

Nature of the Host Contract in a Hybrid Instrument Issued in the Form of a Share

A3.31 To determine whether the features embedded in a hybrid financial instrument issued in the form of a share are clearly and closely related to its host contract, an entity must determine whether the host contract is more akin to debt or more akin to equity. Classification within permanent or temporary equity is not determinative, and in certain cases a contract classified within equity may be considered a debt host for purposes of the embedded feature analysis under Statement 133 (ASC Topic 815). If the host contract is more akin to debt, embedded features should be analyzed as discussed under debt hosts beginning at Paragraph A3.01, irrespective of the fact that the instrument may be equity in legal form.

A3.31a Statement 133 (ASC Topic 815) does not provide comprehensive guidance about determining whether a hybrid instrument, including an instrument issued in the form of a share, contains a debt host or an equity host. (However, the FASB addressed this issue with the issuance of ASU No. 2014-16, Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity (ASU 2014-16), which is summarized at Paragraphs A3.34-A3.41. See Paragraphs A3.34-A3.41 for its effective date and transition provisions.) Before adopting ASU 2014-16, entities should have considered the following general guidance:

- Paragraph 60 of Statement 133 (ASC paragraph 815-15-25-16) states that if the host contract encompasses a residual interest in an entity, its economic characteristics and risks should be considered that of an equity host.
- Paragraph 61(l) of Statement 133 (ASC paragraph 815-15-25-17) states that a typical cumulative fixed-rate preferred stock that has a mandatory redemption feature is more akin to debt, whereas cumulative participating perpetual preferred stock is more akin to an equity instrument. (Note that the guidance in the preceding sentence was deleted when ASU 2014-16 became effective.) This description can be seen to represent ends of a spectrum. However, for instruments that contain some features that are more akin...
to debt and some features that are more akin to equity, judgment may be required to determine which features are predominant.

- DIG Issue B1, "Separating the Embedded Derivative from the Host Contract," indicates that if an instrument has a stated maturity and the holder has none of the rights of a shareholder (e.g., the ability to vote the shares and receive distributions to shareholders), the host contract is a debt instrument.

- DIG Issue K3, "Determination of Whether Combinations of Options with the Same Terms Must Be Viewed as Separate Option Contracts or as a Single Forward Contract," indicates a combination of an embedded purchased call option and an embedded written put option in a single hybrid instrument that have the same terms and same underlyings and that are entered into contemporaneously with the same counterparty should be considered a single forward contract for accounting purposes. We believe there is a presumption that the host contract in a share instrument that must be redeemed (in substance or in form) at a fixed date in the future for a fixed price is more akin to debt.

A3.31b Additionally, the SEC staff noted in a speech at the 2006 AICPA National Conference on Current SEC and PCAOB Developments that some of the things the staff believes should be considered as part of this analysis are:

- Whether there are any redemption provisions in the instrument
- The nature of the returns (stated rate or participating)
- Whether the returns are mandatory or discretionary
- Whether there are any voting rights
- Whether there are any collateral requirements
- Whether the holders participate in the residual
- Whether the holders have a preference in liquidation, and whether the holders have creditor rights (i.e. the right to force bankruptcy).

A3.31c The staff noted that it does not believe any of these factors alone is determinative, and that judgment in this area is required. However, although all of the factors discussed above are important, we believe that redemption provisions should be subjected to particularly close scrutiny. We note that a typical residual interest in an entity varies in value with the performance of the entity and is not subject to required redemption by the issuer. However, we believe the relative impact of a redemption feature on the analysis will depend on (among other things) the likelihood of exercise by the investor, whether the redemption feature is contingent and, if so, on what factors, and how the amount to be paid upon redemption is determined. All relevant factors should be considered in evaluating whether, on an overall basis, the host contract in a hybrid share instrument is substantively more like debt or more like equity.

A3.32 Impact of EITF D-109 (ASC paragraph 815-10-S99-3). In EITF Topic No. D-109 "Determining the Nature of a Host Contract Related to a Hybrid Financial Instrument Issued in the Form of a Share under FASB Statement No. 133" (EITF D-109), the SEC staff stated its view that when evaluating an embedded feature in a share for separation under Statement 133 (ASC
Topic 815), the consideration of the economic characteristics and risks of the host contract should be based on all the stated and implied substantive terms and features of the hybrid share instrument. As such, it is generally not appropriate to exclude from the analysis particular features of the hybrid. In particular, the SEC staff was concerned that some entities were excluding all features of the hybrid except its basic legal form (i.e., the fact that it is legally a share) and concluding that the host contract was more akin to equity on that basis. The staff announcement makes it clear that the evaluation is based on whether the hybrid is in substance more like an obligation or a residual interest in the entity, and classification of the instrument in permanent or temporary equity under U.S. GAAP does not in and of itself determine whether the host contract should be considered more akin to debt or equity for purposes of applying the embedded derivative provisions of Statement 133. Further, the existence or omission of any particular term or feature is also not determinative. Instead, the overall nature and specific terms of the hybrid share instrument must be considered in their totality.

A3.33 Consistent with the announcement, we believe the evaluation of whether the host contract in a hybrid share instrument is more akin to debt or equity should consider all of the features of the hybrid share instrument. However, EITF D-109 (ASC paragraph 815-10-S99-3) acknowledges that certain entities have adopted accounting policies whereby the terms and features pertaining to the individual embedded derivative being evaluated under paragraph 12 of Statement 133 (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) are excluded for purposes of determining the nature of the host contract for that particular embedded feature. Under this approach, an analysis of whether the host contract is more akin to debt or equity is reperformed as each individual embedded derivative feature of the hybrid share instrument is analyzed for possible separation. For each analysis, all features of the hybrid share instrument are considered in the identification of the host except the embedded feature that is being analyzed for separation. Some call this the "Chameleon Approach" because it could result in the host contract in a single hybrid share instrument being considered more akin to debt for purposes of analyzing some features and more akin to equity for purposes of evaluating other features. (ASU 2014-16 clarifies that an entity should consider all relevant terms and features, including the embedded derivative feature being evaluated for bifurcation, in evaluating the nature of the host contract. This precludes the Chameleon Approach. See Paragraphs A3.34-A3.41.) Because this approach would require separate analyses of the nature of the host for each embedded feature, we believe many entities will perform the analysis of whether an instrument is more akin to debt or equity only once and consider all features of the hybrid share instrument in determining whether the host contract is more akin to debt or equity.

A3.33a EITF D-109 (ASC paragraph 815-10-S99-3) only applies to determining the nature of the host contract in a hybrid share instrument, and the SEC staff specifically states that they did not intend to provide guidance on identifying the specific terms of a host contract once it is determined to be more akin to debt or equity, instead referring to Statement 133 (ASC Topic 815) and the DIG Issues for guidance (including DIG Issue B19 "Identifying the Characteristics of a Debt Host Contract"). Our views on identifying the specific terms of a host contract are discussed beginning at Paragraph 12.27a.

A3.34 Effect of ASU 2014-16. ASU 2014-16 clarified how current U.S. GAAP should be interpreted in evaluating the economic characteristics and risks of a host contract in a hybrid
financial instrument that is issued in the form of a share to determine whether it is more akin to debt or to equity.

A3.35 ASU 2014-16 clarifies that for a hybrid financial instrument issued in the form of a share, an entity should determine the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid financial instrument, weighing each term and feature on the basis of the relevant facts and circumstances. That is, in determining the nature of the host contract, an entity should consider the economic characteristics and risks of the entire hybrid financial instrument including the embedded derivative feature that is being evaluated for potential bifurcation. The EITF noted that it was not appropriate to disregard any term or feature when analyzing the economic characteristics and risks of the host contract because the instrument’s cash flows ultimately depend on the interaction of all contractual provisions within the instrument and the way in which an investor or issuer may exercise options within the contract. (Thus, the Chameleon Approach discussed in Paragraph A3.33 is precluded.) However, the EITF acknowledged that this approach could result in situations in which an embedded derivative feature is, in effect, found to be clearly and closely related to itself.

A3.36 In evaluating the stated and implied substantive terms and features, the existence or omission of any single term or feature does not necessarily determine the economic characteristics and risks of the host contract. Although an individual term or feature may weigh more heavily in the evaluation on the basis of the facts and circumstances, an entity should use judgment based on an evaluation of all of the relevant terms and features. For example, an entity should not presume that the presence of a fixed-price, noncontingent redemption option held by the investor in a convertible preferred stock contract, in and of itself, determines whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument. Rather, the nature of the host contract depends on the economic characteristics and risks of the entire hybrid financial instrument.

A3.37 When applying the guidance in Paragraph A3.53, an entity should determine the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid financial instrument, determining whether those terms and features are debt-like versus equity-like, and weighing those terms and features on the basis of their relative strength given the relevant facts and circumstances. In assessing the substance of the relevant terms and features, each of the following may form part of the overall analysis and may inform an entity’s overall consideration of the relative importance (and, therefore, weight) of each term and feature:

- The characteristics of the relevant terms and features themselves (e.g., contingent versus noncontingent, in-the-money versus out-of-the-money)
- The circumstances under which the hybrid financial instrument was issued or acquired (e.g., issuer-specific characteristics, such as whether the issuer is thinly capitalized or profitable and well-capitalized)
- The potential outcomes of the hybrid financial instrument (e.g., the instrument may be settled by the issuer transferring a specified amount of cash, or the instrument may remain legal-form equity), and the likelihood of these potential outcomes. The assessment of the potential outcomes may be qualitative in nature.

A3.38 The EITF decided that an entity should consider the specific facts and circumstances of the transaction and not presume that a single feature, such as a fixed-price, noncontingent...
redemption option held by the investor, would determine that the host contract is more akin to debt or more akin to equity. The EITF considered but rejected providing more determinative guidance, such as a rebuttable presumption that the existence of a fixed-price, noncontingent redemption option held by the investor would determine that a host contract is akin to debt (as a result of the potential downside protection that such a feature provides for the holder). In rejecting that approach, the EITF noted that it was not possible to reasonably establish that as a likely economic outcome. For example, if an issuer lacks sufficient capital, the issuer would be unable to redeem the instrument even if the investor exercised the redemption option. That would be true under various state laws and corporate charters under which a preferred share cannot be redeemed if it would cause the issuer to become insolvent. Accordingly, even with a redemption option, an investor may be exposed to the residual risks (i.e., negative movements) of an equity investment.

A3.39 The EITF also observed that for private issuers of preferred shares, in some instances either the issuer would perform well and have a liquidity event (whereby the conversion option would be exercised) or the issuer would perform poorly (whereby the preferred shareholders would effectively become the residual interest holders). Therefore, the EITF noted that, in those circumstances, the redemption option may not be exercised.

A3.40 The EITF decided that an entity should assess the substance of the relative terms and features - i.e., the relative strength of the debt-like or equity-like terms and features given the facts and circumstances - when considering how to weigh those terms and features. That is, the EITF concluded that it is important to determine not only which terms and features are debt-like versus equity-like in the context of the host contract analysis, but also the extent to which those terms and features are debt like or equity-like.

A3.41 ASU 2014-16 provides the following examples (not an exhaustive list) of common terms and features included within a hybrid financial instrument issued in the form of a share and the types of information and indicators that an entity (an issuer or an investor) may consider when assessing the substance of those terms and features in the context of determining the nature of the host contract:.

<table>
<thead>
<tr>
<th>Feature</th>
<th>General view of feature</th>
<th>Facts and circumstances to evaluate when determining the relative importance of the feature among other terms and features in the hybrid financial instrument</th>
</tr>
</thead>
</table>
| Redemption rights        | The ability for an issuer or investor to redeem a hybrid financial instrument issued in the form of a share at a fixed or determinable price generally is viewed as a debt-like characteristic. | - Whether the redemption right is held by the issuer or investors  
- Whether the redemption is mandatory  
- Whether the redemption is noncontingent or contingent  
- Whether (and the degree to which) the redemption right is in-the-money or out-of-the-money |
However, not all redemption rights are of equal importance. For example, a noncontingent redemption option may be given more weight in the analysis than a contingent redemption option.

- Whether there are any laws that would restrict the issuer or investors from exercising the redemption right (e.g., whether redemption would make the issuer insolvent)

- Issuer-specific considerations (e.g., whether the hybrid financial instrument is effectively the residual interest in the issuer due to the issuer being thinly capitalized or the common equity of the issuer having already incurred losses). Alternatively, the instrument may have been issued by a well-capitalized, profitable entity.

- If the hybrid financial instrument also contains a conversion right, the extent to which the redemption price is more or less favorable than the conversion price (i.e., a consideration of the economics of the redemption price and the conversion price), not simply the form of the settlement on redemption or conversion.

### Conversion rights

The ability of an investor to convert (e.g., a preferred share into a fixed number of common shares), generally is viewed as an equity-like characteristic.

However, not all conversion rights are of equal importance. For example, a conversion option that is noncontingent or deeply in-the-money may be given more weight in the analysis than a conversion option that is contingent on a remote

- Whether the conversion right is held by the issuer or investors

- Whether the conversion is mandatory

- Whether the conversion right is noncontingent or contingent

- Whether (and the degree to which) the conversion right is in-the-money or out-of-the-money

- If the hybrid financial instrument also contains a redemption right held by the investors, whether conversion is more likely to occur before redemption (e.g., because of an expected initial public offering or change-in-control event before the redemption right becomes exercisable).
Voting rights | The ability for a class of stock to exercise voting rights generally is viewed as an equity-like characteristic. However, not all voting rights are of equal importance. For example, voting rights that allow a class of stock to vote on all significant matters may be given more weight in the analysis than voting rights that are only protective in nature.

| • On which matters the voting rights allow the investor’s class of stock to vote (relative to common stock shareholders) • How much influence the investor’s class of stock can exercise as a result of the voting rights. |

Dividend rights | The nature of dividends can be viewed as a debt-like or equity-like characteristic. For example, mandatory fixed dividends generally are viewed as a debt-like characteristic, while discretionary dividends based on earnings are generally viewed as an equity-like characteristic.

| • Whether the dividends are mandatory or discretionary • The basis on which dividends are determined and whether the dividends are stated or participating • Whether the dividends are cumulative or noncumulative |

Protective covenants | Protective covenants generally are viewed as a debt-like characteristic. However, not all protective covenants are of equal importance. Covenants that provide substantive protective

| • Whether there are any collateral requirements akin to collateralized debt • If the hybrid financial instrument contains a redemption option held by the investor, whether the issuer’s performance on redemption is guaranteed by the parent of the issuer • Whether the instrument provides the investor with certain rights akin to |
A3.42 Effective date. For public business entities, ASU 2014-16 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, ASU 2014-16 is effective for fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016.

A3.43 Transition. At the effective date, an entity had to assess each existing hybrid financial instrument issued in the form of a share to determine whether any of those hybrid financial instruments contain one or more embedded derivative features that may have required either of the following adjustments:

- Bifurcation of the embedded derivative feature; or
- A previously bifurcated embedded feature to no longer be bifurcated.

In performing this assessment, an entity had to consider the economic characteristics and risks of the hybrid financial instrument and the embedded derivative feature(s) being evaluated as they existed at the date of initial recognition of the instrument (i.e., on issuance or acquisition).

A3.44 The effects of adopting ASU 2014-16 as of the effective date were to be reported as a cumulative-effect adjustment directly to retained earnings as of the beginning of the year of adoption.

A3.45 If an entity had not bifurcated an embedded derivative feature but is required to do so as a result of applying ASU 2014-16, the carrying amount of the host contract at the effective date was based on a pro forma bifurcation as of the date the entity issued or acquired the hybrid financial instrument (i.e., assume the embedded derivative feature had been bifurcated as of the date the entity issued or acquired the hybrid financial instrument) and the host contract’s subsequent accounting before the effective date. At the effective date, the transition adjustment will be the difference between the total carrying amount of the individual components of the newly bifurcated hybrid financial instrument and the carrying amount of the combined hybrid financial instrument before bifurcation.

A3.46 If an entity had bifurcated an embedded derivative feature but is no longer required to do so as a result of applying ASU 2014-16, the carrying amount of the related hybrid financial instrument at the effective date was the total carrying amount of the host contract and the fair value of the previously bifurcated embedded derivative feature. No cumulative-effect adjustment to beginning retained earnings for the period of adoption would have been warranted.

A3.47 Early adoption, including adoption in an interim period, of ASU 2014-16 was permitted. If an entity early adopted ASU 2014-16 in an interim period, any adjustments (see Paragraphs A3.43-A3.45) should have been reflected as of the beginning of the fiscal year that includes that interim period. Retrospective application was permitted but not required.
Convertible Preferred Stock

A3.48 Convertible preferred stock is an equity instrument that allows the holder to convert the preferred stock into a fixed number of common shares of the entity. If the entity determines that the host contract in a preferred share is more akin to equity, the conversion option is considered clearly and closely related to the equity host by the issuer and the investor because the changes in value of the conversion option and the equity host are driven by the price associated with the equity host contract.

A3.49 If the host contract is more akin to debt, the conversion option is not considered clearly and closely related to the debt host contract for the issuer. When deciding whether the conversion option needs to be accounted for separately from the debt host contract, the concepts discussed in Paragraphs A3.20 - A3.26 of this appendix should be considered. In addition, the issuer should consider whether the conversion option, if it were freestanding, would qualify for the exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) dealing with contracts indexed to the reporting entity's own stock and classified in stockholders' equity. See discussion in Paragraphs A3.20 - A3.24 for guidance on making that determination. Additionally, the embedded conversion option in convertible preferred stock with a mandatory redemption date may qualify for the exception from the conditions in paragraphs 12 - 32 of EITF 00-19 (ASC paragraphs 815-40-25-7 through 25-35) if the host contract is more akin to debt and the convertible instrument is considered conventional, as described in EITF 05-2 (ASC paragraphs 815-40-25-41 and 25-42) (refer to Paragraph A3.23 above).

A3.50 In circumstances in which an entity concludes that the host contract in a convertible preferred share is more akin to equity, questions have been raised about whether it is necessary to evaluate whether the embedded conversion option would meet the conditions for equity classification in applicable U.S. GAAP (e.g., EITF 00-19 and EITF 07-5 (ASC Subtopic 815-40)) to conclude that the conversion option is clearly and closely related to the equity host for purposes of applying paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a)). In general, we believe that an embedded feature that permits conversion into the entity's equity shares could be considered clearly and closely related to an equity host contract without evaluating whether that conversion option would meet the conditions for equity classification if it were a freestanding instrument. However, all facts and circumstances should be considered with respect to the terms of the embedded feature when making that determination. For example, if a conversion option with a down-round provision (as discussed in paragraph A3.27f of this Section) is embedded in an equity host contract, we believe the embedded conversion option would be considered clearly and closely related to the host contract under paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a)), even though that conversion option would not be considered indexed to the entity's own stock after adoption of EITF 07-5. In contrast, if the terms of a conversion feature embedded in an equity host contract were adjusted based on changes in the price of gold or the price of a third party's equity shares, that embedded conversion feature would not be considered clearly and closely related to the equity host contract for purposes of applying paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a)).

Redeemable Equity Securities

A3.51 Statement 150 (ASC Topic 480) addresses freestanding financial instruments and generally requires an issuer to classify a freestanding financial instrument issued in the form of
shares as a liability if the instrument embodies an unconditional obligation that requires the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event certain to occur. The provisions of Statement 150 related to certain types of mandatorily redeemable financial instruments have been indefinitely deferred for non-SEC registrants. However, freestanding financial instruments in the form of the issuer’s equity shares that must be redeemed on specific dates for amounts that are fixed or determined by reference to specified indices are within the scope of Statement 150, even if the issuer is a non-SEC registrant.

A3.52 For SEC registrants, equity securities that are considered redeemable but are not required to be classified as a liability under the provisions of Statement 150 (ASC Topic 480) must be reported separately from stockholders’ equity in the issuer’s financial statements if the securities are redeemable at the option of the holder or redemption is otherwise beyond the control of the issuer. That presentation is required even if the likelihood of redemption is remote. U.S. Securities and Exchange Commission (SEC) Accounting Series Release No. 268, Presentation in Financial Statements of “Redeemable Preferred Stock,” (ASR 268) and EITF Topic No. D-98, "Classification and Measurement of Redeemable Securities” (ASC paragraphs 480-10-S99-3), discusses this requirement for SEC registrants. When analyzing an embedded feature within an issued security to determine whether the embedded feature is considered clearly and closely related, the issuer and the holder must first determine whether the host contract is more akin to debt or more akin to equity, regardless of whether instrument is classified in stockholders' equity in the financial statements of the issuer.

A3.53 We believe that if an equity security is required to be classified outside of permanent equity under ASR 268, that factor should be considered, but is not the sole determining factor, when concluding whether the host contract is more akin to equity or debt (see Paragraph A3.31 above for guidance on what should be considered in that determination). After reaching that conclusion, the entity should compare economic characteristics and risks of the embedded feature with the economic characteristics and risks of the host to determine whether the embedded feature is considered clearly and closely related.

Mandatorily Convertible Equity Securities and/or Mandatorily Redeemable Convertible Equity Securities

A3.54 Mandatorily convertible equity securities and/or mandatorily redeemable convertible equity securities are securities that are convertible into equity shares of the issuer and/or are redeemable for cash by the issuer at a specified stated date or upon an event certain to occur. Those securities may be classified in the issuer’s financial statements as debt, temporary equity (i.e., mezzanine), or permanent equity, depending on the redemption and/or conversion requirements. When analyzing an embedded feature within mandatorily redeemable and/or convertible equity securities to determine whether the embedded feature is considered clearly and closely related, the issuer and the holder must first determine whether the host contract is more akin to debt or more akin to equity, regardless of whether the instrument is classified in stockholders' equity in the financial statements of the issuer (see Paragraph A3.31 above for guidance on what should be considered in that determination). The entity should compare the economic characteristics and risks of the embedded feature with the economic characteristics and risks of the host to determine whether the embedded feature is considered clearly and closely related.
related to the host contract. While equity classification of the security in the issuer’s balance sheet is not the determinative factor of whether the host contract is more akin to debt or equity, the classification in the issuer’s balance sheet of the security (or host contract if the embedded derivative is separated) determines whether the issuer can hedge any risk associated with the security or host contract. That is, the risks within assets and liabilities are eligible to be hedged, while the risks within an instrument classified in equity (including temporary equity, permanent equity, and mezzanine) are not eligible to be hedged under the Standard.

**Calls and Puts on Equity Instruments**

**A3.55** Certain equity instruments enable the holder to require the issuer of the equity instrument to reacquire the equity instrument for cash. This right represents an embedded put option written by the issuer of the equity instrument to the holder of the equity instrument. Because the put option is to be settled in cash, the put option is not considered clearly and closely related to the equity host instrument from the holder’s and issuer’s perspectives. Thus, the holder of the equity instrument should separate the put option embedded in a publicly-traded equity instrument to which it relates if the criteria in paragraphs 12(b) and 12(c) of the Standard (ASC paragraphs 815-15-25-1(b), 25-1(c) and 25-14) are met (unless fair value measurement of the entire hybrid instrument, with changes in fair value recognized in earnings, is elected by the holder under Statement 155). An embedded written put option that may require the issuer of an equity instrument to redeem that equity instrument would not be considered to be a derivative instrument by the issuer of the equity instrument under paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)), provided that it is indexed solely to the company's own stock under EITF 07-5 (ASC Subtopic 815-40) and the conditions for equity classification specified in EITF 00-19 (ASC Subtopic 815-40) are met. Note that the requirements for equity classification in EITF 00-19 are applicable when an issuer is evaluating whether an embedded put option is an equity instrument subject to the exception in paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)) because Statement 150 (ASC Topic 480) does not apply to embedded features (such as the embedded written put option discussed in this paragraph). If an instrument that is classified in equity (or temporary equity) contains an embedded derivative that must be separately accounted for under Statement 133, the entire hybrid instrument is not eligible for the fair value measurement election under Statement 155, regardless of whether the hybrid instrument contains an equity host or a debt host. Equity instruments issued by an entity and classified in stockholders’ equity in its statement of financial position are not eligible for the fair value measurement election under Statement 155. (Refer to footnote 6bb of Statement 155 (ASC paragraph 815-15-25-6), paragraph 8j of Statement 107 (ASC paragraph 825-10-50-8(i)), and DIG Issue C2).

**A3.56** A purchased call option that enables the issuer of an equity instrument to reacquire that equity instrument would not be considered to be a derivative instrument by the issuer of the equity instrument under paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)), provided that it is indexed solely to the company's own stock under EITF 07-5 (ASC Subtopic 815-40) and the conditions for equity classification specified in EITF 00-19 (ASC Subtopic 815-40) are met. Thus, if the call option were embedded in the related equity instrument, the issuer would not separate it from the host contract. However, for the holder of the related equity instrument, the embedded written call option would not be considered clearly and closely related to the equity instrument and, if the criteria in paragraphs 12(b) and 12(c) of the Standard (ASC
paragraphs 815-15-25-1(b), 25-1(c) and 25-14) are met, the holder should separate the option from the host contract (unless fair value measurement of the entire hybrid instrument, with changes in fair value recognized in earnings, is elected by the holder under Statement 155).

**Mandatorily Redeemable Preferred Stock Payable in Gold**

**A3.57** Mandatorily redeemable preferred stock payable in gold is an instrument in which preferred dividends may be payable in cash but the shares will be redeemed for a fixed amount of gold. Regardless of whether the instrument is classified as a liability (e.g., under paragraph 9 of Statement 150 (ASC paragraph 480-10-25-4 and 25-6)) or as equity, and regardless of whether the host is more akin to debt or equity, those instruments contain an embedded feature in which the underlying is the price of gold. That embedded feature is not considered clearly and closely related to either a debt or equity instrument; therefore, if the criteria in paragraphs 12(b) and 12(c) of the Standard (ASC paragraphs 815-15-25-1(b), 25-1(c), and 25-14) are met, the embedded feature should be separated from the host contract and accounted for separately. The hybrid instrument is not eligible for the fair value measurement election under Statement 155 because it is not a financial instrument in its entirety (i.e., the instrument requires redemption for a fixed amount of gold). However, if the nonfinancial derivative has been accounted for separately under FAS 133 (ASC Topic 815) then the host contract may be eligible for a fair value election under paragraph 7(f) of Statement 159 (ASC paragraph 825-10-15-4(f)) if it is classified as a liability under paragraph 9 of Statement 150 (ASC paragraph 480-10-25-4 and 25-6). See DIG Issue B37 paragraph A28 of Statement 155, and paragraph 7(f) of Statement 159 (ASC paragraph 825-10-15-4(f)) for further reference.

**Mandatorily Redeemable Preferred Stock Payable in a Foreign Currency**

**A3.58** Mandatorily redeemable preferred stock with payment denominated in a foreign currency is an instrument in which the periodic preferred dividend payments, redemption payment, or both are payable only in a stipulated amount of foreign currency. Regardless of whether the instrument is more akin to debt or equity, those instruments do not contain an embedded foreign currency derivative that warrants separate accounting under the Standard. Instead, as required by paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10), the reporting entity must apply the provisions of Statement 52 (ASC Topic 830) to the foreign-currency-denominated mandatorily redeemable preferred stock. In contrast, if the holder of the mandatorily redeemable preferred stock has the choice to receive, or the issuer has the choice to make, the redemption payment, the dividend payments, or both in either a stipulated amount of U.S. dollars or a stipulated amount of a specified currency, then the instrument contains an embedded foreign currency option that is subject to the Standard. In that case, because the reporting entity has the option to make payments in U.S. dollars or in a specified amount of foreign currency, the provisions of paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10) are not relevant to that instrument. The embedded foreign currency option should be separated from the host contract and accounted for as a derivative if the remaining conditions in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) were met (unless fair value measurement of the entire hybrid instrument, with changes in fair value recognized in earnings, is elected under Statement 155), because the embedded foreign currency option is not clearly and closely related to the preferred stock. Mandatorily redeemable

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preferred stock containing an embedded foreign currency derivative that would otherwise require separate accounting under the Standard would be eligible for the fair value measurement election under Statement 155 if the instrument is classified as a liability. However, if the mandatorily redeemable preferred stock is classified in equity or temporary equity (e.g., if the instrument is subject to a deferral of the provisions of Statement 150 (ASC Topic 480) applicable to certain mandatorily redeemable financial instruments issued by non-SEC registrants pursuant to FSP FAS 150-3 (ASC paragraph 480-10-65-1)), the financial instrument would not be eligible for a fair value measurement election under Statement 155 or Statement 159 (ASC Subtopic 825-10). See DIG Issue B37 for further reference.

**LEASE HOST CONTRACT**

A3.59 The value of a lease host contract is driven by expectations and risks related to inflation during the term of the lease (i.e., possible changes in the purchasing power of money). As a result, rentals for the use of leased assets and adjustments for inflation on similar property are considered to be clearly and closely related. Thus, unless a significant leverage factor is involved, an inflation-related derivative embedded in an inflation-indexed lease contract would not be separated from the host contract. The value of a lease host contract also is driven by the interest rate inherent in the lease. As a result, the obligation to make future payments for the use of leased assets and the adjustment of those payments to reflect changes in a variable-interest-rate index are considered to be clearly and closely related. Thus, the contingent-rental-related embedded derivative in a lease contract that includes contingent rentals based on changes in the prime rate would not be separated from the host contract.

A3.60 Certain lease contracts require payments based on the lessee’s sales (e.g., a fixed payment plus a percentage of the retail sales originating from the leased property). The contingent-rental-related embedded derivative in lease contracts that include contingent rentals based on certain sales of the lessee would not be separated from the host contract because, under paragraph 10(e)(3) of the Standard (ASC paragraph 815-10-15-59(d)), a nonexchange-traded contract in which the underlying is specified volumes of sales by one of the parties to the contract would not be subject to the requirements of the Standard.

A3.61 While numerous contracts, including leases, can have term-extending features, the Standard only addresses term-extending options specifically related to debt host contracts. Therefore, the guidance provided in Paragraph A3.17 of this appendix relates only to debt host contracts and that guidance should not be extended to other types of host contracts with term-extending options. Entities with term-extending features within a non-debt related contract should apply the general guidance under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-05-1, 815-15-25-1 and 25-14) to determine whether the term-extension option is required to be separately accounted for under the Standard. As a result of applying paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) to term-extension options within non-debt contracts, we believe an entity would generally conclude that the option is considered to be clearly and closely related and, thus, would not be separated from the non-debt host contract. (See DIG Issue B17 for further reference.) For example, a term-extending option for an additional year in a two-year lease that does not reprice would be considered clearly and closely related to the lease. This is because the term extension option (under which
the underlying generally is considered to be related to inflation or interest) generally is considered to be clearly and closely related to the economic characteristics and risks of a lease.

A3.62 Some hybrid instruments contain embedded derivative components that are not associated with any of the characteristics inherent in a lease as discussed above. In those circumstances, the general conclusion is that the embedded derivative component is not clearly and closely related to the lease host contract and would require separate accounting, assuming the other criteria of paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) have been met. Examples of those components include a derivative component embedded in a lease host contract in which the value is determined by changes in an equity price or index, commodity price or index, or an insurance loss index. The fair value measurement elections described in Statement 155 and Statement 159 (ASC Subtopic 825-10) are not available for financial assets and liabilities recognized under Statement 13 (ASC Topic 840, Leases) (a contingent obligation arising out of a cancelled lease and a guarantee of a third party lease are not considered lease contracts).

Appendix B Insurance Contracts

INTRODUCTION

Generally, contracts of the type that are within the scope of FASB Statements No. 60, Accounting and Reporting by Insurance Enterprises (Statement 60), No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments (Statement 97), and No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (Statement 113), (ASC Topic 944, Financial Services--Insurance) are not subject to the requirements of the Standard regardless of whether they are written by insurance enterprises. That is, a contract is not subject to the requirements of the Standard if it entitles the holder to be compensated only if, as a result of an identifiable insurance event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk.

In traditional life insurance contracts, the payment of benefits is the result of an identifiable insurable event (death of the insured), not changes in a variable. Thus, those contracts are not subject to the requirements of the Standard. Similarly, traditional property and casualty contracts are not subject to the requirements of the Standard since the payment of benefits is the result of an identifiable insurable event (e.g., theft or fire), not changes in a variable.

However, certain entities enter into contracts that combine derivative instruments with insurance products or nonderivative contracts. This appendix analyzes common types of those contracts and their interaction with the Standard’s requirements.

Insurance contracts, other than financial guarantees and investment contracts, as discussed in Statement 60 and Statement 97 (ASC Topic 944), are not eligible for a fair value measurement election under Statement 155. Refer to footnote 6bb of Statement 155 (ASC paragraph 815-15-25-6) and paragraph 8c of Statement 107 (ASC paragraph 825-10-50-8(c)). On the other hand, the fair value option under Statement 159 (ASC Subtopic 825-10) is permitted for insurance contracts that are financial instruments and insurance contracts that are not financial instruments.
because they require or permit the insurer to provide goods or services rather than a cash settlement but whose terms permit the insurer to settle by paying a third party to provide those goods or services. Therefore, following adoption of Statement 159, an entity would be permitted to designate such an insurance contract as carried at fair value through earnings and thereby avoid the analysis of embedded features described below.

Guaranteed Investment Contracts

B3.01 In a traditional guaranteed investment contract (GIC), the issuer of the contract takes deposits from a benefit plan (or other institutional investor) and purchases fixed income investments that are held in its general account. The benefit plan is a creditor of the issuing company and, therefore, has credit risk, although generally the issuing company has a high credit-quality rating. The issuer is contractually obligated to repay the principal and specified interest guaranteed to the benefit plan. The benefit plan’s provisions typically permit the participant to withdraw funds at book value (also referred to as account or contract value) for specified reasons such as loans, hardship withdrawals and transfers to other investment options offered by the plan. A benefit-responsive GIC contains provisions that mirror the plan’s participant-directed withdrawal/transfer provisions. Therefore, the issuer is at risk that interest rates could increase, thereby reducing the price of the fixed-income investments backing the GIC liability, while those investments may have to be sold at a loss to cover withdrawals. From the issuer’s perspective, traditional GICs are accounted for in accordance with Statement 97 (ASC Topic 944) in a manner similar to other financial instruments. In addition, traditional GICs neither meet the characteristics of a derivative nor do they typically have embedded derivative components within the scope of the Standard.

Synthetic GICs

B3.02 A synthetic GIC is a contract that simulates the performance of a traditional GIC through the use of financial instruments. A key difference between a synthetic GIC and a traditional GIC is that the policyholder (such as a benefit plan) owns the assets underlying the synthetic GIC. (With a traditional GIC, the policyholder owns only the contract itself that provides the policyholder with a call on the contract issuer’s assets in the event of default.) Those assets may be held in a trust owned by the policyholder and typically comprise government securities, private and public mortgage-backed securities and other asset-backed securities, and investment grade corporate obligations. To enable the policyholder to realize a specific known value for the assets if it needs to liquidate them, synthetic GICs use a wrapper contract that provides market and cash flow risk protection to the policyholder. This wrapper or guarantee may be provided in a variety of structures. In a synthetic GIC, the issuer, in effect, sells a put option to the policyholder. For many synthetic GICs, the option premium is in the form of a fee charged on the outstanding contract book value. For some forms of synthetic GICs, the option premium for the put option is not explicitly stated but, instead, is embedded in the determination of the investment return guaranteed to the policyholder.

B3.03 Synthetic GICs fall into several broad structural categories, including Buy and Hold, Actively Managed, and Fixed-Rate/Fixed Maturity. In each of these, the holder’s exposure to variable cash flows is transferred to the issuer of the contract. In addition, payments under synthetic GICs are not limited to identifiable insurable events (the holder does not need to incur a
loss to receive compensation under the contract). (See ASC paragraphs 815-10-05-9 through 05-15 for further reference.)

B3.04 From the issuer's perspective, a synthetic GIC wrapper contract that provides a guarantee of the cash flows of the underlying assets is a freestanding derivative (e.g., the issuer is selling a put option to the holder of the synthetic GIC) within the scope of ASC Topic 815 (see ASC paragraph 815-10-55-63). The derivative is considered to be freestanding because it was issued after the issuance of the underlying assets by a party other than the issuers of the assets.

B3.05 From the holder's perspective, a synthetic GIC wrapper contract also is a freestanding derivative (e.g., the holder has purchased a put option from the issuer of the synthetic GIC) within the scope of ASC Topic 815 unless the reporting entity is a defined benefit pension plan and the synthetic GIC contract meets the ASC paragraph 815-10-15-68 scope exception for certain contracts accounted for under ASC paragraphs 960-325-35-1 or 960-325-35-3. This scope exception applies only to a defined benefit pension plan that accounts for the contract under ASC Topic 960, Plan Accounting--Defined Benefit Pension Plans.

B3.06 Unless the scope exception in ASC paragraph 815-10-15-68 is met, the synthetic GIC wrapper contract would be marked to fair value with changes in value reflected in earnings currently. The fair value of the derivative contract must take into account all contractual terms of the synthetic GIC wrapper contract. The underlying assets would be accounted for separately by the policyholder under the applicable accounting literature for those investments (e.g., ASC Subtopic 320-10; ASC Topic 323, Investments--Equity Method and Joint Ventures; ASC Subtopic 962-325, or ASC Topic 944).

Traditional Variable Annuity

B3.07 Traditional variable annuity products are investment contracts as contemplated in Statements 60 and 97 (ASC Topic 944). An annuity contract is a contract that provides for fixed or variable periodic payments made from a stated or contingent date and continuing for a specified period. A variable annuity contract is an annuity in which the payment amounts are specified in units, rather than in dollars. When a payment is due, the amount of the unit is determined based on the value of the investments in an annuity fund.

B3.08 Similar to variable life insurance products, in a variable annuity contract, even though the insurance company owns the investments, policyholders direct the investment account asset mix among a variety of mutual funds that comprise equities, bonds, or both, and assume the risks and rewards on investment performance. The insurance company generally maintains the funds in separate accounts. A traditional variable annuity product generally includes the following attributes:

- The policyholder’s payments, after deducting specified sales and administrative charges, are used to purchase units of a separate investment account (a separate account);
- The policyholder directs the allocation of the account value among various investment options (typically various mutual funds) and the policyholder bears the investment risk (i.e., the account value is based entirely on the performance of the directed investments);
• The units may be surrendered for their current value in cash, although there often is a small surrender charge, or the units may be applied to purchase annuity income;
• The issuer guarantees mortality and maximum expense charges, and amounts are deducted periodically from the separate account to cover these charges; and
• If the contract is a deferred annuity contract, it may provide a death benefit during the accumulation period under which the policyholder may receive the greater of the sum of premiums paid or the value of total units to the credit of the account at time of the policyholder’s death.

**B3.09** A traditional variable annuity product is not within the scope of the Standard and contains no embedded derivatives that warrant separate accounting under the Standard, provided the following conditions are met: (See DIG Issue B7 for further reference.)

• The variable annuity contract is established, approved, and regulated under special rules applicable to variable annuities (such as state insurance laws, securities laws, and tax laws);
• The assets underlying the contract are insulated from the general account liabilities of the insurance company (the policyholder is not subject to insurer default risk to the extent of the assets held in the separate account);
• The policyholder’s premium is invested in contract-approved separate accounts at the policyholder’s direction;
• The insurer invests in the assets on which the account values are based;
• If applicable, the policyholder may redirect its investment among the contract-approved investment options;
• The account values are based entirely on the performance of those directed investments;
• All investment returns are passed through to the policyholder (including dividends, interest, and gains/losses);
• The policyholder may redeem its interests at any time; however, it may be subject to surrender charges; and
• If applicable, the policyholder has voting rights in certain separate account structures.

**B3.10** Although the liability to policyholders is not specifically required to be remeasured at fair value with changes reported in earnings under existing GAAP, it should be noted that current accounting practice for traditional variable annuity contracts is to record a liability that is generally equal to the total of the market value of the assets backing the variable investment options held in the separate account for the policyholders.

**Nontraditional Variable Annuity**

**B3.11** Enterprises have developed a wide range of variable annuity contracts with nontraditional features. Nontraditional features of traditional variable annuity contracts result in a sharing of investment risk between the issuer and the holder. Nontraditional variable annuity contracts
provide for a minimum guarantee of the account value at a specified date. This minimum may be guaranteed through a minimum accumulation benefit or a guaranteed account value floor. For example, the floor guarantee might be that, at a specified anniversary date, the contract holder would be credited with the greater of (1) the account value, as determined by the separate account assets, or (2) all deposits that are made, plus 3% interest compounded annually. While these nontraditional variable annuity contracts have distinguishing features, they possess a common characteristic — the issuer and the policyholder share the investment risk associated with the assets backing the contract. In contrast to traditional variable annuity contracts, the investment risk is, by virtue of the nontraditional product features, allocated between the two parties and not borne entirely by one of the parties (the holder in the case of a traditional variable annuity contract) to the contract. The sharing of risks makes nontraditional variable annuities hybrid instruments.

B3.12 The host contract in a nontraditional variable annuity contract would be considered a traditional variable annuity, as described above. Nontraditional features (such as a guaranteed investment return through a minimum accumulation benefit or a guaranteed account value floor) would need to be analyzed to determine whether they are embedded derivatives. (See DIG Issue B8 for further reference.) Specifically, features, such as a guaranteed investment return through a minimum accumulation benefit or a guaranteed account value floor, that are included in variable annuity contracts typically would not meet the *clearly and closely related* requirement in paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a)) and must be accounted for separately if they meet the other requirements in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14).

**Deferred Variable Annuity**

B3.13 An annuity contract for which payments have not yet commenced is referred to as a deferred annuity. Deferred annuities have two phases. The first phase is the deferred or accumulation phase, during which payments received by the insurance enterprise are accumulated and earn either a fixed or variable return. Much like a savings account, the cash surrender value may be withdrawn. The second phase is the payout phase, during which annuity payments are made to the annuitant under one of various options chosen by the policyholder at annuitization, including the following:

- Life-contingent payments (payable for life of the annuitant);
- Payments for a period-certain (e.g., a 10-year period-certain annuity for 10 years to the annuitant or the annuitant’s beneficiary or estate); or
- Period-certain-plus-life-contingent payments (e.g., a life-and-10-year-certain annuity pays the annuity benefit for the greater of the annuitant’s life or 10 years).

B3.14 At the end of the accumulation period, some deferred annuity contracts allow the policyholder to elect an immediate payout of the account value. A minimum guarantee offered in conjunction with a variable annuity that is provided prior to annuitization is discussed in Paragraph B3.12 of this appendix. The remainder of this section relates solely to the interaction of certain features within a deferred variable annuity contract and the Standard during the accumulation period. (See DIG Issue B25 for further reference.)
B3.15 At the end of the accumulation period, some deferred annuity contracts provide the policyholder with the option to annuitize at a guaranteed minimum annuity interest rate. That is, at the date of annuitization, the fixed periodic annuity payments would be determined using the current accumulated account value at the date of annuitization and the higher of the minimum guaranteed interest rate and currently offered annuity interest rates. During the accumulation phase of the deferred annuity contract, the guarantee of a minimum interest rate to be used in computing periodic annuity payments if and when a policyholder elects to annuitize does not require separate accounting under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) because the criterion in paragraph 12(c) of the Standard (ASC paragraph 815-15-25-1(c) and 25-14) is not met. That is, the embedded option does not meet the definition of a derivative instrument because it does not meet the net settlement criteria in paragraphs 6(c) (ASC paragraph 815-10-15-83(c)) and 9 of the Standard (ASC paragraphs 815-10-15-99 through 15-120) because settlement of the option can be achieved only by an investment of the account balance in a payout annuity contract in lieu of electing an immediate payout of the account value. In addition, if a provision existed whereby the policyholder could withdraw all or a portion of its account balance during the payout phase, an embedded derivative still would not exist during the accumulation period because the economic benefit of the guaranteed minimum interest rate would be obtainable only if an entity were to maintain the annuity contract through its specified maturity date.

B3.16 Some deferred variable annuities, in exchange for the issuer’s right to charge a fee, may provide a guaranteed minimum amount available to annuitize after a specified period in addition to a guaranteed minimum annuity interest rate. These benefits are often referred to as guaranteed minimum income benefits, or GMIBs. These payment alternatives have the effect of modifying the account value at the end of the accumulation period. The provision that guarantees a minimum account value that is available to annuitize if and when a policyholder elects to annuitize fails to meet the definition of a derivative during the accumulation phase because it cannot be net settled. The policyholder realizes the benefit of the minimum account value by annuitizing and receiving the economic benefit over the payout term. However, if the policyholder is able to withdraw all or a portion of the guaranteed account balance during the payout (annuitization) period, or the payout (annuitization) period is set to an unrealistically short period such as one year, this right is equivalent to net settlement, and the guarantee (or the portion of the guarantee that is withdrawable, if applicable) is an embedded derivative only during the accumulation period. Typically when an entity reinsures a GMIB benefit, the reinsurer pays the insurance company a lump sum amount when the policyholder elects the GMIB benefit (rather than paying a stream of payments over the life of the policyholder). As a result, the lump sum payment represents net settlement; consequently, when reinsured, the GMIB benefits meet the definition of a derivative.

B3.17 Instead of providing a guaranteed minimum account value at annuitization, some deferred annuities may provide for a variable-payout annuity option with a minimum guarantee on the periodic annuity payments made during the payout phase. That is, once the payout phase has begun, the periodic annuity payments may be variable (i.e., benefits will vary with investment performance of underlying funds, a formula, or an index such as the S&P 500 Index), but with a provision that each periodic payment will be at least equal to a specified minimum amount. An embedded derivative does not exist during the accumulation phase of such a deferred variable annuity contract as the policyholder cannot net settle the contract because the only way the
policyholder can obtain the benefit of the floor payment guarantee is over the life of the variable-payout annuity.

**Variable Annuity With Guaranteed Minimum Payments**

**B3.18** A variable annuity contract (including a deferred annuity during the payout phase) can contain a minimum guarantee on the periodic annuity payments. The term of the annuity payments may be period-certain, solely life-contingent, or period-certain-plus-life-contingent, and some entities offer annuities with partial withdrawal features during the payout phase. The accounting treatment for the contractual provision for guaranteed minimum periodic payments depends on the payout option in the variable-payout annuity contract.

**B3.19** For the period-certain variable-payout annuity, the guaranteed minimum periodic payment is, during the payout phase, an embedded derivative that is required to be separated under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14). This conclusion is based on the assessment that the guaranteed payment floor is not considered clearly and closely related to the host contract — a traditional variable-payout annuity contract. However, a solely life-contingent variable-payout annuity contract with features described above that meets the definition of an insurance contract under paragraph 8 of Statement 97 (ASC paragraphs 944-20-15-18 and 15-19) would not be subject to the requirements of the Standard provided there are no withdrawal features. For a period-certain-plus-life-contingent variable-payout annuity contract, the embedded derivative related only to the period-certain guaranteed minimum periodic payments would be required to be separated under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) whereas the embedded derivative related to the life-contingent guaranteed minimum periodic payments would not be separated under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14). Separate accounting for the embedded derivative related only to the period-certain guaranteed minimum periodic payments would be required even if the period-certain-plus-life-contingent annuity, in its entirety, meets the definition of an insurance contract under paragraph 8 of Statement 97 (ASC paragraphs 944-20-15-18 and 15-19) and has no withdrawal features. (See DIG Issue B25 for further reference.) The separate accounting for the embedded derivative is required even though, as discussed in Paragraph 12.06 of this chapter, the Standard generally does not intend for a contract both to meet the definition of a derivative in its entirety but be excluded in paragraphs 10 and 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82), and be considered a hybrid instrument that contains an embedded derivative that requires separate accounting.

**Market Value Annuity**

**B3.20** A market value annuity (MVA) accounted for as an investment contract under Statement 97 (ASC Topic 944) provides for a return of principal plus a fixed rate of return if held to maturity, or alternatively, a market adjusted value if the surrender option is exercised by the contract holder before maturity. The market-adjusted value typically is based on current interest crediting rates being offered for new MVA purchases. As an example of how the market adjusted value is calculated at any period end, the formula typically takes the contractual guaranteed amount payable at the end of the specified term, including the applicable guaranteed interest, and discounts the future cash flow to its present value using rates currently being offered for new
MVA purchases with terms equal to the remaining term to maturity of the existing MVA. As a result, the market value adjustment may be positive or negative, depending on market interest rates at each period end. In a rising interest rate environment, the market adjustment may be such that less than substantially all principal is recovered on surrender.

**B3.21** An MVA is essentially a debt host contract with an embedded put option. The embedded put option allows the holder to redeem the contract for its fair value on the redemption date. Because the embedded put option has interest rates as its underlying and the host contract is a debt instrument, the embedded put option is considered clearly and closely related to the debt host contract, unless it contains a leverage feature as discussed in paragraph 13 and 61(a) of the Standard (ASC paragraphs 815-15-25-26 through 25-29). Paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) indicates that an embedded derivative would not be considered clearly and closely related to the host contract if “the hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover substantially all of its initial recorded investment.” Although, in a rising interest rate environment, the investor has the potential to lose a substantial portion of principal if the option is exercised, paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a)) applies only if the investor (holder) does not have a choice of selecting settlement. As the embedded put option is exercisable by the holder, it is considered clearly and closely related to the debt host contract (assuming all other criteria in paragraphs 13 and 61(a) of the Standard (ASC paragraphs 815-15-25-26 through 25-29) are met). (See DIG Issues B5 and B9 for further reference.)

**Equity-Indexed Life Insurance**

**B3.22** Equity-indexed life insurance contracts combine term life insurance coverage with an investment feature, similar to universal life contracts. Death benefit amounts are based on the amount selected by the policyholder plus the account value. Charges for the cost of insurance and administrative costs are assessed periodically against the account. The policyholder’s account value, maintained in the insurance company’s general account (not a separate account) is based on the cumulative deposits credited with positive returns based on the S&P 500 Index or some other equity index. An essential component of the contract is that the cash surrender value is also linked to the index. Accordingly, the policy’s cash surrender value also is linked to an equity index. The death benefit amount also may depend on the cumulative return on the index.

**B3.23** Equity-indexed life insurance contracts are accounted for as universal life (UL) insurance contracts under Statement 97 (ASC Topic 944). For those contracts, the customer’s account value (the investment component of a UL contract) is credited with a return indexed to an equity index (e.g., the S&P 500 Index) rather than an interest rate established by the insurer, as is done with typical UL contracts.

**B3.24** If the contract holder is entitled to the change in value of the index only if he or she dies, which is an insurable event as described in paragraph 10(c) of the Standard (ASC paragraphs 815-10-15-52 through 15-54), the embedded derivative should not be separated from the host contract. However if the contract holder can access the equity linked surrender value by cashing out, without dying, the requirements in paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) need to be considered to determine whether the embedded derivative should be separated. In essence, because the host universal life insurance contract is a
debt host, the equity-indexed option is not considered clearly and closely related to the host debt instrument. (See DIG Issue B10 for further reference.)

**Equity-Indexed Annuity**

**B3.25** An equity-indexed annuity (EIA) contract is a deferred fixed annuity contract with a guaranteed minimum interest rate plus a contingent return based on some internal or external equity index, such as the S&P 500 Index. The guaranteed contract value generally is designed to meet certain regulatory requirements so that the contract holder receives no less than 90% of the initial deposit, compounded annually at 3%, which establishes a floor value for the contract. EIAs typically have minimal mortality risk and, therefore, are classified as investment contracts under Statement 97 (ASC Topic 944). EIAs often do not have specified maturity dates; therefore, the contracts remain in the deferral (accumulation) phase until the customer either surrenders the contract or elects annuitization. Customers typically can surrender the contract at any time, at which time they receive their account value, as specified in the contract, less any applicable surrender charges. The account value is defined in the policy as generally the greater of the policyholder’s initial investment plus the equity-indexed return or a guaranteed floor amount (calculated as the policyholder’s initial investment plus a specified annual percentage return).

**B3.26** There are two basic designs for EIA products:

- **The periodic ratchet design.** In the annual version, the customer receives the greater of the appreciation in the equity index during a series of one-year periods (ending on each policy anniversary date) or the guaranteed minimum fixed rate of return over that period.

- **The point-to-point design.** The customer receives the greater of the appreciation in the equity index during a specified period (e.g., five or seven years, starting on the policy issue date), or the guaranteed minimum fixed rate of return over that period.

**B3.27** For many products of either design, the contract holder receives only a portion of the appreciation in the S&P 500 Index (or other index, as applicable) during the specified period (a participation rate) and/or has an upper limit on the amount of appreciation that will be credited during any period (a cap rate). For the annual ratchet design, the prospective participation and cap rates for each one-year period often are at the discretion of the issuer, and may be reset on future policy anniversary dates, subject to contractual guarantees. Flexibility on the part of the issuer to establish new cap and participation rates, coupled with uncertainty around the customer’s account value (which establishes the notional amount of the option) and strike price (which is determined by the level of the index on subsequent anniversary dates) make several of the terms of the forward-starting options unknown at the annuity contract’s inception. However, those flexible terms can be viewed as a bundle of options.

**B3.28** Holders of equity-indexed annuity products traditionally have recognized those contracts on their balance sheets as structured notes in accordance with EITF 96-12 (ASC paragraphs 320-10-35-38 through 35-43 and 320-10-55-10 through 55-19) and recognized the interest credited to the contracts as interest income. Under EITF 96-12 (ASC paragraphs 320-10-35-38 through 35-43 and 320-10-55-10 through 55-19), a structured note is carried on the balance sheet in a manner similar to a Statement 115 (ASC Subtopic 320) debt security, that is, it would be classified as either an available-for-sale security and carried at fair value with changes in fair value recognized in earnings.
value recorded in other comprehensive income or a held-to-maturity security carried at amortized cost. Because the contracts are not carried at fair value with changes in fair value recorded currently in earnings, the paragraph 12(b) (ASC paragraph 815-15-25-1(b)) separation exception in the Standard for such contracts is not met. Furthermore, the embedded equity-indexed return portion of the annuity contract is not considered clearly and closely related to the annuity host contract and meets the definition of a derivative. As a result, the embedded derivative portion of the contract (the equity-indexed return) is required to be separated from the host contract and accounted for as a derivative under the Standard (unless fair value measurement of the entire hybrid instrument, with changes in fair value recognized in earnings, is elected under Statement 155). Even though these equity-indexed annuity products are in the accumulation phase until the customer either surrenders the contract or elects annuitization, the embedded equity-indexed return feature meets the net settlement criteria. This is because the customer can obtain the account value, which includes the equity-indexed return, at any point in time (annuitization is not required to obtain the equity-indexed return).

B3.29 From the insurer’s perspective, both the option component of an EIA product that specifies a point-to-point design and the option component of an EIA product that specified a periodic ratchet design meet the definition of a derivative and require separate accounting under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14). The option component in the periodic ratchet design results in a series of forward starting options on an equity index over the duration of the contract and must be accounted for as one compound derivative. Valuing that derivative will be difficult because the issuer retains the ability to establish new caps and participation rates. In addition, the uncertainty of the account value (notional amount) and strike price makes the terms of the forward-starting options unknown before the option’s start date. Therefore, the key issue with respect to the periodic ratchet design feature is the proper valuation of the series of forward starting options. The valuation of the options requires management to use a significant amount of judgment in estimating the future equity index to which the equity-indexed return feature relates. Also, the derivative should be valued based on expected future terms (i.e., index values and cap and participation rates); however, the value should not be less than the minimum amount specified in the contract. In subsequent periods when the terms of the forward-starting options become known, the actual terms should be substituted for the expected terms for purposes of valuation. (See DIG Issue B29 for further reference.)

B3.30 When separating the option component of an EIA product, the issuer would determine that the hybrid instrument comprises a fixed annuity host and an embedded written equity option. As stated above, the embedded equity option should be accounted for under the provisions of the Standard. The fixed annuity component should be accounted for under the provisions of Statement 97 (ASC Topic 944) that require debt instrument accounting.

B3.31 On receipt of consideration for an EIA, unless fair value measurement of the entire hybrid instrument is elected under Statement 155, the issuing company should allocate a portion of the consideration to the embedded written option using the *with and without* method (i.e., the fair value of the option is assigned to the embedded derivative). The remainder of the consideration should be assigned to the fixed annuity host contract. Both credited interest and changes in the fair value of the embedded equity option would be recognized in earnings. For example, the host contract would be accreted annually to the minimum account value at the end of the contract.
using an effective yield method. As a result, a separate calculation of a Statement 97 (ASC Topic 944) account value of the aggregate contract no longer is required because the derivative is carried at fair value in accordance with the Standard and the host contract is recorded following the GAAP accounting guidance for a Statement 97 investment contract. Therefore, the insurer should ignore any minimum liability that exceeds the sum of the embedded derivative separately accounted for and the host debt instrument that is accounted for by applying the debt model. (See DIG Issue B30 for further reference.)

**Foreign Currency Elements of Insurance Contracts**

**B3.32** Insurance contracts that provide coverage for various types of property and casualty exposure commonly are executed between U.S.-based insurance companies and multinational corporations that have operations outside the U.S. The contracts may be structured to provide for payment of claims in the functional currency of the insurer or in the functional currency of the entity experiencing the loss, and the contract will typically specify the exchange rate to be used in calculating loss payments. Because the insurance company does not record a claim liability until losses are incurred in accordance with Statement 60 (ASC Topic 944), no foreign-currency-denominated liability exists (that would otherwise be subject to Statement 52 (ASC Topic 830), as contemplated by paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6 and 15-10)) during the period between the inception of the insurance contract and the loss occurrence date. Therefore, the insurance contract must be assessed to determine whether it contains an embedded foreign currency derivative under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14).

**B3.33** The scope exception in paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6 and 15-10) may be applied during the period between the inception of the contract and the loss occurrence date, by analogy, to an insurance contract in which losses are denominated in either (a) the functional currency of one of the parties to that contract or (b) the local currency of the country in which the loss is incurred. (See DIG Issue B28 for further reference.)

**Modified Coinsurance and Similar Arrangements**

**B3.34** It is not uncommon for reinsurance arrangements to be conducted on a funds-withheld basis. Examples would include modified coinsurance and similar arrangements. Under funds-withheld arrangements, all or a portion of the reinsurance premiums are maintained by the ceding company, invested and used to pay reinsurance losses. Generally, because the reinsurer is foregoing the opportunity to invest the premium, the ceding company pays the reinsurer a yield on the funds withheld. The yield is usually based on a specified portion of the ceding company’s return on either its general account assets or a specified block of those assets (such as a specific portfolio of its investment securities).

**B3.35** When the ceding company and the reinsurer enter into these arrangements, the reinsurer recognizes a funds-withheld receivable from the ceding insurer as well as a liability representing reserves for the insurance coverage assumed under the arrangement. In essence, the amount of the reinsurer’s receivable (and the ceding company’s payable) is the ceding company’s statutory reserve, whereas the amount of the reinsurer’s liability (and the ceding company’s receivable) is the reserve under generally accepted accounting principles.
B3.36 The ceding company’s funds-withheld payable and the reinsurer’s funds-withheld receivable include an embedded derivative feature that is not considered clearly and closely related to the host contract. The yield on the payable and receivable in the host contract is based on a specified proportion of the ceding company’s return on either its general account assets or a specified block of those assets (such as a specific portfolio of the ceding company’s investment securities). The risk exposure of the ceding company’s return on its general account assets or its securities portfolio is not considered clearly and closely related to the risk exposure arising from the overall creditworthiness of the ceding company, which also is affected by other factors.

B3.37 Consequently, the economic characteristics and risks of the embedded derivative feature are not considered clearly and closely related to the economic characteristics and risks of the host contract and, accordingly, the criterion in paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a)) is met. This analysis applies whether the host contract is determined to be a debt host or an insurance contract. The embedded derivative feature generally will require bifurcation. However, the criteria in paragraphs 12(b) and 12(c) of the Standard (ASC paragraphs 815-15-25-1(b), 25-1(c) and 25-14) must be considered before concluding that the embedded derivative feature should be bifurcated and accounted for separately. The nature of the embedded derivative feature and the host contract should be determined based on the facts and circumstances of the individual contract. (See DIG Issue B36 for further reference.)

Other Insurance Contracts

B3.38 In addition to the insurance contracts discussed in this appendix, readers also should refer to Paragraphs 10c.09 - 10c.10, 10d.16, and 10g.01 - 10g.04 of Chapter 2 to review the effect that the Standard has on the accounting for dual-trigger property and casualty insurance contracts, dual-trigger financial guarantee contracts, and purchases of certain life insurance contracts, respectively.

QUESTIONS & ANSWERS


1. KAG purchases a bond at fair value with a coupon rate that is based on LIBOR. If LIBOR stays within a pre-established range of 4 to 7%, the bond pays LIBOR plus 2%. If LIBOR moves outside that range, the bond pays zero percent for each day that LIBOR is outside the range. This instrument commonly is referred to as a range floater.

Q. Does the instrument in this example contain an embedded derivative component that is required to be accounted for separately from the host under the Standard?

A. No. The hybrid instrument in this example may be viewed as containing two embedded derivatives (written conditional exchange option contracts with notional amounts equal to the par value of the floating-rate instrument). Paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) identifies the conditions that must be present for an embedded derivative instrument to be separated from the host contract and accounted for as a derivative instrument. Specifically, the embedded derivative component (1) must not be
clearly and closely related to the host contract (paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a))), (2) the hybrid instrument must not be measured at fair value through earnings (paragraph 12(b) of the Standard (ASC paragraph 815-15-25-1(b))), and (3) a separate instrument with the same terms as the embedded derivative component must meet the definition of a derivative instrument in paragraph 6 of the Standard (ASC paragraph 815-10-15-83) (paragraph 12(c) of the Standard (ASC paragraphs 815-15-25-1(c) and 25-14)) and must not be explicitly excluded from the scope by paragraphs 10 or 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82).

Because the embedded derivatives in this example have an underlying that is an interest rate index (LIBOR) that alters net interest payments that otherwise would be paid by the debtor or received by the investor on an interest-bearing host contract, the embedded derivatives are considered to be clearly and closely related to the host contract unless either of the conditions in paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) exist. In this example, the embedded derivatives could not potentially result in the investor’s failing to recover substantially all of its initial recorded investment in the debt instrument (refer to paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a))). Additionally, in this example there appears to be no possibility of increasing the investor’s rate of return on the host contract to an amount that is at least double the initial rate of return on the host contract (refer to paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b))). Accordingly, the embedded derivatives are considered to be clearly and closely related to the host contract and should not be separated from the debt host contract.

However, if the terms of the instrument in this example were different such that either of the two conditions in paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) could have the potential to occur at any time during the life of the instrument or contract, the embedded derivative component would not be deemed to be clearly and closely related to the host contract and, thus, would be accounted for separately from the host contract if the bond is not measured at fair value through earnings (unless fair value measurement of the entire hybrid instrument, with changes in fair value recognized in earnings, is elected under Statement 155), if the embedded component meets the definition of a derivative instrument in paragraph 6 of the Standard (ASC paragraph 815-10-15-83), and if it is not explicitly excluded from the scope by paragraphs 10 or 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82).

2. JRE Co. purchases a debt instrument at par with a coupon rate equal to the average three-month LIBOR rate plus 50 basis points. Over the term of the instrument, the calculated coupon rate may not exceed 7.25%(interest cap). Furthermore, the coupon rate for each period could not fall below the effective coupon rate for the previous period plus 25 basis points (interest floor). The instrument commonly is referred to as a ratchet floater.

Q. Does the instrument in this example contain an embedded derivative component that is required to be accounted for separately from the host contract under the Standard?

A. No. A ratchet floater is a bond that pays a floating rate of interest and has an adjustable cap and floor that move with each new reset rate. The instrument is viewed as having embedded purchased and written options that create changing caps and floors and, thus, contains an embedded derivative component. Paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) identifies the conditions that must be present for an embedded
derivative instrument to be separated from the host contract and accounted for as a derivative instrument. Specifically, the embedded derivative component (1) must not be clearly and closely related to the host contract (paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a))), (2) the hybrid instrument must not be measured at fair value through earnings (paragraph 12(b) of the Standard (ASC paragraph 815-15-25-1(b))), and (3) a separate instrument with the same terms as the embedded derivative component must meet the definition of a derivative instrument in paragraph 6 of the Standard (ASC paragraph 815-10-15-83) (paragraph 12(c) of the Standard (ASC paragraphs 815-15-25-1(c) and 25-14)) and must not be explicitly excluded from the scope by paragraphs 10 or 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82).

Because the embedded derivatives in this example have an underlying that is an interest rate index (LIBOR) that alters net interest payments that otherwise would be paid by the debtor or received by the investor on an interest-bearing host contract, the embedded derivatives are considered to be clearly and closely related to the host contract unless either of the conditions in paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) exist. In this example, the embedded derivatives could not potentially result in the investor’s failing to recover substantially all of its initial recorded investment in the debt instrument (refer to paragraph 13(a) of the Standard (ASC paragraph 815-15-25-26(a))). Additionally, in this example there appears to be no possibility of increasing the investor’s rate of return on the host contract to an amount that is at least double the initial rate of return on the host contract (refer to paragraph 13(b) of the Standard (ASC paragraph 815-15-25-26(b))). Accordingly, the embedded derivatives are considered to be clearly and closely related to the host contract and should not be separated from the debt host contract.

However, if the terms of the instrument in this example were different such that either of the two conditions in paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) could have the potential to occur at any time during the life of the instrument or contract, the embedded derivative component would not be deemed to be clearly and closely related to the host contract and, thus, would be accounted for separately from the host contract if the bond is not measured at fair value through earnings (unless fair value measurement of the entire hybrid instrument, with changes in fair value recognized in earnings, is elected under Statement 155), if the embedded component meets the definition of a derivative instrument in paragraph 6 of the Standard (ASC paragraph 815-10-15-83), and if it is not explicitly excluded from the scope by paragraphs 10 or 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82).

3. ABC Corp. purchases a bond in which the coupon rate is zero and the principal varies based on the London Gold Index. This instrument commonly is referred to as a leveraged gold note. The instrument is not itself a derivative because it requires an initial net investment equal to the notional amount.

Q. Does this instrument contain an embedded derivative component that is required to be accounted for separately from the host contract under the Standard?

A. Yes. A leveraged gold note combines an interest-bearing instrument with an embedded derivative that has the London Gold Index as its underlying. Based on the information provided in this example, we believe a reasonable approach would be to view the embedded component as a total return swap in which ABC receives a fixed or floating rate of interest.
based on the notional amount and pays or receives the return on the London Gold Index. The debt host would contain an implied interest rate equal to that of the receive leg of the equity swap. The embedded derivative components (the option contracts) are indexed to the price of gold, which we believe is not clearly and closely related to an investment in a fixed-interest-rate note. Thus, the embedded derivative component would be accounted for separately from the host contract under paragraph 12(a) of the Standard (ASC paragraphs 815-15-25-1(a)).

The embedded derivative component has an underlying (price of gold), a notional amount (principal amount of note), requires little or no initial investment at inception of the contract, and settles net in cash; therefore, we believe that a separate instrument with the same terms as the embedded derivative component meets the definition of a derivative instrument in paragraph 6 of the Standard (ASC paragraph 815-10-15-83) and is not explicitly excluded from the scope by paragraphs 10 or 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82). Thus, the embedded derivative component should be accounted for separately from the host contract under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) if the bond is not measured at fair value through earnings pursuant to a fair value measurement election or guidance in other applicable GAAP.

4. DEF purchases a bond with a fixed 4% coupon rate and guaranteed principal with upside potential if the S&P Index falls to a specified level. This instrument commonly is referred to as an equity-linked bear note.

Q. Does this instrument contain an embedded derivative component that is required to be accounted for separately from the host contract under the Standard?

A. Yes. An equity-linked bear note can be viewed as combining an interest-bearing instrument with a series of embedded option contracts. A portion of the coupon interest rate is used to purchase put options that provide the investor with potential gains resulting from declines in the S&P 500 Index. Because the option contracts are indexed to the S&P 500 Index and, therefore, the underlying is an equity index, we believe the embedded derivative component is not clearly and closely related to an investment that is typically interest-bearing. Thus, the embedded derivative component would be accounted for separately from the host contract under paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a)).

The embedded derivative component has an underlying (S&P 500 Index), a notional amount (principal of bond), requires little or no initial investment at inception of the contract, and settles net in cash; therefore, we believe that a separate instrument with the same terms as the embedded derivative component meets the definition of a derivative instrument under paragraph 6 of the Standard (ASC paragraph 815-10-15-83) and is not explicitly excluded from the scope by paragraphs 10 or 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82). Thus, the embedded derivative component should be accounted for separately from the host contract under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) if the bond is not measured at fair value through earnings pursuant to a fair value measurement election or guidance in other applicable GAAP.

5. Company A originates a loan at an above-market interest rate to Company X. The functional currency of both Company A and Company X is the U.S. dollar. The loan is denominated in
U.S. dollars, but the borrower has the option to repay the loan in U.S. dollars or in a fixed amount of a specified foreign currency.

Q. Does this instrument contain an embedded derivative component that is required to be accounted for separately from the host contract under the Standard?

A. Yes. This instrument can be viewed as a loan at prevailing market interest rates with an embedded foreign currency option. The lender has written a foreign currency option that exposes it to changes in foreign currency exchange rates while the loan is outstanding. The premium for the option was paid as part of the interest rate. We believe a foreign currency option is not clearly and closely related to issuing a loan, an interest-bearing instrument. Also, paragraph 15 of the Standard (ASC paragraphs 815-15-15-5, 15-6, and 15-10) addresses foreign-currency-denominated interest or principal payments but does not apply to foreign currency options. Thus, the embedded derivative component would be accounted for separately from the host contract under paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a)).

The embedded derivative component has an underlying (foreign currency spot rate), a notional amount (principal of loan), requires little or no initial investment at inception of the contract, and settles net in cash or in a foreign currency for which a market mechanism exists to permit net settlement or is readily convertible to cash; therefore, we believe that a separate instrument with the same terms as the embedded derivative component meets the definition of a derivative instrument in paragraph 6 of the Standard (ASC paragraph 815-10-15-83) and is not explicitly excluded from the scope by paragraphs 10 or 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82). Thus, the embedded derivative component would be accounted for separately from the host contract under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) if the loan is not measured at fair value through earnings pursuant to a fair value measurement election or guidance in other applicable GAAP.

6. Company A owns 100,000 shares of Company B’s common stock and it accounts for those shares as available-for-sale securities under Statement 115 (ASC Subtopic 320-10). To lock in some of the gains associated with these shares, Company A issues a debt obligation with a fixed interest coupon of 6% whose return of principal is indexed to the market value of these 100,000 shares of Company B. This instrument commonly is referred to as a specific equity-linked bond.

Q. Does this instrument contain an embedded derivative component that is required to be accounted for separately from the host contract under the Standard?

A. Yes. This equity-indexed debt obligation combines an interest-bearing debt instrument with a forward contract indexed to Company B’s share price. We believe that a forward contract for which the underlying is an equity index is not clearly and closely related to an investment that is typically interest-bearing. Thus, this embedded derivative component would be accounted for separately from the host contract under paragraph 12(a) of the Standard (ASC paragraph 815-15-25-1(a)).
The embedded derivative component has an underlying (price of Company B stock), a notional amount (100,000 shares of Company B stock), requires no initial investment at inception of the contract, and settles net in cash; therefore, we believe that a separate instrument with the same terms as the embedded derivative component meets the definition of a derivative instrument in paragraph 6 of the Standard (ASC paragraph 815-10-15-83) and is not explicitly excluded from the scope by paragraph 10 or 11 of the Standard (ASC paragraphs 815-10-15-13 through 15-82). Thus, the embedded derivative component would be accounted for separately from the host contract under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) if the debt instrument is not measured at fair value through earnings pursuant to a fair value measurement election or guidance in other applicable GAAP.

7. On January 1, 20X0, ABC Corp. enters into a five-year, fixed-rate interest rate swap with a notional amount of $100 million. If the yield on five-year Treasuries falls below 6% on March 1, 20X1, the notional amount of the swap declines to $50 million for the duration of the swap. This swap commonly is referred to as an index-amortizing swap.

Q. Does this instrument contain an embedded derivative component that is required to be accounted for separately from the host contact under the Standard?

A. No. An index-amortizing swap is a written option embedded within a swap contract. The notional principal balance may be amortized based on certain conditions. While paragraph 12 of the Standard (ASC paragraphs 815-15-25-1 and 25-14) sets forth the conditions that need to be present for an embedded derivative instrument to be separated from the host contract and accounted for as a derivative instrument under the Standard, those provisions apply only if a derivative instrument is embedded in a nonderivative instrument. If a derivative instrument is embedded in another derivative instrument, the Standard prohibits separating the instruments to applying hedge accounting. Specifically, to qualify for hedge accounting the entire derivative instrument would have to be designated as the hedging instrument. For example, this compound derivative could not be separated into two derivatives one of which qualifies for hedge accounting while the other does not.

8. On January 1, 20X0 ABC issues a debt instrument at a discount (e.g., 99% of par) with a maturity date of December 31, 20X5 and a stated interest rate of 6%. The terms of the instrument provide that the instrument is puttable at par if there is a change in control before the maturity of the instrument.

Q. Does this debt instrument contain an embedded derivative component that is required to be accounted for separately from the host contract under the Standard?

A. No. In general, a provision in a debt instrument that gives the holder the right to accelerate the redemption date of the debt’s principal amount if a change in control occurs is an embedded contingent put option that may be required to be bifurcated from the host contract if it is not considered clearly and closely related to the host contract. Because the embedded derivative component is a put option on a debt instrument, the analysis of whether the option is clearly and closely related to the debt host must initially follow the guidance in paragraph
Paragraph 61(d) of the Standard (ASC paragraphs 815-15-25-40 and 25-41), as interpreted by DIG Issue B16. In this example, the amount paid upon settlement is par, so the payoff amount is not adjusted based on changes in an index. Additionally, the debt does not involve a substantial premium or discount (the debt was issued at a 1% discount from par and is puttable at par). As such, application of the guidance in paragraph 61(d) (ASC paragraphs 815-15-25-40 and 25-41) and DIG Issue B16 does not result in a conclusion that the put option is not clearly and closely related to the debt host and the decision sequence in DIG Issue B16 specifies that further analysis of the contract under paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) is required. However, paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) provides guidance on applying the provisions of paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 815-15-25-1 and 25-14) to an embedded derivative instrument in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract. This embedded contingent put option contains multiple underlyings (interest rates and the occurrence or nonoccurrence of a change in control), so the guidance in paragraph 13 of the Standard (ASC paragraphs 815-15-25-26 through 25-29) does not apply. As a result, the embedded contingent put option is clearly and closely related to the debt host contract.
Section Four: Recognition and Measurement (updated March 2012)

INTRODUCTION

This chapter discusses the framework for recognizing and measuring derivative instruments pursuant to paragraphs 17 and 18 of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended (Statement 133 or Standard) (ASC paragraphs 815-10-25-1, 815-10-30-1, 815-10-35-2, 815-20-25-45, and 815-20-35-1). It also discusses the guidance for determining the fair value of a derivative instrument in FASB Statement No. 157, Fair Value Measurements (Statement 157) (ASC Section 820-10-20). Although the hedged item in a fair value hedge may not be carried at fair value, the measurement of changes in the fair value of the hedged item attributable to the hedged risk should follow the principles of Statement 157 (ASC Subtopic 820-10).

RECOGNITION AND MEASUREMENT

17.01 Paragraph 17 of the Standard (ASC paragraphs 815-10-25-1 and 815-10-30-1) requires derivative instruments to be measured at fair value:

17. An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights or obligations under the contracts. All derivative instruments shall be measured at fair value.

Derivatives Implementation Group (DIG) Issues B13, B27, B29, B30, and F6 relate to this paragraph. See DIG Issues Index.

Derivative Instruments Should Be Reported as Assets or Liabilities at Fair Value

17.02 The Standard requires that all derivative instruments be recorded in the statement of financial position as assets or liabilities and measured at fair value, consistent with the first two cornerstones (see Paragraphs 3a.01-3d.04 of Section 1 for a discussion of the four cornerstones of accounting for derivative instruments and hedging activities). In determining the fair value of a derivative instrument, an entity should refer to the definition of fair value set forth in paragraph 5 of Statement 157 (ASC Section 820-10-20).

17.03 Statement 157 (ASC Subtopic 820-10) eliminated the reference to Statement 107 (ASC Subtopic 825-10) in paragraph 17 of the Standard (ASC paragraph 815-10-25-1) and the definition of fair value in Appendix F of the Standard (ASC paragraph 815-10-30-1). As the

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1 An alternative to fair value measurement for certain interest rate swaps is provided under the simplified hedge accounting approach. The simplified hedge accounting approach was introduced by the Private Company Council under ASU 2014-03 and provides a practical expedient for certain private companies to apply hedge accounting. Under the simplified hedge accounting approach, a receive-variable, pay-fixed interest rate swap may be measured at settlement value instead of fair value. The simplified hedge accounting approach and the conditions that need to be met in order to qualify for the approach are discussed beginning at paragraph A6.70a of Section 6.

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guidance in Statement 157 (ASC Subtopic 820-10) applies to accounting pronouncements that require or permit fair value measurements, the definition of fair value to be used in Statement 133 (as revised by Statement 157 (ASC Subtopic 820-10)) is as follows:

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

17.03a Statement 157 (ASC Subtopic 820-10), among other things, defines fair value and establishes a framework for measuring fair value. Fair value under Statement 157 (ASC Subtopic 820-10) is premised on the concept of the exit price. Given this, an entity’s measurement of fair value of a derivative asset should be based on the price that would be received to sell the asset in an orderly transaction with a market participant (in this instance, market participant does not include either of the two parties subject to the derivative agreement). Similarly, an entity's measurement of fair value for a derivative liability should be based on the price that would be paid to transfer the liability in an orderly transaction between market participants (again, not including either of the two parties subject to the derivative agreement). For derivative instruments that are exchange traded, the price to be used for fair value measurement purposes would be the exchange price for the derivative instrument on the date of measurement. For non-exchange traded derivative instruments (e.g., over-the-counter derivatives), the price to be received from, or paid to, a market participant would include adjustments necessary to consider timing of cash flows, market valuation adjustments for the liquidity or illiquidity of the derivative instrument, credit valuation adjustments (CVAs) related to the counterparty’s credit risk and the entity’s own risk of non-performance (which includes credit risk), and other adjustments necessary to measure the fair value of the derivative instrument at a value that other market participants (i.e., parties other than the two parties subject to the derivative agreement) would pay or receive. For non-exchange traded derivative instruments, the impact of the counterparty’s credit risk and the entity’s own risk of nonperformance on the fair value of the derivative instrument may be affected by the existence of a master netting agreement that applies to the individual derivative instrument under analysis (refer to subsection titled "Determination of Fair Value of Derivative Instruments that are Subject to a Master Netting Agreement").

17.03a1 In May 2011, the Financial Accounting Standards Board (FASB or Board) issued ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (ASU 2011-04 or the ASU) to achieve a converged definition of fair value and substantially converged fair value measurement and disclosure guidance between U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards. ASU 2011-04 amends Statement 157 (ASC subtopic 820-10) and applies to all entities that measure assets, liabilities, or instruments classified in shareholders’ equity at fair value or provide fair value disclosures. While many of the amendments to U.S. GAAP are not expected to significantly affect current practice regarding the recognition and measurement of derivative instruments, the ASU clarifies how a principal market is determined, addresses the fair value measurement of instruments with offsetting market or counterparty credit risks and the concept of highest and best use, extends the prohibition on blockage factors to all three fair value hierarchy levels, and requires additional disclosures (refer to Section 9 for discussion of disclosures). The ASU has an effective date for interim and annual periods beginning after December 15, 2011 for public entities and annual periods beginning after December 15, 2011 for nonpublic entities. Nonpublic entities may early-adopt the ASU for any
interim period beginning after December 15, 2011. Entities will recognize the effect of applying ASU 2011-04 in the period of adoption in net income as a change in estimate.

17.03b For purposes of determining the fair value of an instrument, Statement 157 (ASC Subtopic 820-10) states that it may be appropriate in certain circumstances to aggregate multiple units of account, to form a unit of measurement, such as when a market participant would determine that highest and best use of an instrument is deemed to be in combination with other instruments. Although ASU 2011-04 eliminates the concept of highest and best use for financial instruments, it does provide alternative guidance for fair value measurement on a portfolio basis (see Paragraph 17.07c1 for related amendments made by the ASU). While it may be appropriate to aggregate units of account for purposes of measuring fair value, it is important to note that such aggregation does not change the unit of account for application of other accounting literature, including Statement 133, which may cause there to be a difference between the unit of measurement (e.g., group of derivative instruments) and unit of account (e.g., individual derivative instrument). For example, this issue may impact certain hedging relationships where the hedging instrument is subject to a master netting agreement.

17.03c In addition to providing expanded guidance on measuring fair value, Statement 157 (ASC Section 820-10-50) requires certain disclosures related to instruments measured at fair value. Statement 157 (ASC Subtopic 820-10) and ASU 2011-04 are only discussed in this section to the extent they are relevant to the recognition and measurement of derivative instruments. Other KPMG publications provide detailed guidance on fair value measurements under Statement 157 (ASC Subtopic 820-10) and the ASU. This section discusses the impact on recognition and measurement of derivative instruments from Statement 157 (ASC Subtopic 820-10) with and without the effect of ASU 2011-04.

17.04 The definition of fair value provided by Statement 157 (ASC Subtopic 820-10) impacts the valuation of derivative instruments under the Standard. The following issues were raised within the context of Statement 157 (ASC Subtopic 820-10) and are relevant to measuring derivative instruments at fair value in accordance with the Standard:

- Consideration of a discount or premium in the valuation of a large position (blockage factor);
- Consideration of changes in creditworthiness;
  - Impact of counterparty credit risk and an entity’s own nonperformance risk in the determination of fair value of derivative instruments
  - Determination of fair value of derivative instruments that are subject to a master netting agreement
- Other considerations related to determining the fair value of derivative instruments;
  - Transaction costs
  - Settlement value
  - Consideration of core deposit intangibles in valuing deposit liabilities; and
  - When it is not practicable to estimate fair value.
17.05 Other fair value related issues were addressed by the FASB during its deliberations of the Standard and Statement 157 (ASC Subtopic 820-10), or have arisen subsequent to the issuance of these Standards. These issues include:

- Estimating the fair value of written loan commitments that relate to the origination of mortgage loans that will be held for sale and written loan commitments that are carried at fair value through earnings under FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (Statement 159) (ASC Subtopic 820-10);
- Estimating the fair value of derivative instruments in the absence of quoted marked prices and other observable data at the inception of the derivative instrument; and
- Impact of principal market determination on hedging relationships.

**BLOCKAGE FACTOR**

17.06 Paragraph 27 of Statement 157 (ASC paragraph 820-10-35-44) precludes an entity from using a blockage factor (i.e., a premium or discount based on the relative size of the position held, such as a large proportion of total available trading units of an instrument) in determining the fair value of a single financial instrument or block position where the instrument is traded in an active market (valuation is classified as Level 1). For derivative instruments that are traded in an active market, the definition of fair value requires that fair value be determined as the product of the number of trading units times a quoted market price (PxQ), with no consideration of the size of the position held as the unit of measurement is the individual derivative instrument. The use of a blockage factor is prohibited, even if a market's current daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

17.06a For derivative instruments that are not actively traded (valuations are classified as Level 2 or Level 3), Statement 157 (ASC Subtopic 820-10) does not specify the unit of measurement. Therefore, the unit of measurement for derivative instruments not traded in an active market could be defined to be a block position in an instrument where the fair value measurement would be determined using a quoted price that is adjusted for the liquidity of the position. The amount of any necessary liquidity adjustment should be determined based on the liquidity of the entity’s principal or most advantageous market for the derivative instrument and not the relative size of the entity’s position to that market. As such, Statement 157 (ASC Subtopic 820-10) eliminated the requirement to use the PxQ methodology for all derivative instruments that, before the adoption of Statement 157 (ASC Subtopic 820-10), was required by Statement 133.

17.06b Under Statement 157 (ASC Subtopic 820-10), the principal market is determined from the standpoint of the entity that holds the asset or liability, and requires the entity to establish the principal market based on the market in which it conducts its highest volume or level of activity. ASU 2011-04 clarifies that the principal market should be determined based on the market the entity has access to with the greatest volume and level of activity for the asset or liability. It also establishes a presumption that, in the absence of evidence to the contrary, the market in which an

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2 The application of a liquidity discount may result in a valuation classified as Level 3 (if significant and the liquidity discount is not based on Level 2 inputs).
entity would normally enter into a transaction is presumed to be the principal market, or in its absence, the most advantageous market. ASU 2011-04 also clarifies that different entities may have different principal markets for identical assets or liabilities depending on their activities and the markets that they can access. Based on that guidance, in some cases different entities within a consolidated group (and businesses within those entities) may have different principal or most advantageous markets for the same derivative instrument. The ASU also extends the prohibition on using blockage factors for Level 1 fair value measurements to Level 2 and Level 3. That is, once ASU 2011-04 becomes effective for an entity, it should not apply any blockage factor in determining fair value measurements regardless of fair value hierarchy level. When a Level 1 input is not available for a single asset or liability (including positions comprising a large number of identical assets or liabilities such as a portfolio of financial instruments), certain premiums or discounts (other than blockage factors) may be appropriate to consider when measuring fair value. While a blockage factor reflects the marketability based on the size of a total position that is an aggregate of multiple units of valuation, a liquidity discount reflects the marketability based on the unit of valuation. Therefore, the unit of valuation is critical to determining whether a discount’s nature is that of a blockage factor or a liquidity discount. Under ASU 2011-04, a premium or discount (other than a blockage factor) should be applied in determining the fair value of a financial instrument categorized as Level 2 or Level 3 if market participants would include the premium or discount when pricing the financial instrument given its unit of valuation. For example, the application of a control premium would be appropriate in the absence of a Level 1 input for an equity security position if: the unit of valuation is a controlling interest, the price to which a control premium is applied reflects the price of an interest without control; and a market participant would pay a premium above that price to obtain control. The same concept may apply to a derivative instrument that was linked to and must be settled in such equity security position (e.g., a call option that must be settled by delivery of a controlling equity interest).

CHANGES IN CREDITWORTHINESS IN VALUING DERIVATIVE INSTRUMENTS

Impact of Counterparty Credit Risk and an Entity's Own Nonperformance Risk in the Determination of Fair Value of Derivative Instruments

17.07 In DIG Issue No. G10, “Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative,” the FASB staff clarified that “the entity must be aware of the counterparty’s creditworthiness (and changes therein) in determining the fair value of the derivative ... a change in creditworthiness would affect the change in the derivative’s fair value.” Therefore, the fair value of a derivative asset should consider the impact of potential nonperformance of the derivative counterparty. However, a question arose as to whether an entity should also consider changes in its own creditworthiness when estimating the fair value of derivative instruments. The answer to this question was provided by Statement 157 (ASC Subtopic 820-10). Paragraph 15 of Statement 157 (ASC paragraphs 820-10-35-16 through 35-18) requires that all liabilities, including derivative liabilities measured at fair value, consider the impact of an entity's own nonperformance risk (which includes credit risk) when determining the fair value of the liability. Before the adoption of Statement 157 (ASC Subtopic 820-10), the inclusion of an entity’s own nonperformance risk in the valuation of derivative liabilities was an election, not a requirement under Statement 133.
17.07a This change added complexity to the determination of fair value of derivative instruments such as swaps and forwards, because these derivatives can be liabilities at some point during their lives and assets at other times (depending on market movements) as well as at different points on the yield curve. Thus, both the risk of counterparty credit risk and an entity’s own nonperformance risk would be considered by a market participant in determining the fair value of these instruments regardless of whether they are currently in an asset or liability position.

17.07a1 We have observed some entities refer to as one item both the underlying derivative instrument and a separate arrangement that mitigates credit-risk exposure in the event of default (e.g., an agreement requiring exchanging collateral based on each party’s net exposure to the other party's credit risk). The unit of account for derivative instruments is generally the individual instrument excluding consideration of separate arrangements. However, whether or not and the extent to which collateral is required to be posted related to a derivative instrument should be included in determining its fair value measurement. This is because the collateral requirement is instrument specific. For example, a lesser credit-risk adjustment could be incorporated into the fair value measurement of a collateralized derivative compared to the credit-risk adjustment for an otherwise equivalent derivative for which there is no requirement to post collateral.

**Determination of Fair Value of Derivative Instruments That Are Subject to a Master Netting Agreement**

17.07b Certain derivative instruments may be entered into as part of a master netting agreement. Master netting agreements allow both parties to the agreement to net any derivative instruments in asset and liability positions subject to the agreement in case of default of either counterparty to the agreement. As such, master netting agreements may reduce the risk or magnitude of potential loss due to nonperformance related to derivative instrument portfolios. When individual derivative instruments are executed with a counterparty that are subject to a master netting agreement and the individual derivative instruments incorporate the provisions of the master netting agreement by reference, the master netting agreement is an attribute of the individual derivative instrument and, therefore, should be considered in estimating the fair value of the derivative instrument. The rationale for this is that under Statement 157 (ASC Subtopic 820-10), it may be proper in certain situations to aggregate multiple units of account to form a unit of valuation, such as when a market participant determines that the highest and best use of an instrument is in combination with other instruments. Thus, the highest and best use of individual derivative instruments that are subject to a master netting agreement is in combination with one another.

17.07c To the extent that offsetting positions exist (although the positions do not have to completely offset), entities should consider this offset when determining the appropriate credit adjustment, if any, when measuring the fair value of the derivative assets and liabilities arising from transactions covered by the master netting agreement. Such a consideration is usually reflected in a reduction in the implied CVA related to the nonperformance risk used in the determination of fair value because derivative instruments supported by other assets have a lower nonperformance risk than derivative instruments supported only by the credit of the counterparty.
While U.S. GAAP prior to the adoption of ASU 2011-04 requires entities to consider the extent of offsetting positions when measuring the fair value of the derivative assets and liabilities subject to master netting agreements since that would be their highest and best use, the ASU removes the concept of highest and best use for financial instruments. Nonetheless, the ASU introduces a broader concept in that it allows financial instruments (including derivative instruments) to be measured on a net portfolio basis when certain conditions are met. That is, the ASU permits an entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position for a particular risk exposure or paid to transfer a net short position for a particular risk exposure in an orderly transaction between market participants if certain conditions are met. One of these conditions requires that the market risks of the individual instruments that comprise the net position that is being measured be substantially the same regarding both their nature (e.g., interest rate risk or currency risk) and duration. For example, an entity could not combine derivative instruments that have interest rate underlyings with derivative instruments that have commodity price underlyings. These risks would not qualify as being substantially the same, and therefore, the derivative instruments would not qualify for measurement on a net basis.

To the extent that there are basis differences for similar risks, that basis risk should be reflected in the fair value of the net position. For example, an entity managing its interest rate risk on a net basis may include derivative instruments with different interest rate bases (e.g., LIBOR versus U.S. treasury) in one portfolio. However, any such difference must be considered in the fair value measurement.

To the extent that there are duration differences, adjustments for duration mismatches should be reflected in the fair value of the net position for the entity’s exposure to market risk. For example, if an entity has a five-year financial instrument and is managing the interest rate risk exposure for the first 12 months of the financial instrument’s duration with a 12-month futures contract, then the exposure to 12 months of interest rate risk may be measured on a net portfolio basis while the interest rate risk exposure from years two to five would be measured on a gross basis. The net portfolio measurement guidance in the ASU is permitted to be used only if the entity:

- Manages the group of financial assets and financial liabilities on the basis of the entity’s net exposure to a particular market or credit risk of a particular counterparty based on its documented risk management or investment strategy;
- Provides information on that basis about the group of financial assets and financial liabilities to the entity’s key management personnel; and
- Measures those financial assets and financial liabilities at fair value in the statement of financial position on a recurring basis.

The net portfolio measurement guidance does not affect financial statement presentation of a portfolio of derivative assets and derivative liabilities because different criteria apply to determine whether financial instruments may be offset in the statement of financial position. While ASU 2011-04 explicitly incorporates the portfolio measurement approach into U.S. GAAP, it is generally consistent with current practice. However, the addition of the qualifying conditions may require an entity to consider whether its current portfolio measurement approach is appropriate under the ASU. We expect that derivative instruments that are subject to a master
netting agreement would meet the above conditions. An entity makes an accounting policy election about whether to use the exception to measure on a net portfolio basis. An entity that uses the exception must apply it consistently from period to period for a particular portfolio.

Other Considerations Related to Determining the Fair Value of Derivative Instruments

TRANSACTION COSTS

17.07d Statement 157 (ASC Subtopic 820-10) states that transaction costs are not an attribute of an asset or liability. Based on this guidance, the price in the principal (or most advantageous market) used to measure the fair value of a derivative asset or liability cannot be adjusted for transaction costs. Instead, transaction costs should be expensed immediately, unless other applicable GAAP allows for an alternative treatment.

SETTLEMENT VALUE

17.07e Settlement value represents the price at which two counterparties could contractually settle a derivative instrument, in limited circumstances, such as in the case of a default by one counterparty or a mutual put clause in the derivative instrument. An entity may not use the settlement value of derivative instruments as a proxy for fair value. Settlement value does not reflect market participants’ views toward information risk, bid/ask spread differentials, and/or creditworthiness of the counterparty. Accordingly, settlement value is not equivalent to fair value.

CORE DEPOSIT INTANGIBLES

17.08 The guidance in FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments Statement 107 (ASC paragraphs 825-10-50-3 through 50-23, and 825-10-55-3 through 55-5), which was not amended by Statement 157 (ASC Subtopic 820-10), precludes an entity from reflecting a long-term relationship with depositors, commonly known as a core deposit intangible, in determining the fair value of a deposit liability because core deposit intangibles are separate intangible assets, not financial instruments. In addition, the fair value of deposit liabilities with no defined maturities is the amount payable on demand at the reporting date.

PRACTICABILITY EXEMPTION

17.09 The Board believes that prudent risk management generally requires an entity to measure the fair value of any derivative instrument that it holds as well as any item (or portion of the item attributable to the identified risk) designated as being hedged in a fair value hedge. Thus, entities are required to determine the fair value of derivative instruments in all circumstances.

17.10 [Not used]

WRITTEN LOAN COMMITMENTS

17.11 A written loan commitment is an agreement to extend credit to a counterparty under certain pre-specified terms and conditions. It typically has a fixed expiration date, may either be
fixed-rate or variable-rate, and generally permits the lender to terminate the agreement under subjective and objective covenants in the agreement. However, the issuer of a loan commitment cannot require execution by the holder. Types of loan commitments include, but are not limited to, one- to four-family residential mortgage loan commitments; loan commitments for multifamily properties, commercial real estate, construction, and land development; commercial loan commitments including loans funding acquisitions; credit card lines; home equity lines; automobile financing loan commitments; and sub-prime lending loan commitments.

17.11a Written loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities (Statement 65) (ASC Topic 948, Financial Services--Mortgage Banking), are accounted for as derivative instruments under the Standard (see Paragraph 6.06 of Section 2 for a discussion of this issue) if they are legally binding contracts, regardless of the existence of a material adverse change clause that may be invoked by the issuer to terminate the agreement based either on a subjective evaluation that a material adverse change has occurred or criteria that are objectively determinable. As derivative instruments are required to be recognized at fair value, a question has arisen as to how to estimate the fair value of such loan commitments. Some believe that the fair value measurement of a loan commitment should consider all possible cash flows that could result from an exercised loan commitment. Such a valuation would consider future cash flow streams assuming the loan commitment is exercised, on a probability-weighted basis, by the holder of the loan commitment. Future cash flow streams might include the loan’s principal and interest payments through expected payoff, mortgage servicing rights, or some non-contractual intangible asset, such as a customer relationship. Estimating the fair value of a loan commitment pursuant to this methodology will often result in the loan commitment having an asset value to the writer of the commitment. Others oppose this view because, in their view, a loan commitment is a written option issued by the potential lender and, as such, should never have an asset value for the writer. In their view, the marketplace is simply valuing the written option in combination with separate intangible assets related to the written option (potential mortgage servicing rights, potential customer relationships, etc.). They believe that intangible assets related to the written option are not derivative instruments and should not be considered when measuring the fair value of a loan commitment, consistent with the Board’s views related to core deposit intangibles (see Paragraph 17.08). Still, others, while agreeing that valuing the loan commitment by including intangible assets is not appropriate, disagree that a loan commitment’s fair value should be estimated in the same manner of a written option. They emphasize that some holders of loan commitments exercise them even though the commitments are out-of-the-money. Therefore, a loan commitment is a complex instrument with some of the features of a written option and of a forward contract. As such, a loan commitment may have an asset value for the writer when interest rates decrease below the fixed rate in the contract. The SEC staff expressed their views on estimating the fair value of a loan commitment in SEC Staff Accounting Bulletin No. 105, Application of Accounting Principles to Loan Commitments (SAB 105) (ASC paragraph 815-10-S99-1), issued in March 2004. The SEC staff’s view as presented in SAB 105 (ASC paragraph 815-10-S99-1) was consistent with the third view summarized above. In other words, SAB 105 (ASC paragraph 815-10-S99-1) stated that expected future cash flows from servicing the loan underlying the loan commitment should not be considered in valuing the loan commitment. Additionally, no other internally developed intangible assets (such as a customer relationship) should be recorded as part of the loan commitment. However, SAB
105 (ASC paragraph 815-10-S99-1) left unanswered the question of whether a loan commitment is a written option that should never have an asset value for the writer.

17.11b On November 5, 2007, SEC Staff Accounting Bulletin No. 109, Written Loan Commitments Recorded at Fair Value Through Earnings (SAB 109) (ASC paragraph 815-10-S99-1), was issued. SAB 109 (ASC paragraph 815-10-S99-1) supersedes the SEC staff's previous guidance related to written loan commitments included in SAB 105 (ASC paragraph 815-10-S99-1) and revises the SEC staff's views on incorporating expected net future cash flows related to loan servicing activities in the fair value measurement of a written loan commitment. The SEC staff's views expressed in SAB 109 (ASC paragraph 815-10-S99-1) apply to all written loan commitments measured at fair value whether under Statement 133 or Statement 159 (ASC Subtopic 825-10). These views also apply to written loan commitments for which fair values are disclosed, such as under Statement 107 (ASC paragraphs 825-10-50-3 through 50-23, and 825-10-55-3 through 55-5).

17.11c SAB 109 (ASC paragraph 815-10-S99-1) states that fair-value measurements of derivative or other written loan commitments recorded through earnings should include the expected net future cash flows related to the associated servicing of the loan. The expected net future cash flows related to the associated servicing of the loan included in the fair value measurement of a derivative loan commitment or a written loan commitment should be determined in the same manner that the fair value of a recognized servicing asset or liability is measured under FASB Statement No. 140, Accounting for Servicing of Financial Assets (Statement 140) (ASC Topic 860, Transfers and Servicing). However, as discussed in paragraphs 61 and 62 of Statement 140 (ASC paragraphs 860-50-05-3 and 05-4 and 860-50-30-1 and 30-2), a separate and distinct servicing asset or liability is not recognized for accounting purposes until the servicing rights have been contractually separated from the underlying loan by sale of securitization of the loan with servicing retained.

17.11d SAB 109 (ASC paragraph 815-10-S99-1) retains the SEC staff's view prohibiting incorporating expected net future cash flows related to internally developed intangible assets in the fair value measurement of a written loan commitment. In addition, the SAB (ASC paragraph 815-10-S99-1) notes its guidance cannot be analogized to support applying fair value accounting under Statement 159 (ASC Subtopic 825-10) for other instruments containing both a financial and non-financial element. Below are our views on certain issues related to how to fair value a loan commitment based on our analysis of SAB 109 (ASC paragraph 815-10-S99-1). Similar to SAB 105 (ASC paragraph 815-10-S99-1), we believe the guidance in SAB 109 (ASC paragraph 815-10-S99-1) applies equally to nonpublic companies.

**Recognition of Written Loan Commitments – Day One Gain**

17.11e Incorporating expected net future cash flows related to loan servicing activities in the fair value measurement of a written loan commitment, as required by SAB 109 (ASC paragraph 815-10-S99-1), could result in recognition of an asset and a related gain at inception of the commitment. All measurements of fair values of loan commitments under SAB 109 (ASC paragraph 815-10-S99-1) should be consistent with Statement 157 (ASC Subtopic 820-10) and should therefore reflect the exit price that would be received if the loan commitment was sold. Among the factors that a market participant would consider would be the difference between the stated interest rate of the loan commitment and the market interest rate for the yet-to-be-funded
loan and the value of the net future cash flows related to loan servicing activities calculated using a market discount rate. Additional considerations would include the volatility of the market interest rate and the impact of changes in that rate in the probability that the loan would be funded.

17.11f Before the issuance of SAB 109 (ASC paragraph 815-10-S99-1) and Statement 157 (ASC Subtopic 820-10), when determining the fair value of a written loan commitment, only the value that arises from the interest rate component of the commitment was to be incorporated into its fair value measurement in the financial statements and a gain was not expected to be recognized at inception of a loan commitment. In other words, SAB 105 (ASC paragraph 815-10-S99-1) required an entity to separate the stated interest rate of the loan commitment into two components: the market interest rate for the yet-to-be funded loan at inception of the loan commitment and the market interest rate for the yet-to-be-funded loan at inception of the loan commitment). SAB 105 (ASC paragraph 815-10-S99-1) required an entity not to recognize any gain or loss associated with the remainder consistent with the requirements of EITF Issue No. 02-3, “Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities” (ASC paragraph 815-10-45-9), as there typically are no quoted market prices in an active market or observable market data for each of the individual components of the remainder.

17.11g Statement 157 (ASC Subtopic 820-10) nullified the guidance included in footnote 3 of EITF Issue 02-3 (ASC paragraph 815-10-45-9), which stated that in the FASB staff's view an entity should not recognize an unrealized gain or loss at inception of a derivative instrument unless the fair value of that instrument is obtained from a quoted market price in an active market or is otherwise evidenced by comparison to other observable current market transactions or based on a valuation technique incorporating observable market data.

17.11h Under Statement 157 (ASC Subtopic 820-10), to support a conclusion that the fair value measurement is different from the transaction price, the subject asset or liability (in this instance the written loan commitment) generally should fall into one of the four categories discussed in paragraph 17 of Statement 157 (ASC paragraph 820-10-30-3). One of those categories is that the transaction to purchase the asset or liability was entered into in a market other than the entity's principal or most advantageous market (in the case where a principal market does not exist) for the sale or transfer of the asset or liability. In the case of a written loan commitment, such condition would be met if the reporting entity (the issuer of the loan commitment) would be able to sell the commitment in a market different from the one in which the commitment was originated.

**Determination of the Value Associated with Loan Servicing Activities**

17.11i As stated in SAB 109 (ASC paragraph 815-10-S99-1), the expected net future cash flows related to the associated servicing of the loan included in the fair value measurement of a written loan commitment should be determined in the same manner that the fair value of a recognized servicing asset or liability is measured under Statement 140 (ASC Topic 860) as amended by FASB Statement No. 156, Accounting for Servicing of Financial Assets (ASC paragraphs 860-50-35-3 through 35-7 and 860-50-50-5). A servicer of loans commonly receives the benefits of servicing revenues from contractually specified servicing fees, a portion of the interest from the
loans, late charges, and other ancillary sources, including float, all of which it is entitled to receive only if it performs the servicing and incurs the costs of servicing the assets. Typically, the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing, and the contract results in a servicing asset. Adequate compensation is the amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the normal profit that would be demanded in the marketplace.

17.11j The value of loan servicing is the value that a market participant would expect to realize when the underlying loan is originated and sold and the servicing is contractually separated from the underlying loan, which may be determined using a discounted cash flow analysis based on projections of the cash flows and the assumptions market participants would use. However, when estimating the fair value of servicing assets and liabilities, with regard to the benefits of servicing that are dependent on future transactions such as collecting late charges, the entity should estimate the value of the right to benefit from the cash flows of potential future transactions, not the value of the expected cash flows to be derived from future transactions. The objective is to calculate a value that a market participant would expect to pay for the right to that benefit.

17.11k Lastly, as discussed in paragraphs 61 and 62 of Statement 140 (ASC paragraphs 860-50-05-3 and 05-4 and 860-50-30-1 and 30-2), a separate and distinct servicing asset or liability is not recognized for accounting purposes until the servicing rights have been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained. Thus, the fair value associated with loan servicing activities is part of the fair value of the written loan commitment (which in turn is included in the basis of the underlying loan when funded) until the servicing rights have been contractually separated from the underlying loan.

The following example illustrates applying the requirements of SAB 109 (ASC paragraph 815-10-S99-1).

Example 4.1: Fair Value of Loan Commitment under SAB 109 (ASC paragraph 815-10-S99-1)

Assume Bank A issues a loan commitment to extend a conforming (e.g., Fannie Mae or Freddie Mac eligible) 6.00%, 30-year mortgage loan to a customer. The commitment is exercisable by the customer any time within the next 30 days (after that point the commitment expires and Bank A is no longer obligated to fund the loan). Bank A's other assumptions, such as risk premiums and fall-out and prepayment rates, are consistent with market participant assumptions.

At inception of the loan commitment, Bank A identifies either the specific TBA mortgage-backed security it is committed to deliver the underlying loan into or a specific 30-day TBA mortgage-backed security that would be the most appropriate based on the underlying loan characteristics of the loan commitment. The entity concludes that the yield of that TBA mortgage-backed security, adjusted for the transaction costs that would be incurred by a market participant to securitize the underlying loan (including agency guarantee fees) and an estimate of the profit required in the market place, equals 5.70%, and represents the market interest rate of the yet-to-be funded loan at inception of the loan commitment without the value of servicing rights. (In this example, the valuation technique is using inputs from the loan securitization market and other adjustments such as profit that would be considered by a
market participant that intended to securitize the funded loans.) The fair value also could have been estimated by obtaining market inputs directly from the whole loan market. The difference between the stated interest rate of the loan commitment (6.00%) and the market interest rate of the yet-to-be-funded loan (5.70%) results in a residual amount of 0.30% for Bank A. Bank A also concludes that a market participant would estimate the expected future net cash flows related to the associated servicing of the loan and other ancillary sources of cash flows, and would conclude that the amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace, is 23 basis points. As a result, in this example, Bank A would recognize a gain for the value of the loan commitment related to the residual amount of 0.07% at inception of the commitment. That amount is related to the excess of the above-market contractual interest rate of 5.77% (i.e., the 6.00% rate specified in the loan commitment less adequate servicing of 0.23%) over the market interest rate of 5.70%. Bank A should consider changes in the inputs in subsequent measurements of fair value of the loan commitment. For example, the market interest rate of the yet-to-be-funded loan, the adequate servicing compensation amount, or the expected cash flows from ancillary sources could change if market conditions change.

Financial Statement Impact

17.11 SAB 109 (ASC paragraph 815-10-S99-1) results in an entity's recognition of the value associated with the servicing of loans for derivative loan commitments previously disallowed by SAB 105 (ASC paragraph 815-10-S99-1). SAB 109 (ASC paragraph 815-10-S99-1) would not have had a similar impact on non-derivative written loan commitments accounted at fair value under Statement 159 (ASC Subtopic 825-10) since such measurements often included expected net future cash flows related to the associated servicing of the loan previously in valuing such loan commitments. However, SAB 109 (ASC paragraph 815-10-S99-1) would impact fair values calculated under Statement 159 (ASC Subtopic 825-10) if such values included the expected net future cash flows to all written loan commitments that are accounted for at fair value through earnings. However, it would have been expected that SAB 109's (ASC paragraph 815-10-S99-1) provision related to these internally developed intangible assets would not be significant because we believe that most entities generally have not ascribed any value to internally developed intangible assets when determining the fair value of derivative loan commitments.

17.11m When a loan that is subject to a written loan commitment is ultimately funded, the carrying value of the written loan commitment should be recorded as part of the basis of the loan (unless the fair value option was elected for the loan, in which case the loan would be initially recorded at fair value). Applicable GAAP for loans should be followed thereafter. For example, for a commitment to originate a mortgage loan to be held-for-sale, the basis adjustment made to the loan should not be amortized; rather, when the loan is sold, the basis adjustment should be recognized as part of the gain or loss on the sale. The carrying value of the loan, including the carrying value of the commitment, will become subject to impairment assessment and impairment will be measured based on the classification of the loan (e.g., lower of cost or fair value, if the loan is classified as held-for-sale). Occasionally, a loan is transferred from held-for-sale to a held-for-investment portfolio; when that is the case, the basis adjustment associated
with the commitment should be amortized as an adjustment to the yield, under FASB Statement
No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring
Loans and Initial Direct Costs of Leases (Statement 91) (ASC Subtopic 310-20, Receivables -
Nonrefundable Fees and Other Costs). Regardless of the classification of the closed loan, the
carrying value of the loan including the value of the written loan commitment, should not exceed
the fair value of the loan at funding.

17.11n SAB 109 (ASC paragraph 815-10-S99-1) does not address the application of Statement
91 (ASC Subtopic 310-20) to loan commitment fees. Accordingly, entities should continue to
apply the provisions of Statement 91 (ASC Subtopic 310-20) to account for loan commitment
fees.

Other Considerations

17.11o To consistently and objectively apply the provisions of SAB 109 (ASC paragraph 815-
10-S99-1), we believe an entity should maintain a policy that addresses how it recognizes and
measures the fair value of all loan commitments it issues. That policy should address that (a) fall-
out rate profiles are consistent with market participant assumptions (taking into account
information that a market participant would have about fall-out rates), especially in a changing
interest rate environment as sharp changes in interest rates would significantly impact fall-out
rates; (b) assumptions (e.g., prepayments, discount rate, servicing costs, risk premiums) and the
model used for estimating the fair value of the expected net future cash flows related to the
associated servicing of the loan incorporates assumptions that market participants would use in
pricing the asset; and (c) the market interest rate used to determine changes in fair value of the
loan commitment does not include, implicitly or explicitly, any components of the stated interest
rate for the loan commitment that relate to the expected future cash flows from internally
developed intangible assets such as customer relationship intangible assets.

Effective Date

17.11p The SEC staff's views on incorporating expected net future cash flows related to loan
servicing activities in the fair value measurement must be applied prospectively to derivative
loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The
SEC staff's views on not incorporating expected net future cash flows related to internally
developed intangible assets (such as customer relationships) is effective as of November 5, 2007,
the issuance date of SAB 109 (ASC paragraph 815-10-S99-1), to all loan commitments recorded
at fair value through earnings, including those commitments accounted at fair value under
Statement 159 (ASC Subtopic 825-10).

17.12-17.23 [Not used]

ESTIMATING THE FAIR VALUE OF DERIVATIVE INSTRUMENTS AT INCEPTION -
DAY ONE GAINS OR LOSSES

17.24 Statement 157 (ASC Subtopic 820-10) removed the guidance in EITF 02-3 (ASC
paragraph 815-10-45-9) that precluded entities from initially recognizing an asset or liability at
any value other than the transaction price, unless that value could be verified by reference to, or
application of a valuation technique that involves observable market data. However, under
Statement 157 (ASC Subtopic 820-10), to support a conclusion that there is a day one gain or

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loss (that the fair value measurement based on unobservable inputs is an amount different from the transaction price), the subject financial asset or liability should generally fall into one of the following categories:

- The transaction to purchase the asset or liability was entered into in a market other than the entity’s principal or most advantageous market (in the case where a principal market does not exist) for the sale or transfer of the asset or liability, or
- A transaction to sell the asset or liability is expected to occur at a different point within the bid/ask spread from where the asset or liability was acquired.

17.24a Although additional examples of when a difference may exist between an entity’s measurement of fair value and the transaction price for a specific asset or liability are discussed in paragraph 17 of Statement 157 (ASC paragraph 820-10-30-3), we believe these instances will be uncommon for financial instruments.

17.24b Consistent with discussions with the SEC staff, to recognize an asset acquired or liability assumed at an amount different from the transaction price, the reporting entity should (1) identify the specific attributes of the transaction that generate the difference between the transaction price and the entity’s estimate of fair value and (2) reconcile those attributes with the guidance given in paragraph 17 of Statement 157 (ASC paragraph 820-10-30-3). Recognition of the difference between the transaction price and the entity’s estimate of fair value is not dependent on where in the fair value hierarchy the reporting entity’s fair value measurement falls (i.e., Level 1, 2, or 3). However, per the SEC staff, the transaction price remains an important piece of objective evidence for determining the fair value measurement of financial instruments. Therefore, as the significance of the assumptions made by a reporting entity increases in importance to the overall measurement of fair value, entities must consider whether the transaction price for the instrument provides better evidence of the fair value of the instrument than the entity’s own estimate of fair value.

17.24c Paragraph C16 of Statement 157 (ASC Subtopic 820-10) also clarifies that fair value measurements should be adjusted for all forms of risk to the extent such risks have not already been considered in the exit price. Such adjustments include the amount market participants would demand because of the risk (uncertainty) inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique (a risk premium notion). The inclusion of all necessary risk adjustments as required by Statement 157 (ASC Subtopic 820-10) in an entity’s fair value measurement may reduce the difference between the transaction price and the entity’s estimate of fair value.

IMPACT OF PRINCIPAL MARKET DETERMINATION ON THE HEDGING RELATIONSHIPS

17.25 ASU 2011-04 clarifies that a principal market is, “The market with the greatest volume and level of activity for the asset or liability” and “the reporting entity must have access to the principal (or most advantageous) market at the measurement date.” This clarification of the principal market guidance may affect the assessment of effectiveness or measurement of ineffectiveness for hedging relationships.

17.25a In a fair value hedge, an entity applies the concepts of Statement 157 (ASC Subtopic 820-10) when measuring the fair value of the hedging instrument and the changes in overall fair value.
or fair value attributable to a specific hedged risk of the hedged item. In many cases, the principal market of the hedged item would not change as a result of the clarification in the ASU because the hedged item and hedging instrument are often traded in the same principal market or the principal markets’ prices of each are correlated. However, if the principal market of the hedged item has changed under ASU 2011-04 as a result of the clarification of the principal market guidance, the fair value of the hedged item may change as well. Under the ASU, the fair value of the hedged item should be based on the principal market, even if the hedged item is transacted in a different market. Therefore, the change in the fair value of the hedged item used in the assessment of effectiveness and measurement of ineffectiveness may be affected. If the hedged item is a non-financial asset or non-financial liability, a change in principal market due to this clarification may result in a change in fair value that reflects a different location than the principal market. Therefore, transportation costs from its location to the principal market need to be considered. For example, an entity purchases wheat futures contracts to hedge its exposure to the changes in overall fair value of its wheat inventory. The entity typically sells its wheat in Iowa, but assume that the principal market for the wheat and the wheat futures is in Chicago. Under ASU 2011-04, the entity calculates the overall change in fair value of the hedged item (wheat) based on the principal market of the hedged item. In this fact pattern, although the entity sells its wheat in Iowa, the principal market for the wheat is the market that the entity has access to (including transportation cost) that has the highest volume and level of activity (i.e., Chicago). Therefore, the change in the fair value of the hedged item, which includes transportation costs used in the assessment of effectiveness and measurement of ineffectiveness, would be different after the adoption of the ASU.

17.25b In a cash flow hedging relationship, the change in cash flows of the hedged item for the risk being hedged is considered when assessing effectiveness and measuring ineffectiveness. Because this analysis evaluates changes in cash flows, rather than changes in fair value, the fair value concepts of principal market in Statement 157 (ASC Subtopic 820-10) are not applicable to the hedged item in a cash flow hedge. The principal market concept change under ASU 2011-04 does not affect the assessment of effectiveness or measurement of ineffectiveness. Building off of the example in the preceding paragraph, assume that the entity purchases wheat futures contracts to hedge its exposure to the changes in overall cash flows associated with the forecasted sale of wheat. The entity calculates the change in the hedged item’s expected cash flows based on the expected actual sales in Iowa and not the principal market in Chicago. Because the fair value concepts of principal market in Statement 157 (ASC Subtopic 820-10) are not applicable to the hedged item in a cash flow hedge, there would be no change in the effectiveness assessment and ineffectiveness measurement after the adoption of the ASU.

17.26 – 17.29 [Not used]

Proportion Versus Portion

18.01 Paragraph 18 of the Standard (ASC paragraphs 815-10-35-2, 815-20-25-45, and 815-20-35-1) discusses the concept of proportion and reads in part as follows:

18. The accounting for changes in the fair value (that is, gains or losses) of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Either all or a proportion of a derivative may be designated as the hedging instrument. The proportion must be expressed as a percentage of the entire derivative so
that the profile of risk exposures in the hedging portion of the derivative is the same as that in the entire derivative. (Thus, an entity is prohibited from separating a compound derivative into components representing different risks and designating any such component as the hedging instrument, except as permitted at the date of initial application by the transition provisions in paragraph 49.) Subsequent references in this Statement to a derivative as a hedging instrument include the use of only a proportion of a derivative as a hedging instrument. Two or more derivatives, or proportions thereof, may also be viewed in combination and jointly designated as the hedging instrument.

DIG Issues B13, B15, B27, B29, B30, C8, E2, F4, H9, H10, J2, J5, J6, and K3 relate to this paragraph. See DIG Issues Index.

**PROPORTION**

18.02 Either all or a proportion of a derivative instrument may be designated as the hedging instrument. If a proportion is designated, it must be expressed as a percentage of the entire derivative instrument. That is, the risk exposure profile in a proportion of a derivative instrument must be the same as that in the entire derivative instrument. As a consequence, entities are prohibited from separating a compound derivative instrument and designating one dissimilar component as the hedging instrument (except as provided by the transition provisions discussed in Section 10). For example, an entity that holds an interest rate swap containing an embedded written option (e.g., an indexed amortizing swap) would be prohibited from separating the derivative instrument into its swap and written option components and using only one of the components as a derivative hedging instrument. Instead, the entity is limited to designating the entire derivative instrument or a proportion thereof (e.g., 60% of the entire derivative instrument) as the derivative hedging instrument. In addition, an entity that holds a six-year interest rate swap would be prohibited from separating the instrument into a swap for the first three years and another swap for the remaining three years and using only one of the components as a hedging instrument. However, the entity could separate a percentage (i.e., a proportion) of the entire six-year swap (e.g., 40%) and designate that component as a hedging instrument.

**PORTION**

18.03 In contrast, the Standard provides entities with some flexibility in identifying the hedged item. Specifically, an entity may designate an asset, liability, firm commitment, or forecasted transaction (or a specific portion thereof) as the hedged item. If a portion of an asset, liability, firm commitment, or forecasted transaction is designated as the hedged item, the portion of the asset, liability, firm commitment, or forecasted transaction is permitted to have characteristics different from the entire asset, liability, firm commitment, or forecasted transaction. This concept is significantly different from the concept of proportion discussed previously. Thus, for example:

- The risk exposure of a loan that is attributable to credit may be designated as the hedged item (the risk exposure attributable to interest rates could be ignored).
- The call option embedded in a debt obligation (which is not separately accounted for as an embedded derivative instrument under the Standard3) could be designated as the hedged item.

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3 See Chapter 3 for a discussion of embedded derivative instruments.

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hedged item (the risk exposure inherent in the remaining portion of the debt obligation could be ignored).

- The first five or last five years of a ten-year debt obligation could be designated as the hedged item (other aspects of the debt obligation could be ignored even though they will add to the complexity of the hedging relationship as discussed in Paragraphs 21a.22-21a.24 of Section 5).

**COMBINATION OF DERIVATIVE INSTRUMENTS**

18.04 The Standard permits the combination of two or more derivative instruments to be jointly designated as the derivative hedging instrument. For example, put and call options can be combined and treated as one derivative hedging instrument. In addition, either all or a proportion of the combined derivative hedging instruments may be designated as the derivative hedging instrument.

**Accounting for Changes in the Fair Value of a Derivative Instrument**

18.05 The remainder of paragraph 18 of the Standard discusses (ASC paragraphs 815-10-35-2, 815-20-25-45, and 815-20-35-1) the accounting for derivative instruments as follows:

<table>
<thead>
<tr>
<th>Gains and losses on derivative instruments are accounted for as follows:</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) <strong>No hedging designation.</strong> The gain or loss on a derivative instrument not designated as a hedging instrument shall be recognized currently in earnings.</td>
</tr>
<tr>
<td>(b) <strong>Fair value hedge.</strong> The gain or loss on a derivative instrument designated and qualifying as a fair value hedging instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk shall be recognized currently in earnings in the same accounting period, as provided in paragraphs 22 and 23.</td>
</tr>
<tr>
<td>(c) <strong>Cash flow hedge.</strong> The effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument shall be reported as a component of other <em>comprehensive income</em> (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraphs 30 and 31. The remaining gain or loss on the derivative instrument, if any, shall be recognized currently in earnings, as provided in paragraph 30.</td>
</tr>
<tr>
<td>(d) <strong>Foreign currency hedge.</strong> The gain or loss on a derivative instrument or nonderivative financial instrument designated and qualifying as a foreign currency hedging instrument shall be accounted for as follows:</td>
</tr>
<tr>
<td>(1) The gain or loss on the hedging derivative or nonderivative instrument in a hedge of a foreign-currency-denominated firm commitment and the offsetting loss or gain on the hedged firm commitment shall be recognized currently in earnings in the same accounting period, as provided in paragraph 37.</td>
</tr>
<tr>
<td>(2) The gain or loss on the hedging derivative instrument in a hedge of an available-for-sale security and the offsetting loss or gain on the hedged</td>
</tr>
</tbody>
</table>
available-for-sale security shall be recognized currently in earnings in the same accounting period, as provided in paragraph 38.

(3) The effective portion of the gain or loss on the hedging derivative instrument in a hedge of a forecasted foreign-currency-denominated transaction shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraph 41. The remaining gain or loss on the hedging instrument shall be recognized currently in earnings.

(4) The gain or loss on the hedging derivative or nonderivative instrument in a hedge of a net investment in a foreign operation shall be reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment to the extent it is effective as a hedge, as provided in paragraph 42.

18.06 The Standard requires that all derivative instruments be reported in the statement of financial position as assets or liabilities and measured at fair value. The accounting for changes in the fair value of a derivative instrument would depend on whether the derivative qualifies for hedge accounting. Following is a broad overview of each of the accounting models.

DERIVATIVE INSTRUMENTS THAT DO NOT QUALIFY FOR HEDGE ACCOUNTING

18.07 Any derivative instrument not designated as a derivative hedging instrument or not meeting the criteria for hedge accounting is treated as a speculative derivative instrument (i.e., a nonhedging derivative instrument). (Refer to Sections 5, 6, and 7 for discussion of hedge criteria.) Changes in fair value of nonhedging derivative instruments are reflected in earnings in the period of change.

DERIVATIVE INSTRUMENTS THAT QUALIFY FOR HEDGE ACCOUNTING

Fair Value Hedge

18.08 A fair value hedge is defined as a hedge of an exposure to changes in the fair value of an asset, liability, or firm commitment due to its fixed terms. A derivative hedging instrument that qualifies for fair value hedge accounting is recorded at fair value in the statement of financial position. Changes in that fair value are recorded in earnings during each reporting period. Also recognized in earnings are the gains or losses on the hedged item (existing asset, liability, or firm commitment) that are attributable to the hedged risk with the offset being recorded as an adjustment to the carrying amount of the hedged item. Thus, the income statement would include both the impact of changes in the fair value of the derivative hedging instrument and the hedged item. The effect is to reflect in earnings the extent to which the hedge is not perfectly effective in achieving offsetting changes in fair value.

18.08a The concepts of fair value measurements in Statement 157 (ASC Subtopic 820-10) are applicable to the hedged item in a fair value hedge. Although the hedged item in a fair value hedge may not be carried at fair value, the measurement of changes in the fair value of the hedged item attributable to the hedged risk should consider and be performed in accordance with the principles outlined in Statement 157 (ASC Subtopic 820-10). For example, if an entity
designates the hedged risk as the overall changes in fair value associated with the hedged item after the initial recognition of the hedged item, or if an entity designates the hedged risk as changes in fair value attributable to only a specific risk associated with the hedged item (e.g., benchmark interest rate), the carrying value of the hedged item will not equal its fair value unless the hedged item is otherwise required to be measured at fair value under other applicable GAAP (e.g., an available-for-sale security). The carrying value of the hedged item will only be adjusted based on the changes in the fair value of the item from the hedge designation date for the changes in the fair value attributable to the hedged risk. In this case, the hedged item would not be carried at fair value; however, the adjustments to the hedged item’s basis due to changes in fair value attributable to the hedged risk are calculated in accordance with Statement 157 (ASC Subtopic 820-10). See paragraphs 17.25 to 17.25b of this chapter for additional information.

18.09 The adjustment to the carrying amount of the hedged item would be accounted for in the same manner as other components of the carrying amount of the hedged item. For example, if changes in the fair value of inventory that is carried at the lower of cost or market are being hedged, then the hedge adjustment would become part of the cost basis of the inventory and would be included in earnings on the sale of the hedged inventory. Similarly, if changes in the fair value of a loan receivable are being hedged, then the hedge adjustment would become part of the carrying amount of the loan and would be amortized or accreted into earnings on a level yield basis.

18.10 The Standard requires that certain specified criteria be met in order to qualify for fair value hedge accounting. These criteria are discussed in Section 5.

**Cash Flow Hedge**

18.11 A cash flow hedge is defined to be a hedge of an exposure to variability in cash flows associated with an existing, recognized asset or liability (such as all or certain future interest receipts (or payments) on variable-rate assets (or liabilities)) or a forecasted transaction (such as a forecasted purchase or sale transaction) due to the variability of the terms. A derivative hedging instrument that qualifies for cash flow hedge accounting is recorded at fair value in the statement of financial position. Changes in that fair value, which are considered to be effective at hedging the designated exposure, are reported in other comprehensive income (OCI). The net gain or loss included in accumulated other comprehensive income (AOCI) is reclassified into earnings during those periods that the hedged transaction affects earnings. When hedging forecasted transactions, the reclassification of the net gain or loss included in AOCI into earnings is accelerated when it is probable that the forecasted transaction will not occur. Changes in the fair value of the derivative hedging instrument that are considered ineffective at hedging the designated exposure and those that are not part of the objective of the hedge are generally reported currently in earnings.  

18.12 To receive cash flow hedge accounting, the Standard requires that certain specified criteria be met. These criteria are discussed in Section 6.

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4 See Paragraph 30.04 of Chapter 6 for a discussion of the accounting for the effective and ineffective portions of a derivative instrument qualifying as a cash flow hedge.
Foreign Currency Hedges

18.13 The Standard retains the functional currency concept of FASB Statement No. 52, Foreign Currency Translation (Statement 52) (ASC Topic 830, Foreign Currency Matters). Consistent with the functional currency concept, the Standard initially provided for the following types of foreign currency hedges, each of which is discussed in more detail in the following paragraphs:

- Fair value hedge of the foreign currency exposure inherent in a firm commitment;
- Fair value hedge of the foreign currency exposure inherent in an available-for-sale security;
- Cash flow hedge of the foreign currency exposure inherent in a forecasted foreign-currency-denominated transaction or a forecasted foreign-currency-denominated intercompany transaction; and
- Hedge of the foreign currency exposure inherent in a net investment in a foreign operation.

18.14 In addition to the types of foreign currency hedges noted in paragraph 18(d) of the Standard (ASC paragraph 815-20-35-1(d)), an entity may designate a hedge of the foreign currency exposure of (1) changes in fair value of a recognized asset or liability, (2) changes in forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability, and (3) changes in functional-currency-equivalent cash flows associated with an unrecognized firm commitment.

Fair Value Hedge of the Foreign Currency Exposure Inherent in a Firm Commitment or a Recognized Asset or Liability

18.15 Under the Standard, an entity may designate a derivative instrument as a fair value hedge of the foreign currency exposure inherent in a firm commitment or a recognized asset or liability. An entity may also designate a foreign-currency-denominated nonderivative financial instrument as a fair value hedge of the foreign currency exposure inherent in a firm commitment. The accounting model for a fair value hedge of the foreign currency exposure inherent in a firm commitment or a recognized asset or liability is basically the same as the accounting for other fair value hedges (see discussion in Paragraphs 18.08-18.10 herein). The only distinction is that the Standard permits the use of a foreign-currency-denominated nonderivative financial instrument as a hedging instrument in a fair value hedge of the foreign currency exposure inherent in a firm commitment, whereas in other fair value hedges only derivative instruments can be used as the hedging instrument. If a foreign-currency-denominated nonderivative hedging instrument is used as the hedging instrument, the foreign currency transaction gain or loss on the nonderivative hedging instrument is recognized in earnings along with the change in the carrying amount of the hedged firm commitment.

18.16 The Standard requires that certain criteria be met to qualify for this type of hedge accounting. These criteria are discussed in Sections 5 and 7.

Fair Value Hedge of the Foreign Currency Exposure Inherent in an Available-For-Sale Security

18.17 The Standard provides that an entity may designate a derivative instrument as a fair value hedge of the foreign currency exposure inherent in an available-for-sale debt or equity security.
The accounting model for a fair value hedge of the foreign currency exposure inherent in an available-for-sale debt or equity security is the same as the accounting for other fair value hedges (see discussion in Paragraphs 18.08-18.10 herein).

18.18 The Standard requires that certain criteria be met to qualify for this type of hedge accounting. These criteria are discussed in Sections 5 and 7.

Cash Flow Hedge of Foreign Currency Exposure

18.19 The Standard provides that an entity may designate a derivative instrument as a cash flow hedge of the foreign currency exposure to variability in cash flows associated with either:

- A forecasted foreign-currency-denominated transaction;
- An unrecognized firm commitment;
- A recognized asset or liability; or
- A forecasted foreign-currency-denominated intercompany transaction.

The accounting model for a cash flow hedge of the exposure to variability in cash flows associated with the above transactions is generally the same as the accounting for other cash flow hedges (see discussion in Paragraphs 18.11-18.12 herein).

18.20 The Standard requires that certain criteria be met to qualify for this type of hedge accounting. These criteria are discussed in Sections 6 and 7.

Hedge of the Foreign Currency Exposure Inherent in a Net Investment in a Foreign Operation

18.21 The Standard provides that an entity may designate a derivative or nonderivative foreign-currency-denominated financial instrument as a hedge of the foreign currency exposure inherent in a net investment in a foreign operation. The distinguishing feature of this type of hedge is that it involves hedging the foreign currency exposure inherent in a foreign operation for which the functional currency is different from the functional currency of the reporting entity. Under Statement 52 (ASC Topic 830), the foreign currency exposure associated with these operations is reported as a translation adjustment in OCI.

18.22 A derivative hedging instrument that qualifies as a hedge of the foreign currency exposure of a net investment in a foreign operation is recorded in the statement of financial position at fair value. Changes in the fair value that are considered effective at hedging the designated risk are reported as a translation adjustment in OCI. Thus, changes in the fair value of the effective portion of the derivative hedging instrument offset the foreign currency exposure associated with the hedged net investment. The balance of the change in the fair value of the derivative hedging instrument, (the ineffective portion or the portion that is not part of the objective of the hedge) is reported currently in earnings. The hedged net investment continues to be accounted for under Statement 52 (ASC Topic 830).

18.23 A hedging instrument that is a nonderivative foreign-currency-denominated financial asset or liability is recorded in the statement of financial position at current spot exchange rates. Changes in the spot exchange rates are reported as a translation adjustment in OCI, thus offsetting the foreign-currency exposure associated with the hedged net investment.
18.24 The Standard requires that certain criteria be met to qualify for this type of hedge accounting. These criteria are discussed in Section 7.

18.25 Exhibit 4.1 provides an overview of the accounting framework described in this chapter.

<table>
<thead>
<tr>
<th>Derivative Instrument Transaction</th>
<th>Example</th>
<th>Accounting for Derivative Instrument</th>
<th>Accounting for Hedged Item</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivative instrument that does not qualify for hedge accounting</td>
<td>Equity call options are written by a mutual fund manager to enhance the yield of a mutual fund.</td>
<td>Derivative instrument recorded in the statement of financial position at fair value with changes in that fair value reported in earnings.</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Fair value hedge</td>
<td>A purchased put option is used to hedge declines in the fair value of a fixed-rate loan receivable.</td>
<td>Derivative instrument recorded in the statement of financial position at fair value with changes in that fair value reported in earnings.</td>
<td>Recognize in earnings the gains or losses on the hedged item attributable to the hedged risk with the offset being recorded as an adjustment to the carrying amount of the hedged item.¹</td>
</tr>
<tr>
<td>Cash flow hedge</td>
<td>A bank enters into a receive-fixed, pay-variable interest rate swap used to hedge the cash flow exposure of its variable-rate loan receivable.</td>
<td>Derivative instrument recorded in the statement of financial position at fair value with changes in that fair value allocated between OCI (effective portion) and earnings (ineffective portion). Amounts accumulated in AOCI are reclassified into earnings during the periods that the variability in cash flows associated with the loan (interest rate reset on the loan) impacts earnings.</td>
<td>Relevant generally accepted accounting principles are not impacted by the Standard.</td>
</tr>
<tr>
<td>Financial Instrument</td>
<td>Description</td>
<td>Hedge Model</td>
<td>Hedge Model</td>
</tr>
<tr>
<td>----------------------</td>
<td>-------------</td>
<td>-------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Fair value hedge of foreign currency exposure</td>
<td>A foreign currency forward contract to sell foreign currency is used to hedge firmly committed sales revenue denominated in a foreign currency.</td>
<td>Use the fair value hedge model discussed.</td>
<td>Use the fair value hedge model.</td>
</tr>
<tr>
<td>Cash flow hedge of foreign currency exposure</td>
<td>A purchased put option in yen is used to hedge forecasted sales that are denominated in yen.</td>
<td>Use the cash flow hedge model discussed.</td>
<td>Use the cash flow hedge model.</td>
</tr>
<tr>
<td>Hedge of foreign currency exposure inherent in a net investment in a foreign operation</td>
<td>Debt denominated in pounds sterling is used to hedge the U.S. parent’s investment in a U.K. subsidiary.</td>
<td>Transaction gain or loss on the hedging instrument is accounted for as a translation adjustment (i.e., in OCI), to the extent it is considered effective.</td>
<td>Translation gain or loss on the hedged net investment will continue to be recorded in OCI pursuant to Statement 52 (ASC Topic 830).</td>
</tr>
</tbody>
</table>

1 The adjustment of the carrying amount of a hedged asset, liability, or firm commitment in a fair value hedge is accounted for in the same fashion as other components of the carrying amount. If the asset or liability is an interest-bearing financial instrument, the hedge adjustment should begin to be amortized to earnings based on a recalculated effective yield no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.
Section Five: Fair Value Hedging (updated June 2016)

INTRODUCTION

Entities often enter into transactions that create fixed cash flows. These transactions may include, for example, lending money at fixed rates, purchasing fixed-rate debt securities, issuing fixed-rate debt obligations, and making certain fixed-price commitments to purchase or sell assets and incur liabilities. Entities entering into transactions with fixed cash flows are exposed to changes in the fair value of the associated asset, liability or firm commitment due to changes in interest rates, foreign currency exchange rates, commodity prices, or credit risk. For example, when an entity commits to sell a security at a future date at a fixed price, the entity bears the risk of a change in the market price of the security through the date on which the trade settles. To reduce or eliminate the exposure resulting from a transaction’s fixed price or rate, entities often enter into hedging transactions. The exposure includes all changes in fair value, increases in fair value, or decreases in fair value. These hedging transactions serve to largely (or even entirely) mitigate the effect on earnings of the risk of changes in fair value due to the fixed nature of the transactions and are described in FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended (Statement 133 or Standard) as fair value hedges.


DEFINITION OF A FAIR VALUE HEDGE

20.01 Paragraph 20 of the Standard (ASC paragraph 815-25-25-1) describes a fair value hedge. This paragraph states, in part:

20. An entity may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof (hedged item) that is attributable to a particular risk.

Derivatives Implementation Group (DIG) Issues related to this paragraph are E18, F6, F8, F10, J3, and K3. See DIG Issues Index.

20.02 The objective of a fair value hedge is to reduce or eliminate the exposure to a change in fair value that is associated with an existing recognized asset or liability, or an unrecognized firm commitment, or an identified portion thereof due to its fixed price or rate.

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1 As more fully discussed in footnote 2 to paragraph 4 of the Standard (ASC paragraph 815-10-05-5), subsequent references to an asset or liability in the Standard (ASC Topic 815) include a firm commitment.
20.03 Common examples of fair value exposures and hedging strategies are as follows:

**Exhibit 5.1: Fair Value Exposures and Hedging Strategies**

<table>
<thead>
<tr>
<th>Fair Value Exposure</th>
<th>Hedging Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Recognized Assets and Liabilities:</strong></td>
<td></td>
</tr>
<tr>
<td>Fixed-rate assets - exposure to changes in fair value</td>
<td>Convert the interest received to variable by entering into an interest rate swap. Terms of the swap call for receipt of interest at a variable rate and payment of interest at a fixed rate. Lock in a minimum value by purchasing a put option to sell the asset at a specified price.</td>
</tr>
<tr>
<td>Fixed-rate liabilities - exposure to changes in fair value</td>
<td>Convert the interest paid to variable by entering into an interest rate swap. Terms of the swap call for receipt of interest at a fixed rate and payment of interest at a variable rate. Lock in a maximum value by purchasing an interest rate floor option.</td>
</tr>
<tr>
<td><strong>Firm Commitments:</strong></td>
<td></td>
</tr>
<tr>
<td>Commitment to issue a fixed-rate debt obligation - exposure to changes in fair value due to changes in market interest rates to date of issuance</td>
<td>Participate in changes in market interest rates from the commitment date through the date of issuance by entering into an interest rate futures contract to purchase U.S. Treasury securities.</td>
</tr>
<tr>
<td>Commitment to purchase inventory - exposure to changes in fair value due to changes in market prices to date of purchase</td>
<td>Participate in changes in the fair value of the inventory to date of purchase by entering into a forward contract to sell inventory.</td>
</tr>
<tr>
<td>Commitment to sell inventory - exposure to changes in fair value due to changes in market prices to date of sale</td>
<td>Participate in changes in the fair value of the inventory to date of sale by entering into a forward contract to purchase inventory.</td>
</tr>
</tbody>
</table>

**FAIR VALUE HEDGING CRITERIA**

20.04 The Standard requires that certain criteria be met for a hedge to qualify for hedge accounting. The criteria ensure that hedge accounting is used in a relatively consistent manner to
enhance the usefulness of the financial information that results from applying hedge accounting. These criteria are addressed in paragraphs 20 and 21 of the Standard (ASC paragraphs 815-20-25-1, 25-3, 25-11, 25-12, 25-43, 25-71 and 25-74 through 25-76). Specifically, the Standard provides the following two sub-sets of criteria that must be met:

- **Qualifying Hedge Criteria.** Paragraphs 20(a) - (c) of the Standard (ASC paragraphs 815-20-25-3, 25-75 and 25-76, and 25-94) discuss the criteria entities must meet for the combination of the hedging instrument and the hedged item (the combination of the derivative hedging instrument and the hedged item is referred to as the hedging relationship) to qualify for fair value hedge accounting.

- **Eligibility Requirements of the Hedged Item.** Paragraphs 21(a) - (f) of the Standard (ASC paragraphs 815-20-25-12(a) through 25-12(f)) discuss requirements that must be met for an item to be eligible for designation as the hedged item.

**QUALIFYING HEDGE CRITERIA**

**20.05** This section discusses the qualifying hedge criteria and is organized as follows:

- Formal documentation (see paragraph 20(a) of the Standard (ASC paragraph 815-20-25-3));
- Effectiveness of hedging relationships (see paragraph 20(b) of the Standard (ASC paragraphs 815-20-25-75 and 25-76));
- Special rule for written options (see paragraph 20(c) of the Standard (ASC paragraph 815-20-25-94)); and
- Proscription against fair value hedges involving nonderivative instruments.

**20.06** Paragraph 20 of the Standard (ASC paragraph 815-20-25-1) states, in part:

20. Designated hedging instruments and hedged items qualify for fair value hedge accounting if all of the following criteria and those in paragraph 21 are met:

**Formal Documentation**

**20a.01** The Standard requires formal documentation of a fair value hedge at its inception. This guidance is set forth in paragraph 20(a) (ASC paragraph 815-20-25-3) of the Standard as follows:

20a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness.

(1) For a fair value hedge of a firm commitment, the entity’s formal documentation at the inception of the hedge must include a reasonable method for recognizing in
earnings the asset or liability representing the gain or loss on the hedged firm commitment.

(2) An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.

DIG Issue related to this paragraph is F5. See DIG Issues Index.

20a.02 For a transaction to qualify for hedge accounting, the Standard requires formal documentation that is contemporaneous with the inception of the hedge of both the hedging relationship and certain key elements of the hedging strategy. While the form of this documentation is at the discretion of an entity’s management, it must include the following:

- Risk management objective of the hedge and the strategy for accomplishing the objective;
- Nature of the risk being hedged (see Paragraphs 21d.01, 21e.01, and 21f.01 of this section for eligible risks);
- Derivative hedging instrument;
- Hedged item;
- For the hedge of a firm commitment, a reasonable method for recognizing in earnings the hedged firm commitment recognized as a result of applying fair value hedge accounting (see Paragraph 20a.14 below);
- Manner in which the entity will retrospectively and prospectively assess hedge effectiveness (see Paragraph 20b.01 of this section); and
- Manner in which the entity will measure hedge ineffectiveness (see Paragraphs 20b.11 – 20b.14 of this section).

RISK MANAGEMENT OBJECTIVES AND STRATEGY

20a.03 Paragraph 20(a) of the Standard (ASC paragraph 815-20-25-3) requires that an entity formally document, at the inception of the hedge, their risk management objectives and strategy for undertaking the hedge. The primary objective of this requirement is to identify the nature of the risk being hedged and document how the derivative hedging instrument selected by the entity is expected to achieve the entity’s objective of reducing its exposure to changes in fair values attributable to the designated risk. The documentation is important because the method of assessing effectiveness and measuring ineffectiveness of the relationship (discussed later in this section) must be consistent with the stated objective and strategy. An example of objectives and strategies is illustrated in Example 5.1 of this section.

NATURE OF THE RISK BEING HEDGED

20a.04 The Standard requires entities to identify the risk(s) being hedged as part of the formal documentation. Risks that are eligible to be hedged are specified in paragraphs 21(d) - (f) of the
Standard (ASC paragraphs 815-20-25-12(d) through 25-12(f)). These requirements are discussed in Paragraphs 21d.01-21d.03, 21e.01-21e.06, and 21f.01-21f.19 of this section.

DERIVATIVE HEDGING INSTRUMENT(S)

20a.05 The formal documentation should identify the derivative hedging instrument(s), including the proportion (i.e., all or some percentage) of the derivative instrument that is designated as the hedging instrument. Paragraphs 18.02-18.03 in Section 4 discuss the concepts of portion and proportion.

20a.06 Sometimes, an entity will need to designate two or more derivative instruments in combination as the derivative hedging instrument in a hedging relationship to effect the aggregate specific terms that will result in a highly effective hedge. For example, an entity may be unable to conclude that an interest rate swap will be highly effective in offsetting the change in the fair value of a fixed-rate debt security that has an embedded call option unless the entity designates the interest rate swap in combination with an option contract because the fair value of only the interest rate swap may not be expected to be highly effective at offsetting changes in the fair value of the debt security. The debt security’s fair value could be affected in amounts that are different from the swap’s fair value due to the call option embedded in the debt security. The combination of two or more derivatives is appropriate under the Standard as long as the formal documentation identifies the combination.

20a.07 In contrast to the hedging strategy involving more than one derivative described in the preceding paragraph, there may be situations in which an entity enters into two derivative instruments, designates one as the derivative hedging instrument in a hedging relationship and characterizes the other as speculative, all in an effort to circumvent generally accepted accounting principles (GAAP). For example, an entity with a fixed-rate debt obligation may enter into an interest rate swap and designate that swap as the hedging instrument in a fair value hedge of the debt. If the entity simultaneously entered into another interest rate swap with the same counterparty, with terms that are the exact mirror image of the first swap, and treated the second swap as speculative, the entity must assess whether the combination of derivatives should be considered as a unit. That is, if the interest rate swaps were entered into in contemplation of one another for the sole purpose of obtaining fair value accounting for the debt (which is not appropriate under GAAP), the entity should conclude that the purpose of the transaction was not to enter into a bona fide hedging relationship involving the first swap. In that case, the two swaps would be viewed as a unit and would not qualify in the hedging relationship since the two derivatives would not be expected to be highly effective in offsetting changes in the fair value of the debt. It should be noted that such a determination will often be highly subjective and difficult to apply in practice. Thus, the application will require a significant amount of judgment and will be based on the facts and circumstances associated with the specific transaction in question. (See DIG Issues K1 and F6 for further reference.)

Derivative Novation

20a.07a Novation refers to the replacement of one party to a derivative instrument with a new party, whereby the original party transfers all rights and obligations to the latter party. Derivative novation may occur for a variety of reasons including but not limited to:
• In response to laws or regulatory requirements;
• When the derivative counterparty merges with and into a surviving entity that assumes the same rights and obligations that existed under a preexisting derivative instrument of the merged entities;
• When the derivative counterparty novates a derivative instrument to an entity under common control with the derivative counterparty;
• When the derivative counterparty decides to exit a particular derivative business or relationship; or
• For an OTC derivative entered into after applying the mandatory clearing requirement of the Dodd-Frank Act, when the counterparties agree in advance to clear the contract through a central counterparty according to standard market terms and conventions, and the entity’s hedging documentation describes the counterparties’ expectations that the OTC derivative will be novated to the central counterparty.

20a.07b In some situations, the derivative instrument that is the subject of the novation might be designated as the hedging instrument in a hedging relationship. In March 2016, the FASB issued ASU 2016-05, Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships (ASU 2016-05) that clarifies that a change in the counterparty to a derivative hedging instrument does not, in and of itself, require dedesignation of that hedging relationship. Instead, the ASU enables the existing hedging relationship to continue.

20a.07c As noted in Paragraph 25.01, a hedge accounting relationship must be discontinued prospectively if the hedging instrument is terminated. In reaching its consensus on derivative novations, the EITF noted that the analysis of whether a derivative instrument has been terminated in the context of hedge accounting was intended to go beyond a legal determination and focus on whether the hedging relationship itself would continue to exist. If the counterparty is the only change to the derivative instrument, the hedging relationship may be largely unaffected. Therefore, when a novation occurs, it is not considered to terminate the hedging instrument, and the hedging relationship can continue (assuming that all other hedge accounting criteria continue to be met).

20a.07d The EITF acknowledged that the hedging relationship would be affected by any change in creditworthiness resulting from the change in counterparties. However, in reaching its decision, the EITF considered that under existing requirements (ASC paragraphs 815-20-35-14 through 35-18) an entity would already be required to assess the creditworthiness of the derivative instrument counterparty in a hedging relationship. Therefore, if a derivative instrument novation involves a new counterparty with different creditworthiness than the old counterparty, the entity would consider that change in creditworthiness in determining whether the hedging relationship continues to qualify for hedge accounting, and the amount of hedge ineffectiveness that should be recorded (to the extent that it does continue to qualify for hedge accounting). Similarly, the EITF also noted that if a novation leads to changes in security or cash collateral posting requirements, those changes would also be incorporated into an entity’s assessment of hedge effectiveness and its measurement of hedge ineffectiveness.

20a.07e Effective Date and Transition. For public business entities, ASU 2016-05 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016.
For all other entities, ASU 2016-05 is effective for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Early adoption, including adoption in an interim period, is permitted. Entities have the option to apply the guidance either on a prospective basis or modified retrospective basis. See paragraphs ASC 815-20-65-2(e) through 65-2(i) for additional guidance on applying the modified retrospective transition provisions.

20a.07f Before the issuance of ASU 2016-05, the guidance in ASC Topic 815 was not explicit about the effect on an existing hedging relationship, if any, of a change in the counterparty to a derivative instrument that had been designated as a hedging instrument. The SEC staff had not objected to the conclusion that in specific circumstances a novation would not terminate the original derivative for accounting purposes and that hedge accounting could continue uninterrupted.\(^2\) The SEC guidance should not, however, be analogized to other circumstances in which the counterparty to a derivative hedging instrument is changed. As a result, if an entity has a derivative novation under other circumstances, it may need to early adopt the ASU to avoid the discontinuation of hedge accounting.

### Intercompany Derivative Hedging Instruments

20a.08 Depending on the risk being hedged, an intercompany derivative may be designated as a hedging instrument in the consolidated financial statements. If the hedged risk is either the risk of changes in fair value attributable to changes in a foreign currency exchange rate or the foreign exchange risk for a net investment in a foreign operation, an intercompany derivative can be designated as a hedging instrument provided that, in a fair value hedge of a recognized foreign-currency-dominated asset or liability or in a net investment hedge in the consolidated financial statements, the counterparty (i.e., the other member of the consolidated group) has entered into a contract with an unrelated third party that offsets the intercompany derivative completely, thereby hedging the exposure it acquired from issuing the intercompany derivative instrument to the affiliate that designated the hedge relationship.

20a.09 Intercompany derivatives may be designated as hedging instruments for hedges of foreign exchange risk in consolidated financial statements to enable entities to comply with the requirements in paragraph 40(a) of the Standard (ASC paragraph 815-20-25-30) that the operating unit with the foreign currency exposure be a party to the hedging instrument. This requirement is necessary because, under the functional currency approach of FASB Statement No. 52, Foreign Currency Translation (ASC Topic 830, Foreign Currency Matters), all foreign currency exposure exists only in relation to an entity’s functional currency. Therefore, exposure to foreign currency risk must be assessed at the operating unit level.

20a.10 In contrast, an intercompany derivative cannot be designated as the hedging instrument in consolidated financial statements if the hedged risk is (1) the risk of changes in the overall fair value of the entire hedged item, (2) the risk of changes in fair value attributable to changes in the designated benchmark interest rate, or (3) the risk of changes in fair value attributable to changes in credit risk. Similarly, an intracompany derivative (i.e., a derivative instrument contract

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\(^2\) See the circumstances described in the SEC letter to the International Swaps and Derivatives Association in May 2012 and the staff speech by Hillary H. Salo at the 2014 AICPA National Conference on Current SEC and PCAOB Developments.
between operating units within a single legal entity) cannot be designated as the hedging instrument in a hedge of those risks. Only a derivative instrument with an unrelated third party can be designated as the hedging instrument in a hedge of those risks in consolidated financial statements.

20a.11 There is no requirement in the Standard for the operating unit that has the interest rate, market price, or credit risk exposure be a party to the hedging instrument. Thus, for example, a parent company’s central treasury function can enter into a derivative contract with a third party and designate it as the hedging instrument in a hedge of a subsidiary’s interest rate risk solely for purposes of the consolidated financial statements. However, if the subsidiary enters into an intercompany derivative obtained from the parent’s central treasury function and qualifies for hedge accounting of the interest rate exposure in its separate-company financial statements that intercompany derivative would not qualify as the hedging instrument in the consolidated financial statements. If the central treasury function entered into a derivative contract with an unrelated third party to offset completely the risk arising from the intercompany derivative, that third-party derivative could be designated as the hedging instrument in the consolidated financial statements. (See DIG Issue E3 for further reference.)

HEDGED ITEM

20a.12 Paragraph 21 of the Standard (ASC paragraph 815-20-25-12) identifies the hedged item requirements. Identification of the hedged item and the risk being hedged in the documentation created at inception cannot be ambiguous because there may be factors, such as the existence of a simultaneous hedging relationship, that could call into question which hedged item or designated risk is part of a hedging relationship. Simultaneous hedges include (1) both a fair value hedge and cash flow hedge of a single instrument (when different risk exposures are being hedged – see Paragraphs 21d.01-21f.19 of this section for a discussion of hedgeable risks) and (2) more than one fair value hedge of the same hedged item (when different risk exposures are hedged with different hedging instruments). An example of simultaneous fair value hedges of the same recognized asset would be a lender’s fair value hedge of the benchmark interest rate and credit changes of the same commercial loan. An example of a simultaneous fair value and cash flow hedge involving the same instrument would be a cash flow hedge of a variable-rate investment security related to the benchmark interest rate and a fair value hedge related to that issuer’s credit risk. Accordingly, because simultaneous hedges are permitted and the hedged item may be subject to another hedge, it is critical to specify and document at inception which item and its associated risk are being hedged.

20a.13 An entity also should document at inception how it will calculate the change in the fair value (i.e., the gain or loss) on the hedged item attributable to the risk being hedged as this affects both the assessment of effectiveness and the amount of ineffectiveness that is reported in earnings.

20a.14 If the hedged item is a firm commitment, the formal documentation created at the inception of the hedging relationship is required to include the method, which must be reasonable, for recognizing in earnings the asset or liability that represents the gain or loss on the hedged firm commitment. Fair value hedge accounting related to firm commitments results in recognition of an asset or liability. That asset or liability represents the gain or loss on the commitment attributable to the hedged risk from the time the hedging relationship begins until it
ends. The documentation specific to firm commitments resulted from the Financial Accounting Standards Board’s (FASB or Board) belief that these assets or liabilities have been created because of the hedging relationship and, thus, there should be a reasonable basis for recognizing that item in earnings as part of the hedging relationship documentation. For some firm commitments, such as a firm commitment to purchase inventory, we expect those earnings adjustments would follow the entity’s existing inventory accounting policies. For other firm commitments, such as those embodied in a noncancelable operating lease, an entity would need to develop a policy for the earnings adjustments.

**METHOD FOR ASSESSING HEDGE EFFECTIVENESS**

20a.15 While the Standard provides an entity with flexibility in determining the method for assessing hedge effectiveness, the method used must be reasonable and must be defined and documented. In practice, effectiveness usually is assessed using either the dollar-offset method or a statistical method (of which regression analysis is most common). Once an entity selects a technique, there are various means of applying those techniques. Refer to Paragraphs A5.15-A5.22 of Appendix A of this section for a discussion of those techniques. Because the Standard provides for alternative techniques and those techniques have various application possibilities, the Standard requires the entity to document at the inception of a hedging relationship its decision about how it will assess effectiveness both on a retrospective and prospective basis. For example, an entity that excludes all or a part of the change in the time value of an option contract used as the derivative hedging instrument from the assessment of hedge effectiveness should include a discussion of that fact and the method used to measure the intrinsic value in its hedge documentation.

**METHOD FOR MEASURING INEFFECTIVENESS**

20a.16 In a fair value hedge, only the dollar-offset method can be used to measure ineffectiveness. However, in applying the dollar-offset method, the amounts that are included in the measurement of ineffectiveness can vary depending on the manner in which an entity assesses effectiveness (e.g., if the assessment of effectiveness excludes the time value components of the derivative, the measurement of ineffectiveness should also exclude those components). See Paragraphs 20b.11-20b.14 for additional discussion. Thus, documentation of how the dollar-offset method will be applied is required at the inception of the hedging relationship. Measuring hedge ineffectiveness is discussed below.

**LEVEL OF DETAIL IN HEDGE DOCUMENTATION**

20a.17 The level of detail required in hedge documentation is a matter of judgment. However, entities should be aware that the U.S. Securities and Exchange Commission (SEC) staff has stated that the method used to assess hedge effectiveness and measure ineffectiveness must be documented with sufficient specificity that a third party could perform the assessment and measurement based on the documentation and arrive at the same result as the entity applying the hedge accounting. We believe that level of specificity applies to all other components of the hedge documentation required by the Standard.
Example 5.1: Documentation of the Hedging Relationship

On January 1, 20X1, PD, a U.S. dollar (U.S.$) functional currency company, enters a firm commitment to purchase a machine from a British manufacturer for 10,000 pounds sterling (£) in 12 months. PD chooses to hedge the exposure to changes in fair value of the firm commitment attributable to foreign currency exchange rates. PD enters into a 12-month forward contract with Euro Bank to exchange a fixed amount of U.S.$ for a fixed amount of euros because PD has determined that changes in the U.S.$/euro exchange rate correlate with changes in the U.S.$/£ exchange rate. Except for the currency in which the forward contract will be settled (euros rather than £), the terms of the forward contract match those of the firm commitment.

Formal Documentation of the Hedging Relationship

Documentation is prepared on January 1, 20X1

Risk Management Objective and Strategy for Accomplishing That Objective, and Nature of the Hedged Risk

On January 1, 20X1, PD entered into a firm commitment to purchase a machine from a British manufacturer for £10,000 in 12 months. As a result, PD is exposed to changes in the fair value of this commitment during the next 12 months due to changes in the U.S.$/£ exchange rate.

PD’s risk management objective is to lock in the fair value (cost) of the firm commitment in its functional currency. PD meets this objective by entering into a 12-month forward contract to exchange a fixed amount of U.S.$ for a fixed amount of euros. PD expects that the amount of euros received under the contract will be sufficient to satisfy the £ obligation inherent in the firm commitment. That is, changes in the fair value of the forward contract caused by fluctuations in the exchange rate between the U.S.$ and euro are expected to be highly effective in offsetting changes in the fair value of the firm commitment caused by fluctuations in the exchange rate between the U.S.$ and £.

PD designates the forward contract (the hedging instrument) as a hedge of its exposure to changes in fair value attributable to changes in the U.S. $ and £ foreign currency exchange rates related to the firm commitment.

Derivative Hedging Instrument

A 12-month forward contract to exchange a fixed amount of U.S.$ for the amount of euros equal to £10,000 at the forward exchange rate at inception of the contract.

Hedged Item

Changes in the fair value of the firm commitment to purchase a machine from a British manufacturer for £10,000 in 12 months attributable to changes in the exchange rate between the U.S.$ and £. The change in the fair value of the firm commitment caused
by such exchange rate fluctuations will be measured based on the total changes in the £ forward exchange rates.

**Method for Recognizing in Earnings the Firm Commitment Asset or Liability**

Any changes in the fair value of the firm commitment caused by fluctuations in the exchange rates during the period in which the hedge is in effect will be reflected as an asset or liability. When the forward contract is closed and the machine is purchased (December 31, 20X1), the firm commitment asset or liability balance will be reclassified as an addition to, or subtraction from, the carrying value of the machine. This carrying value will be recognized in earnings in accordance with PD’s normal depreciation policy.

**How Hedge Effectiveness Will Be Assessed and Hedge Ineffectiveness Will Be Measured**

**Hedge Effectiveness Assessment:**

*At Inception:*

Prospectively: During the 12 months prior to inception of the forward contract, the fluctuations in the 12-month forward exchange rate between the U.S.$ and the euro were very similar to fluctuations in the 12-month forward exchange rate between the U.S.$ and the £. The entity’s cumulative dollar-offset method documented that a comparison of the fluctuations in the two forward exchange rates ranged from 90% to 110% over the past two years. Based on these findings, it is expected that such a relationship will continue during the next 12 months, which is the period that the hedge relationship between the forward contract and the firm commitment will be in place.

*During the Hedging Relationship:*

On a quarterly basis, the Company will assess effectiveness by updating the analysis performed coincident with the hedge designation to reflect the quarter’s fluctuations in the two exchange rates. The Company will consider the risk of default by the counterparty to the forward contract and the Company’s own nonperformance risk in this assessment.

Retrospectively: The Company will evaluate whether the hedging relationship has been highly effective during the quarter just ended by comparing the cumulative dollar fluctuations in the forward exchange rates between the U.S.$ and euro, and between the U.S.$ and £ (where the cumulative period is the period to date from the inception of the hedging relationship) at each quarter end.

Prospectively: On a quarterly basis, the Company will determine whether it expects the hedging relationship to continue to be highly effective based on the updated analysis.

**Measuring Ineffectiveness:**

Every three months ineffectiveness will be measured by comparing the three-month change in the fair value of the hedged firm commitment, measured based on the total changes in the £ forward exchange rates (see Hedged Item section above),
to the three-month change in total fair value of the hedging instrument. The Company will consider the risk of default by the counterparty to the forward contract and the Company's own nonperformance risk in this measurement process.

Effectiveness of Hedging Relationships

20b.01 The Board’s fourth fundamental decision (see Paragraph 3d.01 of Section 1), which serves as a cornerstone to the Standard’s hedge accounting model, states in part that hedge accounting is provided only if the derivative hedging instrument is expected to be, and actually is, effective at offsetting changes in the fair value of the hedged item attributable to the designated risk. Paragraph 20(b) of the Standard (ASC paragraphs 815-20-25-75 and 25-76) states:

20b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, the increases (or decreases) in the fair value of the hedging instrument must be expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship (in accordance with paragraph 20(a) above).

DIG Issues related to this paragraph are E7, E8, E11, F5, and F11. See DIG Issues Index.

20b.02 Fair value hedge accounting is appropriate only when entities have an expectation that changes in the fair value of a derivative hedging instrument will be highly effective at offsetting changes in the fair value of the hedged item attributable to the hedged risk. This expectation must exist both at inception of the hedge and during the period in which the hedge is designated. Entities are required to periodically assess effectiveness in order to validate that expectation.

20b.03 The requirements for assessing effectiveness are among the most difficult provisions of the Standard to understand and implement. Thus, we have developed a comprehensive discussion of hedge effectiveness assessments and the related, but different, concept of measuring hedge ineffectiveness. That discussion is located in Appendix A to this section; the information in this section should be read in conjunction with that appendix. This section briefly addresses the effectiveness requirements of the Standard and is organized as follows:

- Expectation of effectiveness;
- Meaning of highly effective;
- Effective at offsetting changes in fair value attributable to the designated risk;

3 The Standard (ASC Topic 815) permits entities to exclude certain elements of the total fair value of the derivative hedging instrument from the effectiveness assessment because those excluded components may be irrelevant to an entity’s risk management objective. This concept is further discussed in Appendix A to this section.

© 2019 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
• Periodic hedge effectiveness assessments;
• Consistent application of hedge effectiveness assessment methodologies;
• Consistency between assessment methodology and designated hedged risk;
• Relationship between assessing hedge effectiveness and measuring hedge ineffectiveness; and
• Requirement to consider measured ineffectiveness.

EXPECTATION OF EFFECTIVENESS

20b.04 The Standard requires entities to demonstrate both at inception and on an ongoing basis that the designated hedging relationship will be highly effective at offsetting changes in fair value attributable to the hedged risk. It does not, however, require that effectiveness be proven because effectiveness would, in almost all cases, be impossible to prove. Instead, the Standard requires entities to periodically assess effectiveness to conclude whether enough evidence supports an expectation of high effectiveness. These assessments generally involve a combination of quantitative and qualitative analyses. Thus, entities typically compute the relationship of the change in the derivative hedging instrument’s fair value as compared with the change in the fair value of the hedged item attributable to the hedged risk. The quantitative analyses usually involve either a dollar-offset computation or the use of statistics (with regression analysis being the most common technique). The qualitative factors often relate to how to estimate the fair values of the hedged item, the hedging instrument, or both, that are used in the quantitative analyses. For example, in some cases a quoted value of the derivative would not exist, and entities may estimate fair values using a discounted cash flow model, which involves a probability-weighted assessment of the instrument’s cash flows. Qualitative factors are considered in developing those probability weightings. The initial or ongoing application of hedge accounting is appropriate only when the expectation of high effectiveness is present. If during the course of a hedging relationship, the entity can no longer support its expectation of high effectiveness prospectively, hedge accounting would not be appropriate in subsequent periods. Paragraph 26 of the Standard (ASC paragraphs 815-25-40-3 through 40-5) addresses the required accounting in that circumstance and is discussed in Paragraphs 26.01-26.04 of this section.

MEANING OF HIGHLY EFFECTIVE

20b.05 A derivative hedging instrument should be expected to be highly effective at achieving changes in fair value that offset the changes in fair value of the hedged item attributable to the hedged risk during the term of the hedge. The Standard states that the Board intended the term highly effective to have essentially the same meaning as the notion of high correlation used in FASB Statement No. 80, Accounting for Futures Contracts (Statement 80) which the Standard superseded. As a result, we have interpreted highly effective to describe a fair value hedging relationship in which the change in the fair value of the derivative hedging instrument is within 80% to 125% of the opposite change in the fair value of the hedged item attributable to the hedged risk. This range represents the absolute change in the fair value of the derivative hedging instrument divided by the absolute change in the fair value of the hedged item attributable to the hedged risk. For example, if the fair value of the derivative hedging instrument increased by $80 and the fair value of the hedged item decreased by $100, the hedge would be ineffective by 50% (0.50 x 100 = 50).
and the fair value of the hedged item attributable to the hedged risk decreased by $100, practice has considered this relationship to be highly effective at 80% ($80/$100). Likewise, if the fair value of the derivative hedging instrument increased by $100 and the fair value of the hedged item decreased by $80, practice has considered this relationship to be highly effective at 125% ($100/$80).

EFFECTIVE AT OFFSETTING CHANGES IN FAIR VALUE ATTRIBUTABLE TO THE DESIGNATED RISK

20b.06 The Standard provides entities with a significant amount of flexibility in designating the hedged risk. For example, the Standard does not mandate that an entity hedge the entire change in the fair value of the hedged item in all cases. Rather, the Standard prescribes certain risks that may be hedged, and enables entities to define the risk being hedged, either narrowly or broadly, as they wish (within the requirements pertaining to the hedged item in paragraph 21 of the Standard (ASC paragraph 815-20-25-12). The Standard permits entities to select changes in the risk exposure in only one direction (increases or decreases). For example, an entity may hedge only an increase in the benchmark interest rate when hedging fixed-rate debt. When an entity wants to hedge only one side of a prescribed risk exposure (an increase or decrease), it must expect that the hedging instrument will be highly effective at providing offset to the change in the fair value of the hedged item attributable to either the increase or decrease that it is intended to hedge. In other words, it will be necessary to select a hedging instrument that provides that one-sided offset. Typically, an option is used in these circumstances due to its one-sided nature. Accordingly, in establishing hedging relationships, entities have flexibility in designating the hedged risk, but are required to select a derivative hedging instrument that is expected to be highly effective in providing offset to changes in the fair value of the hedged item that result from that risk.

PERIODIC HEDGE EFFECTIVENESS ASSESSMENTS

20b.07 In contrast to the flexibility that the Standard affords in the selection of the hedged risk, the Standard has very specific requirements about continued application of hedge accounting. Primarily because of the significant changes to the accounting for the hedged item and the effect on earnings of applying hedge accounting, the Standard requires that entities assess effectiveness at least every three months (even for entities, such as nonpublic companies, that do not prepare quarterly financial statements) or whenever an entity’s financial statements or earnings are reported, if more frequent. The effectiveness assessment requires that entities determine whether the hedging relationship was highly effective for the period (as defined in the hedge documentation) just ended and whether it is appropriate to continue applying hedge accounting because the relationship is expected to continue to be highly effective. Each time effectiveness is assessed, the results are required to be documented.

CONSISTENT APPLICATION OF HEDGE EFFECTIVENESS ASSESSMENT METHODOLOGIES

20b.08 As previously discussed, the Standard requires an entity, at the time it designates a hedging relationship, to define and document the method it will use to assess hedge effectiveness. It also states that ordinarily an entity should assess effectiveness for similar hedges
in a similar manner; use of different methods for similar hedges should be justified. Furthermore, it requires that an entity use its defined and documented methodology consistently throughout the period of the hedge. If, during the hedging relationship, an entity identifies an improved method of assessing hedge effectiveness, it must discontinue the existing hedging relationship and designate a new hedging relationship using the improved method (see Paragraph 25.01 of this section for a discussion of the discontinuation of hedge accounting). That type of change is not a change in accounting principle under FASB Statement No. 154, (ASC Subtopic 250-10, Accounting Changes and Error Corrections -- Overall). Therefore, no preferability letter from an independent auditor is necessary and the independent auditors’ report need not refer to this change. Nevertheless, entities that change methods need to:

- Document their justification for the change;
- Apply the new method to all similar hedges (unless facts and circumstances support a different method); and
- Prepare documentation for the new hedging relationship in a contemporaneous fashion to attain hedge accounting prospectively. (See DIG Issue E9 for further reference.)

20b.09 An entity should assess effectiveness for similar hedges in a similar manner, and justify the use of different methods for similar hedges. For an entity that has numerous autonomous business units, it would not be unreasonable to define entity at a business unit level rather than at a consolidated level, if those business units individually manage risk. Accordingly, judgment may be used in applying the requirement that an entity assess effectiveness similarly for similar hedges.

CONSISTENCY BETWEEN ASSESSMENT METHODOLOGY AND DESIGNATED HEDGED RISK

20b.10 Regardless of the method used to assess effectiveness, entities must assess effectiveness in a manner that is consistent with the documented risk management objective. In other words, when assessing effectiveness, the change in the fair value of the hedged item should consider only the risks that are being hedged. That change should be compared with the extent of offset provided by the derivative hedging instrument’s total fair value change (excluding changes related to components that are not included in the assessment of effectiveness, e.g., the time value of an option). For example, if an entity is hedging only the change in fair value of interest payments on debt due to an increase in the benchmark interest rate above a certain rate, the assessment of effectiveness should be limited to the extent of the change in the fair value of the debt resulting from increases in the benchmark interest rate over that specified rate. The assessment should not compare changes in the total fair value of the derivative hedging instrument with total changes in the fair value of the debt. To do so would introduce elements of the debt’s fair value (such as changes in the benchmark interest rate below the designated level) that are not considered in the objective of the hedge, which was to offset fair value changes in the interest payments on the debt due to increases in the benchmark interest rate above the specified rate.
RELATIONSHIP BETWEEN ASSESSING HEDGE EFFECTIVENESS AND MEASURING HEDGE INEFFECTIVENESS

20b.11 Once an entity concludes at inception that a hedging relationship is expected to be highly effective, it must periodically assess hedge effectiveness and measure ineffectiveness. Assessing effectiveness means determining the degree to which the change in fair value of the hedged item attributable to the risk being hedged has been and is expected to continue to be offset by the change in the fair value of the derivative hedging instrument. This assessment can be expressed in terms of a percentage of offset (e.g., within a range of 80% to 125%).

20b.12 The concept of effectiveness assessment is different from the measurement of ineffectiveness. In general, measuring ineffectiveness is the computation of the degree to which the changes in fair value of the derivative hedging instrument (limited to those elements of fair value included in the assessment of effectiveness as described in Appendix A to this section) are not equal to the changes in fair value of the hedged item attributable to the risk being hedged.

20b.13 The distinction between assessing effectiveness and measuring ineffectiveness is significant because a hedging relationship might result in a high level of assessed effectiveness, but also result in significant amounts of measured ineffectiveness. That condition may result from the use of regression analysis which expresses effectiveness numerically by representing the degree of the relationship between changes in the two variables to assess effectiveness, while measuring ineffectiveness using dollar-offset as required by the Standard.

20b.14 The measurement of ineffectiveness may be different from the amount that is recorded in earnings as a consequence of applying hedge accounting because, as described in Appendix A to this section, the Standard permits an entity to exclude certain gains and losses of the derivative hedging instrument from the assessment of effectiveness (and, consequently, the measurement of ineffectiveness). While those amounts may be excluded from the assessment of effectiveness and the measurement of ineffectiveness, the Standard requires that changes in those excluded components be recognized in earnings each period. Accordingly, entities may, over the same assessment period, experience a high level of assessed effectiveness, significant amounts of ineffectiveness, and amounts reflected in earnings that are different from the amount of measured ineffectiveness.

REQUIREMENT TO CONSIDER MEASURED INEFFECTIVENESS

20b.15 If, during the hedge period, the entity measures significant ineffectiveness for a hedging relationship, but the prospective and retrospective assessments of effectiveness based on regression analysis (or other statistical methods) indicate that the relationship is highly effective, an entity should investigate the results of its regression analysis to determine whether hedge accounting can be continued. We believe that when entities undertake that investigation, they may identify an aberration in the recent past in the relationship of the two elements being regressed that causes the significant measured ineffectiveness. While we believe that entities may find it relatively easy to identify a change in a market condition that has caused the aberration (e.g., the sudden and unexpected collapse of a major market-maker), significant amounts of judgment are required in assessing the period over which the effects of that market condition might persist and the relationship of that period to the term of the hedging relationship. For example, an entity may conclude that the effects of the market condition will continue for
more than one year while the term of the hedging relationship is only three months and, consequently, the entity would be required to prospectively discontinue hedge accounting. As long as an entity investigates the results of its regression analysis and can continue to conclude that the hedging relationship has been and is expected to be highly effective, it can continue to apply hedge accounting.

Special Rule for Written Options

20c.01 When hedging with a written option in a fair value hedge, the Standard requires that additional conditions be met along with all the other hedge criteria. Paragraph 20(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95) identifies these conditions:

20c. If a written option is designated as hedging a recognized asset or liability or an unrecognized firm commitment the combination of the hedged item and the written option provides at least as much potential for gains as a result of a favorable change in the fair value of the combined instruments as exposure to losses from an unfavorable change in their combined fair value. That test is met if all possible percentage favorable changes in the underlying (from 0% to 100%) would provide at least as much gain as the loss that would be incurred from an unfavorable change in the underlying of the same percentage.

(1) A combination of options (for example an interest rate collar) entered into contemporaneously shall be considered a written option if either at inception or over the life of the contracts a net premium is received in cash or as a favorable rate or other term. (Thus a collar can be designated as a hedging instrument in a fair value hedge without regard to the test in paragraph 20(c) unless a net premium is received.) Furthermore a derivative instrument that results from combining a written option and any other nonoption derivative shall be considered a written option.

7 The reference to combined instruments refers to the written option and the hedged item such as an embedded purchased option.

DIG Issues related to this paragraph are E2, E5, and F7. See DIG Issues Index.

20c.02 In general, an option is a contract that provides the holder with the right, but not the obligation, to buy or sell something, with that right received in exchange for payment of a premium. The premium compensates the writer of the option and is non-refundable. The writer of the option receives the premium either through payment of cash or through favorable (i.e., nonmarket) terms contained in the option contract. The writer of an option is considered to have a written option while the other party to the contract holds a purchased option. Certain contracts discussed below are combinations of options, and the combined derivative may be a net written option.

20c.03 The Board initially intended to prohibit hedge accounting for written options because written options serve to reduce the potential for gain in the hedged transaction while exposing the writer to unlimited loss. This is because the option holder has a right to exercise the option, which occurs only when the option has terms that are favorable to the holder (and consequently, that are adverse to the writer). When market conditions cause the option to have no value to the holder, the option is not exercised. Consequently, only the holder of the option stands to gain
from the intrinsic value of an option, while the writer is exposed to unlimited loss. In an example
of this concept, assume Company A acquired Company B’s common stock for $500 and that
stock now has a fair value of $700. Assume also that Company A writes an option such that
Company C can call the stock from Company A at a price of $700 at any time over the next 12
months and that a premium of $10 was received by Company A in exchange for entering into the
contract. Such a covered call strategy provides Company A with receipt of a premium. However,
it exposes Company A to unlimited economic loss in the event that the shares of Company B
stock increase in fair value above $700 because it is required to sell to Company C those shares
at $700, regardless of the market price of those shares.

20c.04 After considering input received from various constituents, the Board determined that it
would allow written options to be the derivative hedging instrument in very limited
circumstances that generally involve written options used to hedge purchased options that are
embedded in, but not bifurcated from, a host instrument.

20c.05 Written options may be used as a derivative hedging instrument in relationships that
involve recognized assets and liabilities (i.e., on-balance-sheet financial and nonfinancial assets
and liabilities) and unrecognized firm commitments. The Standard’s requirements for hedge
accounting for strategies using written options are based on the symmetry of the gain and loss
potential of the combined hedged position. Specifically, the Standard permits written options (or
net written options) to qualify for hedge accounting when the combination of the hedged item
and the written option provides at least as much potential for gains that result from a favorable
change in the underlying as exposure to losses that result from an unfavorable change in the
underlying of the same percentage (referred to as the written option effectiveness test). This
condition would be met when the hedged item is an embedded purchased option and the written
option has characteristics that offset those of the embedded purchased option. The purchased
option must be one that is not required to be separated from the host contract because, for
example, they are clearly and closely related. We believe that the written option effectiveness
test should be performed by reference to the strike price contained in the written option contract,
and not by reference to the current price of the underlying. For example, if the strike price of the
written option is $50 and the current price of the underlying is $20, the written option
effectiveness test is based on changes in prices of the underlying from $50 (the strike price of the
option). If the written option effectiveness test were based on changes from the current price of
the underlying, the written option effectiveness test typically would be met when the written
option is significantly out-of-the-money and, therefore, hedge accounting would not be
precluded.

20c.06 The Standard does not permit hedge accounting for covered call strategies referred to in
Paragraph 20c.03 of this section. Proponents of the strategy argue that, in a covered call strategy,
the decrease in the fair value attributable to the written option is covered by the increase in the
fair value attributable to the owned asset. However, a covered call strategy would not qualify for
fair value hedge accounting because it changes the risk profile of an asset from symmetrical (the
potential for favorable changes in fair value is at least as great as the exposure to unfavorable
changes in fair value) to asymmetrical (the potential for favorable changes in fair value is sold to
the holder of the option, but the writer retains the exposure to unfavorable changes, net of the
option premium).
20c.07 In a hedging relationship involving a written option, the written option effectiveness test is required only at the inception of the hedging relationship; the other hedge criteria must be met throughout the life of the hedging relationship. The requirement to consider that test only at inception exists because during the hedging relationship the underlying may change in such a way that the written option approaches having intrinsic value, in which case, the symmetry requirement would not be met. In addition, an entity may exclude the time value of a written option (or net written option) when applying the written option effectiveness test, provided that, in defining how hedge effectiveness will be assessed, the entity specifies that it will base its effectiveness assessment only on changes in the option’s intrinsic value. Thus, when applying the written option effectiveness test to determine whether there is symmetry of the gain and loss potential of the combined hedged position for all possible percentage changes in the underlying, an entity is permitted to measure the change in the intrinsic value of the written option (or net written option) combined with the change in fair value of the hedged item. (See DIG Issue F7 for further reference.)

20c.08 The following examples illustrate the written option effectiveness test:

**Example 5.2: Written Option That Does Not Qualify for Hedge Accounting**

Ben Cole Co. owns 1,000 restricted shares of Company B’s publicly traded stock, which are classified as available-for-sale. Ben Cole Co. acquired Company B’s shares for $30 per share and they are presently trading at $40 per share (i.e., there is a $10,000 unrealized gain). The terms of the restriction prohibit Ben Cole Co. from selling these shares for six months. Ben Cole Co. believes the value of these shares is going to remain relatively flat over the six months and wants to write a call option to enhance its return on this investment. Consequently, Ben Cole Co. writes a call option that provides Company C with the ability to call Ben Cole Co.’s 1,000 Company B shares at a price of $48 per share in six months. In return for writing this call option, Ben Cole Co. receives a premium of $1,000. Assume that all other criteria for hedge accounting have been met.

This written option would not qualify for hedge accounting because the combination of the written option and the hedged Company B investment does not always provide as much potential for gain as potential for loss. That is, if the fair value of Company B’s stock decreased to $36 per share as compared to the $48 per share strike price of the written option (i.e., a 25% decrease in fair value), Ben Cole Co. would have sustained an economic loss on the combination of the written option and the hedged investment of $11,000.¹ However, an increase in the fair value of Company B’s stock to $60 per share as compared to the $48 per share strike price of the written option (i.e., a 25% increase in fair value) would result in a cumulative net economic gain of $1,000² on the combined instruments.

¹ The $12,000 economic loss on investment in Company B, as compared to the $48 per share strike price of the written option, less $1,000 premium received on the written option. The written option’s intrinsic value is zero.

² The $12,000 potential economic gain on investment in Company B for the increase in fair value, as compared with the $48 per share strike price of the written option, is fully offset by the intrinsic value loss on the written option. This leaves Company A with $1,000 premium received on the written option.
**Example 5.3: Written Option Qualifying as a Hedge of an Embedded Call Option in a Debt Obligation**

KSB issues a five-year, $100,000 debt obligation. The interest rate on the debt obligation is fixed at 10%. The debt obligation is callable by KSB in three years at par. KSB wishes to hedge the risk of a decrease in the fair value of the embedded call option attributable to increases in interest rates. To accomplish this hedge, KSB writes an option on a swap (i.e., a swaption) that provides Investment Bank B with the option to put an interest rate swap to KSB in three years. The terms of the interest rate swap are such that KSB would receive London Interbank Offered Rate (LIBOR) and pay 10% on a notional amount of $100,000 for two years. KSB received a premium of $1,000 for writing this option. Assume that all other criteria for hedge accounting have been met.

This written option (i.e., the swaption) would qualify for hedge accounting because the combination of the written option and the embedded call option would always provide as much potential for gain as potential for loss because the terms of the written option are exactly the same as the terms of the embedded call option. More specifically, the fair values of these instruments will exactly offset whether interest rates increase or decrease (if interest rates decrease, KSB will call the debt obligation and Investment Bank B will exercise its option; if interest rates increase, KSB will not call the debt obligation and Investment Bank B will not exercise its option). In either case, KSB will receive $1,000, representing the premium received for writing the option.

**Example 5.4: Written Option Qualifying as a Hedge of an Embedded Cap in a Long-term Supply Contract**

XYZ enters into a long-term supply contract with a vendor to purchase a specified amount of a certain material. The purchase price is the then current monthly average list price for the quantity delivered each month but not to exceed $15 per pound. The current list price at the contract signing date is $12 per pound. The contract can be settled only by physical delivery. The contract also includes a penalty provision that is sufficiently large to make performance probable. XYZ is not required to make an up-front cash payment for the embedded purchased price cap in the supply contract. Consequently, the supply contract is neither a recognized asset nor a recognized liability at inception.

The supply contract in its entirety does not meet the definition of a derivative due to the absence of a net settlement characteristic (i.e., the contract does not permit or require net settlement [paragraph 9(a) of the Standard (ASC paragraph 815-10-15-100)], there is no market mechanism [paragraph 9(b) (ASC paragraph 815-10-15-110)], and it does not require delivery of an asset that is readily convertible to cash [paragraph 9(c) (ASC paragraphs 815-10-15-119 and 15-120)]. Pursuant to the guidance in DIG Issue No. B14, “Purchase Contracts with a Selling Price Subject to a Cap and a Floor,” the embedded cap on the selling price is an option that does not warrant separate accounting under the Standard because it is clearly and closely related to the host supply contract. As indicated in footnote 8 to paragraph 21(a) of the Standard (ASC paragraph 815-20-25-12), a supply contract for which the contract is fixed only in certain
circumstances (such as when the selling price is above an embedded price cap or below an embedded price floor) meets the definition of a firm commitment for purposes of designation in a fair value hedge.

XYZ wishes to enter into a transaction to hedge the risk of changes in the fair value of the embedded price cap (a purchased call option) in the supply contract. Accordingly, it writes a net cash settled call option with an unrelated counterparty with a strike price of $15 per pound and a notional amount equal to the quantity specified in the supply contract. In exchange for writing such option, XYZ receives a premium of $1,000. Assume that all other criteria for hedge accounting have been met.

The written option would qualify as a hedging instrument because the combination of the written call option and the embedded purchased call option would always provide at least as much potential for gains as potential for losses since the terms of the options are the same. More specifically, the intrinsic value of the purchased option will exactly offset the intrinsic value of the written option. For example, if market prices rise to $18 per pound, the purchased call option will increase in value (i.e., there will be intrinsic value resulting from the ability to obtain the specified materials at $15 per pound while the market price has risen) while the intrinsic value of the written call option will have an equal but opposite value (i.e., from the requirement to deliver the specified materials at less than market prices). The changes in the intrinsic values will offset, while the writer will benefit from the $1,000 premium received. If the price of the material remains below $15 per pound, neither the purchased or written call option has intrinsic value, while XYZ benefits from monetization of the purchased option’s value with the receipt of the $1,000 premium.

COMBINATIONS OF OPTIONS

20c.09 Entities may use hedging strategies that involve a combination of option contracts. For example, an entity may purchase a put option and write a call option, commonly referred to as a collar. This combination of options provides the entity with a desired amount of protection against changes in fair values outside of a range of values, while offsetting a portion of the cost of the purchased put option through the premium received on the written call option. In determining whether these combinations of options qualify for hedge accounting, an entity first must determine whether the combination of options is a net purchased option or a net written option that would be subject to the written option effectiveness test. For a combination of options, in which the strike price and the notional amount in both the written option component and the purchased option component remain constant over the life of the respective component, to be considered a net purchased option (and thus be eligible to be designated as a hedging instrument without consideration of the written option effectiveness test of paragraph 20(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95)), all of the following conditions must be met:

- No net premium is received (either through payment in cash or another asset, or through favorable terms contained in the contract) at inception or at any point during the life of the option contracts that the combination option comprises;
- The components of the combination option are based on the same underlying;
• The components of the combination option have the same maturity date; and
• The notional amount of the written option component is not greater than the notional amount of the purchased option component.

20c.10 All of the above conditions must be met at the inception of the hedging relationship in order for the combination of options to not be considered a written option in its entirety.

20c.11 If either the written option component or the purchased option component for a combination of options has strike prices or notional amounts that do not remain constant over the life of the respective component, whether that combination of options can be considered not to be a written option in its entirety under paragraph 20(c)(1) of the Standard (ASC paragraph 815-20-25-88) (i.e., whether a net premium in cash or as a favorable rate or other term is received) should be assessed with respect to each date that either the strike prices or the notional amounts change within the contractual term of the instrument. Even though that assessment is made on the date that a combination of options is designated as a hedging instrument to determine the applicability of paragraph 20(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95), an entity must consider the receipt of a net premium (in cash or as a favorable rate or other term) from that combination of options at each point in time that either the strike prices or the notional amounts change. In addition, if any of the four conditions discussed in Paragraph 20c.09 above are not met at any date that either the strike prices or notional amounts change, the entire contract is considered a net written option. (See DIG Issues E2 and E5 for further reference.)

20c.12 The following examples illustrate the evaluation of a combination of options.

Example 5.5: Evaluation of Whether a Combination of Options is a Net Written Option

On January 1, 20X1, LWS Corporation entered into two collar arrangements. The details of the collar arrangements are as follows:

• No net premium was received by LWS Corporation at inception of the collar contracts.
• Both option contracts that comprise the collars are based on the same underlying and have the same maturity date.
• The notional amounts of the purchased option component and the written option component that comprise the two collars are equal and constant over the life of the option contracts.
• The strike prices (cents per unit) of the two collars are as follows:

<table>
<thead>
<tr>
<th>Collar 1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
<th>20X5</th>
<th>20X6</th>
<th>5-yr Avg.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchased Put</td>
<td>98.3</td>
<td>98.3</td>
<td>98.3</td>
<td>98.3</td>
<td>98.3</td>
<td>98.3</td>
</tr>
<tr>
<td>Written Call</td>
<td>110.6</td>
<td>110.6</td>
<td>110.6</td>
<td>110.6</td>
<td>110.6</td>
<td>110.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Collar 2</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
<th>20X5</th>
<th>20X6</th>
<th>5-yr Avg.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchased Put</td>
<td>108.5</td>
<td>108.5</td>
<td>91.5</td>
<td>91.5</td>
<td>91.5</td>
<td>98.3</td>
</tr>
</tbody>
</table>
When strike prices fluctuate over the life of a combination of options and no net premium is received at inception, it is necessary to determine whether a net premium is received as a favorable term in one or more periods within the contractual term of the option contracts (from inception to maturity).

Based on the above set of facts:

- Collar 1 is a zero-cost collar and not a net written option. Since the strike price and the notional amount in both the written option component and the purchased option component remain constant over the life of the respective components and (1) no net premium was received; (2) the components of the combination option are based on the same underlying; (3) the components of the combination option have the same maturity date; and (4) the notional amount of the written option component is not greater than the notional amount of the purchased option component, the combination of options is not considered a written option and, therefore, the effectiveness test requirement of paragraph 20(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95) is not applicable.

- Collar 2 is a net written option. Since the strike prices of the written option component and the purchased option component are not constant over the life of the contract, the assessment to determine whether the combination of options can be considered not to be a written option under paragraph 20(c)(1) of the Standard (ASC paragraph 815-20-25-88) must be performed with respect to each date on which the strike prices change from inception to maturity. In general, when strike prices fluctuate over the life of a combination of options and no net premium is received at inception, a net premium typically will be received as a favorable term in one or more periods from inception to maturity. For Collar 2, premiums are received in early periods as consideration for entering into net written options in later periods. Specifically, the purchased put option contains an average strike price over its life of 98.3. During the 20X2 and 20X3, the strike price of the purchased put option is greater than that average. LWS can put the underlying to the counterparty during 20X2 and 20X3 at a price that is higher than the average for all of the years combined. This premium is received by LWS for the years 20X2 and 20X3 in return for accepting a lower than average strike price of the purchased put option in 20X4, 20X5, and 20X6. Although the premium is not received in cash, it is received in more favorable terms during the first two years of the contract when compared to the last three years of the contract. Thus, the additional effectiveness test requirement of paragraph 20(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95) must be met for the collar to be the hedging instrument in a hedging relationship.
Example 5.6: Hedge of an Available-for-Sale Equity Security with an Equity Collar

Licter owns 100 shares of Company C, a publicly held entity, which are classified as available-for-sale. Licter’s shares of Company C, which were acquired at $10 per share, currently are trading at $30 per share. Licter wants to lock in some of the unrealized gains associated with its investment in Company C. Accordingly, Licter enters into an equity collar with KDR.

The equity collar provides that Licter will pay KDR any appreciation in the market value of Company C stock above $35 (i.e., Licter has written a call option). In addition, KDR is required to pay Licter any depreciation in the market value of Company C stock below $25 (i.e., Licter has purchased a put option).

By entering into this equity collar, Licter ensured that its investment in Company C stock, when combined with the value of the equity collar, will lock in a price in the range of $25 - $35 per share.

There was no net cash paid or received by Licter as a result of entering into this agreement (i.e., the premium received on the written call option equals the premium paid on the purchased put option).

The equity collar has a one-year term and can be settled only at the end of the one-year term (i.e., a European-style option).

Assessment of Hedge Effectiveness

Since the strike price and the notional amount in both the written option component and the purchased option component remain constant over the life of the respective components and (1) no net premium was received; (2) the components of the combination option are based on the same underlying; (3) the components of the combination option have the same maturity date; and (4) the notional amount of the written option component is not greater than the notional amount of the purchased option component, the combination of options is not considered a written option and, therefore, the effectiveness test requirement of paragraph 20(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95) is not applicable. Because an equity collar is the combination of a purchased option and a written option, an entity should use a methodology similar to that used for purchased options in determining whether the equity collar is highly effective as a hedge of Licter’s investment in Company C. Accordingly, Licter can assess effectiveness of this hedge by comparing changes in the intrinsic value of the equity collar with changes in the fair value of its investment in Company C. Because the equity collar will only have intrinsic value when the share price of Company C stock is outside the $25 - $35 per share price range, effectiveness will be assessed only during these periods.

Because the terms of this equity collar is 100 shares of Company C stock, it can be concluded that the changes in the intrinsic value of the equity collar outside the $25 - $35 per share price range will be highly effective at offsetting the changes in the fair value of Licter’s investment in 100 shares of Company C stock.
As the assessment of effectiveness of this hedge will be based on changes in the collar’s intrinsic value, the changes in the time value of the collar should be included currently in earnings.

**Measurement of Hedge Ineffectiveness**

Assume for the first three months of the hedge that Company C’s stock price declined to $20 per share and the fair value of the collar was $525.

There would be no hedge ineffectiveness related to the designated risk because the option’s intrinsic value always will move in tandem with the hedged investment in Company C’s stock outside the $25 - $35 per share range. However, because the assessment of effectiveness of this hedge will be based on changes in the collar’s intrinsic value, the changes in the time value of the collar should be included currently in earnings.

The change in time value would be determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time value of collar at hedge inception</td>
<td>$0</td>
</tr>
<tr>
<td>Time value of collar at end of period</td>
<td>$25</td>
</tr>
<tr>
<td>Change in time value</td>
<td>$25</td>
</tr>
</tbody>
</table>

There was no intrinsic value at inception of the hedge. The entire value of the collar at inception is attributable to time value. The collar’s value at inception is zero; therefore, the time value of the collar at inception is zero.

The time value of the collar at the end of the period was determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of the collar</td>
<td>$525</td>
</tr>
<tr>
<td>Less intrinsic value (($25-$20)*100 shares)</td>
<td>$500</td>
</tr>
<tr>
<td>Time value of the collar</td>
<td>$25</td>
</tr>
</tbody>
</table>

There is no hedge ineffectiveness for the hedged risk (i.e., intrinsic value); therefore, the $25 change in time value (which was documented at inception of the hedge as not being included in the assessment of hedge effectiveness) is the only amount that impacts net earnings.

20c.13 A derivative instrument that combines a written option and a nonoption derivative (e.g., an indexed amortizing swap or a swap with a knock-out provision) is considered a written option and, thus, is required to meet the written option effectiveness test to qualify for hedge accounting.

20c.14 Often, entities enter into interest rate swaps with notional amounts that amortize based on an index. These instruments are referred to as indexed amortizing swaps and are considered to be written options because they combine an interest rate swap (a nonoption derivative) with a written option, and are subject to the written option effectiveness test if an entity attempts to designate it in a hedging relationship. The written option is the option provided to one of the parties to reduce the amount on which interest payments will be exchanged based on a strike price (the relevant index). As the index level is met, the party calls a portion of the notional amount based on the terms of the derivative, and subsequent payment provisions of the swap are based on a new notional amount. When evaluating these instruments, entities must consider...
whether they are the writer or the purchaser of the option. The writer of the option receives at inception or over the life of the contract a net premium either through payment in cash, another asset, or through favorable terms contained in the contract.

20c.15 Indexed amortizing swaps are different from amortizing swaps. The terms of amortizing swaps call for scheduled reductions in the notional amount on which the payment provisions are based and there is no optionality to that feature. Thus, amortizing swaps are neither net written option nor a combination option.

20c.16 In certain derivative contracts, such as interest rate swaps and foreign currency and commodity forward contracts, the terms of the instrument contain knock-out or knock-out/knock-in provisions. These provisions allow the counterparty to cease or modify payments normally due under the derivative when the underlying exceeds a predetermined rate or price. These features lower the cost of the derivative to the customer by decreasing the possible gain that would be generated by the derivative in the absence of the feature that allows the counterparty to modify or cease payment.

20c.17 Take, for example, a transaction in which an entity enters into a pay-fixed, receive-LIBOR interest rate swap agreement with a fixed leg of 6% and a variable leg of LIBOR. The contract contains a knock-out/knock-in provision under which the net settlement payments under the contract are $0 when LIBOR equals or exceeds 8%. If LIBOR subsequently drops below 8%, payments resume. Thus, when the customer would be receiving a 200 or greater basis point spread, the net settlement becomes $0. If this provision were not included in the contract, the cost of the swap to the customer would be higher (e.g., the pay-fixed leg may have been more than 6%).

20c.18 These knock-out and knock-out/knock-in provisions are considered written options, because a net premium is received in the form of a favorable rate or other term in exchange for the provision. When the provision (written option) is combined with a nonoption derivative (the interest rate swap in the example above) paragraph 20(c)(1) of the Standard (ASC paragraph 815-20-25-88) requires that the entire contract be considered a net written option.

20c.19 In the majority of derivative contracts that contain knock-out or knock-out/knock-in provisions, the written option provision reduces the potential gain in the derivative when it is beneficial to the reporting entity. When this feature is combined with the hedged item’s concurrent negative effect, the net result is a loss on the combined derivative and hedged item position. However, when the derivative is detrimental to the reporting entity, there is no offsetting knock-out or knock-out/knock-in provision. Thus, when this is combined with the hedged item’s concurrent positive effect, the result is a neutral effect of the combined derivative and hedged item position. Thus, we believe that circumstances are rare in which a derivative contract containing a knock-out or knock-out/knock-in provision would meet the written option effectiveness test in paragraph 20(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95) and qualify for hedge accounting treatment.

20c.20 There are a variety of issues associated with assessing hedge effectiveness and measuring hedge ineffectiveness in hedging relationships involving option contracts. These issues are discussed in Appendix A to this section.
Proscription Against Fair Value Hedges Involving Nonderivative Instruments

20.07 Paragraph 20 of the Standard (ASC paragraph 815-20-25-71) states the following about nonderivative instruments:

20. A nonderivative instrument, such as a Treasury note, shall not be designated as a hedging instrument, except as provided in paragraphs 37 and 42 of this Statement.

20.08 From an economic perspective, entities can hedge their fair value exposures in several ways. One way of doing so is to use financial instruments (i.e., recognized financial assets or financial liabilities such as investments or debt obligations) to mitigate the risk attributable to existing assets or liabilities or unrecognized firm commitments. For example, an entity might want to designate a fixed-rate asset in a hedge of a fixed-rate liability because the fair values of the two positions may be expected to offset. The accounting model for fair value hedges discussed in this section relates only to hedging relationships that involve instruments that meet the characteristics-based definition of a derivative contained in paragraph 6 of the Standard (ASC paragraph 815-10-15-83). Nonderivative instruments used in economic hedges of existing assets or liabilities or unrecognized firm commitments are required to be accounted for based on the relevant accounting requirements for those instruments.

20.09 Except in the limited circumstances described in Paragraph 20.10 below, the Board believes that accounting for a nonderivative instrument as a hedging instrument is inappropriate because:

- Hedge accounting may result in overriding the established measurement principles for the nonderivative instrument simply because it is part of a hedging relationship; and
- The accounting for nonderivative instruments is adequately addressed by existing accounting literature.

20.10 Items such as securities, trade receivables and payables, and deposit liabilities may not be designated as fair value hedging instruments, except that, consistent with the provisions in Statement 52 (ASC Subtopic 830-10), nonderivative instruments that give rise to foreign currency transaction gains and losses may be designated as fair value hedging instruments of foreign-currency-denominated unrecognized firm commitments and hedges of net investments in foreign operations. These issues are discussed in greater detail in Section 7.

ELIGIBILITY REQUIREMENTS OF THE HEDGED ITEM

21.01 In addition to the qualification requirements discussed in Paragraph 20 of the Standard (ASC paragraphs 815-20-25-94 and 25-95), paragraph 21 of the Standard (ASC paragraph 815-20-25-12) provides the following requirements that must be met for an item to be eligible for designation as the hedged item in a fair value hedging relationship:

The hedged item:

- Is either all or a specific portion of a recognized asset or liability or unrecognized firm commitment (see paragraph 21(a) of the Standard (ASC paragraph 815-20-25-12(a)));
• Presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings (see paragraph 21(b) of the Standard (ASC paragraph 815-20-25-12(c))); and

• Is prohibited from having certain other characteristics (see paragraph 21(c) of the Standard (ASC paragraph 815-20-25-12(c))).

The designated risk being hedged must meet specific conditions for the following hedged items:

• Held-to-maturity securities (see paragraph 21(d) of the Standard (ASC paragraph 815-20-25-12(d)));

• Nonfinancial assets or liabilities (other than recognized loan servicing rights or nonfinancial firm commitments with financial components) (see paragraph 21(e) of the Standard (ASC paragraph 815-20-25-12(e))); and

• Financial assets or liabilities, recognized loan servicing rights, or nonfinancial firm commitments with financial components (see paragraph 21(f) of the Standard (ASC paragraph 815-20-25-12(f))).

Recognized Asset or Liability or Unrecognized Firm Commitment

21.02 Paragraph 21 of the Standard (ASC paragraph 815-20-25-12) discusses eligibility requirements of the hedged item and begins with the following:

21. An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following criteria are met:

(a) The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment.* The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof).

(1) If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10% during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9% to 11%. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7% to 13% would be inconsistent with this provision. In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate: loan type, nature and location of collateral, interest rate type (fixed or variable) and the coupon

* The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof).
interest rate (if fixed), scheduled maturity, prepayment history of the loans (if seasoned), and expected prepayment performance in varying interest rate scenarios.\(^9\)

(2) If the hedged item is a specific portion of an asset or liability (or of a portfolio of similar assets or a portfolio of similar liabilities), the hedged item is one of the following:

(a) A percentage of the entire asset or liability (or of the entire portfolio)

(b) One or more selected contractual cash flows (such as the portion of the asset or liability representing the present value of the interest payments in the first two years of a four-year debt instrument)

(c) A put option or call option (including an interest rate or price cap or an interest rate or price floor) embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 12 of this Statement

(d) The residual value in a lessor’s net investment in a direct financing or sales-type lease.

If the entire asset or liability is an instrument with variable cash flows, the hedged item cannot be deemed to be an implicit fixed-to-variable swap (or similar instrument) perceived to be embedded in a host contract with fixed cash flows.

\(^8\) A firm commitment (as defined in paragraph 540) that represents an asset or liability that a specific accounting standard prohibits recognizing (such as a noncancelable operating lease or an unrecognized mortgage servicing right) may nevertheless be designated as the hedged item in a fair value hedge. A mortgage banker’s unrecognized interest rate lock commitment (IRLC) does not qualify as a firm commitment (because as an option it does not obligate both parties) and thus is not eligible for fair value hedge accounting as the hedged item. (However, a mortgage banker’s forward sale commitments, which are derivatives that lock in the prices at which the mortgage loans will be sold to investors, may qualify as hedging instruments in cash flow hedges of the forecasted sales of mortgage loans.) A supply contract for which the contract price is fixed only in certain circumstances (such as when the selling price is above an embedded price cap or below an embedded price floor) meets the definition of a firm commitment for purposes of designating the hedged item in a fair value hedge. Provided the embedded price cap or floor is considered clearly and closely related to the host contract and therefore is not accounted for separately under paragraph 12, either party to the supply contract can hedge the fair value exposure arising from the cap or floor.

\(^9\) Mortgage bankers and other servicers of financial assets that designate a hedged portfolio by aggregating servicing rights within one or more risk strata used under paragraph 63(g) of Statement 140 would not necessarily comply with the requirement in this paragraph for portfolios of similar assets. The risk stratum under paragraph 63(g) of Statement 140 can be based on any predominant risk characteristic, including date of origination or geographic location.

DIG Issues related to this paragraph are E10, E17, E18, F1, F2, F8, F10, F11, G4, H4, and J14. See DIG Issues Index.

21a.01 The primary issues addressed in paragraph 21(a) (ASC paragraph 815-20-25-12(a)) are as follows:

- Which items may be designated as a hedged item;
- Can a group of similar items be hedged as a portfolio; and
- What is meant by a specific portion.
**WHICH ITEMS MAY BE DESIGNATED AS A HEDGED ITEM**

21a.02 Paragraph 21(a) of the Standard (ASC paragraph 815-20-25-12(a)) states that the hedged exposure in a fair value hedge is required to be a recognized asset or liability or an unrecognized firm commitment. The Board decided that an unrecognized asset or liability that does not embody a firm commitment should not be eligible for designation as a hedged item because applying fair value hedge accounting to such an unrecognized asset or liability would result in recognizing a portion of it. For example, fair value hedge accounting for an unrecognized intangible asset, such as an internally generated core deposit intangible, would have the effect of recognizing the change in the fair value of the intangible asset. The Board believes a change to require or permit recognition of certain intangible assets or potential liabilities that are not now recognized should be made only after careful consideration of the related conceptual and practical issues rather than being a by-product of hedge accounting.

21a.03 However, the Standard permits an unrecognized firm commitment, including one that is embodied in an unrecognized asset or liability such as an operating lease with substantial cancellation penalties or mortgage servicing rights, to be designated as the hedged item in a fair value hedge. The Board recognizes that permitting such firm commitments to be designated as hedged items may be viewed as inconsistent with not permitting other unrecognized assets and liabilities to be hedged items. The Board considered limiting the firm commitments that can be hedged items, for example, to those for which there is no explicit authoritative accounting requirement that precludes recognition of the related asset or liability. However, the Board was unable to identify a specific limitation that would be both workable and equitable. Moreover, the Board notes that a firm commitment as defined in the Standard must have a fixed price and a disincentive for nonperformance sufficiently large to make performance probable (see Paragraph 21a.12 below), which makes hedging a firm commitment less problematic than hedging an unrecognized item such as an internally generated intangible asset. Accordingly, with the limited exceptions discussed in paragraph 21(c) of the Standard (ASC paragraph 815-20-25-12(c)), the Board decided to permit all firm commitments as defined in the Standard to qualify as hedged items in fair value hedges.

21a.04 An event or transaction that is expected to occur in the future (i.e., a forecasted transaction) also would be prohibited from being designated as the hedged item in a fair value hedge (see Paragraphs 28.04-28.07 of Section 6 for a discussion of forecasted transactions).

21a.05 The hedged item in a fair value hedging relationship can be an unrecognized firm commitment, which is defined in Appendix F to the Standard (ASC Section 815-20-20) as follows:

An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

(a) 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 an entity’s functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield.
(b) The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable.

21a.06 The definition of a firm commitment in the Standard requires that the fixed price be specified in terms of a currency (or an interest rate) rather than an index or an asset other than a currency. The Board reasoned that a price that varies with the market price of the item that is the subject of the firm commitment cannot qualify as a fixed price. For example, an agreement to purchase a gold ring in one year would not be a firm commitment if payment were to be made in a fixed quantity of gold because the price of gold is not fixed. The price of the fixed quantity of gold varies with the market price of the gold. However, the price of a firm commitment may be specified in any currency and it need not be in the entity’s functional currency. Therefore, assuming all other firm commitment criteria are met, a contract calling for payment fixed in a foreign currency would be considered a firm commitment even if the entity had the U.S. dollar as its functional currency and the remeasured U.S. dollar amount of the contract varies due to exchange rate fluctuations. Since a firm commitment in a currency other than the entity’s functional currency also exposes the entity to variability in cash flows due to changes in currency rates, it may be a hedged item in a cash flow hedge of foreign currency risk. This is discussed further in Paragraph 40.14 of Section 7.

21a.07 A firm commitment is subject to exposures that are similar to those of an existing asset or liability because they embody certain rights to benefits or obligations to make sacrifices. When the designated hedged item in a fair value hedging relationship is an unrecognized firm commitment, entities are required to estimate its fair value. In doing so, entities may base their estimate of fair value on forward prices (because a firm commitment relates to rights or obligations that will be realized in the future) or on spot prices. Accordingly, when hedging changes in the fair value of a firm commitment attributable to changes in prices, entities may either designate the risk being hedged as either changes in forward prices or changes in spot prices.

21a.08 Examples of firm commitments are as follows:

- An agreement to purchase a particular machine in one year at a specified price;
- A royalty agreement that provides for fixed periodic payments at specific time intervals (if no minimum amount is specified, the agreement would not meet the definition of a firm commitment because the quantity to be exchanged would be unknown);
- A noncancelable operating lease payment or payments with fixed rental payments over a specified period; and
- An agreement to purchase a specified quantity of assets at a specific price and date.

Related Parties

21a.09 A firm commitment must be between two unrelated parties. Therefore, intercompany contracts do not meet the definition of a firm commitment and cannot be hedged in a fair value hedge. Interestingly, the definition of a forecasted transaction does not include a requirement that the transaction be with an unrelated party. Instead, for a forecasted transaction to qualify as a hedgeable exposure, it must be a transaction with a party external to the reporting entity. The
difference between the two terms is not clear. However, we believe the term related party
generally includes all parties specified in FASB Statement No. 57 (ASC Subtopic 850-10,
Related Party Disclosures -- Overall). Thus, we believe the term related party to be more
encompassing than the term party external to the reporting entity. In particular, we believe that
the use of the term party external to the reporting entity limits the prohibition on hedging
forecasted transactions only to transactions with entities that are controlled or consolidated by
the reporting entity. As a result, we believe transactions with parties such as equity-method
investees, affiliates, unconsolidated joint ventures, shareholders, and directors are excluded from
being firm commitments in a fair value hedge but not excluded from being forecasted
transactions (in this context, it is assumed that the hedged forecasted transaction is not a
transaction where hedge accounting is specifically prohibited by the Standard such as in the case
of a forecasted purchase or sale of an equity method investee or receipt of a dividend from an
equity method investee). (See Paragraphs 29c.06 and 29f.02 of Section 6 for a further discussion
of this topic, including a discussion of certain transactions with equity method investees for
which cash flow hedge accounting is not appropriate).

21a.10 As noted in Paragraph 21a.06, since a firm commitment in a currency other than the
entity’s functional currency exposes the entity to variability in cash flows due to changes in
currency rates, it may be a hedged item in a cash flow hedge of foreign currency risk. This is the
case even if the commitment is an intercompany commitment or a commitment with a related
party. In the latter case, the commitment would in fact be a forecasted transaction as discussed in
Paragraph 21a.09 above. See Paragraph 40.15 of Section 7 for a discussion of these transactions.

Options Embedded in Nondervative Contracts

21a.11 The term fixed price as it relates to a firm commitment encompasses not only situations
in which the price is always fixed, but also situations in which the price is fixed only in certain
circumstances through the existence of an embedded option that is not separated from the host
contract under paragraph 12 of the Standard (ASC paragraph 815-15-25-1). Therefore, contracts
that do not meet the definition of a derivative in their entirety that contain embedded price caps,
floors, or both, which is a common characteristic of long-term supply or purchase contracts, meet
the fixed-price criterion of a firm commitment. The embedded caps and floors typically are not
required to be separated from the host contracts in these situations under paragraph 12 (ASC
paragraph 815-15-25-1) because their economic characteristics and risks are clearly and closely
related to the economic characteristics and risks of the host contract. The fair value exposure of
the cap or the floor in these contracts is eligible for fair value hedge accounting. For example,
assume that an entity enters into a long-term supply contract with a customer to sell a specified
amount of a certain material with a selling price equal to the monthly average list price for the
month for the quantity delivered, not to exceed $15 per pound (requiring physical delivery). The
entity could purchase a cash-settled call option with a strike price of $15 per pound and a
notional amount equal to the quantity specified in the supply contract and designate it as a fair
value hedge of the risk of changes in the fair value of the embedded written price cap in the
supply contract provided the other criteria for a fair value hedge are met. (See DIG Issue F10 for
further reference.) Options embedded in nondervative contracts may be purchased options that
entities may hedge with written options in an effort to monetize the value of that purchased
option (refer to Example 5.4 of this section).
Disincentives for Nonperformance

21a.12 A sufficiently large disincentive for nonperformance is required for a contract to be a firm commitment but does not need to be explicitly contained in the contract. The binding provisions of a contract include those legal rights and obligations codified in the laws to which such contract is subject. The existence of legal rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for purposes of applying the definition of a firm commitment under the Standard. For example, Company A enters into an agreement to purchase 20,000 widgets at a fixed price on January 1, 20X0. The provisions of the agreement do not include an explicit provision about nonperformance. However, the laws of the legal jurisdiction to which the agreement is subject provide a disincentive for nonperformance if Company A does not take delivery of the widgets pursuant to the agreement. In this case, the sufficiently large disincentive for nonperformance criterion is met because the counterparty to the transaction may initiate legal remedies that constitute a sufficiently large disincentive. (See DIG Issue F3 for further reference.)

Loan Commitments and Interest Rate Locks

21a.13 Neither a commitment to originate a loan nor an interest rate lock commitment meets the definition of a firm commitment because it does not obligate the potential borrower. Accordingly, neither a loan commitment nor an interest rate lock commitment can be the hedged item in a fair value hedge. (See Paragraphs 6.06 and 10i.01-10i.10 in Section 2 for further reference.)

Normal Purchases and Normal Sales Contracts as Hedged Items in a Fair Value Hedge

21a.14 Agreements to purchase or sell nonfinancial assets may meet the characteristics-based definition of a derivative but qualify for the normal purchases and normal sales exception set forth in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-26) (as discussed at Paragraphs 10b.01-10b.58 in Section 2). A contract that qualifies for the normal purchases and normal sales exception may be designated as the hedged item in a fair value hedge provided the provisions of paragraph 21 (ASC paragraph 815-20-25-12) are met. A contract that qualifies for the normal purchases and normal sales exception typically will satisfy the criteria for a firm commitment and will not be recognized in an entity’s financial statements because of the exclusion from recognition under the Standard or other accounting literature. (See DIG Issue E17 for further reference.)

CAN A GROUP OF SIMILAR ITEMS BE HEDGED AS A PORTFOLIO?

21a.15 If assets or liabilities are aggregated and hedged as a portfolio, such assets or liabilities individually must:

- Share the same risk exposure as the risk designated as being hedged; and
- Be expected to respond proportionately to the total change in fair value of the hedged portfolio.
21a.16 Items are considered similar pursuant to the Standard if they respond generally in a manner proportionate to, and in the same direction as, the total change in fair value of the hedged portfolio. The Standard describes, in an example, that individual items within a group would not be considered to respond proportionately to a change in interest rates if a 100-basis-point increase in interest rates is expected to reduce the fair value of the aggregate portfolio by 10%, but the changes in the fair values of the individual items range from 7% to 13%. However, in the example provided in the Standard, percentage decreases of the individual items within a range of 9% to 11% would be considered proportionate. Based on this example, we believe that items within a portfolio are similar if the change in the fair value of each individual item in the portfolio attributable to the risk being hedged is expected to move in the same direction within 80% to 120% of the percentage change in the fair value the aggregate hedged portfolio attributable to the hedged risk. We believe the evaluation of similar is to be undertaken each period that hedge effectiveness is assessed. In the initial assessment of effectiveness as well as the periodic retrospective and prospective assessments, similarity must also be present to continue to apply hedge accounting. It would be inappropriate to continue to apply hedge accounting, for example, if it were expected over the course of the next hedge assessment period that the portfolio would not continue to be similar as a consequence of market factors. An example of such a situation is more fully described below in the case of a portfolio of prepayable loans. In that case, the similarity of the individual items may change over time as the composition of the hedged portfolio changes due to prepayment activity.

Portfolio of Loans

21a.17 Hedging the changes in fair value due to changes in interest rates, including prepayment risk, of a portfolio of fixed-rate prepayable loans is difficult under the Standard. The difficulties involve:

- Concluding that the loans in the portfolio are similar;
- Constructing a hedging relationship that can be expected to be highly effective; and
- The requirement, under certain circumstances, to dedesignate the hedging relationship.

Similarity in a Portfolio of Loans

21a.18 For individual loans to be considered similar and aggregated in a portfolio, there must be an expectation, at the inception of the hedging relationship and on an ongoing basis, that the change in fair value attributable to the hedged risk for each individual loan responds in a generally proportionate manner to the overall change in fair value of the portfolio attributable to the hedged risk (i.e., changes in interest rates, including prepayment risk). By defining the portfolio of loans in a restrictive manner (such as similar settlement terms, collateralized by property in the same geographic region, similar scheduled maturities, and similar interest rates (which would include a risk-free rate plus a credit spread)) each loan in the portfolio may be expected to meet this test. That is, each loan may be considered to have the same exposure to prepayment risk since each loan has a similar prepayment option.
Effectiveness in Fair Value Hedges Involving a Portfolio of Loans

21a.19 In a fair value hedging relationship of fixed rate, prepayable loans where the designated hedged risk is changes in interest rates, entities typically will select an interest rate swap as the hedging instrument that has a notional amount that amortizes based on a contractual schedule. Generally, the amortization schedule is based on estimates of the expected prepayment speed of the loans in the portfolio. The goal is to have the swap’s notional amortization match the prepayment speed of the portfolio of loans to provide for effectiveness. However, estimating prepayment speeds for a particular loan portfolio, especially over a long period of time, is very difficult. Thus, entities commonly enter into a hedging strategy in which effectiveness is assessed over a period shorter than the life of the amortizing interest rate swap described above. The assessment in that strategy must consider all reasonably possible changes in the fair value of the derivative and the portfolio of hedged loans (i.e., it may not be limited to the likely or expected changes in fair value of the derivative or the hedged portfolio). To this end, the process of forming an expectation about the effectiveness of the hedging relationship generally would involve a probability-weighted analysis of reasonably possible changes in value of the derivative and the loan portfolio. The use of a probability-weighted analysis increases the likelihood that the hedging relationship is expected to be effective over a short period of time. (See DIG Issue F1 for further reference)

Requirements to Redesignate Fair Value Hedges Involving a Portfolio of Loans

21a.20 In practice, the scheduled reduction in the notional amount of the swap described above typically will not match the prepayment speed of the portfolio of loans because, over time, the prepayment pattern of the individual loans in the portfolio often differs from that which was expected at the inception of the hedging relationship. Even when the hedging relationship has been highly effective to date, when the swap’s notional balance amortization does not keep pace with the prepayment speed of the portfolio of loans or when the swap amortizes more quickly than the loans, the hedging relationship may not be expected to continue to be highly effective. The amount of ineffectiveness related to the current period will be the difference between the change in the fair value of the swap (which could have a notional amount different from the hedged portfolio) and the change in fair value of the existing hedged portfolio. If the hedging relationship is not expected to continue to be highly effective, it must be discontinued prospectively. A new hedging relationship may be established with a rebalanced loan portfolio and interest rate swap as long as it is expected to be highly effective. In addition, it must be documented in a manner that meets all of the requirements expected at the inception of the hedging relationship. Thus, although an entity may have the ability to hedge a portfolio of loans, it is expected that such a hedging relationship would require periodic redesignation and documentation of the redesignated hedging relationship in accordance with paragraph 20(a) of the Standard (ASC paragraph 815-20-25-3) to maintain hedge effectiveness. See Paragraph 25.04 for a discussion of the implications of discontinuing hedging relationships.
Fair Value Hedges of Servicing Rights

21a.21 In a fair value hedge of a portfolio of servicing rights, an entity is required to consider the similarity of the individual items in the portfolio. An entity is not, however, required by the Standard to aggregate servicing rights in the same manner as servicing rights are required to be aggregated for purposes of assessing impairment pursuant to paragraph 63(g) (ASC paragraph 860-50-35-11) of FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, (Statement 140) (ASC Topic 860, Transfers and Servicing -- Servicing Assets and Liabilities). That is because the risk strata used for Statement 140 (ASC Topic 860) impairment testing may not be sufficient to satisfy the similarity requirements of Paragraph 21 of the Standard (ASC paragraph 815-20-25-12). (See DIG Issue F1.)

WHAT IS MEANT BY A SPECIFIC PORTION?

21a.22 Paragraph 21(a)(2) of the Standard (ASC paragraph 815-20-25-12(b)(2)) provides examples of specific portions of assets and liabilities (including firm commitments) that may be designated as the hedged item in a fair value hedge. See Paragraph 18.01 of Section 4 for a discussion of a proportion of a derivative hedging instrument versus a portion of a hedged item. When an entity is hedging a specific portion of an asset, liability or firm commitment, the portion must be identified. For example, if an entity is hedging changes in the fair value of a $100 million debt obligation with periodic principal payments, the hedged item cannot be identified as the remaining $50 million outstanding. An acceptable approach would be to identify the $50 million debt by specific certificates.

21a.23 In its deliberations, the Board was reluctant to permit an entity to identify a selected portion of an asset or a liability as the hedged item in a fair value hedge because the Board believes, in many cases, partial-term hedge transactions would fail to meet the highly effective offset requirement. Upon completion of its deliberations, the Board decided not to prohibit partial-term hedging, but to require entities to document that a hedging relationship of part of an asset or a liability qualifies for hedge accounting because the entity believes that the relationship will be highly effective in achieving offsetting changes in fair values. While partial-term hedging is not prohibited, the Board believes that it is difficult to find a derivative that will be effective as a fair value hedge of only selected contractual cash flows. For example, the Board indicated that it would not expect a two-year interest rate swap to be effective at offsetting changes in the fair value of a company’s obligation to make interest payments during the first two years of its four-year fixed-rate debt when the risk being hedged relates to interest-rate risk. The Board noted that in order for such a relationship to be effective, a full repayment of the debt at the end of the second year would have to be expected. (See DIG Issue F2) for further reference.)

4 In March 2006, FASB Statement No. 156, Accounting for Servicing of Financial Assets (Statement 156) (ASC Subtopic 860-50, Transfers and Servicing -- Servicing Assets and Liabilities), was issued. Among other things, Statement 156 provides entities with an election to account for servicing rights at fair value with changes in fair value recognized currently in earnings. Consequently, entities that economically hedge servicing rights with trading securities and derivative instruments can achieve offset in the statement of income without the need to apply fair value hedge accounting. The effective date of Statement 156 (ASC Subtopic 860-50) is the beginning of the first fiscal year that begins after September 15, 2006 with earlier adoption permitted as of the beginning of an entity’s fiscal year, provided the entity has not yet issued financial statements for any period of that fiscal year.

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21a.24 The following example illustrates this concept:

Example 5.7: Partial Term Hedging - Hedge of a Fixed-Rate Debt Instrument with an Interest Rate Swap

Assume that ABC Corp. issues a $1 million, four-year, non-amortizing debt instrument that bears interest at 8%, payable semiannually. ABC wishes to hedge the change in the fair value of the interest payments (due to changes in the benchmark interest rate) to be made only over the first two years. As a result, ABC enters into an at-the-money interest rate swap with terms that call for receipt of fixed interest of 6% and payment of variable interest at LIBOR for a two-year period. Also assume that LIBOR increases from 6% to 7%.

The table below demonstrates that the proposed hedging relationship will not be highly effective:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated fair value of the hedged interest payments on the debt at 6%</td>
<td>$154,140</td>
</tr>
<tr>
<td>Estimated fair value of the hedged interest payments on the debt at 7%</td>
<td>$153,190</td>
</tr>
<tr>
<td>Change in the estimated fair value of the hedged interest payments</td>
<td>$950</td>
</tr>
<tr>
<td>Estimated fair value of the swap at inception</td>
<td>$0</td>
</tr>
<tr>
<td>Estimated fair value of the swap after the 1% change in interest rates</td>
<td>$12,258</td>
</tr>
<tr>
<td>Change in the estimated fair value of the swap</td>
<td>$12,258</td>
</tr>
</tbody>
</table>

As demonstrated above, the hedging relationship would only be 7.8% effective ($950/$12,258). If full repayment of the debt were anticipated at the end of the second year, the estimated change in fair value of the debt due to the 100 basis point change in interest rates would have been $10,296. The derivative instrument would have been highly effective (at 83.4%) in providing offset to the change in the fair value of the debt.

1 Present value of four semiannual interest payments of $40,000, discounted at 6%.
2 Present value of four semiannual interest payments of $40,000, discounted at 7%.
3 Present value of the four net settlements under the swap of $5,000 ($35,000 (at 7%) less $30,000 (at 6%)), each discounted at 7%.
4 Present value of four semiannual interest payments of $40,000 plus the $1 million principal amount at the end of year two, discounted at 7%.

Prohibition Against Use of Preset Hedge Coverage Ratios

21a.25 Certain entities, primarily in the mortgage banking industry, sought to designate the hedged item at the inception of a hedging relationship by initially specifying a series of possible percentages of servicing right assets (referred to as preset hedge coverage ratios) that each correspond to a specified independent variable (e.g., an interest rate). Under that approach, at the end of the hedge assessment period, the entity would determine the hedged item and measure

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5 In March 2006, FASB Statement No. 156, Accounting for Servicing of Financial Assets Statement 156 (ASC Subtopic 860-50, Transfers and Servicing -- ServicingAssets and Liabilities), was issued. See further discussion in footnote 3 to Paragraph 21a.21 of this section on the implication of Statement 156 (ASC Subtopic 860-50) to hedging servicing rights.
hedge ineffectiveness by determining retrospectively which hedge coverage ratio would be applied when designating the hedged item for that period. That approach is different from designating a specific percentage of the recognized servicing asset as the hedged item at inception. The FASB staff rejected this approach since the percentage of the assets being hedged changes after hedge inception and is not determinable until the end of the hedge period. (See DIG Issue F8 for further reference.)

21a.26 A strategy that is not entirely dissimilar from that which was described in the preceding paragraph, but which is acceptable under the Standard, is discussed in Paragraph A5.75 in Appendix A to this section. The strategy incorporates a collar that has different notional amounts for the purchased and written option components. The FASB staff is aware of the inconsistency in rejecting one strategy and accepting a similar one and, thus, has indicated that the collar strategy is a limited exception to the general concept of the Standard that a single percentage of the entire asset or liability (or of the portfolio) must be designated at the inception of the hedge as the hedged item.

PROHIBITION AGAINST RECHARACTERIZATION OF A FINANCIAL INSTRUMENT IN ORDER TO APPLY HEDGE ACCOUNTING

21a.27 While the Standard permits entities to identify a portion of an asset or liability as the designated hedged item in a fair value hedge, entities are not permitted to recharacterize a variable-rate asset as a fixed-rate asset with an embedded interest rate swap in an effort to achieve fair value hedging for an asset that would be precluded from a fair value hedge due to its variable terms.

Hedged Item Must Present an Exposure That Could Affect Earnings

21b. The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings. The reference to affecting reported earnings does not apply to an entity that does not report earnings as a separate caption in a statement of financial performance, such as a not-for-profit organization, as discussed in paragraph 43.

21b.01 Hedge accounting is provided only for hedged items that have an exposure to changes in fair value for the risk being hedged that could affect reported earnings. In other words, a change in the fair value of a hedged item attributable to the risk being hedged must have the potential to change the amount that could be recognized in earnings. There is no requirement that this exposure be probable to occur and consequently be realized. For example, a fixed-rate mortgage loan may present an earnings exposure to a mortgage bank because, as interest rates change, the amount at which the mortgage bank can sell the loan also would change. There is no requirement, however, for the mortgage bank to intend to sell the loan and realize the earnings effect. As a result, the mortgage bank can hedge the exposure related to the fixed-rate mortgage loan.

21b.02 The provision of paragraph 21(b) (ASC paragraph 815-20-25-12(c)) generally would disallow hedges of transactions with shareholders because those transactions generally do not affect earnings. Examples of transactions excluded by the provisions of paragraph 21(b) of the Standard (ASC paragraph 815-20-25-12(c)) include firmly committed issuances of common and preferred stock, hedges of intercompany transactions for which the earnings exposure related to
the hedged risk would be eliminated in consolidation, and hedges of the price of stock expected to be issued pursuant to a stock option plan for which recognized compensation expense is not based on changes in stock prices after the date of grant.

21b.03 It is important to note that hedging intercompany transactions for foreign currency risk is permitted. This risk is not eliminated in consolidation and, therefore, affects consolidated earnings. In addition, hedging intercompany transactions for other eligible risks, such as interest rate, is permitted at the stand-alone financial statement level. At this level, the risk affects earnings. However, the effect of hedge accounting would need to be reversed in the consolidated financial statements that include the intercompany entities to the transaction.

Items Prohibited From Being Designated as Hedged Items

21c. The hedged item is not (1) an asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings, (2) an investment accounted for by the equity method in accordance with the requirements of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, (3) a minority interest in one or more consolidated subsidiaries, (4) an equity investment in a consolidated subsidiary, (5) a firm commitment either to enter into a business combination or to acquire or dispose of a subsidiary, a minority interest, or an equity method investee, or (6) an equity instrument issued by the entity and classified in stockholders’ equity in the statement of financial position.

DIG Issue related to this paragraph is G1. See DIG Issues Index.

21c.01 The Standard specifically prohibits certain items from being designated as the hedged item in a fair value hedge. These items are discussed below.

ITEM THAT IS REMEASURED WITH THE CHANGES IN FAIR VALUE ATTRIBUTABLE TO THE HEDGED RISK REPORTED CURRENTLY IN EARNINGS

21c.02 An asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported in earnings would not be eligible for hedge accounting because the Board concluded that it was not appropriate to change the accounting for the hedged item simply because the hedged item is part of a fair value hedge. For example, the Board did not want a trading security to reflect changes in fair value attributable to only certain risks (as a result of applying fair value hedge accounting) rather than total changes in fair value as required by FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (Statement 115) (ASC Subtopic 320-10, Investments - Debt and Equity Securities -- Overall). As a practical matter, entities can obtain offset in earnings between the changes in the fair value of the asset or liability and the derivative instrument without applying hedge accounting. For example, if an entity wanted to use a derivative instrument to hedge the exposure associated with changes in the fair value of a trading account investment, an entity could naturally achieve offsetting changes (though not necessarily 100% offset) in the fair value of the investment by accounting for the derivative instrument as a speculative derivative instrument in accordance with the Standard. That offset would be reflected in net earnings because changes in the fair values of each financial instrument would be reflected in earnings each period. The Board also prohibited hedge
accounting for firm commitments to acquire an asset or incur a liability that will be remeasured with changes in fair value attributable to the hedged risk reported in earnings.

**Applicability to Assets and Liabilities Remeasured Under Statement 52**

**21c.03** The criteria of paragraph 21(c) of the Standard (ASC paragraphs 815-20-25-43(b) and 25-43(c)) do not preclude recognized foreign-currency denominated assets or liabilities from being designated as the hedged item under the Standard. The Board determined that remeasurement at spot rates under Statement 52 (ASC Topic 830) is not a fair value remeasurement as contemplated by paragraph 21(c) of the Standard (ASC paragraphs 815-20-25-43(b) and 25-43(c)). This issue is discussed further in Paragraph 36.07 of Section 7.

**Applicability to Assets Carried at Lower of Cost or Market**

**21c.04** The Standard does not prohibit entities from designating items that are carried at the lower of cost or market (LOCOM), such as mortgage loans held for sale, as the hedged item in a fair value hedge. While these items may affect earnings as a result of the risk being hedged, such as in the case of a hedge of the risk of a decrease in the fair value of mortgage loans held for sale due to a change in interest rates, they are only carried at market if the market value declines below cost. Consequently, they are not remeasured (up and down) with changes in the fair value attributable to the hedged risk reported currently in earnings. Accordingly, an entity is not precluded from designating items carried at LOCOM as the hedged item in a fair value hedging relationships as a result of the criteria in paragraph 21(c) of the Standard (ASC paragraphs 815-20-25-43(b) and 25-43(c)).

**EQUITY-METHOD INVESTMENT**

**21c.05** Under the equity method of accounting, the investor generally records its share of the earnings or loss from its investment (not the changes in the market price of the common stock). However, changes in the earnings of an equity-method investee presumably affect the market value of its common stock. Accordingly, the Board believes that applying fair value hedge accounting to an equity-method investment could result in some amount of double counting of the value of the investor’s investment. Double counting may result because a portion of the increase (decrease) in the market value of the common stock recorded by the investor by applying fair value hedge accounting already would have been recognized by the investor when it recorded its share of the earnings (loss) from its equity-method investment. In addition, the Board believes that entities should be precluded from designating equity-method investments as the hedged item because these investments are in substance a group of dissimilar assets and liabilities. Thus, entities would be unable to demonstrate that the hedging relationship is highly effective at achieving fair value offset attributable to the hedged risk.

**OTHER PROHIBITIONS**

**21c.06** The Board believes (1) a minority interest in one or more consolidated subsidiaries; (2) a firm commitment either to enter into a business combination or to acquire or dispose of a subsidiary or an equity-method investee; and (3) an equity investment in a consolidated subsidiary should be prohibited from being designated as a hedged item in a fair value hedge. The reasons cited by the Board are essentially the same as those discussed in the preceding
paragraph related to the prohibition from designating an equity method investment as the hedged item in a fair value hedge.

21ce.07 A minority interest and an equity instrument issued by an entity and classified in stockholders’ equity in the statement of financial position do not meet the definition of assets or liabilities and, therefore, are prohibited from being designated as hedged items in a fair value hedge (i.e., the Standard permits fair value hedge accounting for existing assets and liabilities). In addition, we believe that items classified in temporary or mezzanine equity (e.g., certain debt obligations) may not be designated as hedged items because they do not meet the definition of a liability (DIG Issue C2 concluded that temporary equity is considered stockholders’ equity even though it is displayed outside of permanent equity).

21ce.08 At the June 2007 EITF meeting, the SEC staff announced revisions to EITF D-98, "Classification and Measurement of Redeemable Securities" (ASC paragraph 480-10-S99-3) related to the release of Statement 159, The Fair Value Option for Financial Assets and Financial Liabilities (ASC Subtopic 825-10, Financial Instruments -- Overall). The SEC staff announced that it will no longer accept liability classification for financial instruments that meet the conditions for temporary equity classification under ASR 268, Presentation in Financial Statements of "Redeemable Preferred Stocks" and EITF D-98 (ASC paragraph 480-10-S99-3). Registrants that do not choose retrospective application should apply the announcement prospectively to all affected instruments that are entered into, modified, or otherwise subject to a remeasurement event in the registrant's first fiscal quarter beginning after September 15, 2007. Subsequent to initial adoption of this guidance, registrants should not initially apply hedge accounting for an affected financial instrument (or host contract) that continues to be classified as a liability. That is, while an existing financial instrument (or host contract) that otherwise meets the conditions for classification as temporary equity may continue to be classified as a liability when this guidance is adopted prospectively, the financial instrument (or host contract) would not be eligible for initial adoption of hedge accounting in fiscal quarters beginning after September 15, 2007. However, previously established hedge relationships may continue.

Prohibition Against Hedging Investments Classified as Held-to-Maturity

21d. If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, the designated risk being hedged is the risk of changes in its fair value attributable to credit risk, foreign exchange risk, or both. If the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component. (The designated hedged risk for a held-to-maturity security may not be the risk of changes in its fair value attributable to interest rate risk. If the hedged item is other than an option component that permits its prepayment, the designated hedged risk also may not be the risk of changes in its overall fair value.)

21d.01 During its deliberations, the Board indicated that designating a debt security classified as held-to-maturity in accordance with Statement 115 (ASC Subtopic 320-10) as the hedged item in a fair value hedging relationship undermines the intent of the held-to-maturity classification when the risk being hedged is the exposure due to changes in interest rates. Specifically, the
The Board believes entering into a derivative instrument to hedge the fair value of an investment security classified as held-to-maturity is inconsistent with the assertion that amortized cost is the appropriate measurement for such a security. Furthermore, the Board believes an entity’s decision to classify a security as held-to-maturity means that the entity’s decision about continuing to hold that security will not be affected by changes in interest rates. Thus, the Standard limits the circumstances in which a debt security that is classified as held-to-maturity in accordance with Statement 115 (ASC Subtopic 320-10) can be designated as a hedged item.

21d.02 The Standard permits entities to hedge the risk of changes in the fair value of a recognized held-to-maturity debt security attributable to credit risk, foreign currency risk, or both. Credit risk is permitted to be a designated hedged risk because it is not inconsistent with Statement 115 (ASC Subtopic 320-10), which allows a sale or transfer of a held-to-maturity debt security in response to a significant deterioration in the credit quality of the issuer of the security. Also, since special accounting is provided in Statement 52 (ASC Topic 830) for reflecting the effect of changes in foreign exchange rates, even for held-to-maturity securities, and the Standard continues much of that accounting, the Board concluded that the risk of change in fair value due to changes in foreign exchange rates of those securities qualifies as a hedgeable risk. See Section 7 for a discussion of foreign currency hedging.

21d.03 The Standard additionally permits an entity to designate as the hedged item the risk of changes in the fair value of the embedded call option in a held-to-maturity debt security that is prepayable (in reality, this is akin to hedging the prepayment risk). This is because the Board believes selling a security in response to the issuer’s exercise of its call option is not a voluntary sale by the investor and, thus, does not contradict an entity’s stated intention to hold the security to maturity. For example, assume an entity purchased a five-year callable debt security and classified it as held-to-maturity. The callable feature of the security represents a call option held by the issuer of the security. Under paragraph 21(d) of the Standard (ASC paragraph 815-20-25-12(d)), the entity may purchase a put option to hedge the written call option component (i.e., prepayment feature) of the held-to-maturity debt security and designate it as a hedge of the changes in fair value of the call option.

Hedging Risks in Nonfinancial Assets or Liabilities

21e.01 Paragraph 21(e) of the Standard (ASC paragraph 815-20-25-12(e)) permits hedge accounting for nonfinancial assets and liabilities (other than a recognized loan servicing right or nonfinancial firm commitment with financial components) when the designated hedged risk is the risk of changes in the fair value of the entire asset or liability. In that way, paragraph 21(e) (ASC paragraph 815-20-25-12(e)) prohibits an entity from disaggregating the risk profile of a nonfinancial asset or liability and designating one component of the profile as the hedged risk. In addition, when the hedged item is a physical asset, the risk of changes in fair value must reflect the asset’s actual location. The requirements for hedging a nonfinancial asset or liability are set forth in paragraph 21(e) of the Standard (ASC paragraph 815-20-25-12(e)) as follows:

21e. If the hedged item is a nonfinancial asset or liability (other than a recognized loan servicing right or a nonfinancial firm commitment with financial components), the designated risk being hedged is the risk of changes in the fair value of the entire hedged asset or liability (reflecting its actual location if a physical asset). That is, the price risk of a similar asset in a
different location or of a major ingredient may not be the hedged risk. Thus, in hedging the exposure to changes in the fair value of gasoline, an entity may not designate the risk of changes in the price of crude oil as the risk being hedged for purposes of determining effectiveness of the fair value hedge of gasoline.

RISK OF CHANGES IN FAIR VALUE OF THE ENTIRE ASSET

21e.02 Entities may hedge any one (or more) risk exposure(s) of a financial asset or liability. For example, a fixed-rate, foreign-currency-denominated available-for-sale security subjects the holder to credit risk, interest rate risk, and foreign exchange risk. The Standard permits the holder to hedge any one (or more) of those risks. In a similar manner, nonfinancial assets also may expose an entity to numerous risks. For example, inventory consisting of chocolate bars exposes the entity to fair value risk associated with each major ingredient (e.g., cocoa, sugar, butter, milk, etc.) that goes into the manufacturing of a chocolate bar and to other items such as new competition and the success of marketing efforts. These components, when considered in the aggregate, represent the risk of changes in the fair value of the entire chocolate bar. Unlike the designation of a financial asset or liability as the hedged item, the Standard prohibits an entity from designating a major ingredient of a nonfinancial asset or liability as the hedged item. The Board decided not to permit the designation of fair value risk of a major ingredient or other component of a nonfinancial asset or liability as the risk being hedged because changes in the fair value of an ingredient or component of a nonfinancial asset or liability generally do not have a predictable and separately measurable effect on the fair value of the item that is comparable to the effect of, for example, the change in the market interest rates on the price of a bond. Instead, the Standard requires changes in the fair value of the entire asset or liability to be designated as the hedged item in a fair value hedge of nonfinancial assets or liabilities. In the example of a chocolate bar, an entity only would be permitted to designate changes in the fair value of the entire chocolate bar as a hedged risk.

21e.03 Notwithstanding the previous paragraph, an entity may recognize net effects on earnings as a result of applying fair value hedge accounting that are similar to those it would have recognized had it been permitted to hedge a component of a nonfinancial asset (or liability) in a fair value hedge. In particular, the Standard permits a derivative instrument with the price of a component as its underlying to hedge changes in the fair value of the entire nonfinancial asset (or liability). To qualify for hedge accounting, the entity would have to demonstrate that the hedging relationship at inception and on an ongoing basis is highly effective at achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. For example, an entity could designate a derivative instrument with cocoa as its underlying and the inventory of chocolate bars as the hedged item where the risk of changes in the entire fair value of chocolate bars is the hedged risk.

21e.04 The following example illustrates the requirement to hedge the risk of changes in the fair value related to a nonfinancial asset.

Example 5.8: Hedge of a Major Ingredient of Inventory with a Futures Contract

A gold watch manufacturer would not qualify for fair value hedge accounting if it used a gold futures contract to hedge the gold component of its gold watch inventory. However, the gold
watch manufacturer would be able to qualify for fair value hedge accounting if it used a gold futures contract to hedge the fair value risk of its gold watch inventory provided it can demonstrate that the gold futures contract is highly effective in offsetting the changes in fair value associated with the inventory of gold watches.

**RISK OF CHANGES IN FAIR VALUE REFLECTING THE ASSET’S PHYSICAL LOCATION**

21e.05 Paragraph 21(e) of the Standard (ASC paragraph 815-20-25-12(e)) also requires that when measuring changes in the fair value of a physical asset that is the hedged item in a fair value hedge, entities incorporate the characteristics of the hedged item including its physical location. As a consequence, if the underlying of the hedged item is in a different location from the underlying of the derivative hedging instrument, entities may not assume that changes in the fair value of the hedged item will equal changes in the fair value of the derivative hedging instrument. For example, if an entity decides to hedge its Brazilian coffee inventory, the entity may not assume that changes in the value of a Colombian coffee futures contract will equal changes in the value of its Brazilian coffee inventory.

**HEDGES OF RECOGNIZED LOAN SERVICING RIGHTS AND NONFINANCIAL FIRM COMMITMENTS WITH FINANCIAL COMPONENTS**

21e.06 Although recognized loan servicing rights and nonfinancial firm commitments with financial components are not financial assets or liabilities, these instruments are hedged in the same manner as hedges of financial assets and liabilities as discussed below.

**Hedging Risks in Financial Assets or Liabilities**

21f.01 Paragraph 21(f) of the Standard (ASC paragraphs 815-20-25-6 and 25-12(f)) discusses the types of risks that may be designated as being hedged in fair value hedges of financial assets or liabilities. Accounting Standards Update 2013-10, *Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes* (ASU 2013-10) amended that discussion by removing one sentence as noted below effective July 17, 2013 (see additional discussion of amendments made by ASU 2013-10 in Paragraphs 21f.14a, 21f.14b, 21f.16, 21f.18 and A5.51).

21f. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is:

1. the risk of changes in the overall fair value of the entire hedged item,
2. the risk of changes in its fair value attributable to changes in the designated benchmark interest rate (referred to as interest rate risk),
3. the risk of changes in its fair value attributable to changes in the related foreign currency exchange rates (referred to as foreign exchange risk) (refer to paragraphs 37, 37A, and 38), or
4. the risk of changes in its fair value attributable to both changes in the obligor’s creditworthiness and changes in the spread over the benchmark interest rate with
respect to the hedged item’s credit sector at inception of the hedge (referred to as credit risk).

If the risk designated as being hedged is not the risk in paragraph 21(f)(1) above, two or more of the other risks (interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In calculating the change in the hedged item’s fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on all of the contractual cash flows of the entire hedged item. Excluding some of the hedged item’s contractual cash flows (for example, the portion of the interest coupon in excess of the benchmark interest rate) from the calculation is not permitted.* An entity may not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can 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, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of interest rate risk.

* The first sentence of paragraph 21(a) that specifically permits the hedged item to be identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment is not affected by the provisions of this subparagraph.

DIG Issues related to this paragraph are B15 and J14 See DIG Issues Index.

21f.02 Paragraph 21(f) of the Standard (ASC paragraph 815-20-25-12(f)) provides guidance on hedgeable risks in financial assets or liabilities and is discussed in this section as follows:

• Specific risks that may be hedged;
• Simultaneous hedges; and
• Prepayment risk.

SPECIFIC RISKS THAT MAY BE HEDGED

21f.03 When hedging a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the Standard allows an entity to hedge only certain specific risks that expose the hedged item to changes in fair value. These risks are:

• **Market Price Risk.** A fair value hedge may focus on the exposure to changes in the fair value of the entire hedged item. The definition of fair value requires that the fair value of a hedged item be based on a quoted market price in an active market, if available. The Board concluded that the market price risk of the entire hedged item
(i.e., the risk of changes in the fair value of the entire hedged item) should be eligible for designation as the hedged risk in a fair value hedge.

- **Interest Rate Risk.** For financial assets and liabilities, changes in interest rates may affect the fair value of a right to receive (or obligation to pay or transfer) cash or other financial instruments in the future. The time value of money is a broadly accepted concept that is incorporated into generally accepted accounting principles (e.g., in APB Opinion No. 21, Interest on Receivables and Payables (ASC Subtopic 835-30, Interest -- Imputation of Interest), and FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (ASC Subtopic 310-20, Receivables -- Nonrefundable Fees and Other Costs), and the marketplace has developed techniques to delineate and extract interest rate risk from financial instruments. Because of these factors, the Board decided that the risk of changes in interest rates affects the fair value of the hedged item and, thus, warrants being identified as a risk that may be designated as being hedged in a fair value hedge. However, in reaching this decision, the Board decided to limit the risk being hedged to changes in fair value attributable to the benchmark interest rate as further discussed in Paragraphs 21f.08-21f.19 of this section.

- **Foreign Exchange Risk.** The fair value (expressed in the entity’s functional currency) of a recognized asset or liability, such as a foreign-currency-denominated debt or an equity security that is classified as available-for-sale, as well as the fair value of the financial component of a firm commitment that is denominated in a currency other than the entity’s functional currency, generally is exposed to changes in foreign exchange rates. Accordingly, the Board decided that the risk of changes in foreign exchange rates on the fair value of certain hedged items warrants being identified as a risk that may be designated as being hedged in a fair value hedge. When hedging foreign exchange risk there are additional factors that must be considered. (See Section 7 for a discussion of foreign currency hedges)

- **Credit Risk.** Some financial assets involve future performance by a counterparty, such as a counterparty’s obligation to deliver cash or another financial instrument. Accordingly, entities are subject to the credit risk and resulting nonperformance of the counterparty (counterparty risk). This risk directly affects the fair value of the financial asset. In addition, the counterparty’s sector (e.g., industry, geography, and location), that is, its credit sector risk, also directly affects the fair value of the financial asset. The Board decided that the combination of these risks (i.e., credit risk) may be designated as the risk being hedged in a fair value hedge.

21f.04 The two primary reasons underlying the Board’s decision to allow only the aforementioned risks to be hedged as part of a fair value hedge are that:

- It is consistent with the Board’s belief that the largest amount of hedging activity is aimed at protecting against market price risk, interest rate risk, foreign currency exchange risk, and credit risk; and

- A change in the price associated with one of those risks ordinarily will directly affect the fair value of an asset or liability in a determinable manner.
SIMULTANEOUS HEDGES

21f.05 Fair value hedge accounting under the Standard focuses on the change in fair value of the hedged item that is attributable to the risk being hedged. As a result, entities generally are not precluded from hedging more than one risk at a time. We believe, however, that when the designated hedged risk is the risk of overall changes in fair value related to a financial asset or liability, entities are precluded from designating another risk associated with the same item. This proscription exists because to do otherwise would result in the same risk being hedged more than once. For example, an entity may not hedge the risk of overall changes in fair value of an available-for-sale debt security if another risk also is designated as a hedged risk. That is, the other permissible risks (i.e., interest rate, foreign currency, and credit) are components of the overall changes in the fair value and, thus, by designating the overall changes in fair value together with one of its components, an entity would be hedging a particular component more than once.

PREPAYMENT RISK

21f.06 The Standard does not permit an entity to hedge a subcomponent of a specific risk related to a hedged item. Consequently, an entity may not designate only prepayment risk as the risk being hedged because prepayment risk is a subcomponent of interest rate risk. However, for financial instruments with embedded prepayment features, an entity may achieve its objective of hedging prepayment risk by designating as the hedged item the embedded call option (i.e., the prepayment feature) in a fair value hedging relationship of the entity’s exposure to changes in the overall fair value of the embedded prepayment option.

21f.07 An issue arises when an entity designates the embedded call option of a financial instrument as the hedged item and also wishes to hedge the remaining interest rate risk. The Board’s position is that an embedded derivative instrument (i.e., an embedded call option) in a hedged item will modify the nature of the risk exposure (e.g., the interest rate risk exposure). To disregard the effects of an embedded derivative related to the same risk class (i.e., interest rates) could result in a designated hedge that is not effective in achieving changes in fair value. Thus, all embedded derivative instruments related to the same risk class in a hedged item must be considered together in assessing the effectiveness of a derivative hedging instrument. In other words, an entity may designate as a hedged item the embedded call option or the interest rate risk exposure (including the option) but not the interest rate risk exposure exclusive of the option.

BENCHMARK INTEREST RATE

21f.08 The stated interest rate in a financial asset or liability typically contains two components, a risk-free rate and a credit spread. The risk-free rate represents the rate of interest required to compensate an investor for its investment without consideration of default. Generally, the risk-free rate is a government borrowing rate (e.g., in the United States, the risk-free rate would be the U.S. Treasury rate) due to its limited default risk. The credit spread represents the additional interest needed to compensate an investor for the increased credit risk of a nonrisk-free borrower. This credit spread has two components: a component related to counterparty risk and a component related to credit sector risk. The Board decided that, with respect to the separation of interest rate risk and credit risk, for hedging purposes the risk of changes in credit sector spread and any credit spread attributable to a specific borrower should be encompassed in credit risk.
rather than interest rate risk. Thus, interest rate risk would encompass only changes in the risk-free rate.

21f.09 During its previous deliberations on interest rate risk, the Board decided that, in the United States, the interest rate on direct Treasury obligations of the U.S. government provides the best measure of the risk-free rate. Thus, the Board considered defining interest rate risk based only on U.S. Treasury rates in the United States. However, at that time, the Board decided to make an exception and extend the definition of interest rate risk in the United States to include interest rate swap rates based on the London Interbank Offered Rate (LIBOR). At that time the Board made this decision based on its understanding that:

- LIBOR-based interest rate swaps are the most commonly used hedging instruments in the U.S. financial markets in hedges of interest rate risk;
- There are technical factors (such as supply and demand) that may affect the rates on direct obligations of any single issuer, even the U.S. government; and
- Financial markets in the U.S. consider LIBOR rates as inherently liquid, stable, and a reliable indicator of interest rates and, if the rate for hedging interest rate risk was limited to U.S. Treasury rates, many common hedging relationships using LIBOR-based swaps might not qualify for hedge accounting.

21f.10 Because the Board decided to permit a rate that is not fully risk-free to be the designated risk in a hedge of interest rate risk, it developed the general notion of benchmark interest rate to encompass both risk-free rates and rates based on the LIBOR swap curve in the United States. Consequently, when the designated risk being hedged is the risk of changes in interest rate risk, an entity must specifically designate and document the benchmark interest rate it is hedging (e.g., as either U.S. Treasury rates or LIBOR swap rates).

21f.11 Appendix F of the Standard (ASC Section 815-20-20 and paragraph 815-20-25-6A) defines the benchmark interest rate ASU 2013-10 amended that definition by removing the sentences as noted below effective July 17, 2013 (see additional discussion of amendments made by ASU 2013-10 in Paragraphs 21f.14a, 21f.14b, 21f.16, 21f.18 and A5.51).

A widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions.

In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate. In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government and, for practical reasons, the LIBOR swap rate are considered to be benchmark interest rates. In each financial market, only the one or two most widely used and quoted rates that meet the above criteria may be considered benchmark interest rates.

21f.12 The Board considered the practical application of the definition of the benchmark interest rate in global financial markets. The Board acknowledged that, in some foreign markets, the rate...
of interest on sovereign debt is considered the benchmark interest rate; that is, market participants consider that rate free of credit risk. However, in other markets, the relevant interbank offered rate may be the best reflection of the benchmark interest rate. The Board decided that the definition of the benchmark interest rate should allow for one or two rates to be considered benchmark interest rates not only in the United States, but also in foreign financial markets. We believe that the borrowing rate of the national government of euro currency countries may be used as the benchmark rate in addition to the Euro Interbank Offered Rate (Euribor swap rate). In Canada, the Canadian Treasury Rate, in addition to the Bankers' Acceptance Canadian Deposit Offering Rate (BA CDOR), may be used as the benchmark rate. In the United Kingdom, the Bank of England borrowing rate, in addition to the LIBOR swap rate, may be used as the benchmark rate.

21f.13 The Board determined that the definition of the benchmark interest rate should be flexible enough to withstand potential future developments in financial markets. For example, the Board decided that the current definition would result in the ability to replace the LIBOR swap rate with a more relevant benchmark interest rate if changes in the financial markets render the use of LIBOR swap rates obsolete.

21f.14 During its previous deliberations on interest rate risk, the Board considered whether other rates, such as the commercial paper rate and the Fed Funds rate in the U.S. financial markets, should be included in the definition of benchmark interest rate and whether those rates should be permitted to be designated as the hedged risk in a hedge of interest rate risk. The Board also considered defining the benchmark interest rate as the portion of an instrument’s overall interest rate that is used as the underlying basis for pricing a financial instrument. For example, numerous indices or auction rates such as the Fed Funds rate, the Prime rate, the FNMA Par Mortgage rate, and the BMA rate are used as the underlying basis for pricing a financial instrument. At the time of those deliberations, the Board decided that allowing more than two benchmark rates to define interest rate risk was unnecessary and would make the resulting financial statements more difficult to understand.

21f.14a As a result of the financial crisis in 2008, the exposure to and the demand for hedging the Fed Funds rate (also referred to as the Fed Funds Effective Swap Rate, Overnight Index Swap Rate or OIS), increased significantly. That demand was driven by an increased focus by banks on their sources of funding (including an increased focus on overnight interbank borrowings of surplus balances held at the Federal Reserve), the greater (and sometimes volatile) spread between LIBOR and Fed Funds rate, and an increase in the collateralization of derivatives transactions. On July 17, 2013, the FASB issued ASU 2013-10, which permits the Fed Funds rate to be used as a benchmark interest rate for hedge accounting purposes in addition to U.S. Treasury rates and LIBOR. ASU 2013-10 is effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013.

21f.14b One of the effects of the market changes discussed in the preceding paragraph is that the Fed Funds rate is being used by some market participants as the discount rate in measuring the fair value of their derivative instruments. The use of a discount rate to measure the fair value of a derivative hedging instrument that is not the same as the benchmark interest rate designated as the hedged risk in a fair value hedging relationship is a source of ineffectiveness. To eliminate this source of ineffectiveness, entities that use the Fed Funds rate as the discount rate for determining the fair value of derivative hedging instruments may wish to designate, as the
An entity is permitted to designate the risk of changes in the benchmark interest rate as the hedged risk, and the spread above that rate would be deemed to reflect credit risk. The Board concluded that considering all the effects of credit risk together is more understandable because it is consistent with market conventions and hedging practices. As discussed in Paragraph 21f.03 of this section, credit risk includes two components: a component related to counterparty risk and a component related to credit sector risk.

Paragraph 62 of the Standard (ASC paragraphs 815-20-25-80 and 25-81) requires an entity to assess effectiveness for similar hedges in a similar manner. Consistent with that notion, paragraph 21(f) of the Standard (ASC paragraph 815-20-25-6) stated that, ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges and that the use of different benchmark interest rates for similar hedges should be rare and should be justified. ASU 2013-10 removed the requirement that the use of different benchmark interest rates for similar hedges be justified and that the occurrence of such be rare. In other words, for hedging relationships entered into or redesignated before July 17, 2013 an entity could not enter into the same type of hedging relationship (e.g., hedging the interest rate risk associated with two separate fixed-rate debt obligations) and designate the benchmark interest rate risk as U.S. Treasury rates for one hedging relationship and designate the benchmark interest rate risk as LIBOR swap rates for the other hedging relationship unless that occurrence was justified in the specific circumstances. For hedging relationships entered into or redesignated on or after July 17, 2013 an entity can enter into two hedging relationships of the same type whereby, for example, LIBOR is the designated hedged risk for one and the Fed Funds rate is the designated hedged risk for the other.

The benchmark interest rate can be the designated hedged risk in a hedge of interest rate risk regardless of the credit risk inherent in the hedged item. For example, the LIBOR swap rate could be the designated hedged risk in an AAA-rated debt security even if the overall interest rate of the instrument is less than the LIBOR swap rate. This allows entities to hedge financial instruments that are priced on either a positive or negative credit spread to the benchmark interest rate.

As mentioned in Paragraph 21f.14 above, there exist numerous indices that serve as a basis for pricing financial instruments. While changes in indices other than the LIBOR swap rate and the U.S. Treasury rate (and the Fed Funds rate for hedging relationships entered into or redesignated on or after July 17, 2013) cannot be the designated hedged risk in a fair value hedging relationship involving the benchmark interest rate, entities may apply fair value hedge accounting when a hedging relationship involves an interest rate swap with a variable leg based on an index other than one of the specified benchmark interest rates so long as the risk being hedged is either the change in fair value due to changes in a benchmark interest rate or the
change in the total fair value of the fixed-rate hedged item (assuming that such relationships are highly effective). For example, an entity may hedge a fixed-rate debt instrument with an interest rate swap with a variable-rate leg based on the Prime rate if the risk being hedged is changes in the overall fair value of the debt instrument. In such a hedging relationship, the entity would be required to determine whether the changes in the fair value of the Prime-based swap would be highly effective in achieving offset to the change in the total fair value of the debt instrument. Such an occurrence would be more likely if the fair value of the debt instrument were not affected by changes in credit risk or foreign currency risk or both.

21f.19 When calculating the changes in the fair value of a hedged item due to changes in the benchmark interest rate, the estimated cash flows used must be based on all contractual cash flows of the entire hedged item. See Paragraph 22.08 below for additional discussion of this issue.

ACCOUNTING FOR A FAIR VALUE HEDGE

22.01 Paragraph 22 of the Standard (ASC paragraphs 815-25-35-1 through 35-4) discusses the accounting requirements for the derivative hedging instrument and the hedged item in a fair value hedge as follows:

22. Gains and losses on a qualifying fair value hedge shall be accounted for as follows:

(a) The gain or loss on the hedging instrument shall be recognized currently in earnings.

(b) The gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized currently in earnings.

If the fair value hedge is fully effective, the gain or loss on the hedging instrument, adjusted for the component, if any, of that gain or loss that is excluded from the assessment of effectiveness under the entity’s defined risk management strategy for that particular hedging relationship (as discussed in paragraph 63 in Section 2 of Appendix A), would exactly offset the loss or gain on the hedged item attributable to the hedged risk. Any difference that does arise would be the effect of hedge ineffectiveness, which consequently is recognized currently in earnings. The measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent with the entity’s risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 20(a). Nevertheless, the amount of hedge ineffectiveness recognized in earnings is based on the extent to which exact offset is not achieved. Although a hedging relationship must comply with an entity’s established policy range of what is considered highly effective pursuant to paragraph 20(b) in order for that relationship to qualify for hedge accounting, that compliance does not assure zero ineffectiveness. Section 2 of Appendix A illustrates assessing hedge effectiveness and measuring hedge ineffectiveness. Any hedge ineffectiveness directly affects earnings because there will be no offsetting adjustment of a hedged item’s carrying amount for the ineffective aspect of the gain or loss on the related hedging instrument.
DIG Issues related to this paragraph are E7 and K4. See DIG Issues Index.

22.02 The Board decided that special accounting for fair value hedges of existing assets and liabilities (including firm commitments) was needed because of the differences in the way derivative instruments and hedged items were recognized and measured (e.g., fair value versus cost). Without hedge accounting, changes in fair value of derivative instruments would be reported in earnings in a different period from the earnings effect of the hedged item. In addition, in developing fair value hedge accounting requirements the Board wanted to:

- Avoid recognizing realized gains or losses on derivative hedging instruments as separate assets or liabilities; and
- Reflect any ineffectiveness in earnings.

22.03 In general, for hedges of fair value exposures, the Standard provides for certain gains and losses on designated hedged items to be recognized in earnings in the same period as the losses and gains on the related derivative hedging instrument. This approach can be summarized as follows:

Exhibit 5.2: Fair Value Hedge Accounting Model

The following provides additional guidance about the accounting in a fair value hedge for both the derivative hedging instrument and hedged item.

**Derivative Hedging Instrument**

22.04 The Standard requires that the derivative hedging instrument used in a fair value hedge be recorded as an asset or liability measured at fair value, with changes in that fair value recognized in earnings during each reporting period (see Paragraph 17.01 in Section 4 for a discussion of fair value). These requirements are consistent with the first two fundamental decisions reached by the Board that serve as cornerstones for the Standard (see Section 1 for further discussion).
Hedged Item

22.05 In addition, the Standard permits earnings offset by accelerating the recognition of the offsetting gains or losses (i.e., the change in fair value) attributable to the risk being hedged and adjusting the carrying amount of the hedged item accordingly. This notion is consistent with the Board’s second fundamental decision (see Paragraph 3b.01 of Section 1). Consequently, changes in fair value of the derivative hedging instrument that do not exactly offset the changes in fair value on the hedged item attributable to the hedged risk will have an effect on current earnings (i.e., all hedge ineffectiveness is reflected in earnings currently).

22.06 The amount of the adjustment of the hedged item for the risk being hedged should be calculated consistently with the entity’s risk management strategy and the method used to assess effectiveness of the hedging relationship. That is, in a fair value hedge of a firm commitment, if an entity assesses hedge effectiveness based on the entire gain or loss on the derivative hedging instrument (i.e., including the time value component), the adjustment of the hedged firm commitment for the risk being hedged for that relationship must also be based on the total change in its fair value, including the time value component. In contrast, because a recognized asset or liability is fair valued at current prices (i.e., spot prices) an entity’s risk management strategy and assessment of effectiveness would likely consider only changes in spot prices of the hedging derivative instrument. Accordingly, the adjustment to the carrying value of a recognized asset or liability would be limited to changes in the fair value of the hedged item attributable to changes based on spot prices.

22.07 In paragraph 21(f), the Standard (ASC paragraph 815-20-25-12(f)) provides additional guidance about determining the change in a hedged item’s fair value that is attributable to changes in the designated benchmark interest rate. The Board decided that in calculating the change in the hedged item’s fair value attributable to changes in the designated benchmark interest rate, the estimated cash flows used must be based on all of the contractual cash flows of the entire hedged item. That guidance does not prescribe the method, but it precludes the use of a method that excludes from the calculation some of the hedged item’s contractual cash flows (such as the portion of interest payments attributable to the obligor’s credit risk above the benchmark rate). The Board concluded that excluding some of the hedged item’s contractual cash flows would introduce a new approach to bifurcation of a hedged item that does not currently exist in the Standard’s hedging model.

22.08 The Board specified that all contractual cash flows of the hedged item must be considered in the calculation of the change in fair value of the hedged item because it was concerned that entities would erroneously conclude that there is no ineffectiveness in the hedging relationship. In other words, entities are not permitted to separate the stated fixed rate of interest into separate components (i.e., one being the implied benchmark interest rate and the other being all other implied risks (e.g., credit risk)) and only hedge an identified component of the fixed rate of interest.

22.09 Although the Standard requires all of the contractual cash flows to be considered in the calculation of the change in fair value the Standard, does not specify the discount rate that must be applied. For purposes of determining the change in fair value attributable to changes in the benchmark interest rate, we believe the discount rate can be either (1) the benchmark interest rate designated as being hedged, or (2) the market interest rate of the hedged item at inception of the
hedge, adjusted for changes in the benchmark interest rate being hedged. Therefore, for example, if an entity was hedging the changes in fair value attributable to changes in LIBOR of a $1 million, five-year, 4% fixed-rate debt obligation issued at par on January 1, 200X, the following two approaches would be acceptable to calculate the change in fair value of the debt relating to changes in LIBOR in the period from January 1, 200X to March 31, 200X where LIBOR increased from 2 ½% to 3% and interest payments of $10,000 were made:

- The cash flows to be included are the remaining contractual cash flows at the end of the period of interest of $30,000 for the first year and $40,000 per year for the remaining four years, and $1 million of principal at the maturity of the debt. These total contractual cash flows would be discounted at 2½ % (the LIBOR at the beginning of the period) and at 3% (the LIBOR at the end of the period). The difference between those two amounts would be the change in fair value of the debt relating to changes in LIBOR.

- The total contractual cash flows calculated above could, instead, be discounted at 4% (the debt’s market interest rate which equals its stated coupon rate since the debt was issued at par) and at 4½% (the debt’s market interest rate at inception of the hedge adjusted for changes in LIBOR for the period or 50 basis points). The difference between these two amounts would be the change in fair value of the debt relating to changes in LIBOR.

22.10 The following examples illustrate the accounting for fair value hedges.

**Example 5.9: Accounting for the Hedge of Long-Term Debt with an Interest Rate Swap (Shortcut Method)**

(Refer to Paragraphs A5.36-A5.58 in Appendix A for a discussion of the requirements for use of the shortcut method.)

For simplicity, the effect of commissions and other transaction costs, initial margins, and income taxes have been ignored.

On January 1, 20X1, Katz Company issues a three-year, $1,000,000 debt obligation. The interest rate on the debt obligation is fixed at 10%. Katz Company simultaneously enters into a three-year interest rate swap with a notional amount of $1,000,000 to receive interest at a fixed rate of 9.5% and pay interest at a variable rate equal to six-month LIBOR. The combination of the interest rate swap and debt obligation results in Katz Company paying a net interest rate equal to six-month LIBOR plus 50 basis points. Both the debt obligation and interest rate swap require payments to be made or received on June 30 and December 31 of each year. The variable rate on the interest rate swap resets on January 1 and July 1 of each year. No premium was paid or received for the interest rate swap. Katz Company designates the interest rate swap as a fair value hedge of the changes in fair value of the fixed-rate debt obligation attributable to changes in the benchmark interest rate (i.e., six-month LIBOR).

**Assumptions**

- All criteria for hedge accounting have been met. The example is based on annual periods; normally the assessment of effectiveness, measurement of ineffectiveness
and fair value adjustments of the hedged item and derivative would be done at least quarterly.

- All the conditions set forth in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106) for use of the shortcut method have been met.
- Katz Company prepares financial reports at the end of each year (i.e., ignore effect of interim reporting).
- The six-month LIBOR rates are as follows:
  
<table>
<thead>
<tr>
<th>Date</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20X1</td>
<td>9.5%</td>
</tr>
<tr>
<td>1/1/20X2</td>
<td>8.5%</td>
</tr>
<tr>
<td>1/1/20X3</td>
<td>10.5%</td>
</tr>
</tbody>
</table>

- Payments made (received):
  
<table>
<thead>
<tr>
<th>Date</th>
<th>Fixed-rate debt obligation</th>
<th>Interest rate swap</th>
<th>Net cash payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/X1</td>
<td>$100,000</td>
<td>0</td>
<td>$100,000</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>$100,000</td>
<td>(10,000)</td>
<td>$90,000</td>
</tr>
<tr>
<td>12/31/X3</td>
<td>$100,000</td>
<td>10,000</td>
<td>$110,000</td>
</tr>
</tbody>
</table>

- Assumed fair value amounts (after cash settlements):
  
<table>
<thead>
<tr>
<th>Date</th>
<th>Asset (liability): Fixed-rate debt obligation (due solely to changes in the benchmark interest rate)</th>
<th>Interest rate swap</th>
<th>Change in fair value (gain (loss)): Fixed-rate debt obligation</th>
<th>Interest rate swap</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/X1</td>
<td>$ (1,150,000)</td>
<td>150,000</td>
<td>$ (150,000)</td>
<td>150,000</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>$ (1,090,000)</td>
<td>90,000</td>
<td>$ 60,000</td>
<td>(60,000)</td>
</tr>
<tr>
<td>12/31/X3</td>
<td>$ 0</td>
<td>0</td>
<td>$ 90,000</td>
<td>(90,000)</td>
</tr>
</tbody>
</table>

The journal entries required to be made on December 31, 20X1, 20X2, and 20X3 follow:

There would be a memorandum entry made on **January 1, 20X1** documenting the existence of this hedging relationship. The financial records of Katz Company would not otherwise be affected as of this date because the interest rate swap was issued at market rates.

Note: Journal entries (for all years) are presented gross for illustrative purposes but could be combined.

The journal entries on **December 31, 20X1** would be as follows:

1. Interest expense (P&L) | $100,000
   Cash (B/S)               | $100,000

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(To recognize interest expense on the fixed-rate debt obligation)

2. Interest rate swap (B/S) 150,000
   Unrealized gain on interest rate swap (P&L) 150,000

(To record the derivative hedging instrument in the statement of financial position at fair value)

3. Unrealized loss on fixed-rate debt obligation (P&L) 150,000
   Fixed-rate debt obligation (B/S) 150,000

(To record the change in fair value of the fixed-rate debt obligation due to changes in interest rates)

The journal entries on December 31, 20X2 would be as follows:

1. Interest expense (P&L) 100,000
   Cash (B/S) 100,000

   (To recognize interest expense on the fixed-rate debt obligation)

2. Unrealized loss on interest rate swap (P&L) 60,000
   Interest rate swap (B/S) 60,000

   (To record the change in fair value of the derivative hedging instrument)

3. Fixed-rate debt obligation (B/S) 60,000
   Unrealized gain on fixed-rate debt obligation (P&L) 60,000

   (To record the change in fair value of the fixed-rate debt obligation due to changes in interest rates)

4. Cash (B/S) 10,000
   Interest expense (P&L) 10,000

   (To record the net interest cash receipt of the interest rate swap as a decrease in interest expense)

The journal entries on December 31, 20X3 would be as follows:

1. Interest expense 100,000
   Cash 100,000

   (To recognize interest expense on the fixed-rate debt obligation)

2. Unrealized loss on interest rate swap (P&L) 90,000
   Interest rate swap (B/S) 90,000

   (To record the change in fair value of the fixed-rate debt obligation due to changes in interest rates)
(To record the change in fair value of the derivative hedging instrument)

3. Fixed-rate obligation (B/S) 90,000
   Unrealized gain on fixed-rate debt obligation (P&L) 90,000

(To record the change in fair value of the fixed-rate debt obligation due to changes in interest rates)

4. Interest expense (P&L) 10,000
   Cash (B/S) 10,000

(To record the net interest cash payment on the interest rate swap as an increase in interest expense)

5. Fixed-rate debt obligation 1,000,000
   Cash 1,000,000

(To record the cash paid by the borrower upon maturity of the fixed-rate debt obligation)

Observations

Because the hedge was 100% effective, recording both the derivative hedging instrument at fair value and the changes in fair value of the hedged debt obligation due to changes in the benchmark interest rate in the statement of financial position resulted in converting the interest expense on the 10% fixed-rate debt obligation to six-month LIBOR plus 50 basis points. This result is illustrated as follows:

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on fixed-rate debt obligation</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Interest on interest rate swap</td>
<td>(0)</td>
<td>(10,000)</td>
<td>10,000</td>
</tr>
<tr>
<td>Net interest expense</td>
<td>$100,000</td>
<td>$90,000</td>
<td>$110,000</td>
</tr>
</tbody>
</table>

Alternatively:

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding principal</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Six-month LIBOR plus 50 basis points</td>
<td>× 10%</td>
<td>× 9%</td>
<td>× 11%</td>
</tr>
<tr>
<td>Net interest expense</td>
<td>$100,000</td>
<td>$90,000</td>
<td>$110,000</td>
</tr>
</tbody>
</table>
Example 5.10: Fair Value Hedge of the LIBOR Swap Rate in a Fixed-Rate Noncallable Note

On January 1, 20X1, Company A issues at par a $100,000 BBB-rated, two-year noncallable note at a fixed rate of 10%. Interest is paid annually on December 31. On that date, the Company A enters into a 2-year interest rate swap based on the 12-month LIBOR swap rate and designates it as the hedging instrument in a fair value hedge for changes in the fair value of the note due to changes in the benchmark interest rate (12-month LIBOR swap rate). Under the terms of the swap, Company A will receive fixed interest at 7% and pay variable interest at 12-month LIBOR. The variable leg of the swap resets each year on December 31 for the payments due the following year. Since the swap reprices annually, the shortcut method cannot be used. Pursuant to paragraph 68(h) of the Standard (ASC paragraph 815-20-25-105(c)), to be eligible for the shortcut method, the frequency of repricing generally should be three to six months.

This example has been simplified by assuming that the interest rate applicable to a payment due at a future date is the same as the rate for a payment at any other date (i.e., the yield curve is flat).

The hedge objective and strategy is to hedge the change in the fair value of the $100,000 BBB-rated, two-year debt obligation due to changes in the benchmark interest rate (12-month LIBOR) with a two year $100,000 interest rate swap to receive 7% and pay 12-month LIBOR.

The assessment of hedge effectiveness will be made by comparing the cumulative change in the fair value of the hedge item attributable to changes in the benchmark interest rate with the cumulative changes in the fair value of the interest rate swap. The change in the fair value of the debt obligation will be calculated based on discount rates equal to the note’s coupon rate adjusted for changes in the benchmark interest rate from inception to the beginning of the period for which the change in fair value is being calculated and the note’s coupon rate adjusted for changes in the benchmark interest rate from inception to the end of that period.

Hedge ineffectiveness will occur if the change in the fair value of the note attributable to changes in the benchmark interest rate does not equal changes in the fair value of the hedging instrument. Ineffectiveness will be recognized immediately in earnings each period.

Assumptions

12-month LIBOR swap rates reset as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X1</td>
<td>7.00%</td>
</tr>
<tr>
<td>December 31, 20X1</td>
<td>7.50%</td>
</tr>
</tbody>
</table>

The example is based on annual periods; normally the assessment of effectiveness, measurement of ineffectiveness and fair value adjustments of the hedged item and derivative would be done at least quarterly. Also, there is no adjustment of the hedged item for the hedged risk for the year ended December 31, 20X2, since the debt matured at that date.

The journal entries as of January 1, 20X1 would be as follows:

1. Cash $100,000
   Debt Obligation $100,000
(To record issuance of the $100,000, 2-year, 10% debt obligation)

2. There would be a memorandum entry on January 1, 20X1 to document the existence of this hedging relationship. The financial records are not otherwise affected as of this date because the interest rate swap had a fair value of zero at inception.

Entries as of **December 31, 20X1** would be as follows:

1. **Interest expense (P&L)** 10,000
   **Cash (B/S)** 10,000
   (To record payment of interest on $100,000 debt obligation at 10%)

2. **Debt obligation (B/S)** 452
   **Unrealized gain on debt obligation (P&L)** 452
   (To record the change in the fair value of the debt obligation due to changes in the benchmark interest rate. The calculation of the change in fair value is as follows: Beginning carrying value of $100,000 less the change in fair value due to the change in 12-month LIBOR of $452. This is calculated based on the remaining contractual cash flows of principal and interest of $110,000 discounted at the beginning of the period coupon rate of 10% and at 10.5% which is the beginning of the period rate adjusted for changes in 12-month LIBOR for the period of .5%. 
   \[ \frac{110,000}{1.105} - \frac{110,000}{1.10} \]

3. **Unrealized loss on interest rate swap (P&L)** 465
   **Interest rate swap (B/S)** 465
   (To record change in the fair value of the interest rate swap due to changes in the benchmark interest rate)

4. Note: There is no entry for swap interest payments during the period because the pay fixed and receive 12-month LIBOR legs of the swap were both 7% for the year.

Entries as of **December 31, 20X2** would be as follows:

1. **Interest expense (P&L)** 10,000
   **Cash (B/S)** 10,000
   (To record payment of interest on $100,000 debt obligation at 10%)

2. **Unrealized gain on debt obligation (P&L)** 452
   **Debt obligation (B/S)** 452

(To record the change in the fair value of the debt obligation due to changes in the benchmark interest rate. The calculation of the change in fair value is as follows: Beginning carrying value of $100,000 less the change in fair value due to the change in 12-month LIBOR of $452. This is calculated based on the remaining contractual cash flows of principal and interest of $110,000 discounted at the beginning of the period coupon rate of 10% and at 10.5% which is the beginning of the period rate adjusted for changes in 12-month LIBOR for the period of .5%. 
\[ \frac{110,000}{1.105} - \frac{110,000}{1.10} \]
(To record the change in the fair value of the debt obligation due to changes in the benchmark interest rate. Since the debt obligation is due, the fair value of the obligation will equal the payment amount of $100,000 since the use of discounting is not required. (($100,000 original carrying amount - $452 adjustment at 12/31/X1) - $100,000 payment amount))

3. Unrealized loss on interest rate swap (P&L) 35
   Interest rate swap (B/S) 35
   (To record change in the fair value of the swap due to the passage of time (note that the benchmark rate did not change during the year) ($465 x 7.5% = $35))

4. Interest rate swap (B/S) 500
   Cash (B/S) 500
   (To record swap settlement payment for the period ended December 31, 20X2)

5. Debt Obligation (B/S) 100,000
   Cash (B/S) 100,000
   (To record repayment of debt obligation at 12/31/X2)

Hedge effectiveness at December 31, 20X1 is 102.9% based on the change in fair value of the swap of $465 divided by the change in fair value of the debt obligation for the hedged risk of $452. Hedge ineffectiveness was $13, which amount is recognized in earnings after recording entries 2 and 3 at December 31, 20X1.

**Observations**

Company A hedged the change in fair value of its debt obligation attributable to changes in the benchmark interest rate (12-month LIBOR) by converting the fixed-rate obligation to a 12-month LIBOR based variable rate with an interest rate swap. This results in a variable rate of approximately 12-month LIBOR plus 3% since the receiving leg of the swap is fixed at 7% compared to the debt obligation’s fixed rate of 10%. The expense for the year ended December 31, 20X2 was $10,487, which is comprised of interest expense on the debt of $10,000, unrealized loss on the interest rate swap of $35, and the increase in the fair value of the debt obligation of $452. The 12-month LIBOR rate in effect during this year was 7.5%, and accordingly, the swap provided an effective rate of 10.5% (7.5% plus a 3% spread). The income statement impact for the year was 10.49% ($10,487/100,000). The slight difference in the expected effective rate of 10.5% and the actual rate of 10.49% is due to the fact that only the benchmark rate was hedged (i.e., only 7% of the fixed 10% rate).

**Example 5.11: Accounting for a Hedge of a Firm Commitment to Purchase Silver with a Forward Contract**
For simplicity, the effect of commissions and other transaction costs, initial margin, and income taxes have been ignored. In addition, the example assumes that there will be no ineffectiveness to measure for this hedging relationship.

MBS produces silver platters for sale to department stores. The sales price of the silver platters depends in large part on the market price of silver as of the date of sale. MBS has a contract to purchase 100,000 ounces of silver (this transaction is considered a normal purchase as defined in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-26)) from JAE at $4.99 per ounce on December 31, 20X1. If MBS does not purchase the silver from JAE, it will be required to pay JAE a substantial penalty of $300,000 (i.e., MBS’s contract with JAE is a firm commitment). MBS is concerned with the fluctuations of the price of silver during the commitment period (i.e., the inventory would be recorded at other than market price at the date of purchase). Therefore, to hedge against the fluctuations in fair value of its firm commitment due to changes in the market price of silver, MBS enters into an OTC silver forward contract on July 1, 20X1 that settles in cash on a net basis on December 31, 20X1. The forward contract requires MBS to sell 100,000 ounces of silver at $4.99 per ounce. The forward contract is designated as a fair value hedge of MBS’s firm commitment to purchase 100,000 ounces of silver from JAE in six months.

Assumptions

- The hedging relationship will have no ineffectiveness to measure. MBS will assess hedge effectiveness based on the changes in the forward price of silver. At inception MBS concluded and documented that the hedging relationship is expected to be highly effective (in this instance, 100% effective). On an ongoing basis, MBS will ascertain and document that the hedging relationship has been, and will continue to be, highly effective (in this instance, 100% effective as the change in the fair value of the actual derivative exactly offsets the change in the fair value of the firm commitment).

- The basis adjustment recognized in earnings related to the firm commitment will be equal to the changes in the discounted fair value of the forward contract.

- All criteria for hedge accounting have been met.

- The forward contract is at market rates; therefore, no cash was exchanged at inception of the contract.

- The spot price and forward price of silver, and the fair value of the forward contract, are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot Price</th>
<th>Forward Price</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1, 20X1</td>
<td>$ 5.00</td>
<td>$ 4.99</td>
<td>(1)</td>
</tr>
<tr>
<td>September 30, 20X1</td>
<td>4.98</td>
<td>4.95</td>
<td>3,960</td>
</tr>
<tr>
<td>December 31, 20X1</td>
<td>5.10</td>
<td>-</td>
<td>(11,000)</td>
</tr>
</tbody>
</table>

(1) Determined using the change in forward rates, discounted at the risk-free rate.
The changes in fair value of the forward contract are (gain (loss)):
September 30, 20X1 $ 3,960
December 31, 20X1 (14,960)
The forward contract settles on December 31, 20X1 with MBS paying $11,000
((100,000)*($4.99 - $5.10)).

The following journal entries are required to be made on July 1, September 30, and December 31, 20X1.

There would be a memorandum entry made on July 1, 20X1 documenting the existence of this hedging relationship. The financial records of MBS would not otherwise be affected as of this date because the forward contract was at market rates.

The journal entries made at **September 30, 20X1** would be as follows:

1. Forward contract (B/S) $ 3,960
   Unrealized gain on forward contract (P&L) $ 3,960
   (To record the change in fair value of the forward contract attributable to the discounted change in the forward rate (i.e., the effective portion))

2. Unrealized loss on firm commitment (P&L) 3,960
   Firm commitment (B/S) 3,960
   (To record the change in fair value of the firm commitment to purchase silver)

The journal entries as of **December 31, 20X1** would be as follows:

1. Unrealized loss on forward contract (P&L) 14,960
   Forward contract (B/S) 14,960
   (To record the change in fair value of the forward contract attributable to the discounted change in the forward rate (i.e., the effective portion of the hedge))

2. Firm commitment (B/S) 14,960
   Unrealized gain on firm commitment (P&L) 14,960
   (To record the change in fair value of the firm commitment to purchase silver)

3. Forward contract (B/S) 11,000
   Cash (B/S) 11,000
   (To record the settlement of the forward contract at December 31, 20X1)

4. Silver inventory (B/S) 510,000
   Firm commitment (B/S) 11,000
   Cash (B/S) 499,000
Observations

MBS entered into this hedging transaction because of concerns that changes in silver prices would cause fluctuations in the fair value of the firm commitment. Since silver prices increased, MBS realized a gain of $11,000 on the firm commitment with JAE. This gain was offset by an $11,000 loss on the forward contract. Therefore, even though MBS paid $499,000 for the silver inventory (i.e., the contract price), the inventory was recorded at the current market price of $510,000 (i.e., the purchase price plus the fair value of the firm commitment).

It should be noted that since MBS assessed effectiveness of the hedge based on the changes in the total fair value of the forward contract, the firm commitment and the silver inventory balances include $1,000, which represents the time value component of the forward contract ((100,000) * ($5.00 - $4.99)).

HEDGE OF ITEMS MEASURED AT FAIR VALUE THROUGH OTHER COMPREHENSIVE INCOME

23.01 Paragraph 23 of the Standard (ASC paragraph 815-25-35-6) discusses the hedging of items measured at fair value through other comprehensive income (OCI) as follows:

23. If a hedged item is otherwise measured at fair value with changes in fair value reported in other comprehensive income (such as an available-for-sale security), the adjustment of the hedged item’s carrying amount discussed in paragraph 22 shall be recognized in earnings rather than in other comprehensive income in order to offset the gain or loss on the hedging instrument.

23.02 When the hedged item in a fair value hedge is measured at fair value with the changes in fair value reported in OCI, the Standard requires that during the period the hedge is in effect, the changes in the hedged item’s fair value attributable to the risk being hedged be reflected in earnings consistent with the accounting prescribed in paragraph 22 of the Standard (ASC paragraphs 815-25-35-1 through 35-4). Accordingly, the Standard amended Statement 115 (ASC Subtopic 320-10) to require that when an available-for-sale security is the hedged item in a fair value hedge, the changes in its fair value attributable to the risk being hedged must be reflected in earnings rather than OCI. Thus, when only a portion of risk is being hedged, the gain or loss associated with the designated hedged risk is recorded in earnings and the other changes in fair value of the hedged item are reported in OCI.

23.03 The following example illustrates the requirements of paragraph 23 of the Standard (ASC paragraph 815-25-35-6).
Example 5.12: Hedge of an Available-for-Sale Security with a Put Option

For simplicity, the effect of commissions and other transaction costs, initial margin, and income taxes have been ignored. In addition, the example assumes that there will be no ineffectiveness to measure for this hedging relationship.

Company A owns 1,000,000 shares of Company B’s publicly traded stock. As of January 1, 20X1, these shares are trading at $50 per share and Company A has an unrealized gain of $2,000,000 in accumulated other comprehensive income (AOCI) associated with them. Company A wants to lock in its unrealized gain. Thus, Company A purchases a put option on Company B’s stock from Bank C for $200,000. The purchased put option allows Company A to put its 1,000,000 shares of Company B stock to Bank C at $50 per share at December 31, 20X1. The purchased put option has been designated as a hedge of the decline in the fair value of Company A’s investment in Company B.

Assumptions

- Company A will assess effectiveness of the hedge by comparing changes in the intrinsic value of the put option with changes in the fair value of Company B’s shares. Because the option provides only one-sided protection, effectiveness is required to be assessed during only those periods in which the put option has an intrinsic value.

- The hedging relationship will have no ineffectiveness to measure. At inception, Company A concluded that the changes in the intrinsic value of the option will be highly effective (in this instance, 100% effective) at offsetting the changes in the fair value of its investment in 1,000,000 shares of Company B. On an ongoing basis, Company A will ensure and document that the hedging relationship has been, and will continue to be, highly effective (in this instance, 100% effective).

- Because changes in the time value of the option have been excluded from the assessment of the hedges effectiveness, changes in these amounts should be included in earnings each reporting period.

- All criteria for hedge accounting have been met.

- Company A prepares financial reports at the end of every quarter.

- Company A sold its investment in Company B at December 31, 20X1.

- Company A accounts for its investment in Company B as available-for-sale securities pursuant to Statement 115 (ASC Subtopic 320-10).

- The share price and fair value of Company A’s investment in Company B were as follows:

<table>
<thead>
<tr>
<th>Share Price</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X1</td>
<td>$50,000,000</td>
</tr>
<tr>
<td>March 31, 20X1</td>
<td>60,000,000</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>45,000,000</td>
</tr>
</tbody>
</table>
- The fair value, intrinsic value, and time value of the put option are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>(A) Fair Value</th>
<th>(B) Intrinsic Value</th>
<th>(A) - (B) Time Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X1</td>
<td>$200,000</td>
<td>$</td>
<td>$200,000</td>
</tr>
<tr>
<td>March 31, 20X1</td>
<td>180,000</td>
<td>$</td>
<td>180,000</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>5,150,000</td>
<td>5,000,000</td>
<td>150,000</td>
</tr>
<tr>
<td>September 30, 20X1</td>
<td>10,050,000</td>
<td>10,000,000</td>
<td>50,000</td>
</tr>
<tr>
<td>December 31, 20X1</td>
<td>20,000,000</td>
<td>20,000,000</td>
<td>-</td>
</tr>
</tbody>
</table>

The following journal entries would be made by Company A at January 1, March 31, June 30, September 30, and December 31, 20X1:

The journal entry made at **January 1, 20X1** would be as follows:

1. Purchased put option (B/S) $200,000
   Cash (B/S) $200,000

   (To record the purchased put option in the statement of financial position at fair value)

The journal entries made at **March 31, 20X1** would be as follows:

1. Change in fair value of the time value of the put option (P&L) 20,000
   Purchased put option (B/S) $20,000

   (To record the change in the time value portion of the put option)

2. Investment in Company B (B/S) 10,000,000
   OCI 10,000,000

   (To record the increase in fair value of the investment in Company B in OCI; note that there was no change in the intrinsic value of the put option)

The journal entries made at **June 30, 20X1** would be as follows:

1. Change in fair value of the time value of the put option (P&L) 30,000
   Purchased put option (B/S) 30,000

   (To record the change in the time value portion of the put option)

2. Purchased put option (B/S) 5,000,000
   Unrealized gain on put option (P&L) 5,000,000
To record the change in the intrinsic value of the purchased put option

3. OCI 10,000,000
   Unrealized loss on investment in Company B (P&L) 5,000,000
   Investment in Company B (B/S) 15,000,000

(To record the change in fair value of the investment in Company B. Note that the loss on this investment that is recognized in earnings is limited to the change in the put option’s intrinsic value (i.e., the hedged risk). The remainder of the change in fair value is recorded in OCI)

The journal entries made at September 30, 20X1 would be as follows:

1. Change in fair value of the time value of the put option (P&L) 100,000
   Purchased put option (B/S) 100,000

(To record the change in the time value of the put option)

2. Purchased put option (B/S) 5,000,000
   Unrealized gain on put option (P&L) 5,000,000

(To record the change in the intrinsic value portion of the purchased put option)

3. Unrealized loss on investment in Company B (P&L) 5,000,000
   Investment in Company B (B/S) 5,000,000

(To record the change in fair value of the investment in Company B; note that the entire loss on this investment was recognized in earnings because the loss is equal to the change in the put option’s intrinsic value)

The journal entries made at December 31, 20X1 would be as follows:

1. Change in fair value of the time value of the put option (P&L) 50,000
   Purchased put option (B/S) 50,000

(To record the change in the time value portion of the put option)

2. Purchased put option (B/S) 10,000,000
   Unrealized gain on put option (P&L) 10,000,000

(To record the change in the intrinsic value of the purchased put option, this entry would be made prior to the settlement of the put option)

3. Unrealized loss on investment in Company B (P&L) 10,000,000
   Investment in Company B (B/S) 10,000,000
(To record the change in fair value of the investment in Company B; note that the entire loss on this investment was recognized in earnings since the loss is equal to the change in the put option’s intrinsic value)

4. Cash (B/S) 50,000,000
   Investment in Company B (B/S) 30,000,000
   Purchased put option (B/S) 20,000,000

(To record the settlement of the purchased put option through delivery of the shares of Company B’s stock at a price of $50 per share to Bank C)

5. AOCI (B/S) 2,000,000
   Realized gain on investment in Company B (P&L) 2,000,000

(To reclassify the unrealized gain on Company B’s shares from AOCI to earnings on the sale of the shares to Bank C)

Observations

Even though Company B’s share price fell to $30 per share, Bank A was able to lock in a $50 share price as a result of entering into the put option. Thus, it was able to realize the gain of $2,000,000 (less the $200,000 premium paid for the option).

Because the intrinsic value of the put option was perfectly effective at offsetting changes in the fair value of Company A’s investment in Company B’s stock, each change in the intrinsic value of the put option recognized in earnings was offset by an equal amount that represents the change in the investment in Company B’s stock attributable to changes in market prices. In addition, the premium paid for the put option was recognized in earnings as the fair value of the time value portion of the put option changed over time.

SUBSEQUENT ACCOUNTING FOR BASIS ADJUSTMENT

24.01 Paragraph 24 of the Standard (ASC paragraphs 815-25-35-8 and 35-9) discusses the accounting for the basis adjustment related to the hedged asset or liability as follows:

24. The adjustment of the carrying amount of a hedged asset or liability required by paragraph 22 shall be accounted for in the same manner as other components of the carrying amount of that asset or liability. For example, an adjustment of the carrying amount of a hedged asset held for sale (such as inventory) would remain part of the carrying amount of that asset until the asset is sold, at which point the entire carrying amount of the hedged asset would be recognized as the cost of the item sold in determining earnings. An adjustment of the carrying amount of a hedged interest-bearing financial instrument shall be amortized to earnings; amortization shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

24.02 The basis adjustment that results from recording the changes in fair value of the hedged item attributable to the hedged risk in a fair value hedge is accounted for pursuant to the accounting standards for that particular type of asset or liability. For example, if the hedged item

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was property, plant, or equipment, the basis adjustment would be capitalized as part of the hedged item and subsequently depreciated over the remaining life of the asset. Likewise, if the hedged item was an interest-bearing financial instrument that is carried at amortized cost (e.g., a long-term borrowing), the basis adjustment would be amortized as interest income or interest expense over the expected remaining life of the interest-bearing instrument using the effective-yield method. The amortization of this basis adjustment is required to begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged, however, an entity may begin amortization at an earlier point depending on its accounting policy. When the hedged item is a firm commitment, refer to Paragraph 20a.14.

24.03 Entities often enter into hedging relationships to hedge changes in interest rates on debt associated with long-term projects that are subject to FASB Statement No. 34, Capitalization of Interest Cost (Statement 34) (ASC Subtopic 835-20, Interest - Capitalization of Interest). In applying Statement 34 (ASC Subtopic 835-20), the Emerging Issues Task Force (EITF) concluded in EITF Issue No. 99-9, Effect of Derivatives Gains and Losses on the Capitalization of Interest (ASC paragraph 815-25-35-14), that the amounts recorded in an entity’s income statement as interest costs should be included in the capitalization rate that is used to determine capitalized interest. Those amounts would include amortization of the adjustments of the carrying amount of the hedged debt if an entity elects to begin to amortize those adjustments during the period in which the interest is eligible for capitalization. The EITF (ASC paragraph 815-25-35-14) observed that the ineffective portion of the fair value hedge should not be reflected in the interest capitalization rate.

DISCONTINUATION OF HEDGE ACCOUNTING

25.01 Paragraph 25 of the Standard (ASC paragraphs 815-25-40-1 and 40-2) discusses the discontinuation of hedge accounting as follows:

25. An entity shall discontinue prospectively the accounting specified in paragraphs 22 and 23 for an existing hedge if any one of the following occurs:

(c) Any criterion in paragraphs 20 and 21 is no longer met.
(d) The derivative expires or is sold, terminated, or exercised.
(e) The entity removes the designation of the fair value hedge.

In those circumstances, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in paragraphs 25(a) and 25(c) above, a different hedged item or a hedged transaction if the hedging relationship meets the criteria specified in paragraphs 20 and 21 for a fair value hedge or paragraphs 28 and 29 for a cash flow hedge.

25.02 An entity is required to discontinue hedge accounting prospectively if it fails to meet any of the hedge accounting criteria in paragraphs 20 and 21 of the Standard (ASC paragraphs 815-20-25-3 through 25-12). Additionally, an entity is required to cease applying hedge accounting if the derivative hedging instrument expires or is sold, terminated, or exercised, or if the entity removes the designation of the fair value hedge (i.e., the designation that was formally documented at inception of the hedge in accordance with paragraphs 20 and 21 of the Standard.
(ASC paragraphs 815-20-25-3 through 25-12). Discontinuation of hedge accounting is also required if the recognized asset, liability, or firm commitment (or portions thereof) is no longer eligible for designation as a hedged item. This would occur, for example, when an entity acquires, or otherwise must consolidate, the counterparty to a hedged firm commitment resulting in that transaction no longer being with an unrelated party to the reporting entity or when an entity sells, or otherwise must deconsolidate, a subsidiary resulting in a hedged item of that subsidiary becoming derecognized.

25.02a We believe that the modification of collateral requirements associated with an existing derivative hedging instrument or the addition of a new guarantor would not result in the existing derivative being viewed as terminated, because the substantive terms of the derivative (e.g., strike price, maturity date, and counterparty) did not change. Accordingly, we do not believe that these changes would cause a redesignation of the associated hedging relationship. However, the fair value of the derivative instrument may be affected by these changes, which may affect hedge effectiveness.

25.03 On discontinuation of hedge accounting, an entity should not recognize in earnings the adjustment, if any, of the carrying amount of the hedged item that was recorded in accordance with paragraphs 22 and 23 of the Standard (ASC paragraphs 815-25-35-1 through 35-6). Instead, the carrying amount (including the basis adjustment caused by designating the item as the hedged item) of the hedged asset, liability, or firm commitment will remain as part of the basis of that asset or liability and would be accounted for in accordance with the GAAP applicable to those assets or liabilities. Thus, for example, if an entity were hedging the fair value of inventory and the carrying amount of the inventory increased by $100,000 as a result of applying fair value hedge accounting, that increase would remain part of the carrying amount of the hedged inventory (subject to ongoing impairment tests discussed in Paragraph 27.01 of this section) and used to measure the cost of sales upon its sale. Additionally, if an entity were hedging a financial asset or liability that is carried at amortized cost (e.g., a long-term borrowing), the basis adjustment would be treated as a premium or discount and amortized as interest income or interest expense over the expected remaining life of the interest-bearing instrument using the effective-yield method. The amortization of the basis adjustment would begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. Note that DIG Issue E22 addresses the accounting for basis adjustments associated with hedging relationships required to be discontinued as a result of adopting FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities (ASC Subtopic 810-10, Consolidation -- Overall), as originally issued or as revised (FIN 46). See Section 10 for further discussion.

25.04 As discussed in paragraph 21 of the Standard (ASC paragraph 815-20-25-12), the hedged item in a hedging relationship must be specifically identified as either all or a specific portion of a single recognized asset or liability or of an unrecognized firm commitment or a portfolio of similar assets or liabilities. In addition, as described in Paragraph 20a.06 of this section, the derivative hedging instrument can be a combination of derivatives. Additions or deletions (a rebalancing) to either the portfolio of hedged items or derivative hedging instruments in a hedging relationship would call for a prospective discontinuation of that relationship. This rebalancing of the portfolios may be needed to continue to achieve the high effectiveness of the relationship such as in a hedge of a portfolio of prepayable fixed-rate loans as discussed in
Paragraphs 21a.17-21a.20 in this section or in a delta-neutral dynamic hedging relationship discussed in Paragraph A5.79 in Appendix A to this section. We believe that scheduled loan amortizations of principal, prepayments or write-offs are not considered deletions in the context discussed herein. Entities that must discontinue hedging relationships may decide to redesignate the portfolio of hedged items in a new hedging relationship. The issue is whether the basis adjustment of the financial hedged item that resulted from the previous hedging relationship should begin to be amortized as interest income/expense when that relationship ceases, if not begun earlier. Paragraph 24 of the Standard (ASC paragraphs 815-25-35-8 and 35-9) requires that such amortization for hedged interest-bearing financial instruments should begin no later than when the hedged items cease to be adjusted for changes in fair value attributable to the risk being hedged. We believe that if a hedging relationship is discontinued and the original hedged items are redesignated in a relationship hedging the same risks with a rebalanced combination of derivatives, amortization is not required to begin (because these items continue to be hedged for changes in fair value attributable to the same risk). Likewise, if the original hedged items are redesignated with additional items added to the portfolio of hedged items in a relationship hedging the same risks, amortization is not required to begin. However, if the original hedged items were redesignated in a relationship specifically hedging a different risk, amortization should begin. An approach that may assist entities to mitigate the effects of the requirement to redesignate hedging relationships where there is a change to the hedged item or the derivative hedging instrument would include designating a proportion of the derivative hedging instrument to each item in a portfolio and to separately identify a hedging relationship with respect to each hedged item.

25.05 In certain situations, an entity issues public debt and at the same time acts as a market maker for that debt. As a market maker, the entity would be expected to acquire and subsequently resell some of the debt. Questions have arisen about the effect of hedging this debt including whether acquisitions and resales constitute additions to or deletions from a portfolio of hedged items (i.e., individual certificates). We believe that the hedged item is not necessarily a portfolio of certificates, but instead could be identified as an individual debt issuance. This designation of the hedged item is consistent with paragraph 4 (ASC paragraph 470-60-15-4) of FASB Statement No. 15, Accounting for Debtors and Creditors for Troubled Debt Restructurings (ASC Subtopic 470-60, Debt -- Troubled Debt Restructurings by Debtors), which states that a bond constitutes one payable even though there are many bondholders and FASB Staff Position 115-1 and 124-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments” (ASC paragraph 320-10-35-20), which states that securities of the same issuer bearing the same CUSIP number can be aggregated and treated as a single security when assessing and measuring impairment. Accordingly, when the hedged item is designated as an individual debt issuance, acquisitions and resales of a portion of the debt issuance result in the outstanding principal balance of the designated hedged item fluctuating. The acquisition of a portion of the debt during the hedging period would cause ineffectiveness because the notional amount of the derivative would exceed the outstanding principal balance of the hedged item. This would be true even when the hedged item is designated as a portion of the entire debt issuance, for example, 90% of the entire issuance. In that instance, if an entity acquires a portion of the debt issuance, the hedged balance would be 90% of the new outstanding principal balance. In the initial and ongoing assessments of effectiveness, the entity would need
to consider the effect of the market making activities. This may result in the entity concluding that the relationship will not or has not been highly effective, thus precluding hedge accounting.

25.06 If the derivative instrument remains outstanding after hedge accounting is discontinued, it would continue to be recorded in the statement of financial position at fair value. The subsequent changes in the derivative instrument’s fair value would be recognized in earnings each reporting period unless the derivative was redesignated as the derivative hedging instrument in a cash flow hedge. In that instance, the relevant hedge accounting criteria would be required to be met. The derivative may also be redesignated as the hedging instrument in a different hedging relationship.

25.07 The following example illustrates the requirements of paragraph 25 of the Standard (ASC paragraphs 815-25-40-1 and 40-2):

<table>
<thead>
<tr>
<th>Example 5.13: Termination of Interest Rate Swap Hedging Fixed-Rate Debt</th>
</tr>
</thead>
</table>
| On January 1, 20X1, ARK issues a five-year, $10,000,000 debt obligation. The interest rate on the debt obligation is 10%. Simultaneously, ARK enters into a five-year interest rate swap with a notional amount of $10,000,000 to receive interest at a fixed rate of 10% and pay interest at a variable rate equal to three-month LIBOR. The interest rate swap was designated and was effective as a hedge of changes in fair value of the debt obligation due to changes in three-month LIBOR, the designated benchmark interest rate. On December 31, 20X3, ARK terminated the interest rate swap. ARK paid $1,000,000 to the counterparty, which was the interest rate swap’s fair value at the date of termination. As a result of having applied hedge accounting, the carrying value of the fixed-rate debt obligation was $9,000,000 at December 31, 20X3. The following journal entries are required to be made on December 31, 20X4 and 20X5:

ARK would account for the $1,000,000 adjustment to the carrying amount (i.e., the basis adjustment) of the fixed-rate debt obligation as a discount on the debt obligation and amortize that amount as interest expense over the expected remaining life of the debt obligation using the effective-yield method.

The journal entries as of December 31, 20X4 would be as follows:

1. Interest expense (P&L) 1,000,000  
   Cash (B/S) 1,000,000  
   (To record the interest payment on the debt obligation)

2. Amortization of debt obligation basis adjustment (P&L) $ 462,500  
   Fixed-rate debt obligation (B/S) $ 462,500  
   (To amortize the $1,000,000 basis adjustment on the fixed-rate debt obligation using the effective yield method. For financial reporting purposes, the amortization would be recorded as interest expense)

   \(^{1}\) Amortization determined using an effective yield of 16.25%
The journal entries as of December 31, 20X5 would be as follows:

1. Interest expense (P&L) 1,000,000
   Cash (B/S) 1,000,000
   (To record the interest payment on the debt obligation)

2. Amortization of debt obligation basis adjustment (P&L) 537,500
   Fixed-rate debt obligation (B/S) 537,500
   (To amortize the $1,000,000 basis adjustment on the fixed-rate debt obligation using the effective yield method)

3. Fixed-rate obligation (B/S) 10,000,000
   Cash (B/S) 10,000,000
   (To record repayment of the fixed-rate debt obligation on December 31, 20X5)

HEDGING RELATIONSHIP IS NO LONGER HIGHLY EFFECTIVE

26.01 Paragraph 26 of the Standard (ASC paragraphs 815-25-40-3 through 40-5) discusses the accounting for hedging relationships that are no longer highly effective as follows:

26. In general, if a periodic assessment indicates noncompliance with the effectiveness criterion in paragraph 20(b), an entity shall not recognize the adjustment of the carrying amount of the hedged item described in paragraphs 22 and 23 after the last date on which compliance with the effectiveness criterion was established. However, if the event or change in circumstances that caused the hedging relationship to fail the effectiveness criterion can be identified, the entity shall recognize in earnings the changes in the hedged item’s fair value attributable to the risk being hedged that occurred prior to that event or change in circumstances. If a fair value hedge of a firm commitment is discontinued because the hedged item no longer meets the definition of a firm commitment, the entity shall derecognize any asset or liability previously recognized pursuant to paragraph 22 (as a result of an adjustment to the carrying amount for the firm commitment) and recognize a corresponding loss or gain currently in earnings.

26.02 If an entity determines that the hedging relationship no longer is highly effective in achieving offsetting changes in fair values attributable to the hedged risk, the entity would be required to cease using hedge accounting as of the latest date on which it can demonstrate that the hedging relationship was highly effective. In other words, if an entity evaluates hedge effectiveness on a quarterly basis and cannot identify the event or change in circumstances that caused the hedging relationship to fail the effectiveness criterion, the entity would cease applying hedge accounting to the related hedged item as of the end of the last quarter (i.e., presumably, the last time the hedge relationship was highly effective). The following example illustrates the requirements of this provision.
Example 5.14: Hedging Relationship No Longer Highly Effective

Groveland has 20,000 barrels of West Texas Grade A crude oil in its inventory. To hedge the fair value of this oil, Groveland enters into a six-month futures contract on 20,000 barrels of West Texas Grade B crude oil. Groveland has entered into a futures contract on West Texas Grade B crude oil because it is more economical and futures contracts on West Texas Grade B crude oil historically have been highly effective in achieving offsetting changes in fair value of West Texas Grade A crude oil inventory.

During the first three months of the futures contract, Groveland determined that the hedging relationship was highly effective. However, at the end of the fourth month, Groveland’s management determined that the hedging relationship no longer was highly effective as a result of a major fire (during the fourth month of the hedging relationship) in one of the oil wells that produces West Texas Grade B crude oil.

Groveland would be required to stop applying hedge accounting as of the latest date that it can be demonstrated that the hedging relationship was highly effective, which presumably would be the date of the fire. However, Groveland could resume hedge accounting (i.e., a new hedging relationship) if it concluded that the hedging relationship was expected to be effective in the future, provided all the other hedge criteria are met.

26.03 Paragraph 26 of the Standard (ASC paragraphs 815-25-40-3 through 40-5) indicates that if a fair value hedge of a firm commitment is discontinued because the hedged item no longer meets the definition of a firm commitment, the entity should derecognize any asset or liability previously recognized in accordance with paragraph 22 (ASC paragraph 815-25-35-1) and recognize a corresponding loss or gain currently in earnings. This accounting is based on the fact that the asset or liability that represented the fair value of the firm commitment no longer exists (e.g., the counterparty terminated the agreement). The Board believes that those circumstances should be rare. A pattern of discontinuing hedge accounting and derecognizing assets or liabilities related to firm commitments would call into question the firmness of future hedged firm commitments and the ability to apply hedge accounting for future fair value hedges of firm commitments.

26.04 Ongoing monitoring of hedge effectiveness as well as whether the firm commitment definition continues to be met are critical because of the accounting effect if hedge accounting no longer is appropriate.

ASSESSING IMPAIRMENT

27.01 Paragraph 27 of the Standard (ASC paragraph 815-25-35-10) discusses the impairment requirements for assets or liabilities as follows:

27. An asset or liability that has been designated as being hedged and accounted for pursuant to paragraphs 22 - 24 remains subject to the applicable requirements in generally accepted accounting principles for assessing impairment for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 22 of this Statement. Because the
An asset or liability that has been designated as the hedged item in a fair value hedge would remain subject to impairment literature applicable to that item. The assessment of impairment should be performed after fair value hedge accounting is applied to the hedged asset or liability. When assessing impairment, the fair value or cash flows of the hedging derivative instrument should not affect the determination of whether the hedged item is impaired. To do so would be inconsistent with the fact that the derivative is a separate asset or liability. An apparent inconsistency with this concept is the SEC staff’s view of the application of the full cost method of accounting for entities with oil and gas producing activities. The SEC staff has concluded in that narrow issue that the prices to be received after taking into account cash flow hedging arrangements should be used to calculate the current price of the quantities of the future production of oil and gas reserves covered by the hedges as of the reported balance sheet date. The current price is then used to determine whether the capitalized cost of the oil and gas producing company exceed the full cost limitation. See Paragraph 34.04 in Section 6 for additional discussion.

In assessing impairment of a loan (using the guidance in FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan (Statement 114) (ASC Subtopic 310-10, Receivables -- Overall) that is being hedged in a fair value hedging relationship for changes in the benchmark interest rate, the calculation of the present value of expected future cash flows should be determined using the new effective rate implicit in the adjusted carrying amount of the hedged loan. When the recorded investment of a loan has been adjusted under fair value hedge accounting, the effective rate is the discount rate that equates the present value of the loan’s future cash flows with that adjusted recorded investment. The rationale for using this new effective rate for the measurement of impairment under Statement 114 (ASC Subtopic 310-10) is that the loan’s original effective interest rate becomes irrelevant once the recorded amount of the loan is adjusted for any changes in fair value since the basis adjustment changes the rate of return implicit in the loan. That approach is consistent with Statement 114’s (ASC Subtopic 310-10) requirements to discount an impaired loan’s future cash flows at its implicit interest rate. To do otherwise would cause a portion of the resulting impairment charge to include a component attributable to the change in benchmark interest rate rather than achieving the goal of Statement 114 (ASC Subtopic 310-10) to limit the measurement of impairment to credit risk. (See DIG Issue F4 for further reference.)

This guidance applies to all entities applying Statement 114 (ASC Subtopic 310-10) to loans that are hedged items in a fair value hedge, regardless of whether those entities have delayed amortizing to earnings the adjustments of the loan’s carrying amount that arise from fair value hedge accounting until the hedging relationship is dedesignated.

The following example illustrates this guidance:
Example 5.15: Interaction of the Standard and Statement 114 (ASC Subtopic 310-10)

Company A formally documents a qualifying fair value hedging relationship involving the fair value changes attributable to changes in the benchmark interest rates (12-month LIBOR) of a fixed-rate loan receivable from Company B and an interest rate swap. The 5-year, fixed-rate loan to Company B has a principal amount of $1,000,000 payable at maturity and interest payable annually at 10%. One year after inception of the hedging relationship, the benchmark interest rates decreased from 10% to 9.5%, resulting in a loss of $16,022 on the derivative with the counterparty and an offsetting gain of $16,022 on the fixed-rate loan attributable to changes in benchmark interest rates. (Refer to row B in the following Exhibit, which presents the calculation—at the end of the first year of the loan’s term—of the present value of contractual cash flows based on the loan’s original effective interest rate adjusted for a 50 basis point decrease in the 12-month LIBOR swap rate.) In addition, one year after the inception of the hedging relationship, there has been an adverse change to Company B’s creditworthiness, which had no effect on the fair value of the interest rate swap with the counterparty.

Assume that the repayment of the loan does not depend on the underlying collateral. In applying the requirements of Statement 114 (ASC Subtopic 310-10) to the loan, Company A determines that the loan is impaired and that the present value of expected future cash flows discounted at the loan’s effective interest rate at inception of the loan is $930,000. (Refer to Row C in the following Exhibit, which presents calculation—at the end of the first year of the loan’s term—of the net present value of current estimates of expected future cash flows based on the loan’s original effective interest rate.)

Accordingly, in this example, the total change in the fair value of the loan would be analyzed as follows:

| Decrease in the fair value due to credit risk ($1,016,022 less $944,901) | $ (71,121) |
| Increase in the fair value due to changes in benchmark interest rates | 16,022 |
| **Total decrease in the fair value of the loan** | **$ (55,099)** |

Thus, after adjusting the carrying amount of the hedged loan by $16,022 pursuant to paragraph 22 of the Standard (ASC paragraph 815-25-35-1), Company A should apply the requirements of paragraph 13 of Statement 114 (ASC paragraph 310-10-35-24) by:

(a) Comparing the recorded investment of the loan after the effect of the fair value hedge, or $1,016,022, to the $944,901 present value of expected future cash flows discounted using the rate that reflects the rate of return implicit in the loan after adjusting the carrying amount of the hedged loan pursuant to paragraph 22 of the Standard (ASC paragraph 815-25-35-1) (i.e., 9.5%), then

(b) Recognizing the impairment by creating a valuation allowance (with the offsetting entry charged to expense) for the difference of $71,121.
Exhibit

Following are calculations (at the end of the first year of the loan’s term) of the net present value of the contractual cash flows and the creditor’s best estimate of expected future cash flows based on the loan’s original effective rate and the new effective rate.

<table>
<thead>
<tr>
<th>Rate</th>
<th>NPV at End of Year 1</th>
<th>Assumed Cash Flow in Year 2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Original Cash Flows and Original Effective Rate</strong></td>
<td>10.0%</td>
<td>$1,000,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>B. Original Cash Flows and New Implicit Rate</strong></td>
<td>9.5%</td>
<td>1,016,022</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>C. Expected Future Cash Flows and Original Effective Rate</strong></td>
<td>10.0%</td>
<td>930,000</td>
<td>93,000</td>
<td>93,000</td>
<td>93,000</td>
</tr>
<tr>
<td><strong>D. Expected Future Cash Flows and New Implicit Rate</strong></td>
<td>9.5%</td>
<td>944,901</td>
<td>93,000</td>
<td>93,000</td>
<td>93,000</td>
</tr>
</tbody>
</table>

Appendix A: Fair Value Hedging: Assessing Effectiveness and Measuring Ineffectiveness

A5.01 This appendix discusses the concepts behind assessing effectiveness and measuring ineffectiveness for a fair value hedging relationship, as required by the Standard. This appendix explains the meaning of assessing effectiveness, distinguishes that concept from the Standard’s requirements to measure ineffectiveness, identifies how those concepts differ from amounts that are recorded in earnings each period, and identifies specific issues that entities need to consider when assessing effectiveness. The appendix should be considered in conjunction with the guidance related to effectiveness and ineffectiveness discussed in this section.

A5.02 The first section of this appendix (Paragraphs A5.04-A5.30) answers the following questions:

- What is meant by a highly effective hedging relationship?
- How often must an effectiveness assessment be performed?
- How does the designation of the hedged risk affect earnings?
- Is it possible to exclude some of the changes in fair value of the derivative hedging instrument from the assessment of effectiveness and what is the resulting effect on earnings?
- How is the effectiveness assessment performed?
- How is the measurement of ineffectiveness performed?
- What other considerations are required?
- Is it possible to make an assumption of perfect effectiveness and, thus, no ineffectiveness?
A5.03 The second section of this appendix (Paragraphs A5.31-A5.79) discusses some effectiveness matters specific to swaps, forward and futures contracts, and options. In addition, this section discusses the impact on the assessment of hedge effectiveness and the measurement of ineffectiveness of master netting agreements that cover derivative instruments included in fair value hedging relationships.

MEANING OF A HIGHLY EFFECTIVE HEDGING RELATIONSHIP

A5.04 Entities commonly think of a highly effective hedging relationship from an economic point of view, that is, whether the derivative provides the desired risk management effect. Often, that view is consistent with the Standard’s notion that high effectiveness is achieved when the changes in the fair value of a derivative hedging instrument are highly effective at offsetting changes in the fair value of the hedged item attributable to the hedged risk. Generally speaking, when applying the Standard’s fair value approach, a hedge is considered highly effective when the derivative’s change in fair value provides for offset in a range between 80% and 125% when compared with the change in the fair value of the hedged item for the risk being hedged. The distinction between an effective economic hedge and a hedge that is permitted under the Standard is significant because hedge accounting is permitted only if the specific criterion of effectiveness and the Standard’s other eligibility criteria are met.

PERIODIC EFFECTIVENESS ASSESSMENT

A5.05 To qualify for fair value hedge accounting, the Standard requires an entity to assess effectiveness in two different ways. The first is a prospective assessment that is forward looking. The second is a retrospective assessment that focuses on actual performance. Thus, we believe the following step-by-step methodology to assess hedge effectiveness should be used:

1. At inception of the hedging relationship, entities should use regression or other statistical analysis of past changes in fair values, based on historical data as well as other relevant information, to determine whether the relationship is expected to be highly effective over future periods in achieving offsetting changes in fair value (i.e., prospective assessment). Dollar-offset may also be used in this assessment based on historical data.

2. During the hedging period, entities should periodically (at least quarterly):
   a. assess whether the hedging relationship has been highly effective in achieving offsetting changes in fair value through the date of the periodic assessment (i.e., retrospective assessment). The assessment can be based on regression or other statistical analysis of past changes in fair values or may be based on other relevant information (e.g., dollar-offset may be used in this assessment based on historical data); and
   b. determine whether the relationship is expected to continue to be highly effective over future periods in achieving offsetting changes in fair value, based on regression or other statistical analysis of past changes in fair values as well as other relevant information (i.e., prospective assessment). Again, dollar-offset may be used in this assessment, if that method was chosen in step 1, above. (This prospective assessment updates step 1.)
The prospective assessment, both at inception and ongoing, justifies the expectation that the hedge will be highly effective, which is a requirement to qualify for hedge accounting. The retrospective assessment confirms that high effectiveness, in fact, has been achieved and, thus, fair value hedge accounting for the period can be applied. (See DIG Issue E7 for further reference.)

**A5.06** As noted above, the assessment of effectiveness should be performed at the inception of the hedging relationship and at least quarterly during the relationship. If the hedging relationship is shorter than three months (such as daily or weekly, which is not unusual when using a dynamic hedging strategy as described in Paragraph 25.04 of this section), the effectiveness assessment must be performed to match the hedge period. In other words, if the hedge period is daily, the effectiveness assessment must be performed daily and must be based on daily changes in fair value of the derivative and portfolio of hedged items.

**HOW THE DESIGNATION OF THE HEDGED RISK AFFECTS EARNINGS**

**A5.07** In establishing a hedging relationship, entities may limit their hedging relationship to changes in the fair value of the hedged item that are attributable to specific risks. For example, an entity may seek to hedge only decreases in the market price of an available-for-sale investment security it owns. In that case, the entity would be required to identify a hedging instrument that will provide offset to the designated risk. When applying fair value hedge accounting, an entity recognizes changes to the fair value of the hedged item associated with the hedged risk, with only those changes reflected in earnings. The hedging derivative is recorded on the balance sheet at fair value, with changes in its entire fair value recognized in earnings. Accordingly, the entire change in the fair value of the derivative from period to period may not be exactly offset by the change in the fair value of the hedged item, particularly when the hedged risk is very narrowly defined and there is no derivative hedging instrument with a fair value that changes in a like manner. Consequently, how an entity defines the hedged risk has the potential to affect amounts reported in earnings in a fair value hedge. However, the changes in the derivative’s fair value must still be highly effective at offsetting the changes in the fair value of the hedged item for the risk being hedged.

**GAINS AND LOSSES OF THE DERIVATIVE HEDGING INSTRUMENT INCLUDED IN THE EFFECTIVENESS ASSESSMENT**

**A5.08** Similar to the Standard’s flexibility about the designated hedged risk, the Standard, provides that entities may exclude from the assessment of effectiveness some of the elements of the changes in fair value of the derivative hedging instrument. Specifically, because the fair value of a derivative instrument usually has a component attributed to the time value of money, but some or all of that component may not be relevant to an entity’s risk management objective, the Standard permits entities to exclude all or part of the time value component of a hedging derivative’s fair value from that assessment. If an entity assesses hedge effectiveness by excluding all or some changes in the time value of the derivative hedging instrument, changes in the excluded component still would be included currently in earnings, together with any hedge ineffectiveness that results under the defined method of measuring hedge ineffectiveness. This is because in all instances the derivative hedging instrument is recorded on the balance sheet at fair value.
value with changes reflected in earnings. While the Standard’s requirements for the accounting for a fair value hedge may cause earnings volatility, this flexibility is important because the ability to exclude certain gains or losses from the effectiveness assessment may be the only means an entity has available to establish a highly effective hedging relationship and thus, be able to apply hedge accounting.

A5.09 Paragraphs A5.10-A5.14 below address when entities elect to include all gains and losses in the fair value of the derivative hedging instrument and when entities elect to exclude all or some of the changes related to the instrument’s time value, and the effect of those decisions on the assessment of effectiveness and the amount of measured ineffectiveness.

Inclusion of Gains and Losses

A5.10 An entity may decide to include the entire change in the fair value of the derivative hedging instrument in the assessment of hedge effectiveness. If so, determining whether the hedge has been and is expected to be highly effective in achieving offset implies that an entity compares the total change in fair value of the derivative hedging instrument with the change in the fair value of the hedged item attributable to the hedged risk. If an entity includes all gains and losses on the derivative hedging instrument, it may experience reduced levels of effectiveness (and increased levels of measured ineffectiveness) if the fair value of the hedged item is not affected by (or to the same extent as) the time value component of the fair value of the derivative hedging instrument. Such an instance would arise in a hedging relationship where the designated hedged item is a recognized asset or liability.

A5.11 The following example illustrates a hedging relationship that includes all of the fair value changes of the derivative hedging instrument in the assessment of hedge effectiveness.

Example A5.1: Assessment of Hedge Effectiveness - Hedge of a Firm Commitment to Purchase Wheat in Six Months with a Futures Contract

TAA purchases wheat to be used in its production of cereal. TAA enters into a firm commitment to purchase wheat in six months at a fixed price from SWM (this purchase is considered a normal purchase as defined in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-26)). TAA is concerned that the price of wheat will fall during the coming months. A decline in wheat prices would decrease the value of the purchase commitment (i.e., TAA would pay more than market value for the wheat six months from now). To hedge this exposure, TAA enters into a futures contract, which settles net cash, to sell wheat in six months at a fixed price. If the price of wheat decreases, the fair value of the futures contract will increase while the fair value of the firm commitment will decrease. Conversely, if the price of wheat increases, the fair value of the futures contract will decrease while the fair value of the firm commitment will increase.

TAA will assess the effectiveness of this hedging relationship by comparing the changes in the fair value of the firm commitment to purchase wheat to changes in the entire fair value of the six-month wheat futures contract, which includes time value. The inclusion of all gains and losses on the derivative hedging instrument in the assessment of effectiveness in the hedging relationship may be to the benefit of TAA if the time value element of the six-month futures
Exclusion of Gains and Losses Attributable to Changes in Time Value (Intrinsic Value Method)

A5.12 When an entity elects to exclude the entire time value component of the fair value of the derivative hedging instrument from the assessment of effectiveness, paragraph 63 of the Standard (ASC paragraphs 815-20-25-82 and 25-83) provides the following guidance:

- When the derivative hedging instrument is an option and hedge effectiveness is based on changes in fair value attributable to changes in the option’s intrinsic value, an entity may exclude the change in fair value attributable to the time value of the option from the assessment of hedge effectiveness;
- When the derivative hedging instrument is an option and hedge effectiveness is based on changes in the option’s minimum value, that is, its intrinsic value after the effect of discounting, an entity may exclude the volatility value of the option from the assessment of hedge effectiveness; and
- When the derivative hedging instrument is a forward or futures contract and hedge effectiveness is based on changes in fair value attributable to changes in spot prices, an entity may exclude the change in fair value of the contract attributable to the difference between the spot price and the forward or futures price from the assessment of hedge effectiveness.

A5.13 In addition to excluding all changes in the time value from the assessment of hedge effectiveness, the Standard permits an entity to exclude certain aspects of the change in an option’s time value (e.g., changes in time value attributable to either the passage of time, volatility, or interest rates) from the assessment of hedge effectiveness when using the intrinsic value method. See Paragraphs A5.70-A5.71 for a discussion of this issue. Entities typically seek to exclude some or all of those components because including them would reduce assessed effectiveness in hedging relationships if the hedged item’s fair value is not affected by (or not affected to the same extent as) the same component.

A5.14 The following example illustrates a hedging relationship that excludes the time value of the derivative hedging instrument from the assessment of hedge effectiveness.

Example A5.2: Assessment of Hedge Effectiveness - Hedge of Available-for-Sale Securities Using a Put Option

EBM owns 100 shares of XYZ common stock that are classified as available-for-sale pursuant to Statement 115. These securities were purchased for $50 per share and are now trading at $100 per share (i.e., the securities have an unrealized gain of $5,000 that has been included in AOCI). EBM wants to lock in most of the unrealized gain in AOCI. Accordingly, EBM purchases an option for $75 that allows it to put 100 shares of XYZ common stock to ATS at today’s $100 per share market price for a two-year period. This option, which provides EBM with one-way protection against a decline in the market price of XYZ common stock, is
designated as a hedge of the fair value of EBM’s investment in XYZ. Management indicated that it will assess effectiveness based on changes in the intrinsic value of the option.

Effectiveness of this hedge will be assessed by comparing changes in the intrinsic value of the put option and changes in the fair value of 100 shares of XYZ common stock for possible declines in the share price of XYZ below $100 (note that because this option is being used to purchase one-way protection against a decline in the market price of XYZ common stock, it is not necessary to assess effectiveness in instances if the value of XYZ’s stock price increases). The changes in the fair value of the option related to time value will be reported currently in earnings during each reporting period.

COMMON TECHNIQUES FOR ASSESSING EFFECTIVENESS

A5.15 Two common techniques for assessing hedge effectiveness are the dollar-offset method and regression analysis. The technique to be used to assess effectiveness on a prospective and retrospective basis must be documented at inception of the hedging relationship. Either technique can be used in both the prospective and the retrospective hedge effectiveness assessment. In addition, it is permissible to use one technique for the prospective assessment and a different technique for the retrospective assessment. However, an entity is not permitted to document that it will use a variety of different techniques for the prospective analysis or a variety of different techniques for the retrospective analysis, depending on the circumstances. For example, while an entity may believe that the effectiveness of the hedging relationship may significantly change if there are unexpected movements in the fair value of the hedged item or the hedging instrument, it cannot devise and document a variety of effectiveness tests whereby one technique would be performed in certain cases while another technique would be performed in other cases. Regardless of the approach documented and used for the prospective and retrospective assessments, the selected approaches must be applied consistently throughout the hedging relationship.

A5.16 The dollar-offset method compares the dollar amount of the change in fair value of the hedging instrument with the dollar amount of the change in fair value of the hedged item for the risk being hedged over the assessment period. This method is easy to apply, but may not achieve high effectiveness when the change in the fair value of the hedging instrument and the hedged item involve small dollar amounts but large percentages.

A5.17 When using the dollar-offset method periodically to assess whether a fair value hedging relationship has been highly effective in the retrospective evaluations, an entity may use either a period-by-period approach or a cumulative approach for individual fair value hedges. The period-by-period approach involves comparing the changes in the hedging instrument’s fair values that have occurred during the period being assessed with the changes in the hedged item’s fair value attributable to the hedged risk that have occurred during the same period. The period

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6 As with footnote 2 to Paragraph 20b.02 of this section, when discussing the assessment of effectiveness in this appendix, the Standard permits entities to exclude certain elements of the total fair value of the derivative hedging instrument from the effectiveness assessment because those excluded components may be irrelevant to an entity’s risk management objective. Accordingly, unless otherwise stated, when discussed in this appendix, the fair value of the derivative hedging instrument is meant to include or exclude components of fair value as designated by the entity.
for this assessment can be as short as an entity chooses (and documents), but cannot exceed three months. The cumulative approach involves comparing the cumulative changes in the hedging instrument’s fair value to the cumulative changes in the hedged item’s fair value attributable to the hedged risk since inception of the hedging relationship. The selected approach should be determined and documented at hedge inception. That defined and documented approach must be used consistently throughout the hedging relationship. Further, the selection of an approach should be consistent with the approach selected for similar hedging relationships. (See DIG Issue E8 for further reference).

A5.18 We believe that most entities that choose dollar-offset for the retrospective assessment of effectiveness will elect the cumulative approach instead of the period-by-period approach. The cumulative approach provides more periods of data that may minimize the likelihood of a temporarily reduced level of effectiveness in a hedging relationship.

A5.19 The following example illustrates the dollar-offset method for retrospectively assessing hedge effectiveness.

**Example A5.3: Cumulative Dollar-Offset**

At inception of the hedge, on March 31, 20X0, the hedging relationship was expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is expected to be in place. VRS Corp. has documented that its retrospective assessment of hedge effectiveness will be assessed based on changes in the fair value of the derivative hedging instrument and changes in the fair value of the hedged item attributable to the hedged risk on a cumulative basis. The following is VRS Corp.’s documentation supporting its retrospective assessment of hedge effectiveness using the cumulative dollar-offset method at March 31, 20X1.

<table>
<thead>
<tr>
<th>Three Months Ended</th>
<th>Derivative Hedging Instrument Gain (Loss)</th>
<th>Hedged Item Gain (Loss)</th>
<th>Period Change Ratio</th>
<th>Cumulative Change Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31, 20X0</td>
<td>$100</td>
<td>$(90)</td>
<td>111%</td>
<td>111%</td>
</tr>
<tr>
<td>June 30, 20X0</td>
<td>25</td>
<td>(21)</td>
<td>119%</td>
<td>113%</td>
</tr>
<tr>
<td>September 30, 20X0</td>
<td>(20)</td>
<td>24</td>
<td>83%</td>
<td>121%</td>
</tr>
<tr>
<td>December 31, 20X0</td>
<td>(5)</td>
<td>4</td>
<td>125%</td>
<td>120%</td>
</tr>
<tr>
<td>March 31, 20X1</td>
<td>25</td>
<td>(19)</td>
<td>132%</td>
<td>123%</td>
</tr>
<tr>
<td><strong>Net gain or loss to date</strong></td>
<td><strong>$125</strong></td>
<td><strong>$(102)</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

From the above table, it is apparent that VRS would not be able to apply hedge accounting for the March 31, 20X1 period if it selected the period-by-period dollar-offset method for its retrospective assessment of hedge effectiveness. This is because VRS would have been unable to conclude that the relationship under such an effectiveness assessment methodology has been highly effective because for the three-month period, the period-to-period assessment of effectiveness was 132%. However, with the same derivative hedging instrument and the same hedged item, VRS is able to apply hedge accounting because its chosen method of...
retrospectively assessing effectiveness is based on cumulative changes. As the table above demonstrates, on a cumulative basis, this relationship has been highly effective.

A5.20 While regression analysis and other statistical analysis methods can be used for assessing effectiveness on a retrospective or prospective basis or both, applying those methods to assess effectiveness is complex. Appropriate interpretation and an understanding of the statistical inferences of statistical methods are critical in applying those methods. In particular, depending on the facts and circumstances, regression analysis needs to be applied to either the changes in the two variables over time or the variables themselves. When using statistical analysis methods, such as regression analysis, it is important to keep in mind that the objective of the assessment is to conclude that the hedging relationship has been or is expected to be highly effective or both (i.e., the change in the fair value of the derivative hedging instrument will be highly effective at offsetting changes in the fair value of the hedged item attributable to the hedged risk). Thus, entities should analyze data that support that conclusion. Therefore, one would expect that a regression analysis would evaluate the relationship between changes in the fair value of the derivative and the hedged item instead of the fair values themselves. A detailed discussion of regression analysis and other statistical methods for assessing hedge effectiveness is beyond the scope of the Handbook. Entities should ensure that they involve personnel with the requisite knowledge to apply the methods properly. These individuals may be internal or external specialists. If external specialists are used, we believe they should be independent parties (e.g., a party that is not a party to the derivative or other similar transactions with the entity). Additionally, auditors should refer to professional standards related to the use of specialists.

A5.21 The SEC staff indicated that while the use of regression analysis is not problematic for assessing effectiveness, the statistical validity of that analysis must be adequately considered. That is, the entity must consider all the relevant outputs from a regression analysis used to determine whether the hedging relationship has been and is expected to be highly effective. While the assessment of whether a hedging relationship has been and is expected to be highly effective will be determined based on the facts and circumstances of that specific relationship, the SEC staff believes that, at a minimum, certain regression outputs such as the coefficient of determination (R-squared), the slope coefficient, and the t or F-statistic should be considered. Additionally, depending on the specifics of the hedging strategy, other regression outputs may also need to be considered. The SEC staff indicated that it expects entities that use statistical techniques to assess hedge effectiveness to understand how to use and appropriately evaluate those techniques, which may necessitate the use of specialists.

A5.22 We observe that entities typically choose to use regression analysis in their retrospective and prospective assessments of effectiveness. While it is more difficult to apply regression analysis and more difficult to understand the related results, that method provides a significant benefit because regression analysis allows an entity to use historical data for periods before the inception of the hedge for both the initial and ongoing effectiveness assessments. In contrast, in applying the dollar-offset method for the ongoing retrospective effectiveness assessment, only data from the hedge period are considered. For example, assume an entity is retrospectively assessing hedge effectiveness at the first reporting period after inception of a fair value hedge (i.e., one quarter after inception) and the changes in the fair value of the hedging instrument did not effectively offset the changes in the fair value of the hedged item as anticipated. If the entity initially chose to use a dollar-offset method in its retrospective assessment, the entity would be
required to conclude that the designated hedging relationship does not qualify for hedge accounting for the period just ended. However, if the entity initially chose to use a statistical analysis based on a trailing-12-month average, which, at the end of the first quarter after hedge inception, includes three months of the hedge period and nine months before the hedge period, it may be able to conclude that the designated hedging relationship qualifies for hedge accounting for the period just ended because the results of the earlier nine months may negate the unfavorable hedge results of the most recent three months. That result is not uncommon, nor inappropriate, but serves to highlight that, even with the same derivative hedging instrument, hedged item, and hedging strategy, the Standard’s provisions that provide for flexibility in assessing effectiveness are important. In one instance hedge accounting would be precluded for the period just ended, and in the other it may not be precluded.

METHODOLOGY FOR MEASURING INEFFECTIVENESS

A5.23 Measuring ineffectiveness is the computation of the degree of inexact offset provided by the change in fair value of the derivative hedging instrument limited to those elements of fair value included in the assessment of effectiveness as compared to the change in the fair value of the hedged item attributable to the hedged risk, expressed in absolute terms and computed pursuant to the dollar-offset method for the assessment period just ended. The Standard requires that the approach to measuring hedge ineffectiveness for a particular hedging relationship be consistent with the entity’s risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship. In other words, if the assessment of effectiveness excludes all of the time value elements of a derivative, the measurement of ineffectiveness also should exclude those elements. See Paragraph 22.06 for a further discussion of this issue.

A5.24 The following example illustrates the difference between assessed effectiveness and measured ineffectiveness.

Example A5.4: Assessing Hedge Effectiveness and Measuring Hedge Ineffectiveness

Assume the same facts as Example A5.3 of this appendix. Also assume that VRS Corp. is six months further into the hedging relationship. The following table illustrates the changes between the fair value of the derivative hedging instrument and the fair value of the hedged item attributable to the hedged risk during a three-month period.

<table>
<thead>
<tr>
<th>Three Months Ended</th>
<th>Derivative Hedging Instrument Gain (Loss)</th>
<th>Hedged Item Gain (Loss)</th>
<th>Period Change Ratio</th>
<th>Assessment Period Cumulative Change Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30, 20X1</td>
<td>$35</td>
<td>$(31)</td>
<td>113%</td>
<td>120%</td>
</tr>
<tr>
<td>Sept 30, 20X1</td>
<td>$32</td>
<td>$(32)</td>
<td>97%</td>
<td>116%</td>
</tr>
</tbody>
</table>

The change between the fair value of the derivative hedging instrument and the fair value of the hedged item attributable to the hedged risk is within the acceptable range of 80%-125% (as
stated above, since the retrospective assessment is based on cumulative changes, for the assessment period of March 31, 20X0 through September 30, 20X1 the assessed level of effectiveness is 116%). Thus, the hedge was considered to be highly effective for the three months of the hedging relationship (i.e., retrospective assessment).

During the assessment period of July 1, 20X1 through September 30, 20X1, the ineffective portion of the hedge was $1 (i.e., $32 less $33) and represented the change in the fair value of the hedged item attributable to the hedged risk in excess of the absolute amount of the change in the fair value of the derivative hedging instrument on a period-by-period basis.

OTHER CONSIDERATIONS

Determining the Period Over Which Effectiveness Will Be Assessed

A5.25 In documenting the risk management strategy for a fair value hedge, the FASB staff has stated that an entity may specify an intent to consider the possible changes (and not just the probable or expected changes) in the value of the derivative hedging instrument and the hedged item over a period that is shorter than the derivative’s remaining life in formulating its expectation that the hedging relationship will be highly effective in achieving offsetting changes in fair value for the risk being hedged. In this context, we believe the interpretation of possible changes should be consistent with the FASB’s notion of probabilistic cash flows used to determine probability-weighted cash flow estimates (as contemplated by FASB Statement of Financial Accounting Concepts No. 7, Using Cash Flow Information and Present Value in Accounting Measurements (SFAC 7)). Thus, the entity does not need to contemplate the offsetting effect of the derivative hedging instrument for the entire term of the hedging instrument and/or hedging relationship. For example, if an entity enters into a derivative with a five-year term and designates that derivative as a hedging instrument in a fair value hedge of a financial asset that also has a five-year term, it may specify in documenting its risk management strategy that every three months it (a) will assess the effectiveness of the existing hedging relationship for the past three-month period and (b) intends to consider possible changes (and not only those that are probable or expected) in the fair value of the hedging derivative and the hedged item over the next three months in deciding whether it expects that the hedging relationship will continue to be highly effective at achieving offsetting changes in fair value. That is, the entity may compare the fair value change during the next three months of the derivative and the hedged item to prospectively assess whether the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value for the risk being hedged. However, when measuring ineffectiveness, the entity must consider the total fair value change of the derivative and the total fair value change of hedged item for the risk being hedged. (See DIG Issue F5 for further reference.)

A5.26 Another situation where this approach may be used is when a hedged item’s risk exposure is limited, but the risk exposure of the hedging derivative is not. For example, if an entity issues 10-year fixed-rate debt that is callable at the end of the fifth year and decides to convert the interest payments on the debt from fixed to floating using a 10-year receive-fixed, pay floating, non-cancelable interest rate swap, there is limited risk exposure on the hedged item, as a result of the embedded call, without comparable limits on the derivative hedging instrument. The assessment of hedge effectiveness could be documented to consider the possible changes in the
fair value of the derivative hedging instrument and not be limited to the likely or expected changes in the fair value of the derivative hedging instrument (consistent with the concepts in SFAC 7) for a period shorter than the derivative’s life, such as the next three months. In this example, the entity would be required to assign a probability-weighting to the possible changes in the fair value of the hedged item inclusive of its embedded call option. After completing that analysis, the entity may still determine that the hedging relationship is expected to be highly effective at achieving offsetting changes in fair value if the probability weighting assigned to the embedded call option results in minimal value (because, for example, the call option is priced significantly out-of-the-money). (See DIG Issue E11 for further reference.)

**Extent of Period Used in Assessing Hedge Effectiveness**

A5.27 Regardless of the technique used to assess hedge effectiveness to support that an effective hedging relationship is expected, we believe entities should document the historical relationship between changes in the fair values of both the hedged item and the derivative hedging instrument over an appropriate period. The appropriate period is subject to judgment. However, entities should consider that the objective of the prospective effectiveness assessment is to conclude that the hedging relationship is expected to be highly effective. For example, if an entity is considering a two-year potential foreign currency hedging relationship involving U.S. dollars and euros, we would expect that the entity would not limit its prospective assessment of effectiveness to changes in the U.S. dollar/euro exchange rate for the last month. These changes for the last month may not be indicative of the potential changes in the exchange rate that are reasonably expected to occur over the next two years. If an entity elects at the inception of a hedging relationship to use the same regression analysis approach for both prospective and retrospective assessments of effectiveness, those regression analysis calculations generally should incorporate the same number of data points during the term of that hedging relationship.

**Consideration of Counterparty Credit Risk and the Entity's Own Nonperformance Risk**

A5.28 The fair value of a derivative is affected by the creditworthiness of the counterparty to the contract and the entity's own nonperformance risk (which includes credit risk). That effect stems from the performance requirements of the contract. Refer to Section 4 for additional discussion of the impact of FASB Statement No. 157, Fair Value Measurements (Statement 157) (ASC Subtopic 820-10) on the valuation of derivative instruments. In hedging relationships that involve derivative instruments that are acquired on a regulated exchange, an entity is subject to the credit risk of the exchange, not of the counterparty.

A5.28a A change in the counterparty's credit risk or the entity's own nonperformance risk will have an immediate impact on the assessment of effectiveness and measurement of ineffectiveness of a fair value hedging relationship accounted for under the long-haul method (i.e., method other than the shortcut method or critical terms match as discussed in subtopic entitled "Assumption of No Ineffectiveness"). This is because fair value hedging focuses on the offsetting of the changes in the fair values of the derivative and hedged item for the risk being hedged, and changes in counterparty credit risk and the entity's own nonperformance risk have a direct impact on the fair value of the derivative hedging instrument but do not affect the fair value of the hedged item. Accordingly, an entity must assess whether it will collect the payments
it would be owed under the contractual provisions of the derivative as well as assess whether the entity will make the payments it owes under the contractual provisions of the derivative as part of its original and ongoing assessment of hedge effectiveness and when it measures ineffectiveness. In a fair value hedge, this means that an entity should ascertain that the counterparty’s credit risk and the entity's own nonperformance risk is appropriately considered in developing the fair value for the derivative instrument when assessing effectiveness and measuring ineffectiveness. (See DIG Issue G10 and Paragraph 17.07 of Section 4 for additional reference.). When a derivative counterparty or the entity itself experiences a deterioration in credit, the results of hedge effectiveness testing will often result in a conclusion that the hedge is no longer highly effective. Refer to the following subtopic entitled "Assumption of No Ineffectiveness" for a discussion of the effect of changes in the counterparty's credit risk or the entity's nonperformance risk on fair value hedging relationships that are accounted for using the shortcut method or critical terms match.

**Documentation Requirements**

A5.29 The Standard requires that entities document their assessment of hedge effectiveness at inception of a hedging relationship (and on an ongoing basis). That is, entities must provide documentation supporting why and how they expect changes in the fair value of the derivative hedging instrument to offset changes in the fair value of the hedged item attributable to the hedged risk. In addition, in periodic assessments, an entity must document how the derivative is expected to be and has been highly effective in offsetting changes in fair values.

**ASSUMPTION OF NO INEFFECTIVENESS**

A5.30 After considering the requirements of the above sections, an entity’s assessment of effectiveness and measurement of ineffectiveness may be significantly simplified under certain circumstances. If the criteria for the shortcut method are met when the hedging instrument is an interest rate swap or the critical terms of the derivative hedging instrument and the hedged item match when the hedging instrument is a forward contract, a futures contract or a purchased option, an entity’s assessment of hedge effectiveness and measurement of ineffectiveness in a fair value hedge may be simplified as follows:

- If a hedging relationship of the benchmark interest rate risk that involves an interest rate swap and a recognized interest-bearing financial asset or liability (or a firm commitment as discussed in Paragraph A5.36) meets the conditions in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106), an entity may assume no ineffectiveness. This approach is referred to as the shortcut method. Under the shortcut method, initial and ongoing effectiveness assessments are not necessary and there is no measurement of ineffectiveness. However, an entity must consider the credit risk of the counterparty to the derivative and the entity’s own nonperformance risk due to the contractual obligations to make either fixed or variable-rate payments.

- If a hedging relationship involves a derivative hedging instrument other than an interest rate swap or a hedged item other than a recognized interest-bearing financial asset or liability (or a firm commitment as discussed in Paragraph A5.36) or the risk is other than, or in addition to, the benchmark interest rate risk, the relationship is not eligible for the shortcut method. However, if the critical terms of the derivative...
hedging instrument (i.e., a forward or futures contract or purchased option) and the hedged item match, an entity may conclude that the changes in fair value of the hedged item attributable to the risk being hedged are expected to be completely offset by the changes in fair value of the hedging derivative, except for any amounts excluded from the assessment of effectiveness and measurement of ineffectiveness, as further discussed in this appendix. An initial effectiveness assessment must be performed and documented. The extent of that assessment is based on judgment and would vary depending on the complexity of the derivative and hedged item.

Subsequent assessments can be performed by verifying and documenting whether the critical terms of the hedging instrument and the hedged item changed during the period under review and whether there have been developments concerning counterparty credit risk or the entity's own nonperformance risk related to the derivative hedging instrument that could affect the assessment of effectiveness and the assumption of no effectiveness. If the entity concludes that there have been no changes in critical terms (including the creditworthiness of the counterparty to the derivative and the entity's own nonperformance risk), the entity can document and conclude that the hedging relationship has been perfectly effective and that there is no ineffectiveness to measure.

- Statement 157 (ASC Subtopic 820-10) requires that counterparty credit risk and an entity's own nonperformance risk (which includes credit risk) be included in the valuation of derivative instruments. Any change in the counterparty's credit risk or the entity's own nonperformance risk would affect the fair value of the derivative hedging instrument. Therefore, we believe that the adoption of Statement 157 (ASC Subtopic 820-10) effectively precludes the use of the critical-terms-match approach for fair value hedging relationships.

**A5.31** Guidance for assessing hedge effectiveness and measuring ineffectiveness has developed for specific hedging relationships. Because entities commonly consider the Standard’s requirement to assess hedge effectiveness and measure ineffectiveness in the context of the type of derivative hedging instrument that is being used, this section of the appendix is organized by type of derivative instrument.

**A5.32** Specifically, this section of the appendix addresses:

- Swaps
- Forwards / Futures
- Options

In addition, this section discusses the impact on the assessment of hedge effectiveness and measurement of ineffectiveness of master netting agreements that cover derivative instruments included in fair value hedging relationships.

**Swaps**

**A5.33** There are several types of swaps currently offered in the marketplace and new types of swaps are constantly being created. The basic types of swaps are interest rate swaps, currency swaps, commodity swaps, equity swaps, and cross-currency swaps. The most widely used swap...
is the interest rate swap. For that reason, the Standard provides more specific hedge effectiveness
guidance for interest rate swaps than for any other type of hedging instrument.

A5.34 An interest rate swap is a contractual agreement between two parties to exchange one type
of interest-rate-based cash flows for another type of interest-rate-based cash flows on specified
dates in the future. One type of interest rate swap that is typically used in a fair value hedging
relationship is a fixed-for-floating interest rate swap. This type of swap involves the exchange of
fixed-rate cash flows for floating interest rate cash flows that change with a specific reference or
index (e.g., LIBOR, Commercial Paper, and Prime). The fixed rate of the swap is typically set
for the entire term of the swap, whereas the floating rate is reset on specified reset dates. The
frequency with which the floating rate is reset usually is at the discretion of the two parties. To
determine the net settlements of a fixed-for-floating interest rate swap, the applicable fixed-rate
and floating rate as of the reset date are multiplied by the notional amount in effect at that date.
The computed swap payments (i.e., the computed difference) are then paid to or received from
the counterparty, as applicable, on designated settlement dates.

A5.35 A fair value hedging relationship that involves an interest rate swap as the hedging
instrument may be assessed for hedge effectiveness and ineffectiveness may be measured in
different ways depending on the type of hedged item and the designated hedged risk. The
following methods are used to assess hedge effectiveness and measure ineffectiveness for
hedging relationships that involve an interest rate swap:

- If a fair value hedging relationship of the benchmark interest rate risk that involves a
  recognized interest-bearing financial asset or liability (or a firm commitment as
discussed in Paragraph A5.36) and an interest rate swap meets the conditions in
paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106), an
entity may assume no ineffectiveness (referred to as the shortcut method). As a result,
the entity is not required to perform a detailed assessment of effectiveness at either
inception or on an ongoing basis. In addition, there is no ineffectiveness to measure.
Thus, the change in the fair value of the interest rate swap is used as a proxy to
measure the change in the fair value of the hedged item with no effect on net income.
However, in applying the shortcut method for hedges of interest rate risk with interest
rate swaps, an entity must consider the credit risk of the counterparty to the derivative
and the entity's own nonperformance risk due to the contractual obligations to make
either fixed or variable-rate payments.

- If a fair value hedging relationship involves an interest rate swap and a recognized
interest-bearing financial asset or liability (or a firm commitment as discussed in
Paragraph A5.36) and the provisions of paragraph 68 of the Standard (ASC
paragraphs 815-20-25-102 through 25-106) are not met, entities will need to
determine the change in fair value of the derivative instrument and the hedged item.
Calculating the fair value of an interest rate swap is generally not difficult. However,
the calculation of the change in fair value of the recognized interest-bearing financial
asset or liability (or firm commitment as discussed in Paragraph A5.36) for changes
in the benchmark interest rate under the Standard is impacted by certain requirements,
including that the estimated cash flows used much be based on all of the contractual
cash flows of the entire financial instrument being hedged. See Paragraphs 22.05-
22.09 of this section for a discussion of these issues. We believe the critical-terms-
match approach discussed in Paragraph A5.61 cannot be applied in relationships involving swaps.

Shortcut Method

A5.36 If a fair value hedging relationship of the benchmark interest rate risk that involves a recognized interest-bearing financial asset or liability (or a firm commitment arising on the trade date to purchase or issue an interest-bearing asset or liability) and an interest rate swap meets the conditions in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106), an entity may assume no ineffectiveness. In the case of a firm commitment, the shortcut method can be applied to the hedging relationship only if the trade date of the interest-bearing financial asset or liability differs from its settlement date due to generally established conventions in the marketplace in which the transaction is executed. Unless otherwise stated, subsequent references in this appendix (related to the criteria for the shortcut method) to a recognized interest-bearing financial asset or liability includes a firm commitment as discussed above. (See Example 5.9 in this section for an illustration of the accounting for a fair value hedge using the shortcut method.) We believe that an entity’s documentation at inception of the hedging relationship should identify how those criteria are met.

A5.36a Paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106) previously stated that the shortcut method could be applied only to a hedging relationship that involved a recognized interest-bearing asset or liability as the hedged item. However, an implementation issue arose as it is common for entities to designate a hedging relationship on the trade date of both the swap and the hedged item, even though the hedged item is not recognized until its settlement date (for example, when hedging a debt obligation). In these situations, there was concern that the shortcut method could not be applied, as the hedged item would not be a recognized financial asset or liability upon the designation of the hedge. DIG Issue E23 addressed the inconsistency between this practice and paragraph 68 (ASC paragraphs 815-20-25-102 through 25-106) by revising the guidance to clarify that these types of relationships would qualify for the shortcut method, assuming that the length of time between the trade date and the settlement date of the hedged item is within generally established conventions in the marketplace in which the transaction is executed. Entities will have to apply judgment when determining if the trade date and settlement date of the hedged item differ due to established market conventions and would need to consider the facts and circumstances of the specific transaction and the market in which the transaction is being executed in order to make this determination. In certain markets, where transactions may be executed on a less frequent basis, it may be more difficult to determine if the length of time between the trade date and settlement date is within established conventions for that marketplace.

A5.36b Consider an example in which an entity enters into a hedging relationship to hedge the risk of changes in the fair value due to changes in the benchmark interest rate related to debt issued on the trade date that will settle five days later. The interest rate swap in the hedging relationship is entered into on the trade date of the debt at a zero fair value. On the trade date, the entity would record the interest rate swap and the firm commitment that represents the debt that will settle in five days; both of which would have a fair value and carrying amount of zero. Any changes in the fair value of the interest rate swap (and the equal and offsetting changes in the fair value of the firm commitment) from the trade date to the settlement date would be recorded in
earnings. In addition, the carrying amount of the interest rate swap would be adjusted to its fair value and the carrying amount of the firm commitment would be adjusted by an offsetting amount. On the settlement date of the debt, the carrying amount of the firm commitment would become the basis for the recognized debt instrument and the entity would continue accounting for the relationship under the shortcut method going forward. (See DIG Issue E23 for further reference.)

A5.37 The shortcut method may be applied only to a hedging relationship that involves a recognized interest-bearing asset or liability and an interest rate swap. That specific asset or liability must be identified and documented at inception of the hedging relationship. As a result, an entity is not permitted to substitute, replace, or change the recognized interest-bearing asset or liability during the hedging relationship. The hedge of a firm commitment and subsequent recognition and continued hedge of the related interest-bearing asset or liability is not considered to be a substitution, replacement, or change of the recognized interest-bearing asset or liability.

A5.38 The criteria of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106) that are applicable to fair value hedges are:

(a) The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged.

(b) If the hedging instrument is solely an interest rate swap, the fair value of that swap at the inception of the hedging relationship must be zero, with one exception. The fair value of the swap may be other than zero at the inception of the hedging relationship only if the swap was entered into at the relationship's inception, the transaction price of the swap was zero in the entity's principal market (or most advantageous market), and the difference between transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction. If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in paragraph 68(d), the premium for the mirror-image call or put option must be paid or received in the same manner as the premium on the call or put option embedded in the hedged item. That is, the reporting entity must determine whether the implicit premium for the purchased call or written put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium) or is being paid over the life of the hedged item (through an adjustment of the interest rate). If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition, the fair value of the hedging instrument at the inception of the hedging relationship must be equal to the fair value of the mirror-image call or put option. In contrast, if the implicit premium for the call or put option embedded in the hedged item is principally being paid over the life of the hedged item, fair value of the hedging instrument at the inception of the hedging relationship must be zero (except as discussed previously regarding differing prices due to the existence of a bid-ask spread).
(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 indicated in the following sentences. 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 instrument is a compound derivative composed of an interest rate swap and a mirror-image call option. The call option is considered a mirror image of the call option embedded in the hedged item if (1) 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 (2) the entity is the writer of one call option and the holder (or purchaser) of the other call option. Similarly, 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 instrument is a compound derivative composed of an interest rate swap and a mirror-image put option.

(dd) The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.*

(e) 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.

Conditions applicable to fair value hedges only

(f) The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.

(g) There is no floor or cap on the variable interest rate of the swap.

(h) 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).

18b1 This guidance is applicable only to transactions considered at market (that is, transaction price is zero exclusive of commissions and other transaction costs, as discussed in paragraph 9 of FASB Statement No. 157, Fair Value Measurements).

* For cash flow hedge situations in which the cash flows of the hedged item and the hedging instrument are based on the same index but that index is not the benchmark interest rate, the shortcut method is not permitted. However, the entity may obtain results similar to results obtained if the shortcut method was permitted.
DIG Issues related to the shortcut method are E4, E6, E10, E12, E15, E16, E20, E23, G7, G10, G12, G13, G21, G25, and J9. See DIG Issues Index.

A5.39 As previously indicated, the shortcut method can be applied only to hedging relationships of benchmark interest rate risk that involve a recognized interest-bearing asset or liability and an interest rate swap. If any other derivative is used in the hedging relationship, including a forward-starting interest rate swap, the hedged item is a firm commitment (unless it meets the conditions set forth in Paragraph A5.36), or the entity is hedging a risk other than, or in addition to, the benchmark interest rate risk, the shortcut method cannot be used. (See DIG Issue E4 for further reference.)

NOTIONAL AMOUNT OF SWAP MATCHES PRINCIPAL AMOUNT OF THE INTEREST-BEARING ASSET OR LIABILITY

A5.40 The first criterion of paragraph 68 of the Standard (ASC paragraph 815-20-25-104(a)) is that the notional amount of the swap must match the principal amount of the interest-bearing asset or liability that is being hedged. When an entity is hedging the interest rate risk of an entire financial asset or liability, this condition is easy to evaluate. Similarly, a hedging relationship that identifies a proportion of a financial asset or liability (e.g., $50 million of a $100 million fixed-rate debt obligation) as the hedged item meets the requirement of paragraph 68(a) (ASC paragraph 815-20-25-104(a)) if the notional amount of the interest rate swap designated as the hedging instrument matches the proportion of the financial asset or liability that is designated as being hedged. The entity should be specific in its identification of the proportion of the financial asset or liability being hedged. In other words, in the example above, the hedged item cannot be the remaining $50 million of a $100 million fixed-rate debt obligation, after scheduled principal payments. An acceptable approach would be to identify the $50 million debt by specific certificates. Likewise, a hedging relationship that identifies a proportion of an interest rate swap (e.g., $50 million notional of a $100 million notional swap) as the hedging instrument and a financial asset or liability (or a proportion thereof) with a balance of $50 million also would meet the requirement of paragraph 68(a) (ASC paragraph 815-20-25-104(a)). Additionally, a hedging relationship that identifies a portfolio of similar interest-bearing assets or liabilities (or proportions thereof) meets the requirements of paragraph 68(a) of the Standard (ASC paragraph 815-20-25-104(a)) if the notional amount of the interest rate swap matches the aggregate notional amount of the portfolio that is being hedged. However, each individual item in the portfolio must meet the remaining criteria in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106) for use of the shortcut method to be appropriate. That is, it is appropriate to apply the shortcut method to portfolios that meet the requirements of paragraph 21(a)(1) of the Standard (ASC paragraph 815-20-25-12(a)(1)) only if the individual assets or liabilities in the portfolio meet the same stringent criteria within paragraph 68 (ASC paragraphs 815-20-25-102 through 25-106). As a practical matter, these requirements result in the need for the characteristics of the individual items in the portfolio to be the same except for the notional amount. Thus, opportunities for portfolio hedging using the shortcut method are limited. (See DIG Issue E10 for further reference.)
FAIR VALUE OF THE SWAP AT INCEPTION OF THE HEDGING RELATIONSHIP

A5.41 The second criterion of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106) is that if the hedging instrument is an interest rate swap, the fair value of that swap at the inception of the hedging relationship must be zero, with one exception. This exception relates to the interaction of paragraph 68(b) of the Standard (ASC paragraph 815-20-25-104(c)), which required the swap's fair value to be zero at the inception of the hedging relationship, and the revised definition of fair value under Statement 157 (ASC Subtopic 820-10). Before Statement 157 (ASC Subtopic 820-10), the fair value of an interest rate swap that was entered into in an entity’s principal market was generally considered to be the transaction price, which is an entry price. The fair value of a swap at initial recognition under Statement 157 (ASC Subtopic 820-10) is based on an exit price that likely would be other than zero because of a bid-ask spread. Therefore, DIG Issue E23 clarified that paragraph 68(b) (ASC paragraph 815-20-25-104(c)) would be met for an interest rate swap with all of the following characteristics:

- It is entered into at the inception of the hedging relationship.
- It has a transaction price of zero (exclusive of commissions and other transaction costs as described in paragraph 9 of Statement 157 (ASC paragraph 820-10-35-7)) in the entity’s principal or most advantageous market (as applicable).
- The difference between the transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction.

Unless otherwise stated, subsequent references in this appendix (related to the criteria for the shortcut method) to the fair value of the swap being equal to zero includes a swap with a non-zero fair value if it meets the conditions noted above.

A5.42 If the hedging instrument is a compound derivative that comprises an interest rate swap and mirror-image call or put option as discussed in paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)), (an instrument often used to hedge prepayable instruments), the premium for the mirror-image call or put option must be paid or received in the same manner as the premium on the call or put option that is embedded in the recognized interest-bearing asset or liability. That is, the entity must determine whether the implicit premium for the call or put option embedded in the recognized interest-bearing asset or liability was principally paid at inception-acquisition (through an original issue discount or premium) or is being paid over the life of the recognized interest-bearing asset or liability (through an adjustment of the interest rate). That determination would be made by way of a comparison with the terms of an instrument with terms that are equivalent to the terms of the hedged item, except for the embedded option. If the implicit premium for the call or put option that is embedded in the recognized interest-bearing asset or liability was principally paid at inception-acquisition, the fair value of the hedging instrument at the inception of the hedging relationship must be equal to the fair value of the mirror-image call or put option. In contrast, if the implicit premium for the call or put option embedded in the recognized interest-bearing asset or liability is principally being paid over the life of the recognized interest-bearing asset or liability, the fair value of the hedging instrument at the inception of the hedging relationship must be zero.
A5.42a Consider an example in which an entity that could borrow at a fixed rate of 5% with noncallable debt instead borrows at a fixed rate of 5½% with callable debt. In other words, it pays 50 basis points for the (purchased) embedded call option over the life of the debt. To qualify for the shortcut method, the hedging instrument for the noncallable debt would be an interest rate swap with a fixed-rate-receive leg of 5% and a variable-rate pay leg of LIBOR and a fair value at inception of the hedging relationship of zero. For the callable debt, the hedging instrument would be a compound derivative comprised of an interest rate swap with a mirror-image (written) call option.

A5.43 Since the premium for the embedded purchased call option is being paid over the life of the debt, the swap’s fixed-rate receive leg would be 5½% and the variable-rate pay leg would be LIBOR. The swap would not be at market terms and thus would have a fair value other than zero. This value would be offset by the value of the written option’s premium embedded within the swap. Therefore, the net fair value of the compound derivative would be zero at the inception of the hedging relationship. In contrast, if the entity instead issued callable debt with a stated fixed rate of 5% and thus issued the debt at a discount to yield 5½%, the embedded purchased call option’s premium would have been paid at inception (i.e., the debt discount). The hedging instrument that would qualify for the shortcut method would be a similar compound derivative as above, except that the swap’s fixed-rate receive leg would be 5% and the variable-rate pay leg would be LIBOR. The swap’s terms (assuming no embedded written call option) would be at market and thus would have a fair value of zero. The written call option embedded within the swap would have a value equal to its time value. Thus the premium of the option would be received at inception. (In this situation, the swap with an embedded written option is a net written option. A written option with terms that are a mirror image of the hedged item when used as the hedging instrument in applying the shortcut method does not need to be evaluated under the written option effectiveness test. This is because it is assumed that the written option effectiveness test would be met if a hedging relationship also meets the requirements for application of the shortcut method.)

A5.44 Entities must consider the interrelationship of negotiating the terms of the swap and related hedged item to ensure that day one fair value of the swap has been properly identified even if value is included in payment made by means other than upfront cash exchange between the entity and the swap counterparty. For example, banks that accept deposits acquired through a broker (brokered certificates of deposit or brokered CDs) may finance the related broker’s commission as an inherent element of a related interest rate swap arrangement. In such an arrangement, the swap counterparty pays the broker’s commission upfront on behalf of the bank, and then recoups that loan by adjusting the payments it will receive on the swap, typically by 20 to 25 basis points. Thus, the swap has an embedded financing component and the swap’s initial fair value is equal to the amount of the broker’s commission that was financed by the swap counterparty. The terms of the swap usually are designed to match the related terms of the CD, and the swap typically is designated as a hedge of changes in the fair value or cash flows of the CD. Since the fair value of the swap is not zero at the inception of the hedging relationship (due to the embedded financing arrangement), the swap does not qualify for the shortcut method.
Accounting by the Acquirer of Existing Hedges Accounted for by the Target Using the Shortcut Method in a Purchase Business Combination

A5.45 In a purchase business combination, the acquirer may not automatically continue to use the shortcut method after the business combination unless (1) the applicable hedging relationship meets the requirements in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106) at the date of the business combination (which would be highly unlikely since the swap’s fair value rarely would be zero at that date) and (2) the combined entity chooses to designate the swap and the hedged item in a hedging relationship to be accounted for under the shortcut method. The inability to continue to use the shortcut method in a purchase business combination results from the acquirer individually purchasing the assets and liabilities of the target, including any existing derivatives. Accordingly, any pre-existing hedging relationships of the acquired entity are required to be designated anew by the combined entity at the date of the business combination in accordance with the relevant requirements of the Standard. The post-acquisition hedging relationship designated by the acquirer is a new relationship that has a new inception date. Therefore, in order for the shortcut method to be applied by the combined entity, all of the paragraph 68 (ASC paragraphs 815-20-25-102 through 25-106) shortcut method criteria would need to be met at the inception of the new hedging relationship, including the requirements with regard to the fair value of the swap at the inception of the hedging relationship (i.e., the swap has a fair value of zero if the hedging instrument is not a compound derivative and the premium is paid or received in the same manner as the mirror-image option premium embedded in the hedged item if the swap is a compound derivative). We believe that the prohibition against continuation of the shortcut method in a purchase business combination also applies to the post-acquisition separate financial statements of a subsidiary that has been acquired, regardless of whether push down accounting is applied. (See DIG Issue E15 for further reference.) See Section 10 for a discussion of the continuation of the shortcut method when an entity is required to discontinue a hedging relationship previously accounted for under the shortcut method as a result of the adoption of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, or No. 46 (revised December 2003), Consolidation of Variable Interest Entities (ASC Subtopic 810-10, Consolidation -- Overall).

FORMULA FOR COMPUTING NET SETTLEMENT

A5.46 The third criterion of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106) is that the formula for computing net settlements of the swap must be the same for each net settlement. A swap that contains an initial stub period (during which net settlements in that period are calculated in a manner inconsistent with the remaining net settlements under the swap) does not violate this condition provided that the stub rate is the floating rate that corresponds with the length of the stub period. A stub period is simply a market convention that is necessary to determine the prices of interest rate swaps that are traded on dates that do not coincide with swap reset dates; the period is not inconsistent with the Board’s overall objective of limiting the shortcut method to situations in which no ineffectiveness is expected to result from the hedging relationship. (See DIG Issue E12 for further reference.)
INTEREST-BEARING ASSET OR LIABILITY MAY NOT BE PREPAYABLE

A5.47 The fourth criterion of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106) is that the interest-bearing financial asset or liability may not be prepayable except in limited situations. A hedged item may contain an embedded call or put option and qualify for the use of the shortcut method, as long as the interest rate swap contains a mirror-image option (i.e., it is a compound derivative). An interest-bearing asset or liability should be considered prepayable under the provisions of paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)) when one party to the contract has the right to cause the payment of principal before the scheduled payment dates unless (1) the debtor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always greater than the then fair value of the contract without that right or (2) the creditor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always less than the then fair value of the contract without that right. A right to cause a contract to be prepaid at its then fair value would not cause the interest-bearing asset or liability to be considered prepayable under paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)), since that right would have a fair value of zero at all times and essentially would provide only liquidity to the holder. Notwithstanding the above, any term, clause, or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent on the occurrence of a specific event related to the debtor’s credit deterioration or other change in the debtor’s credit risk (e.g., the debtor’s failure to make timely payment, thus making it delinquent; its failure to meet specific covenant ratios; its disposition of specific significant assets (such as a factory); a declaration of cross-default; or a restructuring by the debtor) should not be considered a prepayment provision under the provisions of paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)). Likewise, any term, clause or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent on the occurrence of a specific event that (a) is not probable at the time of debt issuance, (b) is unrelated to changes in benchmark interest rates or any other market variable, and (c) is related either to the debtor’s or creditor’s death or to regulatory actions, legislative actions, or other similar events that are beyond the control of the debtor or creditor, should not be considered a prepayment provision under the provisions of paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)). (See DIG Issue E6 for further reference.)

A5.48 Based on the guidance above, the following should be noted:

- A fixed-rate debt instrument that permits the debtor to call the debt at a fixed amount (e.g., at par or at a specified premium over par) is considered prepayable for purposes of applying paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)).

- A fixed-rate mortgage note that is secured by certain property that permits the lender to accelerate the maturity of the note if the borrower sells the property is not considered prepayable for purposes of applying paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)).

- A fixed-rate debt instrument that permits the debtor to call the debt at fair value or a premium over fair value is not considered prepayable for purposes of applying paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)).
A fixed-rate debt instrument that provides that in the event of certain changes in tax
law that would subject the investor to additional incremental taxes, the coupon
interest rate of the debt increases and the debtor (issuer) can call the debt at par is not
considered prepayable for purposes of applying paragraph 68(d) of the Standard
(ASC paragraph 815-20-25-104(e)). However, the impact of the feature that increases
the interest rate of the debt must be evaluated against the remaining criteria for the
shortcut method.

A5.49 As noted above, when an interest-bearing asset or liability is prepayable, the criterion of
paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)) cannot be considered met
unless the hedging interest rate swap contains an embedded mirror-image option and the
criterion of paragraph 68(b) of the Standard (ASC paragraph 815-20-25-104(c)), as discussed
above in Paragraphs A5.41-A5.44, also is met. The option is considered a mirror image of the
option embedded in the hedged item if (a) the terms of the two call options match (including
matching maturities, strike price, notional amounts, timing and frequency of payments and dates
on which the instruments may be called) and the entity is the writer of one option and the holder
(or purchaser) of the other option.

A5.50 The carrying amount of a debt instrument often is different from its redemption amount at
maturity because of deferred debt issuance costs or because the instrument was issued at a
premium or discount. If the debt is callable, its carrying amount may be different from the strike
price of the call option; however, the carrying amount of the debt has no effect on whether the
swap contains a mirror-image call option under paragraph 68(d) of the Standard (ASC paragraph
815-20-25-104(e)). As a result, the strike price (in the context of paragraph 68(d) of the Standard
(ASC paragraph 815-20-25-104(e))). should be understood to mean the amount for which the
debt instrument can be called. One means of determining whether the strike prices are the same
would be to (a) impute the yield to maturity at a price equal to the call price for a
noncallable/non-puttable debt instrument that is otherwise identical to the hedged debt
instrument and (b) compare that yield with the yield on the call or put embedded in the swap.
(See DIG Issue E20 for further reference.)

INDEX OF SWAP MATCHES INDEX OF HEDGE ITEM

A5.51 The fifth criterion of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102
through 25-106) is that the index on which the variable leg of the swap is based exactly matches
the benchmark interest rate that is designated as the interest rate risk that is being hedged in that
hedging relationship. For example, if the variable leg of an interest rate swap is indexed to 90-
day LIBOR and the benchmark interest rate designated as the interest rate risk being hedged is
60-day LIBOR, the relationship would not qualify for the shortcut method. This criterion is
necessary to be consistent with the benchmark interest rate concept in the Standard when
hedging interest rate risk. A U.S. entity would not be able to use the shortcut method if the
interest rate swap has a variable-rate that is indexed to rates other than the LIBOR swap rate or
the U.S. Treasury rate (or the Fed Funds rate for hedging relationships entered into or
redesignated on or after July 17, 2013).
ALL OTHER TERMS OF THE FINANCIAL INSTRUMENT AND SWAP SHOULD BE TYPICAL AND THOSE TERMS DO NOT INVALIDATE THE ASSUMPTION OF NO INEFFECTIVENESS

A5.52 The sixth criterion of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106) is that all other terms in the interest-bearing financial instrument or interest rate swap should be typical of those instruments and should not invalidate the assumption of no ineffectiveness. The Board included this criterion to ensure that all terms of the hedging relationship are considered in evaluating the appropriateness of the shortcut method. The second part of this criterion is important because it highlights that implicit in the ability to use the shortcut method is an assumption of no ineffectiveness. However, the Standard discusses two sources of ineffectiveness that would not affect the assumption of no ineffectiveness in the shortcut method. The first is comparable credit risk of the parties at the inception of the hedge. To achieve perfect offset requires that the same discount rate be used to determine the fair value of the swap and of the hedged item. To use the same discount rate, the credit risk related to both parties to the swap as well as the party to the hedged item would have to be the same. The FASB concluded that, because of the complication caused by the interaction of interest rate risk and credit risk, that are not easily separable, comparable creditworthiness is not considered a necessary condition to assume no ineffectiveness in a hedge of interest rate risk. The second is that the fixed rate on the hedged item need not exactly match the fixed component on the swap. Differences in the fixed rates would result in differences in the respective changes in the fair values of the derivative and the hedged item as well as impact whether options embedded in the instruments are considered mirror. Because of the differences, the two option holders will not be economically compelled to exercise their options at the same time. For example, a swap counterparty receiving a fixed-rate of 5% would presumably put the swap back to the counterparty at a different time (i.e., when rates are above 5%) than a borrower would call a fixed-rate debt with a coupon of 15% (i.e., when rates are below 15%). Practice has interpreted the acknowledgment that the fixed rates need not exactly match to address any mismatches of fixed rates on interest rate swaps (including callable/puttable swaps) and fixed rates on hedged items (including callable/puttable hedged items).

A5.53 Convertible debt (i.e., debt convertible into common stock of the issuer) cannot be hedged for changes in fair value due to changes in the benchmark rate using the shortcut method. The FASB staff has noted that the interaction between equity prices and interest rates on convertible debt adds a level of complexity not envisioned by the FASB in the shortcut method. Similarly, we believe that other debt instruments with complex features, such as interest deferral features in debt obligations commonly issued by financial institutions under trust preferred structures, cannot be hedged using the shortcut method. These interest deferral features allow the entity to defer the payment of interest at its option for up to 20 quarters in any period during which the entity is not in default. The deferred amounts themselves bear interest. This feature would generate ineffectiveness if the interest rate swap did not include a mirror feature. Alternatively, if the swap had the mirror feature, it would not meet the third criterion for the shortcut method that requires that the swap’s formula for computing net settlement be the same for each net settlement.

A5.54 Interest rate swaps are contractual arrangements that require the periodic exchange of two cash flows (usually in a net-settled fashion) – one related to the fixed interest rate leg of the swap...
and the other related to the variable interest rate leg of the swap. In plain-vanilla interest rate swaps, the fixed interest rate leg does not change; however, the variable interest rate leg of the swap is determined (i.e., reset) at the beginning of each period with payment of the swap generally occurring at the end of that period. However, some interest rate swaps have variable interest rate legs that reprice in arrears, meaning that the variable rate is determined at the end of the period and applied retrospectively to calculate the swap settlement payment for that period. The use of the shortcut method is not precluded for hedging relationships that involve interest rate swaps-in-arrears as long as all other applicable conditions of paragraph 68 (ASC paragraphs 815-20-25-102 through 25-106) are met. (See DIG Issue E16 for further reference.)

OTHER FAIR VALUE HEDGE REQUIREMENTS

A5.55 The Board also included additional criteria for using the shortcut method that apply only to fair value hedges. These are:

- The expiration date of the swap matches the maturity date of the interest-bearing asset or liability. Those dates match if they are exactly the same or correspond exactly.

- There is no floor or cap on the variable interest rate of the swap. This criterion prohibits introducing a floor or cap on the variable interest rate of the swap. If an entity were to enter into an interest rate swap with a floor or cap, changes in the benchmark interest rate below the floor or above the cap would not be taken into account when determining the fair value of the interest rate swap, thereby resulting in ineffectiveness.

- 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).

A5.56 Because the shortcut method is an exception to the requirements of the Standard to assess effectiveness and measure ineffectiveness (i.e., entities can assume no ineffectiveness, the assessment of effectiveness is less onerous and the accounting is simplified), the term match (as used in paragraph 68 (ASC paragraphs 815-20-25-102 through 25-106)) is defined narrowly and is intended to mean _be exactly the same as or correspond exactly_. Therefore, for example, for purposes of apply the provisions of paragraph 68(f) of the Standard (ASC paragraph 815-20-15-105(a)), if the expiration of the swap is December 31, 2009, then the maturity of the hedged item also must be December 31, 2009. The SEC staff has indicated that the circumstances in which the shortcut method can be applied are limited to those where the specific criteria are met. The staff does not believe the shortcut method criteria have a _spirit or principle_ that can be met without strictly complying with the stated requirements.

A5.57 As noted in Paragraph A5.52, The Standard addresses an inherent difficulty with the assumption of no ineffectiveness. That is, the discount rates used to determine the fair value of the swap may be different from the hedged item due to differences in credit risk. As a result the Standard provides that comparable credit risk at inception of the hedging relationship is not necessary to assume no ineffectiveness even though achieving perfect offset would require that the same discount rate be used to determine the fair value of the interest rate swap and the hedged item. Notwithstanding that provision, an entity must consider the likelihood of noncompliance with the contractual terms of the interest rate swap that require the counterparty
or the entity to make either fixed interest payments (resulting from the fixed leg of the swap) or payments based on changes in the benchmark interest rate (resulting from the variable leg of the swap). As discussed above, implicit in the criteria for use of the shortcut method is an assumption of no ineffectiveness. Changes in creditworthiness of the counterparty to the derivative hedging instrument or the entity's own nonperformance risk may invalidate the assumption of no ineffectiveness.

A5.57a DIG Issue E4 “Application of the Shortcut Method” states that if a hedging relationship qualifies for the shortcut method, a change in the creditworthiness of the counterparty of the swap would not require recognition of ineffectiveness in earnings or preclude the continued use of the shortcut method. We believe it is appropriate to apply this guidance to the entity's own nonperformance risk.

A5.57b We also believe that, consistent with DIG Issue G10, no ineffectiveness would be recognized and the shortcut method may continue to be used as long as the likelihood that the counterparty or the entity will not default continues to be probable. Therefore, changes in counterparty credit risk and the entity’s own nonperformance risk will have no impact on the assessment of effectiveness or measurement of ineffectiveness and the changes in the fair value of the derivative instrument related to counterparty credit risk and an entity’s own nonperformance risk would be included in earnings with the same amount as a basis adjustment to the hedged item. However, if the likelihood of the counterparty or the entity not defaulting is assessed as no longer probable, the use of the shortcut method must be discontinued. If the entity can identify the event or change in circumstances that caused the likelihood of the counterparty or the entity not defaulting to no longer be probable, hedge accounting would stop and all subsequent changes in fair value of the derivative that occurred from that date to the current date are reported in earnings and the hedged item’s subsequent basis adjustments are not recognized. If the entity cannot identify the event or changes in circumstances during the assessment period that caused the likelihood of the counterparty or the entity not defaulting to no longer be probable, all changes in the fair value of the derivative during the entire assessment period would be reported in earnings and the hedged item’s basis adjustments are not recognized. However, the hedging relationship may be redesignated using the long-haul method, if the entity has strong evidence indicating that the new hedging relationship is expected to be highly effective. Strong evidence would be needed to overcome the impact of the credit/nonperformance issues of the derivative on the effectiveness of the hedging relationship. We expect these situations to be rare.

A5.58 If all of the requirements in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106) are met for a fair value hedging relationship, the entity does not need to perform effectiveness testing at inception or during the life of the hedging relationship, unless the credit risk of the counterparty to the derivative or the entity's own nonperformance risk changes so that it is no longer probable that the counterparty or entity will not default and, as a result, the entity cannot assume no ineffectiveness. The following steps represent the accounting for a fair value hedging relationship that qualifies for the shortcut method:

1. Compute the difference between the fixed rate to be received (paid) on the swap and the fixed rate to be received (paid) on the hedged item.

2. Combine that difference with the variable rate to be received (paid) on the swap.
Step 3. Compute and recognize interest income or expense using that combined rate and the fixed-rate asset’s or liability’s principal amount. (Amortization of any purchase premium or discount on the asset must also be considered, although that complication is not incorporated here.)

Step 4. Determine the fair value of the interest rate swap.

Step 5. Adjust the carrying amount of the swap to its fair value and adjust the carrying amount of the asset or liability by an offsetting amount.

See Example 5.9 in this section for an illustration of the accounting for a fair value hedge using the shortcut method.

FORWARDS / FUTURES

A5.59 Forward contracts are negotiated between two parties to purchase a specific quantity of a commodity, a financial instrument, or a foreign currency at a specified price with delivery or settlement in the future. Those contracts can be physically settled by receipt of the underlying for a payment of cash or can be net cash settled by the parties, with one party receiving a payment for the difference between the price of the underlying on the date of the settlement (i.e., the spot price) and the forward price agreed to in the contract multiplied by the notional amount of the contract (i.e., number of units). Futures contracts and forward contracts have similarities but futures contracts are standardized and traded on a regulated exchange. The other key differences between forward contracts and futures contracts are:

- Forward contracts are available for essentially any underlying if two parties agree to the contract, whereas futures contracts are available for only certain underlyings (i.e., those underlyings with liquid markets) due to their standardized nature;
- Forward contract values are affected by the creditworthiness of the counterparty and the entity's own nonperformance risk; whereas, futures contract values are affected by the creditworthiness of the exchange on which the contract trades; and
- Forward contracts can either be gross (physically) settled or net cash settled; whereas, futures contracts generally provide for net cash settlement.

A5.60 A fair value hedging relationship that involves a forward or futures contract as the hedging instrument may be assessed for hedge effectiveness and measured for hedge ineffectiveness essentially in one of two ways:

- If the critical terms of the forward or futures contract and the hedged item match, an entity may be able to conclude that changes in the fair value of the hedged item that are attributable to the risk being hedged are expected to be completely offset by the hedging derivative (i.e., there is no hedge ineffectiveness), except for amounts that are excluded from the assessment of effectiveness, if any. See discussion of this method in Paragraphs A5.61-A5.63.
- Statement 157 (ASC Subtopic 820-10) requires that counterparty credit risk and an entity's own nonperformance risk (which includes credit risk) be included in the valuation of derivative instruments. Any change in the counterparty's credit risk or the entity's own nonperformance risk would affect the fair value of the
derivative hedging instrument. Therefore, we believe that the adoption of Statement 157 (ASC Subtopic 820-10) effectively precludes the use of the critical-terms-match approach for fair value hedging relationships.

- If the critical terms of the forward or futures contract and the hedged item do not match (e.g., the underlying of the contract is not the same as the asset being hedged), entities must determine the change in fair values of the hedging derivative instrument and the hedged item. Calculating the fair value of a forward or futures contract is generally not difficult. However, the calculation of the changes in fair value of the hedged item that are attributable to the risk being hedged is more difficult. For example, the calculation of the change in fair value of a recognized interest-bearing financial asset or liability for changes in the benchmark interest rate under the Standard is impacted by certain requirements, including that the estimated cash flows used must be based on all contractual cash flows of the entire financial instrument being hedged. See discussion of these issues in Paragraphs 22.04-22.09 of this section.

**Critical Terms Match**

**A5.61** For fair value hedging relationships in which critical terms are the same and involve a forward or futures contract, an entity may conclude that changes in the fair value of the hedged asset, liability or firm commitment that are attributable to the risk being hedged are expected to be completely offset by the hedging derivative and there is no hedge ineffectiveness. Thus if the entity believes the relationship would generate ineffectiveness if it were measured or effectiveness were assessed, the critical-terms-match approach should not be used. An initial effectiveness assessment must be performed and documented. The extent of that assessment is based on judgment and would vary depending on the complexity of the derivative and hedged item. That initial assessment might consist solely of a statement that the critical terms of the hedging instrument and the hedged item are the same and, accordingly, changes in fair value attributable to the risk being hedged are expected to be completely offset by the hedging derivative and no hedge ineffectiveness is expected (after consideration of the amounts, if any, excluded from the assessment of effectiveness and measurement of ineffectiveness). Subsequent assessment can be performed by verifying and documenting whether the critical terms of the hedging instrument and the hedged item changed during the period under review and whether there have been any developments concerning counterparty credit risk or the entity's own nonperformance risk related to the derivative hedging instrument that could affect the assessment of effectiveness and the conclusion of no ineffectiveness. If the conclusion is reached that there have been no changes in critical terms (which include the evaluation of creditworthiness of the counterparty to the derivative and the entity's own nonperformance risk), entities can document and conclude that the hedging relationship has been perfectly effective and there is no ineffectiveness to measure. An important component of this process is the assessment of whether there have been developments in the creditworthiness of the counterparty to the forward or futures contract or the entity's own nonperformance risk. DIG Issue G10 states that a change in the counterparty’s creditworthiness of a derivative instrument in a fair value hedging relationship would have an immediate impact on the assessment of effectiveness and measurement of ineffectiveness. We believe it is appropriate to analogize the guidance in DIG Issue G10 to also include changes in the entity's own nonperformance risk. Therefore, a change in either the counterparty's credit risk or the entity's nonperformance risk would affect the fair value of the...
derivative hedging instrument and preclude the use of the critical-terms-match approach. In that circumstance, the assumption of no ineffectiveness would no longer be appropriate and the entity should evaluate the fair value hedging relationship under the long haul method. If the hedge effectiveness testing under the long haul method results in a conclusion that the hedge is no longer highly effective, the hedging relationship would cease and the carrying amount of the hedged item would no longer be adjusted for changes in its fair value attributable to the risk being hedged.

**A5.62** The critical terms of a forward or futures contract and a hedged item match if:

- The forward or futures contract is for the purchase or sale of the same quantity of the same underlying, at the same location as the hedged item (for nonfinancial underlyings), and at the same time (if the fair value of the hedged item is affected by the time value of money (i.e., a firm commitment) and the entity includes that time value in the assessment of hedge effectiveness and measurement of ineffectiveness). For example, an entity that is hedging a firm commitment to sell West Texas natural gas can assume that a forward contract will be fully effective only if the forward contract’s underlying is West Texas natural gas and is for the same quantity as the firm commitment and settles at the same time and in the same location as the firm commitment; and
- The fair value of the forward or futures contract at inception of the hedge is zero, and either:
  - The change in the spot-forward price difference on the forward or futures contract is excluded from the assessment of effectiveness and included directly in earnings for recognized assets, liabilities, or firm commitments valued using spot rates (see Paragraphs A5.12-A5.14, above); or
  - The change in the fair value of the forward or futures contract is included in the assessment of effectiveness for firm commitments valued using forward rates.

**A5.63.** When critical terms match, the change in the fair value of the derivative hedging instrument can be viewed as a proxy for the change in the fair value of the hedged item and, as a result, there is no requirement to separately evaluate the change in the fair value of the hedged item.

**OPTIONS**

**A5.64** Unlike swaps, forwards, and futures contracts that require an entity to buy or sell an underlying instrument or to swap cash flows with another party, an option contract provides an option holder with the right, but not the obligation, to buy or sell an underlying instrument or to exchange cash flows with another party. The key features of options are:

- An option contract defines a price, referred to as the *strike price*, and establishes the term of the option, referred to as the *exercise period*.
- An option contract normally provides an option holder a *call option* or a *put option*. A call option enables the holder to profit from an increase in the value of the underlying
instrument above the exercise price, while a put option enables the holder to profit from a decrease in the value of the underlying instrument below the exercise price.

- Options generally are either American or European depending on their exercisability. The holder of an American option can exercise the option at any time during the exercise period whereas the holder of a European option can exercise the option only at maturity.

- An option holder (buyer) usually pays a premium for the right to exercise the option. Because of the nature of an option, the holder benefits from favorable movements (either up or down depending on whether it is a call or a put) in the price of the underlying instrument while risking only the loss of the option premium that it paid for the contract.

- An option writer (seller), on the other hand, is exposed to virtually unlimited loss in exchange for receipt of the option premium.

- An option comprises time value and intrinsic value. Time value represents the value of the time to the end of the exercise period, which is affected by volatility of the price of the underlying, the remaining option term, and other economic factors. Intrinsic value, commonly characterized by the term in the money is the amount by which the value of the underlying exceeds or is less than an option’s strike price depending on whether the option is a call or a put, respectively. But in either case, it normally can only be a positive amount (meaning that an option cannot have an intrinsic value less than zero, even when economically the option is underwater).

- Options can be combined with other options (e.g., an interest rate collar that combines a cap and a floor) or with other types of derivatives (e.g., an option within a swap).

**A5.65** It is important to note that before an entity can consider an option contract, a combination of option contracts, or a combination of an option contract with a non-option derivative as a hedging instrument in a fair value hedging relationship, it must determine whether the option or combination is a net purchased option or net written option. If the option or combination is a net written option, the hedging relationship must meet the Standard’s written option effectiveness test to be eligible for fair value hedging. See discussion of those issues in Paragraphs 20c.01-20c.20 of this section.

**A5.66** A fair value hedging relationship that involves a purchased option or combination of options resulting in a net purchased option or zero-cost collar as the hedging instrument may be assessed for hedge effectiveness in different ways:

- For hedging relationships in which critical terms match and the assessment of effectiveness is based on the contract’s intrinsic value, an entity may conclude that changes in the fair value of the hedged asset, liability, or firm commitment that are attributable to the risk being hedged are expected to be completely offset by the hedging derivative and there is no hedge ineffectiveness. However, the excluded component of time value of the option contract will affect earnings each period. See discussion of this method in Paragraph A5.68 below.
• Statement 157 (ASC Subtopic 820-10) requires that counterparty credit risk and an entity's own nonperformance risk (which includes credit risk) be included in the valuation of derivative instruments. Any change in the counterparty's credit risk or the entity's own nonperformance risk would affect the fair value of the derivative hedging instrument. Therefore, we believe that the adoption of Statement 157 (ASC Subtopic 820-10) effectively precludes the use of the critical-terms-match approach for fair value hedging relationships.

• If the critical terms of the option contract and the hedged item do not match (e.g., the underlying of the derivative hedging instrument is not the same as the asset being hedged), entities must measure the change in the fair value of the option and the hedged item. Calculating the fair value of a purchased option is generally not difficult. However, the calculation of the changes in fair value of the hedged item that are attributable to the risk being hedged is more difficult. For example, the calculation of the change in fair value of a recognized interest-bearing financial asset or liability for changes in the benchmark interest rate under the Standard is impacted by certain requirements, including that the estimated cash flows used must be based on all contractual cash flows of the entire financial instrument being hedged. See discussion of these issues in Paragraphs 22.04-22.09 of this section.

A5.67 Hedging with options tends to be complex due to the one-sided nature of the contracts. The FASB staff clarified the application of the Standard through the DIG process in light of those complexities. These clarifications are discussed in Paragraphs A5.69-A5.79 below.

Critical Terms Match

A5.68 As mentioned above, entities may conclude that a hedge of an existing asset, liability, or a firm commitment with a purchased option contract will have no ineffectiveness to be recognized in earnings if all critical terms match. However, if the entity believes the relationship would generate ineffectiveness if it were measured or effectiveness were assessed, the critical-terms-match approach should not be used. An initial effectiveness assessment must be performed and documented. The extent of that assessment is based on judgment and would vary depending on the complexity of the derivative and hedged item. That initial assessment might consist solely of a statement that the critical terms of the hedging instrument and the hedged item are the same and, accordingly, changes in fair value attributable to the risk being hedged are expected to be completely offset by the hedging derivative and no hedge ineffectiveness is expected (after consideration of the amounts excluded from the assessment of effectiveness and measurement of ineffectiveness). Subsequent assessment can be performed by verifying and documenting whether the critical terms of the hedging instrument and the hedged item changed during the period under review and whether there have been any developments concerning counterparty credit risk and an entity's own nonperformance risk related to the derivative hedging instrument that could affect the assessment of effectiveness and the conclusion of no ineffectiveness. If the conclusion is reached that there have been no changes in critical terms (which include the evaluation of creditworthiness of the counterparty to the derivative and the entity's own nonperformance risk), entities can document and conclude that the hedging relationship has been perfectly effective and there is no ineffectiveness to measure. An important component of this process is the assessment of whether there have been developments in the creditworthiness of the
counterparty to the option contract or the entity's own nonperformance risk. DIG Issue G10 states that a change in the counterparty’s creditworthiness of a derivative instrument in a fair value hedging relationship would have an immediate impact on the assessment of effectiveness and measurement of ineffectiveness. We believe it is appropriate to analogize the guidance in DIG Issue G10 to also include changes in the entity's own nonperformance risk. Therefore, a change in either the counterparty's credit risk or the entity's own nonperformance risk would affect the fair value of the derivative hedging instrument and preclude the use of the critical-terms-match approach. In that circumstance, the assumption of no ineffectiveness would no longer be appropriate and the entity should evaluate the fair value hedging relationship under the long haul method. If the hedge effectiveness testing under the long haul method results in a conclusion that the hedge is no longer highly effective, the hedging relationship would cease and the carrying amount of the hedged item would no longer be adjusted for changes in its fair value attributable to the risk being hedged.

The critical terms match if:

- The option is for the same quantity of the same underlying and at the same location as the hedged item (for nonfinancial underlyings). For example, an entity hedging a firm commitment to sell natural gas with delivery at Henry Hub, Louisiana can assume that an option will be fully effective only if the option’s underlying is natural gas with delivery at Henry Hub, Louisiana and is for the same quantity as the firm commitment, and;

- All of the time elements of the option are excluded from the assessment of effectiveness and included directly in earnings. (See Paragraphs A5.12-A5.14, above).

Under the critical-terms-match approach, when there have been no changes in critical terms, amounts recognized in earnings each period are limited to the change in the fair value of the derivative hedging instrument that is attributable to changes in time value of the option.

Other Issues Related to Options

A5.69 When excluding the time value of the hedging option derivative from the assessment of effectiveness and measurement of ineffectiveness as discussed in Paragraph A5.12 above, the following issues should be considered:

- The various measures of intrinsic value;
- The requirement that all changes in intrinsic value be included in the assessment of hedge effectiveness and measurement of ineffectiveness; and
- The ability to exclude certain portions of the change in time value from the assessment of hedge effectiveness and measurement of ineffectiveness.

VARIOUS MEASURES OF INTRINSIC VALUE

A5.70 As indicated in Paragraph A5.64 above, the total value of an option contract, at a point in time, can be separated into time value and intrinsic value. Market convention considers all of the following to be measures of intrinsic value:
• The difference between the strike price and the spot price of the underlying asset,
• The present value of the difference between the strike price and the forward price of the underlying asset, and
• The difference between the strike price and the forward price of the underlying, undiscounted.

**A5.71** An entity may assess effectiveness and measure ineffectiveness using either of the first two of these three methods when an option is used as the hedging instrument in a fair value hedging relationship. (However, in the area of cash flow hedge accounting, there is more flexibility in the measurement of the change in value of the hedged cash flow, and, accordingly, the last of these three methods may be used only in a cash flow hedging relationship.) As part of the overall documentation for each hedging relationship, entities must document the measure of intrinsic value that will be used in the assessment of hedge effectiveness and measurement of ineffectiveness. That measure must be used consistently for each period following designation of the hedging relationship. (See DIG Issue E19 for further reference.)

**REQUIREMENT TO INCLUDE ALL CHANGES IN INTRINSIC VALUE IN EFFECTIVENESS ASSESSMENT AND INEFFECTIVENESS MEASUREMENT**

**A5.72** Regardless of how an entity measures the intrinsic value of an option in a fair value hedging relationship for effectiveness assessment testing, that assessment of effectiveness (and related fair value hedge accounting) must be performed for all changes in the intrinsic value, i.e., for all periods of time when the option has an intrinsic value, however calculated. As a result, an entity cannot arbitrarily exclude some portion of the option’s intrinsic value from the hedge effectiveness assessment and measurement of ineffectiveness simply through an articulation of the risk exposure definition.

**ABILITY TO EXCLUDE CERTAIN PORTIONS OF THE CHANGE IN TIME VALUE FROM EFFECTIVENESS ASSESSMENT AND INEFFECTIVENESS MEASUREMENT**

**A5.73** As described in Paragraph A5.12 of this appendix, entities commonly seek to exclude the time value component of a derivative hedging instrument from the assessment of effectiveness and measurement of ineffectiveness because that component is not relevant to the entity’s risk management strategy. Instead of excluding all of the change in time value, entities may exclude the portion of the change in time value of an option attributable to:

- The passage of time (theta);
- Volatility (vega); and
- Interest rates (rho).

However, entities may not exclude from the assessment of hedge effectiveness and measurement of ineffectiveness the aspect of the change in time value due to changes in other market variables (i.e., other than rho and vega). (See DIG Issue E19 for further reference.)

**A5.74** To compute the changes in an option’s time value that would be excluded from the assessment of hedge effectiveness and measurement of ineffectiveness, entities must use a technique that appropriately isolates those aspects of the change in time value. Generally, to
allocate the total change in an option’s time value to its different aspects (i.e., the passage of time and the market variables) the change in time value attributable to the first aspect to be isolated is determined by holding all other aspects constant as of the beginning of the period. Each remaining aspect of the change in time value is then determined in turn in a specified order based on the ending values of the previously isolated aspects. If one aspect of the change in time value is excluded from the assessment of hedge effectiveness and measurement of ineffectiveness (e.g., \( \theta \)), that aspect must be the first aspect for which the change in time value is computed and would be determined by holding all other parameters constant for the period used to assess hedge effectiveness. However, in cases in which more than one aspect of the change in time value is excluded from the assessment of hedge effectiveness and measurement of ineffectiveness (e.g., \( \theta \) and \( \nu \)), entities must determine the amount of that change in time value by isolating each of those two aspects in turn in a pre-specified order (one first, the other second). The second aspect to be isolated would be based on the ending value of the first isolated aspect and the beginning values of the remaining aspects. The portion of the change in time value that is included in the assessment of effectiveness and measurement of ineffectiveness is determined by deducting from the total change in time value the portion of the change in time value attributable to excluded components. (See DIG Issue E19 for further reference.)

**Combination of Options**

**DIFFERENT NOTIONAL AMOUNTS**

A5.75 In DIG Issue E18, the FASB staff concluded that when a hedging relationship in which a zero-cost collar that comprises a single purchased option and single written option that have different notional amounts is designated as the hedging instrument and the hedge’s effectiveness is assessed based on changes in the collar’s intrinsic value, the hedged item may be specified as two different proportions of the same asset referenced in the collar, based on the upper and lower price ranges specified in the two options that comprise the collar. That is, the quantities of the forecasted transaction that is designated as being hedged may be different based on the price ranges in which the collar’s intrinsic value is other than zero. This strategy is used by entities that seek full protection from downside risk while partially paying for this protection by selling some of the upside potential. This approach is permitted only for zero-cost collars that are a combination of a single written option and a single purchased option for which the underlying in both options is the same. The FASB staff stated that this approach cannot be analogized for other derivatives that are designated as hedging instruments. We believe the prohibition from analogizing to this approach is meant to preclude entities, such as those in the mortgage banking industry, from designating the hedged item at the inception of a hedging relationship by initially specifying a series of possible percentages of the hedged item, such as a servicing right asset, so that each corresponds to a specified independent variable, such as an interest rate, as discussed in Paragraph 21a.25 of this section. Therefore, we believe entities may be able to enter into hedging relationships in which effectiveness is based on the intrinsic value of a combination of options when that combination of options is not within the scope of the FASB staff’s guidance. For example, we believe a hedging relationship that involves a combination of options in which the notional amounts are the same, but the strike prices are different, is not equivalent to the hedging relationship covered by the staff’s guidance. (See Question 26 in the Questions and Answers section that follows this appendix.) (See DIG Issues E18, G15, and G20 for further reference.)
A5.76 The following example illustrates the application of this approach:

EMT enters into a zero-cost collar that contains the following combination of options:

- A purchased put option with a notional amount equal to 20,000 shares of MAD stock and a strike price of $100 per share. The purchased put option provides EMT a return of $20,000 for each dollar that the price of MAD falls below $100.

- A written call option with a notional amount equal to 14,000 shares of MAD stock and a strike price of $120 per share. The written call option obligates EMT to pay $14,000 for each dollar that the price of MAD stock increases above $120.

EMT has 20,000 shares of MAD stock classified as available-for-sale. The current market value is $100 per share.

This zero-cost collar qualifies as the hedging instrument in a fair value hedge of the overall changes in fair value of MAD stock. The hedged risk is changes in the overall fair value of the hedged item, which is 100% of 20,000 shares of MAD stock for price changes below $100 per share and 70% of each of the same 20,000 shares of MAD stock for price changes above $120 per share. Fair value hedge accounting can be applied for those changes in the underlying (i.e., market price of MAD stock) that cause changes in the collar’s intrinsic value (i.e., decreases below $100 per share and increases above $120 per share).

EFFECTIVENESS ASSESSMENT ONLY WHEN INTRINSIC VALUE CHANGES

A5.77 In a fair value hedging relationship in which a combination of options (deemed to be a net purchased option) is designated as the hedging instrument and the effectiveness of the hedge is assessed based only on changes in intrinsic value of the hedging instrument(s), the assessment of effectiveness may be based only on changes in the underlying that cause a change in the intrinsic value of the hedging instrument(s). As a result, the assessment should exclude ranges of changes in the underlying for which there is no change in the hedging instrument’s intrinsic value. Accordingly, hedging relationships that offer protection only within various ranges of changes in the underlying, instead of in all ranges of change, may qualify for fair value hedge accounting if the hedging instrument (a combination of options) is considered a purchased option or a net purchased option. Since the changes in the hedging instrument’s underlying that occur outside of the various ranges not covered in the hedging strategy are excluded from the assessment of hedge effectiveness, the related changes in the fair value of the combination option for the excluded components would be currently recognized in earnings.

DIFFERENT UNDERLYINGS

A5.78 The financial marketplace developed complex option contracts to simultaneously mitigate the effects of a variety of risks. Often, these complex options contain multiple underlyings and are structured to achieve certain economic results. When an entity uses complex option contracts in a fair value hedging relationship, all of the requirements in the Standard must be met to apply hedge accounting. When reviewing those requirements, the following should be kept in mind:

- If the hedged item is a group of individual items, those individual items must share the same risk exposure for which they are designated as being hedged. Thus, the hedged item cannot be a group of assets and liabilities since the Standard was not
structured to permit hedge accounting for strategies that involve hedges of a spread between assets and liabilities.

- The hedging relationship must be expected to be highly effective, both at inception and throughout the hedge period, in achieving offsetting changes in fair values attributable to the hedged risk. Paragraphs 21(e) and 21(f) of the Standard (ASC paragraphs 815-20-25-12(e) and 25-12(f)) indicate the risks that an entity may designate as the hedged risk. When defining the risk to be hedged, an entity cannot indicate that it is hedging a specific risk but only when another specific risk is also present, even when the complex option contains two or more underlyings that are economically related to those risks. For example, an entity cannot define its hedging strategy as hedging the risk of changes in fair value due to changes in the benchmark interest rate of a firm commitment to purchase a fixed-rate bond, but only when oil prices are above a certain level.

Dynamic Hedging Strategies

A5.79 Under the Standard, it is inappropriate for an entity to designate a derivative as the hedging instrument when the entity expects that the derivative will not be highly effective in achieving offsetting changes in fair values attributable to the hedged risk during the period over which effectiveness will be assessed. However, an entity may document undertaking a dynamic hedging strategy in which it commits itself to an ongoing repositioning strategy for its hedging relationship and to an assessment period that is shorter than the term of the hedging instrument. In this way, high effectiveness is expected over that assessment period. The Standard provides an example of a dynamic hedging strategy as follows: in a delta-neutral dynamic hedging strategy, the entity commits to constant monitoring of the option’s delta—the ratio of changes in the option’s price to changes in the price of the hedged item. As the delta ratio changes, that entity must rebalance the portfolio of options (i.e., buy or sell options) so that the change in the fair value of all of the options held can be expected to counterbalance or offset the next change in the value of the hedged item. Thus, in a delta-neutral hedging strategy, the hedging instrument is constantly being changed and the assessment of effectiveness considers only the next change in fair value. A rebalancing of the hedging derivatives in a hedging relationship calls for a discontinuation of that relationship. Thus, in a dynamic hedging strategy, a new hedging relationship must be established and documented whenever a rebalancing is done. See Paragraph 25.04 of this section for a further discussion of this issue.

IMPACT OF MASTER NETTING AGREEMENTS ON DERIVATIVE INSTRUMENTS

A5.80 As discussed in Section 4, when derivative instruments are subject to a master netting agreement, the determination of their fair value must incorporate the master netting agreement. Thus, when an entity has a portfolio of derivative instruments with a counterparty subject to a master netting agreement, the fair value measurement of the derivative instruments is often made at the portfolio level even though the portfolio is comprised of more than one unit of account. In determining the fair value of the derivative instruments subject to the master netting agreement at the portfolio level, counterparty credit risk and an entity’s own nonperformance risk generally would be calculated as a top level adjustment for credit risk on a portfolio basis. However, for
applying hedge accounting, the Standard requires that the assessment of effectiveness and measurement of ineffectiveness be performed at the individual hedge relationship level. As the assessment of effectiveness and measurement of ineffectiveness require the comparison of the changes in the fair value of the derivative hedging instrument to the changes in the fair value of the hedged item, a change in the fair value of the derivative instrument will impact the assessment and measurement.

A5.81 Questions have arisen as to whether an entity with a portfolio of derivative instruments subject to a master netting agreement that includes derivatives designated as hedging instruments, must allocate the portfolio level credit adjustment to the individual derivative instruments that are part of the hedging relationships. The following guidance related to the impact of credit risk on derivative instruments subject to master netting agreements is based on discussions with the SEC and FASB staffs and affects hedging relationships differently based on the method used for assessing effectiveness and measuring ineffectiveness.

Assessment of Effectiveness Analysis

A5.82 For fair value hedges applying the shortcut method, Statement 133 (including the guidance in DIG Issues G10 and E4) allows an entity to conclude that, excluding other sources of ineffectiveness, the hedging relationship would qualify for the shortcut method, and thus no ineffectiveness would be recognized, if the likelihood that the interest rate swap's counterparty or the entity itself will not default is deemed probable. Therefore, changes in the fair value of the swap due to changes in counterparty credit risk and the entity’s own nonperformance risk would be recorded in earnings with the same amount recorded as a basis adjustment to the hedged item. As such, if the swap was subject to a master netting agreement and the likelihood of either party to the contract not defaulting is probable, an entity could conclude that the hedging relationship would be highly effective without performing an allocation of the portfolio level credit adjustment. However, an allocation may be necessary to account for the basis adjustment of the hedged item (refer to the discussion of measurement of ineffectiveness below). Nonetheless, shortcut method fair value hedging relationships would need to be terminated as discussed in Paragraph A5.57b once an entity cannot conclude that the likelihood of the counterparty to the swap or the entity itself not defaulting is probable.

A5.83 For fair value hedges accounted for using long-haul, changes in the fair value of a derivative related to counterparty credit risk and an entity’s own nonperformance risk would have an immediate impact on the assessment of effectiveness and measurement of ineffectiveness, based on the guidance provided in DIG Issue G10. Therefore, if the master netting agreement contains derivatives that are hedging instruments in fair value hedges accounted for using long-haul, an entity would need to consider the impact of any changes in credit risk on the effectiveness assessment. This would normally necessitate the allocation of the portfolio level credit adjustment to individual derivatives unless the entity applies the following guidance. The SEC staff has stated that an entity must perform an analysis (either qualitative or quantitative) to determine if it is necessary to allocate the portfolio level credit adjustment to the individual derivative instruments subject to the master netting agreement for the purpose of assessing effectiveness. The SEC staff would not object to the use of a qualitative analysis to conclude that it is not necessary to allocate the portfolio level credit adjustment to the individual derivative instruments subject to the master netting agreement for the purpose of assessing
effectiveness, as long as the qualitative analysis results in a reasonable conclusion, based on the specific facts and circumstances. The SEC staff indicated that an entity should use reasonable judgment in performing the qualitative analysis.

**A5.84** The qualitative analysis should consider all relevant facts and circumstances, including: the size of the portfolio level credit adjustment; the hedging relationships’ degree of effectiveness without considering the portfolio level credit adjustment; the creditworthiness of the counterparty and the entity itself; the probability of default by either party; the method used to assess effectiveness; and other potential future sources of ineffectiveness. If an entity is unable to conclude that the likelihood of the counterparty or the entity itself not defaulting is probable, a solely qualitative analysis would not be appropriate. However, the SEC staff indicated that a conclusion that the likelihood of the counterparty or the entity itself not defaulting is deemed probable, by itself, is not a sufficient qualitative analysis. For example, assume that an entity’s derivative instruments are subject to a master netting agreement. The net position under the master netting agreement is a $10 billion liability position and the portfolio level credit adjustment is $1 million. The derivative instruments subject to the master netting agreement are part of fair value hedging relationships accounted for under long-haul, and the entity uses regression for assessment purposes. Both the counterparty to the derivatives and the entity itself are AA-rated and the likelihood of either party not defaulting is deemed probable. Other sources of ineffectiveness are minimal, such that the hedging relationships are at least 95% effective without consideration of the portfolio level credit adjustment. Based on these facts, an entity may conclude that a qualitative analysis is sufficient for determining an allocation of the portfolio level credit adjustment is not necessary for the purpose of assessing effectiveness.

**A5.85** If a reasonable conclusion that the hedging relationships including derivative instruments subject to the master netting agreement would be highly effective cannot be reached solely through a qualitative analysis, a quantitative analysis would be necessary. Quantitative procedures may include the selection of an allocation approach for the portfolio level credit adjustment, the completion of the allocation, and an assessment of effectiveness on an individual hedging relationship basis using fair values of the derivative(s) including the impact of the allocation. If the entity determines that a quantitative analysis is necessary and that the portfolio level credit adjustment needs to be allocated to the derivative instruments within a portfolio, it should identify a systematic and rational allocation method and should apply that method consistently.

**A5.85a** The following are examples of methods for allocating portfolio level credit adjustments that would be considered systematic and rational. However, other methods may be appropriate for purposes of allocating a portfolio level credit adjustment to the individual derivatives within the portfolio. Because a derivative portfolio consists of assets and liabilities, the portfolio level credit adjustment allocations to the individual derivatives would include increases and decreases that should sum up to the overall credit adjustment for the portfolio.

- Marginal contribution allocation - Allocate a portion of the portfolio level credit adjustment to each derivative instrument within the portfolio by determining the incremental amount that each derivative instrument within the portfolio contributes to the overall portfolio level credit adjustment.
• Relative fair value allocation - Allocate a portion of the portfolio level credit adjustment to each derivative instrument within the portfolio in proportion to the relative fair values of each of the derivative instruments to the fair value of the portfolio.

• In-exchange fair value allocation - Allocate a portion of the portfolio level credit adjustment to each derivative instrument within the portfolio in proportion to the in-exchange fair value of each derivative instrument (that is, the standalone value of each derivative as if it were not within a portfolio).

• Relative credit adjustment allocation - Allocate a portion of the portfolio level credit adjustment to each derivative instrument within the portfolio in proportion to the relative credit adjustment that would be required for each of the derivative instruments on a stand-alone basis. Similar to the in-exchange fair value allocation approach, the use of an in-exchange measurement would be applied to each derivative instrument within the portfolio to apply this method.

A5.85b In May 2011, the FASB issued ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (ASU 2011-04 or the ASU) which, among other things, addresses the fair value measurement of financial instruments with offsetting market or counterparty credit risks. The ASU has an effective date for interim and annual periods beginning after December 15, 2011 for public entities and annual periods beginning after December 15, 2011 for nonpublic entities. Nonpublic entities may early-adopt the ASU for any interim period beginning after December 15, 2011. The examples above are systematic and rational methods for allocating portfolio level credit adjustments to the individual derivative instruments within that portfolio. This would often apply to derivative instruments subject to master netting agreements. The portfolio measurement guidance provided in the ASU however, would also apply to portfolios of derivative instruments that are not subject to a master netting agreement. Further, it also would apply to nonderivative financial instruments. Regardless of the method that an entity uses, the appropriate allocation method is affected by the fair value hierarchy of the financial instruments within the portfolio. We understand from conversations with the FASB staff that the FASB staff believes the fair value allocated to financial instruments within the portfolio classified in Level 1 of the fair value hierarchy should be determined using the instrument price times the quantity (PxQ) consistent with the guidance in paragraph 27 of Statement 157 (ASC 820-10-35-44). We would expect that this would not apply to portfolio level credit adjustments because the portfolio to which such adjustments would apply would likely not contain Level 1 derivative instruments. However, this may be applicable to adjustments related to other risks such as interest rate, foreign currency or price risks because the portfolio to which these adjustments would apply may contain Level 1 instruments. For example, assume an entity holds 10,000 exchange-traded equity securities and has an offsetting position of forward contracts to sell 6,000 of the same exchange traded equity securities. In addition, the entity concludes the portfolio measurement exception criteria have been met and the entity has elected to apply the net portfolio exception. The entity should allocate to the forward contracts the fair value measurement adjustment that resulted from the valuation of the net portfolio position with no adjustment being allocated to the Level 1 equity securities (i.e., equity securities are valued at PxQ). If allocating the net portfolio adjustment to the forward contracts results in an unexpected basis in the forward contracts, the entity should
carefully reevaluate the appropriateness of using the net portfolio exception. See Paragraphs 17.03a and 17.07c1 of Section 4 for additional information.

**Measurement of Ineffectiveness Analysis**

A5.86 If the master netting agreement contains derivatives that are hedging instruments in fair value hedges accounted for using the shortcut method, an entity also must determine if it is necessary to allocate the portfolio level credit adjustment to the individual derivative instruments for the purpose of calculating the basis adjustment of the hedged item. An entity may perform an analysis instead of performing the allocation to determine if it is necessary to allocate the portfolio level credit adjustment to the individual derivative instruments subject to the master netting agreement to ascertain if the amounts recorded on the income statement and balance sheet related to derivatives in hedging relationships subject to the master netting agreement are reasonably stated (basis of hedged item versus earnings). A qualitative analysis similar to the analysis of the assessment of effectiveness may be used as long as it considers the analysis’ objectives. These objectives relate to the reasonableness of the hedging relationship’s impact on the basis of the hedged item and earnings. If an allocation of the portfolio level credit adjustment to the individual derivatives under the master netting agreement is not deemed necessary, amounts related to the portfolio level credit adjustment would be recorded in earnings rather than recorded in the basis of the hedged item.

A5.87 If a reasonable conclusion that the amounts recorded on the income statement and balance sheet related to derivatives in hedging relationships subject to the master netting agreement are reasonably stated cannot be reached based on a solely qualitative analysis, a quantitative analysis would be necessary. Quantitative procedures may include the selection of an allocation approach (refer to discussion in Assessment of Effectiveness Analysis section), the completion of the allocation, and the potential adjustment of the basis of the hedged item to include the effect of the allocation. No analysis is required related to the measurement of ineffectiveness for fair value hedges accounted for using long-haul as any ineffectiveness related to those hedging relationships would be recorded directly in earnings. As such, there is no impact to the financial statements if the portfolio level credit adjustment is allocated to the individual derivatives and recorded in earnings or if the portfolio level credit adjustment is not allocated to the individual derivatives and is recorded in earnings in its totality.

**Timing of Procedures and Ongoing Requirements**

A5.88 This qualitative or quantitative analysis should be considered as an additional component of the assessment of effectiveness for fair value hedges accounted for using long-haul and the monitoring of credit for fair value hedges accounted for under the shortcut method. Therefore, in order for an entity to continue to apply hedge accounting related to derivative instruments subject to a master netting agreement subsequent to the adoption of the guidance, we would expect either a qualitative or quantitative analysis to be performed as often as the hedge documentation for the hedging relationship requires an assessment of effectiveness (long-haul hedges) and the monitoring of credit (shortcut method hedges), whether on a daily, weekly, monthly, quarterly, or other basis.

A5.89 This guidance should not be analogized to other fact patterns.
QUESTIONS & ANSWERS

**Definition of a Fair Value Hedge (Paragraph 20 of the Standard) (ASC paragraphs 815-20-25-1, 25-3, 25-11, and 25-75 through 25-95)**

1. SWM owns 100 shares of Company B common stock. SWM is restricted from selling the common stock for one month. SWM is concerned that Company B’s share price will decline in the coming months and decides to hedge this exposure by entering into a short position in Company B’s stock. To do so, SWM borrows 100 shares of Company B stock from Bank X for a one-month period. SWM immediately sells these shares in the open market at fair market value. At the end of the month, SWM satisfies its obligation to Bank X using the 100 shares of Company B that it owns.

   Q. Would SWM be permitted to designate the short position as a fair value hedge of its investment in Company B?

   A. No. Paragraph 20 of the Standard (ASC paragraphs 815-20-25-1, 25-3, 25-11, and 25-75 through 25-95) generally prohibits nonderivative financial instruments from being designated as the derivative hedging instrument in a fair value hedge. Short positions generally do not meet the definition of a derivative instrument under paragraphs 6(b) (ASC paragraph 815-10-15-83(b)) and 8 of the Standard (ASC paragraphs 815-10-15-94 and 15-95) because they require an initial investment equal to the notional amount. In this instance, at inception of the contract SWM was required to borrow 100 shares of Company B, which is the notional amount. As a consequence, this transaction would not qualify as a fair value hedge.

   In paragraph 290 of the Standard, the Board intentionally did not address whether short sales arrangements would always (or never) meet the definition of a derivative instrument pursuant to paragraph 6 of the Standard (ASC paragraph 815-10-15-83) because the terms and customs of the contracts vary. Instead, the specific terms of the contract must be evaluated to determine whether it meets the Standard’s definition of a derivative instrument.

2. Q. Can an instrument like a swaption, which is an option on a swap, qualify as a derivative hedging instrument in a fair value hedge for the writer of the option?

   A. Although it is unlikely, a swaption could qualify as a derivative hedging instrument provided all the requirements in paragraph 20(c) of the Standard (ASC paragraph 815-20-25-94) as well as all the other hedge criteria are met. Paragraph 20(c) of the Standard (ASC paragraph 815-20-25-94) states that a written option (or net written option) can qualify for hedge accounting of a recognized asset or liability, or an unrecognized firm commitment, if the combination of the hedged item and the written option (or net written option) provides at least as much potential for gains as a result of increases in the fair value of the combined instruments as exposure to losses from declines in their combined fair value. Paragraph 20(c)(1) (ASC paragraph 815-20-25-88) states that a derivative that results from combining a written option and any other nonoption derivative is considered a written option. Thus, paragraph 20(c) (ASC paragraph 815-20-25-94) applies to a swaption.

3. Q. An entity that is the issuer of fixed-rate debt enters into an interest rate swap (Swap 1) and designates it as a hedge of the fair value exposure of the debt to interest rate risk. The fair
value hedge of the fixed-rate debt involving Swap 1 meets the criteria in paragraphs 20 (ASC paragraphs 815-20-25-1, 25-3, 25-11, and 25-75 through 25-95) and 21 of the Standard (ASC paragraphs 815-20-55-11 through 55-16) to qualify for hedge accounting. The entity simultaneously enters into a second interest rate swap (Swap 2) with the same counterparty with the exact mirror terms as Swap 1 and does not designate Swap 2 as part of that hedging relationship. Is the entity required to view the two swaps as a unit and is it, therefore, precluded from applying fair value hedge accounting to Swap 1, by analogy to DIG Issue No. K1, “Determining Whether Separate Transactions Should Be Viewed as a Unit”? (DIG Issue E6)

A. Generally, no. The Standard is a transaction-based standard. It generally does not provide for the combination of separate financial instruments to be evaluated as a unit, unless two or more derivatives in combination are designated as a hedging instrument. The guidance in DIG Issue K1 is an exception to the fundamental principle that the Standard is a transaction-based standard. However, the guidance in that issue is meant to be applied in circumstances in which there is an attempt to circumvent accounting for a derivative contract. In this example, the swaps were not entered into to circumvent the definition of a derivative in the Standard.

However, similar to the reasoning in DIG Issue K1, if certain indicators are present, those indicators should be considered in determining whether the overall intent of a transaction is to circumvent generally accepted accounting principles. That is, if separate derivative contracts are entered into contemporaneously and in contemplation of one another, if they are entered into with the same counterparty, if they relate to the same risk, and if there is no substantive business purpose for structuring the transactions separately, judgment should be applied to determine whether the separate derivative contracts have been entered into in lieu of a structured transaction in an effort to circumvent GAAP. In instances where such a determination is made, the derivative contracts should be viewed as a unit.

In this example (in which Swaps 1 and 2 were entered into contemporaneously with the same counterparty), if Swap 2 was entered into in contemplation of Swap 1 and the overall transaction was executed for the sole purpose of obtaining fair value accounting treatment for the debt, it should be concluded that the purpose of the transaction was not to enter into a bona fide hedging relationship involving Swap 1. In that case, the two swaps should be viewed as a unit and the entity would not be permitted to adjust the carrying value of the debt to reflect changes in fair value attributable to interest rate risk.

However, if Swap 2 was not entered into in contemplation of Swap 1 or there is a substantive business purpose for structuring the transactions separately, and if both Swap 1 and Swap 2 were entered into in arms-length transactions (i.e., at market rates), then the swaps should not be viewed as a unit.

Qualifying Hedge Criteria-Formal Documentation (Paragraph 20(a) of the Standard) (ASC paragraph 815-20-25-3)

4. Q. What methodology does the Standard prescribe for determining whether a hedging relationship is highly effective?

A. The Standard does not specify a methodology that is required to be used in determining whether a hedging relationship is highly effective. Rather, paragraph 20 of the Standard (ASC
paragraphs 815-20-25-1, 25-3, 25-11, and 25-75 through 25-95) requires an entity, at the inception of a hedge, to define how it will assess a derivative hedging instrument’s effectiveness in achieving offsetting changes in the hedged item’s fair value attributable to the risk being hedged.

For example, if a hedging relationship involving an interest rate swap and recognized interest-bearing financial instrument meets the conditions set forth in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106), an entity may assume no ineffectiveness (referred to as the shortcut method). We believe that the entity’s documentation at the inception of the hedging relationship should set forth how the criteria of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106) are met. However, if the hedging relationship involves a hedging instrument other than an interest rate swap, but the critical terms of the hedging instrument and the hedged item match, the relationship is not eligible for the shortcut method, but the entity can conclude that changes in fair value attributable to the risk being hedged are expected to be completely offset by the hedging derivative. At inception of the hedging relationship, the entity will need to assess whether the relationship is expected to be perfectly effective. Subsequent effectiveness assessments and measurements of ineffectiveness can be performed by only verifying and documenting whether the critical terms have changed during the period under review (including consideration of the credit risk of the counterparty to the derivative and the entity’s own nonperformance risk).

The Standard requires that the methodology used be reasonable. The Standard also requires that the assessment of hedge effectiveness be used in a consistent manner throughout the hedge period and that it is used for similar types of hedges. (See Paragraph A5.05 for additional discussion of hedge effectiveness.)

**Shortcut Method of Assessing Effectiveness (Paragraphs 20(b)-70 of the Standard (ASC paragraphs 815-20-25-75 and 25-76, 815-20-25-102 through 25-111))**

5. Q. Can the shortcut method be applied if most but not all of the applicable conditions in paragraph 68 (ASC paragraphs 815-20-25-102 through 25-106) are met?

A. No. The shortcut method can be applied only if all of the applicable conditions in paragraph 68 are met. That is, all the conditions applicable to fair value hedges must be met to apply the shortcut method to a fair value hedge and all the conditions applicable to cash flow hedges must be met to apply the shortcut method to a cash flow hedge. A hedging relationship cannot qualify for application of the shortcut method based on an assumption of no ineffectiveness justified by applying other criteria.

6. Q. Can the shortcut method be applied to a fair value hedge of a callable interest-bearing debt instrument if the hedging interest rate swap has matching call provisions?

A. An entity is not precluded from applying the shortcut method to a fair value hedging relationship of interest rate risk involving an interest-bearing asset or liability that is prepayable due to an embedded call option provided that the hedging interest rate swap contains a mirror-image call option. The call option combined with the swap is considered a mirror image of the call option embedded in the hedged item if (a) the terms of the two call options match exactly (including matching maturities, strike prices, related notional amounts, timing and frequency of payments, and dates on which the instruments may be called) and (b)
7. Q. Can the shortcut method be applied to a hedging relationship that involves the use of an interest rate swap-in-arrears?

A. Yes. The shortcut method may be applied to a hedging relationship that involves the use of an interest rate swap-in-arrears provided all of the applicable conditions in paragraph 68 (ASC paragraphs 815-20-25-102 through 25-106) are met. While paragraph 68(k) (ASC paragraph 815-20-25-106(d)) may be problematic for cash flow hedges, there does not appear to be any criteria in paragraph 68 (ASC paragraphs 815-20-25-102 through 25-106) applicable to fair value hedges that would be problematic regarding this term. Therefore, as long as all the applicable conditions of paragraph 68 (ASC paragraphs 815-20-25-102 through 25-106) are met, the shortcut method is applicable.

8. Q. Can the shortcut method be applied to convertible debt?

A. No. Use of the shortcut method would not be appropriate as paragraph 68(e) (ASC paragraph 815-20-25-104(g)) could not be met. This is because the interaction and interdependency of the inherent and multiple risks of the hedged item (i.e., interest rate and equity risks) add a level of complexity not envisioned by the FASB in the shortcut method.

9. Q. Does an interest rate swap that has terms that would result in its fair value being other than zero (with the exception of an interest rate swap where the difference between the transaction price and the fair value is attributable solely to differing prices within the bid-ask spread as further discussed in Paragraph A5.41), absent an upfront payment to the counterparty, qualify for use in applying the shortcut method?

A. No. In accordance with paragraph 68 (b) of the Standard (ASC paragraph 815-20-25-104(c)), the shortcut method is not appropriate since the fair value of the swap at inception of the hedging relationship is not zero. In addition, contrary to paragraph 68(c) (ASC paragraph 815-20-25-104(d)), the formula for net settlements of the swap is not the same for each settlement date since an additional payment is due at inception.

10. Q. Can the shortcut method be applied when the first cash flow on the interest rate swap includes debt issuance fees?

A. No. Paragraph 68 (c) (ASC paragraph 815-20-25-104(d)) states that the formula for computing net settlements under the interest rate swap must be 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 or no adjustment.) Thus, if the first cash flow on the swap includes debt issuance fees, the swap is not eligible for the shortcut method since the formula for each net settlement is not the same.

11. Q. Can the shortcut method be applied to a fixed-rate debt with an interest rate that increases if the issuer’s credit rating deteriorates?

A. No. Use of the shortcut method would not be appropriate as paragraph 68(e) (ASC paragraph 815-20-25-104(g)) could not be met. This is because the change in the debt’s fair
value attributable to changes in the benchmark interest rate and the change in the fair value of
the interest rate swap with the fixed-leg interest rate equal to the debt’s original rate are not
expected to fully offset, thus invalidating the accounting assumption of no ineffectiveness. In
calculating the debt’s fair value attributable to changes in the benchmark interest rate, the
estimated cash flows used must be based on all contractual cash flows of the entire hedged
debt, including those potential increased cash flows (probability-weighted) due to a
deterioration of the issuer’s credit rating. The interest rate swap’s change in fair value would
not incorporate the potential increased cash flows. Even if the interest rate swap’s terms
incorporated the same increase in the fixed-leg as the debt, use of the shortcut method would
not be appropriate. This is because (a) the shortcut method can be used only when the risk
being hedged is interest rate risk and the hedging relationship would incorporate interest and
credit risks, (b) the interest rate swap would contain an option (the feature that increases the
interest rate in the fixed-leg), and (c) the fixed rate on the swap is not the same throughout the
term as required by paragraph 68(c) (ASC paragraph 815-20-25-104(d)), and thus would not
be eligible for the shortcut method.

Eligibility Requirements of Hedged Item-All Criteria (Paragraph 21 of the Standard)

12. LDB, an investment advisor, is the general partner of ABC Investment Co. LDB owns
20% of ABC and is considered to have significant influence over the affairs of ABC. Thus,
LDB uses the equity method of accounting for its investment in ABC. ABC invests in various
equity securities with the objective of replicating the Standard & Poor’s (S&P) 500. LDB
believes the S&P 500 will fall in the coming year and purchases a put option on the S&P 500
to hedge the exposure inherent in its investment in ABC.

Q. Will this put option qualify as a fair value hedge of LDB’s investment in ABC?
A. No. Paragraph 21(c)(2) of the Standard (ASC paragraph 815-20-25-43(b)(1)) prohibits
investments accounted for using the equity method of accounting from being designated as
hedged items. Accordingly, a hedge of LDB’s investment in ABC would not qualify for fair
value hedge accounting.

13. Q. Can a chocolate manufacturer designate a cocoa forward contract as a hedge of the
cocoa component of its chocolate inventory?
A. No. Paragraph 21(e) of the Standard (ASC paragraph 815-20-25-12(e)) prohibits a major
ingredient of a nonfinancial asset or liability from being designated as the hedged item. Rather,
the entire nonfinancial asset or liability must be designated as the hedged item. Accordingly,
the chocolate manufacturer would be permitted to use the cocoa forward as a hedge of its
chocolate inventory only if it could establish that the forward was highly effective in achieving
offsetting changes in the entire fair value of the chocolate inventory, inclusive of its location.

13a. Q. Entity A enters into an operating lease with fixed lease payments that represents a firm
commitment. If Entity A wishes to enter into a fair value hedge of the lease payments, can it
designate a specific risk (e.g., risk of changes in the benchmark interest rate) as the hedged
risk?
A. No. Under an operating lease, the lessor performs when, and only when, the leased asset(s) is made available to the lessee within the agreed upon time period (However, a lessee’s accounting for an operating lease will change under ASU 2016-02, Leases, and the lessee will generally recognize a nonfinancial right of use asset). Consequently, an operating lease is a nonfinancial executory contract, not a recognized financial asset or liability.

Paragraph 21(e) of the Standard (ASC paragraph 815-20-25-12(e)) requires that if a nonfinancial asset or liability is the hedged item, the designated risk being hedged is the risk of changes in the fair value of the entire hedged asset or liability. Consequently, in a fair value hedge of an operating lease, an entity would be unable to designate a specific risk (e.g., risk of changes in the benchmark interest rate) as the hedged risk. However, the entity would be permitted to designate the total changes in the fair value of the operating lease payments as the hedged risk.

13b Q. In a capital lease, can an entity designate a specific risk (e.g., risk of changes in the benchmark interest rate) as the hedged risk in a fair value hedge?

A. Yes. Under capital leases, financial assets and financial liabilities are recognized by the lessors and lessees, respectively. Paragraph 21(f) of the Standard (ASC paragraph 815-20-25-12(f)) permits specific types of risks to be hedged in a fair value hedge of a financial asset or liability. Therefore, an entity would be permitted to hedge risks such as interest rate risk, foreign exchange risk, and credit risk.

14. SMS entered into a contract to sell its wholly-owned subsidiary to Company X at a fixed price in one year.

Q. Would SMS be able to hedge the fair value of its wholly-owned subsidiary as a fair value hedge?

A. No. This transaction would not qualify as a fair value hedge because paragraph 21(c)(4) of the Standard (ASC paragraph 815-20-25-43(c)(4)) prohibits an equity investment in a consolidated subsidiary from being designated as the hedged item in a fair value hedge.

15. MJW enters into a contract to sell 100,000 bushels of wheat to EWT at the then fair value in one month. This transaction is considered a normal sale as defined in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 through 15-26). If MJW cancels this contract it will be required to pay a $50,000 penalty to EWT.

Q. Can MJW designate this contract to sell as a hedged item in a fair value hedge?

A. No. The definition of a firm commitment, as provided in Appendix F to the Standard (ASC Section 815-20-20), states, among other things, that all significant terms of the exchange are to be specified in the agreement. The price of the item to be purchased or sold is considered a significant term. Because this contract provides for the sale of wheat to EWT at fair value as opposed to a fixed price, it would not qualify as a firm commitment. However, this contract may qualify as a cash flow hedge of a forecasted transaction.

16. Redco owns 5% of CMM, a nonpublic company, and wants to enter into a derivative instrument to hedge this investment. Redco accounts for this investment using the cost method of accounting.
Q. Would Redco be permitted to hedge changes in the fair value of its investment in CMM?
A. Yes, assuming Redco was able to find a derivative instrument that would be highly effective in hedging the exposure to changes in the fair value of this investment.

17. An entity owns a fixed-rate loan receivable that is held-for-sale and measured at the lower of cost or market (LOCOM).

Q. Can this entity designate the changes in fair value of the loan attributable to changes in the benchmark interest rate as the hedged risk?
A. Yes. Paragraph 21(c)(1) of the Standard (ASC paragraph 815-20-25-43(c)(3)) prohibits designating as a hedged item an asset or liability that is remeasured with changes in fair value attributable to the hedged risk reported currently in earnings. Because a fixed-rate loan receivable that is held-for-sale and measured at LOCOM is carried at market only if market declines below cost, we do not believe the prohibition of paragraph 21(c)(1) (ASC paragraph 815-20-25-43(c)(3)) applies. Moreover, we do not believe the Board intended assets accounted for at LOCOM to be prohibited from being designated as a hedged item.

18. An entity enters into a firm commitment to purchase a security that will be classified in the entity’s trading portfolio.

Q. Can the firm commitment be designated as the hedged item in a fair value hedge?
A. No. Paragraph 21(c)(1) of the Standard (ASC paragraph 815-20-25-43(c)(3)) prohibits designating an asset or liability (including firm commitments to acquire an asset or incur a liability that will be) remeasured at fair value with changes in the fair value attributable to the hedged risk reported currently in earnings as a hedged item.

19. One of the characteristics of a firm commitment, as defined in Appendix F to the Standard (ASC Section 815-20-20), is that the agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable.

Q. Can the disincentive for nonperformance be in the form of opportunity cost? For example, can a disincentive exist when a manufacturer’s commitment to purchase certain raw materials from one supplier is considered probable because to purchase the same raw materials from other suppliers would be significantly more expensive? Can the disincentive for nonperformance be in the form of a potential write-off? For example, a significant amount of capitalized assets related to an in-process project may be considered worthless if certain materials needed to complete a project are not purchased from a particular supplier?
A. No. Paragraph 540 of the Standard (ASC Section 815-20-20) states that a firm commitment is an agreement that includes, among other things, a disincentive for nonperformance that is sufficiently large to make performance probable. The disincentives above are not included in the agreements, nor are they part of the legal rights or obligations codified in the laws to which such agreements are subject. Thus, we believe the agreements are not firm commitments.

20. Q. Can an entity designate a portion of a nonfinancial asset or liability (other than a recognized loan servicing right or a nonfinancial firm commitment with financial components) as the hedged item in a fair value hedge?
A. No. Paragraph 21(a)(2) of the Standard (ASC paragraph 815-20-25-12(b)(2)) permits a specific portion of an asset or liability to be the hedged item in a fair value hedge. However, paragraph 21(e) of the Standard (ASC paragraph 815-20-25-12(e)) requires that if a nonfinancial asset or liability (other than a recognized loan servicing right or a nonfinancial firm commitment with financial components) is the hedged item, the designated risk being hedged is the risk of changes in the fair value of the entire hedged asset or liability. Consequently, to meet the requirement of paragraph 21(e) (ASC paragraph 815-20-25-12(e)), an entity would be unable to designate only a portion of the nonfinancial asset or liability as the hedged item.

21. Company L owns a portfolio of stocks, classified as available-for-sale, that precisely comprises a specific equity index (i.e., 0% tracking error). Company L often hedges the changes in the overall fair value of the portfolio by purchasing the specific index put options or entering into short index forward contracts. Company L expects the change in fair value of the derivatives to be 100% effective at offsetting the overall fair value of the portfolio, excluding time value.

Q. Can Company L achieve fair value hedge accounting for this transaction?

A. No. Since the portfolio comprises the stock of various companies, it would not be expected that the market prices of each stock within the portfolio would respond in a generally proportionate manner to changes in the value of the overall portfolio as required by the similar assets test in paragraph 21(a)(1) of the Standard (ASC paragraph 815-20-25-12(b)(1)) to aggregate and hedge similar assets or liabilities as a portfolio.

22. Q. Can ABC Corp. hedge changes in the fair value of assets or liabilities of an investee when ABC applies the proportional consolidation method (which is applied frequently in the extractive industries when the investee is an unincorporated entity such as a partnership and no investor is considered to be controlling) to that investee?

A. Yes. As ABC’s investment in the underlying assets or liabilities of the investee is recognized in its financial statements, we believe the Company could hedge the recognized assets or liabilities as if the investee were a consolidated subsidiary, subject to all of the criteria in the Standard.

Accounting for a Fair Value Hedge (Paragraph 22 of the Standard) (ASC paragraph 815-25-35-1)

23. ALB purchased 10,000 units of widget inventory three months ago for $100,000. Since that time, the widgets have increased in value to $150,000. Because ALB carries its inventory at the lower of cost or market, ALB has not recognized the $50,000 appreciation in this inventory. To hedge the fair value of these 10,000 units of widget inventory, ALB purchases a put option to sell 10,000 widgets at a price of $15 each. ALB assesses effectiveness using the option’s intrinsic value.

Q. If, as of the next reporting date (e.g., one month later), the intrinsic value of the option has increased by $20,000 and the fair value of the inventory has declined by $20,000, at what amount would ALB carry this inventory on its books?
A. ALB would carry the inventory at $80,000, which represents the carrying amount of the inventory at inception of the hedge ($100,000) less the change in its fair value during the hedge period ($20,000). Under the Standard, preexisting gains and losses on the hedged item at the inception of the hedge would not be recognized in the statement of financial position, except when a fair value type hedge relationship exists at adoption of the Standard (see Section 9 for transition guidance). Thus, even though the fair value of the hedged inventory is $130,000, application of the fair value hedge accounting requirements results in this inventory being carried at an amount below its fair value. In essence, if the hedge is effective, the fair value hedge accounting approach has the effect of locking in the gain or loss that existed at the beginning of the hedge.

24. Q. Can an entity exclude the premium of an interest rate futures or forward contract from its assessment of hedge effectiveness?

A. Yes. The Standard permits the forward premium to be excluded on an interest rate futures or forward contract. Paragraph 63 of the Standard (ASC paragraphs 815-20-25-82 and 25-83) permits excluding all or a part of the derivative hedging instrument’s time value from the assessment of hedge effectiveness.

25. At inception of a hedging relationship, on January 1, 20X1, an entity formally documented that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. The entity also documented that its established policy for the range of what is considered highly effective is 80 to 125%. Assume the changes in fair value of the derivative hedging instrument and the hedged item attributable to the hedged risk during the three months ended March 31, 20X1 were $(50,000) and $45,000, respectively.

Q. Because the hedging relationship was highly effective during the three months ended March 31, 20X1 in achieving offsetting changes in fair value attributable to the hedged risk (i.e., $45,000/$50,000 = 90% effective) is the entity required to record in earnings the $5,000 which represents the loss on the derivative hedging instrument in excess of the gain on the hedged item?

A. Yes. Paragraph 22 of the Standard (ASC paragraph 815-25-35-1) states that the gain or loss on the hedging instrument should be recognized currently in earnings. In addition, 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 currently in earnings. Thus, even though the hedge performed as intended, the amount of ineffectiveness still must be recorded currently in earnings.

26. Company A owns a marketable equity security classified as available-for-sale. In an effort to limit the downside potential on the equity security, Company A entered into a put spread collar which comprises a written put option exercisable at the option of the counterparty at a lower put strike price of $43 per share, a purchased put option exercisable at the option of Company A at an upper put strike price of $74 per share, and a written call option exercisable at the option of the counterparty at a call strike price of $196 per share. At inception of the potential hedging relationship, the market price per share of the equity security was approximately $74 per share. The purpose of entering into the two written options was to mitigate the cost of entering into the purchased option. It should be noted that the combination
of options meets the criteria contained in DIG Issue E2 “Combinations of Options,” and is considered a net purchased option or zero-cost collar and not a net written option. Company A plans on assessing effectiveness based on the combination of the options’ intrinsic values. The put spread collar results in protection against changes in the fair value of the equity security when the price of the security is between the upper put strike price of $74 per share and the lower put strike price of $43 per share and when the price of the security is above the call strike price of $196 per share.

**Q.** For a fair value hedging relationship in which a combination of options (a written put option, a purchased put option and a written call option, referred to as a put spread collar) is designated as the hedging instrument, may the assessment of effectiveness exclude ranges of changes in the underlying for which there are no changes in the hedging instrument’s intrinsic value?

**A.** DIG Issue No. G15, “Combination of Options Involving One Written Option and Two Purchased Options,” addresses the issue of cash flow hedges involving combinations of options. The guidance provided by the DIG Issue indicates that when a combination of options is used as the hedging instrument, the assessment of hedge effectiveness can exclude ranges of changes in the underlying security for which there is no change in the hedging instrument’s intrinsic value. We believe that this guidance can be applied to fair value hedging relationships and relationships involving two written options and one purchased option when such combination is not a net written option.

Thus, the hedging relationship described above should be treated as a fair value hedge and accounted for as follows:

When the share price of the underlying security is between the upper strike price ($74) and the call strike price ($196) or below the lower put strike price ($43), changes in the fair value of the security should be reflected in OCI (i.e., no hedge accounting effect), while changes in the fair value of the put spread collar (entirely due to time value) should be reflected in earnings; and

When the price of the underlying security is between the lower put strike price ($43) and the upper put strike price ($74) or above the *call strike price* ($196), both the change in the fair value of the underlying security and the put spread collar should be reflected in earnings.

**27.** LH issues a floating rate, nonamortizing debt instrument with a maturity of two years. The variable liability resets every six months at the six-month LIBOR rate. At the same time, LH enters into a six-month interest rate swap agreement, with a notional amount equal to the face amount of the debt instrument. Under the terms of the swap agreement, LH will receive the six-month LIBOR rate and pay the one-month LIBOR rate. LH wants to designate the interest rate swap as a fair value hedge of changes in fair value of the variable-rate debt obligation attributable to changes in the benchmark interest rate.

**Q.** Would LH be able to designate the swap as a hedging instrument of changes in fair value of the variable-rate debt obligation, attributable to changes in the benchmark interest rate?

**A.** Yes. The variable-rate debt obligation has fair value exposure due to changes in interest rates during the six month period between LIBOR reset dates even though the obligation...
would be at fair value (due to changes in interest rates) on each reset date. Thus, the hedged risk would be the changes in fair value of the debt instrument due to the six-month fixed nature of the LIBOR-based interest rate.
INTRODUCTION

Many entities wish to reduce or eliminate variability of future cash flows to ensure that the amount and timing of those cash flows are either relatively fixed or that the cash flows of a forecasted transaction will change in a single direction, that is, either increase only or decrease only. For example, an entity may wish to eliminate all fluctuations in the cash flows associated with variable-rate debt, or may seek to reduce only the exposure to increases in the variable rate of interest.

Cash flow hedges are structured to reduce the variability in expected future cash flows due to changes in variable rates or prices. By entering into cash flow hedges, entities may reduce their cash flow variability exposure from either forecasted transactions or existing assets or liabilities. This type of hedging activity is different from a fair value hedge because a fair value hedge reduces the variability in the fair value of assets, liabilities, or firm commitments due to the fixed rates or prices inherent in those items.


DEFINITION OF A CASH FLOW HEDGE


28. An entity may designate a derivative instrument as hedging the exposure to variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction (such as a forecasted purchase or sale).

For purposes of paragraphs 28-35, the individual cash flows related to a recognized asset or liability and the cash flows related to a forecasted transaction are both referred to as a forecasted transaction or hedged transaction.

Derivative Implementation Group (DIG) Issues related to this paragraph are G2, G13, G14, G16, G25, and J3. See DIG Issues Index.

28.02 The objective of a cash flow hedge is to mitigate exposure to variability in expected future cash flows. Cash flow variability can be associated with either:

- Recognized variable-rate assets or liabilities (e.g., all or selected future interest receipts or payments); or
• Transactions that are expected to occur (e.g., forecasted purchases, sales, or borrowing transactions).

Throughout this section individual cash flows related to recognized variable-rate assets or liabilities and the cash flows related to forecasted transactions collectively are referred to as forecasted transactions.

28.03 Common examples of cash flow exposures and hedging strategies are:

**Exhibit 6.1: Cash Flow Exposures and Hedging Strategies**

<table>
<thead>
<tr>
<th>Cash Flow Exposure</th>
<th>Hedging Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Recognized assets and liabilities:</strong></td>
<td></td>
</tr>
<tr>
<td>Variable-rate assets – exposure to variability in interest receipts</td>
<td>Convert the interest received to fixed by entering into an interest rate swap for receipt of interest at a fixed rate and payment of interest at a variable rate.</td>
</tr>
<tr>
<td></td>
<td>Lock in a minimum yield by purchasing an interest rate floor option.</td>
</tr>
<tr>
<td>Variable-rate liabilities – exposure to variability in interest payments</td>
<td>Convert the interest paid to fixed by entering into an interest rate swap for receipt of interest at a variable rate and payment of interest at a fixed rate.</td>
</tr>
<tr>
<td></td>
<td>Lock in a maximum cost of funds by purchasing an interest rate cap option.</td>
</tr>
</tbody>
</table>

**Forecasted transactions:**

| Forecasted sale of a mortgage loan – exposure to variability in market prices to date of sale | Lock in a minimum price on the forecasted sale of a mortgage loan by purchasing a put option. |
| Forecasted issuance of a fixed-rate debt obligation – exposure to variability in market interest rates to date of issuance | Fix the interest rate on the forecasted issuance of a debt obligation by entering into an interest rate lock agreement or forward starting interest rate swap. |
| Forecasted purchase of inventory – exposure to variability in market prices to date of purchase | Lock in the cost of a forecasted purchase price of inventory by entering into a forward contract to purchase inventory. |
| Forecasted sale of inventory – exposure to variability in market prices to date of sale | Lock in the sales price of inventory by entering into a forward contract to sell inventory. |
Forecasted Transactions

28.04 Cash flow hedging applies to hedges of forecasted transactions. Appendix F (ASC Section 815-20-20) of the Standard defines a forecasted transaction as:

A transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices (emphasis added).

Appendix F (ASC Section 815-20-20) defines a firm commitment as:

An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

a. 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 an entity’s functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield.

b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable.

28.05 As more fully explained in Paragraphs 21a.05-21a.08 of Section 5, the key features of a firm commitment are the specificity of its terms (i.e., the quantity, fixed price, and timing), probability of occurrence, and enforceability. These features create exposures that are similar to exposures that exist for recognized assets and liabilities with fixed terms. In contrast, a forecasted transaction has variability because that transaction will occur at prevailing market rates or prices.

28.06 Entities may not choose which hedging model to apply to a transaction that it expects to occur. If a transaction qualifies as a firm commitment, the entity may apply only the fair value hedge accounting model (unless the risk being hedged is foreign currency risk, as further discussed in Paragraphs 37.03-37.07 and 40.14-40.15 of Section 7). Conversely, if a transaction qualifies as a forecasted transaction, the entity may apply only the cash flow hedge accounting model.

28.07 However, an entity may select, designate, and document the hedged item in a manner that allows it to use the hedging model that it wishes. For example, an entity may designate inventory as the hedged item in a fair value hedge or the forecasted sale of inventory as the hedged item in a cash flow hedge. Therefore, it is important that the hedged item be appropriately described and documented. The Standard’s eligibility requirements for forecasted transactions to be hedged in a cash flow hedge and special considerations in designating and documenting forecasted transactions are discussed in Paragraphs 29.01-29h.21 of this section.
CASH FLOW HEDGING CRITERIA

28.08 In its deliberations, the Financial Accounting Standards Board (FASB or Board) initially reasoned that hedge accounting for forecasted transactions was not conceptually defensible because the hedged item is not yet recognized in the financial statements. In essence, cash flow hedging involves designating an opportunity cost or a lost benefit as the hedged item. The Board was not comfortable that those items should, as a result of applying cash flow hedge accounting, result in recognized assets and liabilities. Rather than prohibit all cash flow hedge accounting, the Board decided to limit the use of hedge accounting to certain forecasted transactions and to require that the effective portion of the change in fair value of the hedging derivative in a cash flow hedge be reflected in Other Comprehensive Income (OCI) rather than record a forecasted transaction as an asset or liability. The Board concluded that the best way to limit the use of hedges of forecasted transactions was to impose criteria to qualify for cash flow hedge accounting. Those criteria are addressed in paragraphs 28 and 29 of the Standard (ASC paragraphs 815-20-25-1, 25-3, 25-13 through 25-15, 25-43, 25-50, 25-51, 25-75, 25-76, 25-80, 25-94, and 25-95). Specifically, the Standard contains the following two subsets of criteria that must be met:

• **Qualifying Hedge Criteria.** Paragraphs 28(a) - (d) of the Standard (ASC paragraphs 815-20-25-3, 25-13 through 25-15, 25-50, 25-51, 25-75, 25-76, 25-80, 25-94, and 25-95) discuss the criteria entities must meet for the combination of the hedging instrument and the hedged item (the combination of the derivative hedging instrument and the hedged item is referred to as the hedging relationship) to qualify for cash flow hedge accounting.

• **Eligibility Requirements of the Forecasted Transaction.** Paragraphs 29(a) - (h) of the Standard (ASC paragraph 815-20-25-15) discuss requirements that must be met for a forecasted transaction to be eligible for designation as the hedged item.

QUALIFYING HEDGE CRITERIA

28.09 This section discusses the qualifying hedge criteria and is organized as follows:

• Formal documentation (see paragraph 28(a) of the Standard (ASC paragraphs 815-20-25-3 and 25-13));

• Effectiveness of hedging relationships (see paragraph 28(b) of the Standard (ASC paragraphs 815-20-25-75, 25-76, 25-80));

• Special rule for written options (see paragraph 28(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95));

• Special rule for basis swaps (see paragraph 28(d) of the Standard (ASC paragraphs 815-20-25-50 and 25-51)); and

• Proscription against cash flow hedges involving nonderivative instruments.

28.10 Paragraph 28 of the Standard (ASC paragraph 815-20-25-1) states, in part:
28. Designated hedging instruments and hedged items or transactions qualify for cash flow hedge accounting if all of the following criteria and those in paragraph 29 are met:

**Formal Documentation**

28a.01 The Standard requires formal documentation of a cash flow hedge at its inception. This guidance is set forth in paragraph 28(a) of the Standard (ASC paragraph 815-20-25-3 and 25-13) as follows:

28a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged transaction, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in hedging the exposure to the hedged transaction’s variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness.

   (1) An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value from the assessment of hedge effectiveness, as discussed in (paragraph 63 in Section 2 of Appendix A).

   (2) Documentation shall include all relevant details, including the date on or period within which the forecasted transaction is expected to occur, the specific nature of asset or liability involved (if any), and the expected currency amount or quantity of the forecasted transaction.

      (a) The phrase expected currency amount refers to hedges of foreign currency exchange risk and requires specification of the exact amount of foreign currency being hedged.

      (b) The phrase expected...quantity refers to hedges of other risks and requires specification of the physical quantity (that is, the number of items or units of measure) encompassed by the hedged forecasted transaction. If a forecasted sale or purchase is being hedged for price risk, the hedged transaction cannot be specified solely in terms of expected currency amounts, nor can it be specified as a percentage of sales or purchases during a period. The current price of a forecasted transaction also should be identified to satisfy the criterion in paragraph 28(b) for offsetting cash flows.

The hedged forecasted transaction shall be described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. Thus, the forecasted transaction could be identified as the sale of either the first 15,000 units of a specific product sold during a specified 3-month period or the first 5,000 units of a specific product sold in each of 3 specific months, but it could not be identified as the sale of the last 15,000 units of that...
DIG Issue related to this paragraph is G9. See DIG Issues Index.

28a.02 For a transaction to qualify for hedge accounting, the Standard requires formal documentation that is contemporaneous with the inception of the hedge of both the hedging relationship and certain key elements of the hedging strategy. While the form of the documentation is at the discretion of an entity’s management, it must include the following:

- Risk management objective of the hedge and strategy for accomplishing the objective;
- Nature of the risk being hedged (see Paragraphs 29e.01, 29g.01 and 29h.01 of this section for eligible risks);
- Derivative hedging instrument;
- Hedged transaction;
- Manner in which the entity will retrospectively and prospectively assess hedge effectiveness (see Paragraph 28b.01 of this section); and
- Manner in which the entity will measure hedge ineffectiveness (see Paragraphs 28b.12-28b.16 of this section).

RISK MANAGEMENT OBJECTIVE AND STRATEGY

28a.03 Paragraph 28(a) (ASC paragraphs 815-20-25-3 and 25-13) of the Standard requires that an entity formally document, at inception of the hedge, its risk management objective and strategy for undertaking the hedge. The primary objective of this requirement is to identify the nature of the risk being hedged and document how the derivative hedging instrument selected by the entity is expected to achieve the entity’s objective of reducing its exposure to variability in cash flows attributable to the designated risk. The documentation is important because the method of assessing effectiveness and measuring ineffectiveness of the relationship (discussed later in this section) must be consistent with the stated objective and strategy. An example of objectives and strategies is illustrated in Example 6.1 of this section.

NATURE OF THE RISK BEING HEDGED

28a.04 The Standard requires an entity to identify the risk(s) being hedged as part of the formal documentation. Risks that are eligible to be hedged are specified in paragraphs 29(e), 29(g), and 29(h) of the Standard (ASC paragraphs 815-20-25-15(f), 25-15(i), 25-15(j), and 25-43(d)(3)). These requirements are discussed in Paragraphs 29e.01-29e.03, 29g.01-29g.08, and 29h.01-29h.21 of this section.

DERIVATIVE HEDGING INSTRUMENT(S)

28a.05 The formal documentation should identify the derivative hedging instrument(s), including the proportion (i.e., all or some percentage) of the derivative instrument that is designated as the product sold during a 3-month period (because the last 15,000 units cannot be identified when they occur, only when the period has ended).
hedging instrument. Paragraphs 18.02-18.03 in Section 4 discuss the difference between portion and proportion.

28a.06 Sometimes, an entity will need to designate two or more derivative instruments in combination as the derivative hedging instrument in a hedging relationship to effect the aggregate specific terms that will result in a highly effective hedge. For example, an entity may be unable to conclude that an interest rate swap will be highly effective in offsetting changes in the cash flows of a variable-rate debt security that has an embedded option that caps the interest rate on the security unless the entity designates the interest rate swap in combination with an option contract because the cash flows of only the interest rate swap may not be expected to be highly effective at offsetting changes in the cash flows of the debt security. The debt security’s cash flows could be affected in amounts that are different from the swap’s cash flows due to the cap embedded in the debt security. The combination of two or more derivatives is appropriate under the Standard as long as the formal documentation identifies the combination.

Derivative Novation

28a.06a Novation refers to the replacement of one party to a derivative instrument with a new party, whereby the original party transfers all rights and obligations to the latter party. Derivative novation may occur for a variety of reasons including but not limited to:

- In response to laws or regulatory requirements;
- When the derivative counterparty merges with and into a surviving entity that assumes the same rights and obligations that existed under a preexisting derivative instrument of the merged entities;
- When the derivative counterparty novates a derivative instrument to an entity under common control with the derivative counterparty;
- When the derivative counterparty decides to exit a particular derivative business or relationship; or
- For an OTC derivative entered into after applying the mandatory clearing requirement of the Dodd-Frank Act, when the counterparties agree in advance to clear the contract through a central counterparty according to standard market terms and conventions, and the entity’s hedging documentation describes the counterparties’ expectations that the OTC derivative will be novated to the central counterparty.

28a.06b In some situations, the derivative instrument that is the subject of the novation might be designated as the hedging instrument in a hedging relationship. In March 2016, the FASB issued ASU 2016-05, Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships (ASU 2016-05) that clarifies that a change in the counterparty to a derivative hedging instrument does not, in and of itself, require dedesignation of that hedging relationship. Instead, the ASU enables the existing hedging relationship to continue.

28a.06c As noted in Paragraph 32.01, a hedge accounting relationship must be discontinued prospectively if the hedging instrument is terminated. In reaching its consensus on derivative novations, the EITF noted that the analysis of whether a derivative instrument has been terminated in the context of hedge accounting was intended to go beyond a legal determination
and focus on whether the hedging relationship itself would continue to exist. If the counterparty is the only change to the derivative instrument, the hedging relationship may be largely unaffected. Therefore, when a novation occurs, it is not considered to terminate the hedging instrument, and the hedging relationship can continue (assuming that all other hedge accounting criteria continue to be met).

**28a.06d** The EITF acknowledged that the hedging relationship would be affected by any change in creditworthiness resulting from the change in counterparties. However, in reaching its decision, the EITF considered that under existing requirements (ASC paragraphs 815-20-35-14 through 35-18) an entity would already be required to assess the creditworthiness of the derivative instrument counterparty in a hedging relationship. Therefore, if a derivative instrument novation involves a new counterparty with different creditworthiness than the old counterparty, the entity would consider that change in creditworthiness in determining whether the hedging relationship continues to qualify for hedge accounting, and the amount of hedge ineffectiveness that should be recorded (to the extent that it does continue to qualify for hedge accounting). Similarly, the EITF also noted that if a novation leads to changes in security or cash collateral posting requirements, those changes would also be incorporated into an entity’s assessment of hedge effectiveness and its measurement of hedge ineffectiveness.

**28a.06e Effective Date and Transition.** For public business entities, ASU 2016-05 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. For all other entities, ASU 2016-05 is effective for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Early adoption, including adoption in an interim period, is permitted. Entities have the option to apply the guidance either on a prospective basis or modified retrospective basis. See ASC paragraphs 815-20-65-2(e) through 65-2(i) for additional guidance about applying the modified retrospective transition provisions.

**28a.06f** Before the issuance of ASU 2016-05, the guidance in ASC Topic 815 was not explicit about the effect on an existing hedging relationship, if any, of a change in the counterparty to a derivative instrument that had been designated as a hedging instrument. The SEC staff had not objected to the conclusion that in specific circumstances a novation would not terminate the original derivative for accounting purposes and that hedge accounting could continue uninterrupted. The SEC guidance should not, however, be analogized to other circumstances in which the counterparty to a derivative hedging instrument is changed. As a result, if an entity has a derivative novation under other circumstances, it may need to early adopt the ASU to avoid the discontinuation of hedge accounting.

**Intercompany Derivative Hedging Instruments**

**28a.07** Depending on the risk being hedged, an intercompany derivative may be designated as a hedging instrument in the consolidated financial statements. If the hedged risk is either the risk of changes in cash flows attributable to changes in a foreign currency exchange rate or the

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1 See the circumstances described in the SEC letter to the International Swaps and Derivatives Association in May 2012 and the staff speech by Hillary H. Salo at the 2014 AICPA National Conference on Current SEC and PCAOB Developments.
foreign exchange risk for a net investment in a foreign operation, an intercompany derivative can be designated as the hedging instrument in the consolidated financial statements provided that:

(1) In a cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment hedge, the counterparty (i.e., the other member of the consolidated group) has entered into a contract with an unrelated third party that offsets the intercompany derivative completely, thereby hedging the exposure it acquired from issuing the intercompany derivative instrument to the affiliate that designated the hedge; or

(2) In a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment, the counterparty (i.e., the other member of the consolidated group) has entered into a derivative contract with an unrelated third party to offset the exposure that results from that internal derivative or if the conditions in paragraph 40B of the Standard (ASC paragraphs 815-20-25-62 and 25-63) are met, entered into derivative contracts with unrelated third parties that would offset, on a net or aggregate basis for each foreign currency, the foreign exchange risk arising from multiple intercompany derivative contracts.

28a.08 Intercompany derivatives may be designated as hedging instruments for hedges of foreign exchange risk in the consolidated financial statements to enable entities to comply with the requirement in paragraph 40(a) of the Standard (ASC paragraph 815-20-25-61) that the operating unit with the foreign currency exposure be a party to the hedging instrument. This requirement is necessary because, under the functional currency approach of FASB Statement No. 52, Foreign Currency Translation (Statement 52) (ASC Topic 830, Foreign Currency Matters), all foreign currency exposure exists only in relation to an entity’s functional currency. Therefore, exposure to foreign currency risk must be assessed at the operating unit level. In addition, to facilitate the continued use of a central treasury function by entities, the Board decided to permit the counterparty to the intercompany derivative for foreign currency cash flow hedges of forecasted borrowings, purchases or sales, or unrecognized firm commitments, to enter into derivative contracts with unrelated third parties that would offset, on a net or aggregate basis for each foreign currency, the foreign exchange risk that arises from multiple intercompany derivatives. See Paragraphs 40.04-40.08 and 40B.01-40B.07 of Section 7 for additional discussions of these issues.

28a.09 In contrast, an intercompany derivative cannot be designated as the hedging instrument in consolidated financial statements if the hedged risk is (1) the risk of changes in the overall cash flows of the entire hedged item, (2) the risk of changes in cash flows attributable to changes in the designated benchmark interest rate, or (3) the risk of changes in cash flows attributable to changes in credit risk. Similarly, an intracompany derivative (i.e., a derivative instrument between operating units within a single legal entity) cannot be designated as the hedging instrument in a hedge of those risks. Only a derivative instrument with an unrelated third party can be designated as the hedging instrument in a hedge of those risks in consolidated financial statements.

28a.10 There is no requirement in the Standard for the operating unit that has the interest rate, market price, or credit risk exposure be a party to the hedging instrument. Thus, for example, a parent company’s central treasury function can enter into a derivative contract with a third party and designate it as the hedging instrument in a hedge of a subsidiary’s interest rate risk solely for
purposes of the consolidated financial statements. Even if the subsidiary enters into an intercompany derivative obtained from the parent’s central treasury function, and qualifies for hedge accounting of the interest rate exposure in its separate-company financial statements, that intercompany derivative would not qualify as the hedging instrument in the consolidated financial statements. If the central treasury function entered into a derivative contract with an unrelated third party to offset completely the risk arising from the intercompany derivative, that third-party derivative could be designated as the hedging instrument in the consolidated financial statements. However, the offset of the risk of those intercompany derivatives and third-party derivatives must be done on an individual basis, not on a net or aggregate basis. (See DIG Issue E3 for further reference.)

**HEDGED FORECASTED TRANSACTION**

28a.11 Paragraph 29 of the Standard (ASC paragraphs 815-20-25-15 and 25-43) identifies the hedged forecasted transaction requirements. Identification of the hedged forecasted transaction and the risk being hedged in the documentation created at inception cannot be ambiguous because there may be factors, such as the existence of a simultaneous hedging relationship, that could call into question which forecasted transaction or designated risk is part of a hedging relationship. Simultaneous hedges include (1) both a fair value hedge and cash flow hedge of a single instrument (when different risk exposures are being hedged – see Paragraphs 29e.01-29e.03, 29g.01-29g.08 and 29h.01-29h.21 of this section for a discussion of hedgeable risks) and (2) more than one cash flow hedge of the same hedged item (when different risk exposures are hedged with different hedging instruments). An example of simultaneous cash flow hedges of the same forecasted transaction would be a borrower’s cash flow hedge of the benchmark interest rate and foreign currency exchange rate of the same existing variable-rate debt obligation. An example of a simultaneous fair value and cash flow hedge involving the same instrument would be a cash flow hedge of a variable-rate investment security related to the benchmark interest rate and a fair value hedge related to that issuer’s credit risk. Accordingly, because simultaneous hedges are permitted and the hedged item may be subject to another hedge, it is critical to specify and document at inception which item or forecasted transaction and its associated risk are being hedged.

28a.12 The documentation of the forecasted transaction should include reference to the timing (i.e., the estimated date it is expected to occur), the nature, and amount (i.e., the hedged quantity or amount) of the forecasted transaction. The Standard permits a reasonable estimate of the timing of the transaction; therefore, it is not necessary to specify the exact date on which a hedged forecasted transaction will occur, as long as when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. (Paragraphs 29b.08-29b.09 of this section provide additional information to be considered when determining the timing of the forecasted transaction.) If the hedged forecasted transaction is denominated in a foreign currency, paragraph 28(a)(2) of the Standard (ASC paragraph 815-20-25-3(d)(iii)(01)) requires the entity to specify the exact amount of foreign currency being hedged. Hedges of foreign currency exposures are discussed in detail in Section 7. Identification of the hedged forecasted transaction is more complex when the hedged item is a portfolio of individual transactions. Refer to Paragraphs 29a.03 and 29h.04 for further discussion.
28a.13 An entity also should document at inception how it will calculate the change in the cash flows of the hedged forecasted transaction attributable to the risk being hedged because how this is calculated affects both the assessment of effectiveness and the amount of ineffectiveness that is reported in earnings. An entity is required to document the expected market price of the forecasted transaction, both at inception of the hedge and subsequently, because this information is necessary to determine the change in expected cash flows. Additionally, although the Standard does not specifically address the issue, we believe the documentation also must include a reasonable method for reclassifying into earnings amounts reported in Accumulated Other Comprehensive Income (AOCI) (see Paragraphs 31.01-31.07 of this section for further discussion of this issue).

METHOD FOR ASSESSING HEDGE EFFECTIVENESS

28a.14 While the Standard provides an entity with flexibility in determining the method for assessing hedge effectiveness, the method used must be reasonable and must be defined and documented. In practice, effectiveness usually is assessed using either the dollar-offset method or a statistical method (of which regression analysis is most common). Once an entity selects a technique, there are various means of applying those techniques. Refer to Paragraphs A6.14-A6.20 of Appendix A of this section for a discussion of those techniques. Because the Standard provides for alternative techniques and those techniques have various application possibilities, the Standard requires the entity to document at the inception of a hedging relationship its decision about how it will assess effectiveness both on a retrospective and prospective basis. For example, an entity that excludes all or a part of the change in the time value of an option contract used as the derivative hedging instrument from the assessment of hedge effectiveness should include a discussion of that fact and the method used to measure the intrinsic value in its hedge documentation.

METHOD FOR MEASURING INEFFECTIVENESS

28a.15 In a cash flow hedge, only the cumulative dollar-offset method can be used to measure ineffectiveness. However, in applying the dollar-offset method, the amounts that are included in the measurement of ineffectiveness can vary depending on the manner in which an entity assesses effectiveness (e.g., if the assessment of effectiveness excludes the time value components of the derivative, the measurement of ineffectiveness should also exclude those components). See Paragraphs 28b.12-28b.16 for additional discussion. Thus, documentation of how the dollar-offset method will be applied is required at the inception of the hedging relationship.

LEVEL OF DETAIL IN HEDGE DOCUMENTATION

28a.16 The level of detail required in hedge documentation is a matter of judgment. However, entities should be aware that the U.S. Securities and Exchange Commission (SEC) staff has stated that the method used to assess hedge effectiveness and measure ineffectiveness must be documented with sufficient specificity such that a third party could perform the assessment and measurement based on the documentation and arrive at the same result as the entity applying the hedge accounting. We believe that level of specificity applies to all other components of the hedge documentation required by the Standard.
Example 6.1: Documentation of the Hedging Relationship

On January 1, 20X1, EMT issues a five-year, $100,000,000 debt obligation. The interest rate on the debt obligation is variable at the six-month London Interbank Offered Rate (LIBOR) plus 1.5%. EMT enters into a five-year interest rate swap with a notional amount of $100,000,000 to receive interest at six-month LIBOR and pay interest at a fixed rate of 8.5% on January 15, 20X1. The debt obligation reprices and requires payments to be made on July 1 and January 1 of each year. The swap reprices and requires payments to be made or received on July 15 and January 15 of each year.

Formal Documentation of the Hedging Relationship

Documentation is prepared on January 15, 20X1

Risk management objective and strategy for accomplishing that objective, and nature of the hedged risk

On January 1, 20X1, EMT issued a five-year, $100,000,000 debt obligation. The interest rate on the debt obligation is variable at six-month LIBOR plus 1.5%. As a result, EMT is exposed to variability in cash flows related to changes in its forecasted interest payments as six-month LIBOR (the benchmark interest rate) changes.

EMT’s risk management objective is to lock in the interest cash outflows on this debt obligation. EMT meets this objective by entering into a five-year interest rate swap with a notional amount of $100,000,000 to receive interest at a variable rate equal to six-month LIBOR and to pay interest at a fixed rate of 8.5%. EMT designates the swap (the hedging instrument) as a cash flow hedge of the interest rate risk associated with the benchmark rate of six-month LIBOR attributable to the forecasted interest payments on its five-year, $100,000,000 variable-rate debt obligation (the hedged forecasted transactions).

Derivative hedging instrument

EMT identifies the following interest rate swap as the derivative hedging instrument:

- Date of Swap = January 15, 20X1
- Notional amount = $100,000,000
- Premium paid = $0
- Term = Five years maturing on January 14, 20X7
- Fixed leg = 8.5% per annum
- Fixed leg payer = EMT
- Floating leg = six-month LIBOR, repricing July 15 and January 15 of each year
Floating leg payer = Bank A
Settlement = net cash due in arrears on July 15 and January 15 of each year.

The hedged forecasted transaction

Forecasted interest payments to be made on July 1 and January 1 of each year on its five-year $100,000,000 debt obligation issued January 1, 20X1 and maturing on December 31, 20X6. The interest payments on the $100,000,000 debt obligation are repriced on July 1 and January 1 of each year, with payments due in arrears. As interest expense is accrued on the debt obligation, amounts in AOCI related to that expense will be reclassified into earnings.

How hedge effectiveness will be assessed and hedge ineffectiveness will be measured

Hedge Effectiveness Assessment:

At inception:
Prospectively: EMT has designated the risk of changes in its interest cash flows on its five-year $100,000,000 debt obligation issued January 1, 20X1 attributable to changes in six-month LIBOR (the benchmark interest rate) as the hedged risk. Although the variable leg of the hedging instrument is equal to six-month LIBOR and EMT is hedging interest rate risk, EMT cannot automatically conclude that the hedging relationship would have been highly effective over the period equivalent to the designated hedging relationship because the variable leg of the swap that is designated as the hedging instrument reprices at different dates from the variable leg of the debt obligation. As a result, the changes in the variable interest payments of the debt may not offset the changes in the cash flows of the swap.

EMT concluded that the hypothetical derivative is a swap with terms that identically match the terms of the variable-rate debt obligation (i.e., would meet the criteria of the shortcut method) and is equivalent to the hedging instrument in this hedging relationship except that the variable leg of the swap would reprice and require payment or receipt on July 1 and January 1 of each year. As a result, EMT performed a regression analysis to compare the period-by-period change in the fair value of the hypothetical derivative to the change in fair value of the actual derivative on a quarterly basis for the preceding 20 years. Based on this analysis, EMT concluded that the hedging relationship would have been highly effective historically for the equivalent of at least four hedging periods. (Note that the documentation of this analysis should be included in the hedge documentation.)

Based on the regression analysis just completed, it is expected that on an ongoing basis the hedging relationship will remain effective throughout the hedging relationship.

During the hedging relationship:

On a quarterly basis, EMT will assess effectiveness by updating the analysis performed coincident with the hedge designation (to reflect the most recent change in interest rates). EMT will consider the risk of default by the counterparty to the swap contract and its own nonperformance risk in this assessment.
Retroactively: EMT will evaluate whether the hedging relationship has been highly effective during the quarter just ended by updating the regression analysis performed at the inception of the hedge. In performing that regression analysis, EMT will use the same number of data points used in the prospective analysis performed at inception, except that the earliest data points will be discarded and replaced with data points that have occurred after the inception of the hedge.

Prospectively: On a quarterly basis, EMT will determine whether it expects the hedging relationship to continue to be highly effective based on the updated analysis.

Measuring Ineffectiveness:

EMT will measure ineffectiveness using the hypothetical derivative method. Under this method, the calculation of ineffectiveness, as required under paragraph 30(b)(2) of the Standard (ASC paragraph 815-30-35-3(b)(2)), will be done by using the change in fair value of the hypothetical derivative (described above). That is, the actual swap will be recorded at fair value on the balance sheet and AOCI will be adjusted to an amount that reflects the lesser of either the cumulative change in the fair value of the actual swap or the cumulative change in the fair value of the hypothetical derivative. The fair value of the hypothetical derivative and the actual swap will be based on discount rates for the respective swap curves.

In addition, EMT will consider the risk of default by the counterparty to the swap contract and its own nonperformance risk in this measurement process through adjustment of the discount rate used to measure fair value.

Effectiveness of Hedging Relationships

28b.01 The Board’s fourth fundamental decision (see Paragraph 3d.01 of Section 1), which serves as a cornerstone to the Standard’s hedge accounting model, states in part that hedge accounting is provided only if the derivative hedging instrument is expected to be, and actually is, effective at offsetting changes in the cash flows of the hedged forecasted transaction attributable to the hedged risk. The Standard’s requirements in this regard are set forth in paragraph 28(b) of the Standard (ASC paragraphs 815-20-25-75, 25-76, and 25-80) as follows:

28b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28(d) below. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. If the hedging instrument, such as an at the money option contract, provides only one-sided offset against the hedged risk, the cash inflows (outflows) from the hedging instrument must be expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

DIG Issues related to this paragraph are E7, E8, E11, G9, G10 and G20. See DIG Issues Index.
28b.02 Cash flow hedge accounting focuses on the accounting for a derivative instrument that is used to reduce the exposure to variability in the cash flows of a hedged forecasted transaction associated with a particular risk over a defined period. Thus, a key element to qualifying for cash flow hedge accounting is that an entity expects that cash flows of a derivative hedging instrument will be highly effective at offsetting cash flows of the hedged forecasted transaction attributable to the hedged risk. This expectation must exist both at inception of the hedge and during the period in which the hedge is designated. Entities are required to periodically assess effectiveness to validate that expectation.

28b.03 The requirements for assessing effectiveness are among the most difficult provisions in the Standard to understand and implement. Thus, we have developed a comprehensive discussion of hedge effectiveness assessment and the related, but different, concept of measuring hedge ineffectiveness. That discussion is located in Appendix A to this section; the information in this section should be read in conjunction with that appendix. This section briefly addresses the effectiveness requirements of the Standard and is organized as follows:

- Expectation of effectiveness;
- Calculating the changes in cash flows;
- Meaning of highly effective;
- Effective at offsetting changes in cash flows attributable to the designated risk;
- Periodic hedge effectiveness assessments;
- Consistent application of hedge effectiveness assessment methodologies;
- Consistency between assessment methodology and designated hedged risk;
- Relationship between assessing hedge effectiveness and measuring hedge ineffectiveness; and
- Requirement to consider measured ineffectiveness.

EXPECTATION OF EFFECTIVENESS

28b.04 The Standard requires entities to demonstrate both at inception and on an ongoing basis that the designated hedging relationship will be highly effective at offsetting changes in cash flows attributable to the hedged risk. It does not, however, require that effectiveness be proven because effectiveness would, in almost all cases, be impossible to prove. Instead, the Standard requires entities to periodically assess effectiveness to conclude whether enough evidence supports an expectation of high effectiveness. These assessments generally involve a combination of quantitative and qualitative analyses. Thus, entities typically compute the relationship of the change in the derivative hedging instrument’s cash flows as compared with the change in the cash flows of the hedged forecasted transaction attributable to the hedged risk. The quantitative analyses usually involve either a dollar-offset computation or the use of

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2 When discussing the assessment of effectiveness in this section, it should be understood that the Standard permits entities to exclude certain cash flows of the derivative hedging instrument from the effectiveness assessment because those excluded components may be irrelevant to an entity’s risk management strategy. This concept is further discussed in Appendix A to this section.

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statistics (with regression analysis being the most common technique). The qualitative factors often relate to how to estimate the cash flows of the hedged forecasted transaction, the derivative hedging instrument, or both, that are used in the quantitative analyses. For example, in some cases entities will be required to estimate the timing and amounts of cash flows, which involves a probability-weighted assessment of the forecasted transaction’s cash flows. Qualitative factors are considered in developing those probability weightings. The initial or ongoing application of hedge accounting is appropriate only when the expectation of high effectiveness is present. If during the course of a hedging relationship, the entity can no longer support its expectation of high effectiveness prospectively, hedge accounting would not be appropriate in subsequent periods. Paragraph 32 of the Standard (ASC paragraphs 815-30-40-1 through 40-3) addresses the required accounting in that circumstance and is discussed in Paragraphs 32.01-32.14 of this section.

**CALCULATING THE CHANGES IN CASH FLOWS**

28b.05 The Standard does not prescribe a required method for calculating the changes in the derivative hedging instrument’s cash flows or the changes in the hedged forecasted transaction’s cash flows attributable to the hedged risk for the effectiveness tests. However, because the focus of the effectiveness of a cash flow hedging relationship is on cash flows, the timing of the respective cash flows must be taken into consideration. As a result, when determining the change in cash flows of the derivative hedging instrument, we believe a present value methodology generally should be incorporated in the calculation. The discount rate to be used in that present value methodology would be the discount rate used to determine the fair value of the cash flows. When determining the change in cash flows of the hedged forecasted transaction attributable to the hedged risk, we believe a present value methodology also generally should be incorporated in the calculation. The discount rate to be used in that present value methodology would be the discount rate applicable to the cash flows to arrive at fair value (i.e., the relevant curve for those cash flows) as if the cash flows were related to an instrument that has identical cash flows to those of the hedged forecasted transaction. While we believe that discounting should generally be incorporated into the calculation of the changes in cash flows when performing the effectiveness tests, the discount rates incorporated within the calculations of the changes in the cash flows of the derivative and the hedged forecasted transaction attributable to the hedged risk may not be the same as a result of the timing of the respective cash flows, the credit risk of the counterparty to the derivative, the credit risk of the entity itself, and other relevant factors. However, if the effectiveness tests are based on the changes in cash flows of the derivative hedging instrument and the hedged forecasted transaction, instead of their changes in fair value, an entity may use the same credit risk adjustment that is used to determine the fair value of the derivative to calculate the change in the cash flows of the hedged forecasted transaction, as long as the likelihood that the counterparty to the derivative or the entity will not default is probable.

28b.05a One exception to the guidance that discounting should generally be incorporated into the calculation of the changes in cash flows when performing the effectiveness tests arises when an entity uses a forward contract as the hedging instrument and chooses to exclude the spot-forward difference from the hedge relationship. In these circumstances, the entity may choose from one of the two methods below when calculating the changes in cash flows attributable to changes in spot prices, which would be included in earnings:
(a) The expected cash flows of the derivative hedging instrument and the hedged forecasted transaction are discounted to convert them to current amounts based on the date the respective cash flows will actually occur; or

(b) The expected cash flows of the derivative hedging instrument and the hedged forecasted transaction are not discounted because they both are assumed to occur at the reporting date. In effect, a critical terms match approach could be used and no ineffectiveness would arise when the other terms, such as notional amount and currency, are the same (however, the changes in value of the spot-forward difference would be included currently in earnings).

The different approaches are illustrated in Example 6.1a:

**Example 6.1a: Calculating Changes in Cash Flows – Discounted versus Undiscounted**

ABC Company is a manufacturer with USD as its functional currency. On January 1, 20X6, ABC forecasts the sale of FC 1,000,000 worth of goods to a foreign country on July 31, 20X6 (seven months from the date of hedge inception). ABC does not have any firm contracts yet, but based on historical experience and its forecasts, it concludes that these sales are probable of occurring. ABC is exposed to changes in USD to foreign currency exchange rates and enters into a six-month forward contract to buy USD and sell the foreign currency. The hedging derivative has the following terms:

- **Contract amount**: FC 1,000,000
- **Trade date**: January 1, 20X6
- **Maturity date**: June 30, 20X6
- **Forward contract rate**: FC 1 = USD 1.2

ABC chooses to apply hedge accounting and formally designates and documents the hedging relationship on January 1, 20X6, electing to exclude the spot-forward difference and recognize changes in that difference in current earnings. The spot and forward exchange rates for different dates as applicable to the actual hedging derivative are given in the table below:

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot rate</th>
<th>Forward rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X6</td>
<td>USD 1.11/FC</td>
<td>USD 1.20/FC</td>
</tr>
<tr>
<td>March 31, 20X6</td>
<td>1.13/FC</td>
<td>1.23/FC</td>
</tr>
<tr>
<td>June 30, 20X6</td>
<td>1.14/FC</td>
<td></td>
</tr>
</tbody>
</table>

The spot and forward exchange rates for different dates as applicable to the hedged forecasted sale are given in the table below:

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot rate</th>
<th>Forward rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X6</td>
<td>USD 1.11/FC</td>
<td>USD 1.25/FC</td>
</tr>
<tr>
<td>March 31, 20X6</td>
<td>1.13/FC</td>
<td>1.28/FC</td>
</tr>
<tr>
<td>July 31, 20X6</td>
<td>1.15/FC</td>
<td></td>
</tr>
</tbody>
</table>

On March 31, 20X6, ABC calculates the amounts to be reflected in the financial statements. The changes in fair value of the forward contract, changes in cash flows of the hedged forecasted transaction, and the resulting ineffectiveness are shown in the tables below:
If changes in cash flows due to changes in spot prices are not discounted:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change due to forward exchange rates</td>
<td></td>
<td>USD (29,851)$^1$</td>
</tr>
<tr>
<td>Change due to change in spot rates</td>
<td>(20,000)$^2$</td>
<td>USD 20,000</td>
</tr>
<tr>
<td>Change due to spot-forward difference (recognized in earnings)</td>
<td>(9,851)$^3$</td>
<td></td>
</tr>
</tbody>
</table>

This approach results in no ineffectiveness, as the change in fair value of the forward exchange contract and change in cash flows of the hedged anticipated sale due to the change in spot rate will be equal.

If changes in cash flows due to changes in spot prices are discounted$^4$:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change due to forward exchange rates</td>
<td></td>
<td>USD (29,851)</td>
</tr>
<tr>
<td>Change due to change in spot rates</td>
<td>(19,900)$^5$</td>
<td>USD 19,864$^6$</td>
</tr>
<tr>
<td>Change due to spot-forward difference (recognized in earnings)</td>
<td>(9,951)$^7$</td>
<td></td>
</tr>
</tbody>
</table>

This approach results in ineffectiveness of USD 36 (the difference between the change in the fair value of the forward contract due to change in spot rates of USD 19,900 and the change in the cash flows of the hedged anticipated sale of USD 19,864). The change in the excluded spot-forward difference of USD 9,951 is recognized in net income.

The choice of methods for calculating the spot-forward difference is considered to be an accounting policy election that an entity makes and should be applied consistently to all applicable hedging relationships.

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$^1$ FC1,000,000 × (1.2 - 1.23) ÷ (1 + [0.02 ÷ 12])$^3$
$^2$ FC1,000,000 × (1.11 - 1.13)
$^3$ USD(29,851) - USD(20,000)
$^4$ The entity discounts the projected cash flows of the forward exchange contract over 3 months because it matures on June 30, 20X6. The entity discounts the projected cash flows of the anticipated sale over 4 months because it is forecasted to occur on July 31, 20X6. The discount rates for the 3 month and 4 month periods for the remaining term of the derivative and the hedged forecasted sale are assumed to be 2% and 2.05% respectively.
$^5$ FC1,000,000 × (1.11 - 1.13) ÷ (1 + [0.02 ÷ 12])$^3$
$^6$ FC 1,000,000 × (1.13 - 1.11) ÷ (1 + [0.0205 ÷ 12])$^4$
$^7$ USD(29,851) - USD(19,900)
MEANING OF HIGHLY EFFECTIVE

28b.06 A derivative hedging instrument should be expected to be highly effective at achieving changes in cash flows that offset the changes in the cash flows of the hedged forecasted transaction attributable to the hedged risk during the term of the hedge. The Standard states that the Board intended the term *highly effective* to have essentially the same meaning as the notion of high correlation used in FASB Statement No. 80, *Accounting for Futures Contracts* (Statement 80), which the Standard superseded. As a result, we have interpreted highly effective to describe a cash flow hedging relationship in which the change in the cash flows of the derivative hedging instrument is within 80 to 125% of the opposite change in the cash flows of the hedged forecasted transaction attributable to the hedged risk. This range represents the absolute change in the cash flows of the derivative hedging instrument divided by the absolute change in the cash flows of the hedged forecasted transaction attributable to the hedged risk. For example, if the cash flows of the derivative hedging instrument increased by $80 and the cash flows of the hedged forecasted transaction attributable to the hedged risk decreased by $100, this relationship would be considered to be highly effective at 80% ($80/$100). Likewise, if the cash flows of the derivative hedging instrument increased by $100 and the cash flows of the hedged forecasted transaction attributable to the hedged risk decreased by $80, this relationship would be considered to be highly effective at 125% ($100/$80).

EFFECTIVE AT OFFSETTING CHANGES IN CASH FLOWS ATTRIBUTABLE TO THE DESIGNATED RISK

28b.07 The Standard provides entities with a significant amount of flexibility in designating the hedged risk. For example, the Standard does not mandate that an entity hedge the entire change in cash flows for hedged forecasted transactions in all cases. Rather, the Standard prescribes certain risks that may be hedged, and enables entities to define the prescribed risk being hedged either narrowly or broadly, as they wish (within the requirements pertaining to the hedged forecasted transaction in paragraph 29 of the Standard (ASC paragraphs 815-20-25-15 and 25-43)). The Standard, however, permits entities to select changes in the risk exposure in only one direction (increases or decreases). For example, an entity may hedge only an increase in the benchmark interest rate when hedging variable-rate debt. When an entity wants to hedge only one side of a prescribed risk exposure (an increase or decrease), it must expect that the hedging instrument will be highly effective in providing offset to the change in cash flows of the hedged forecasted transaction attributable to either the offsetting increase or decrease. In other words, it will be necessary to select a hedging instrument that provides only that one-sided offset. Typically, an option is used in these circumstances due to its one-sided nature. Accordingly, in establishing hedging relationships, entities have flexibility in designating the hedged risk, but are required to select a derivative hedging instrument that is expected to be highly effective in providing offset to changes in the cash flows of the hedged forecasted transaction that result from that risk.

PERIODIC HEDGE EFFECTIVENESS ASSESSMENTS

28b.08 In contrast to the flexibility that the Standard affords in the selection of the hedged risk, the Standard has very specific requirements about continued application of hedge accounting. Primarily because of the effect on earnings of applying hedge accounting, which are discussed
beginning with Paragraph 30.01 of this section, the Standard requires an entity to assess
effectiveness at least every three months (even for entities, such as nonpublic entities, that do not
prepare quarterly financial statements) or whenever the entity’s financial statements or earnings
are reported, if more frequent. The effectiveness assessment requires that entities determine
whether the hedging relationship was highly effective for the period (as defined in the hedge
documentation) just ended and whether it is appropriate to continue applying hedge accounting
because the relationship is expected to continue to be highly effective. Each time effectiveness is
assessed, the results are required to be documented.

CONSISTENT APPLICATION OF HEDGE EFFECTIVENESS ASSESSMENT
METHODOLOGIES

28b.09 The Standard requires an entity, at the time it designates a hedging relationship, to define
and document the method it will use to assess hedge effectiveness. It also states that ordinarily an
entity should assess effectiveness for similar hedges in a similar manner; use of different
methods for similar hedges should be justified. Furthermore, it requires that an entity use its
defined and documented methodology consistently throughout the period of the hedge. If, during
the hedging relationship, an entity identifies an improved method of assessing hedge
effectiveness, it must discontinue the existing hedging relationship and designate a new hedging
relationship using the improved method (see Paragraphs 32.01-32.14 of this section for a
discussion of the discontinuation of hedge accounting). That type of change is not a change in
accounting principle under FASB Statement No. 154, Accounting Changes and Error
Corrections (ASC Subtopic 250-10, Accounting Changes and Error Corrections - Overall).
Therefore, no preferability letter from an independent auditor is necessary and the independent
auditors’ report need not refer to this change. Nevertheless, entities that change methods need to:

• Document their justification for the change;

• Apply the new method to all similar hedges (unless facts and circumstances support a
different method); and

• Prepare documentation for the new hedging relationship in a contemporaneous
fashion to attain hedge accounting prospectively. (See DIG Issue E9 for further
reference.)

28b.10 An entity should assess effectiveness for similar hedges in a similar manner, and justify
the use of different methods for similar hedges. For an entity that has numerous autonomous
business units, it would not be unreasonable to define entity at a business unit level, rather than at
a consolidated level if those business units individually manage risk. Accordingly, judgment may
be used in applying the requirement that an entity assess effectiveness similarly for similar
hedges.

CONSISTENCY BETWEEN ASSESSMENT METHODOLOGY AND DESIGNATED
HEGDED RISK

28b.11 Regardless of the method used to assess effectiveness, entities must assess effectiveness
in a manner that is consistent with the documented risk management objective. In other words,
when assessing effectiveness, the change in the cash flows of the hedged forecasted transaction
should consider only the risks that are being hedged. That change should be compared with the
extent of offset provided by the derivative hedging instrument’s total cash flow change (excluding changes related to components that are not included in the assessment of effectiveness, for example, the time value of an option). For example, if an entity is hedging only the change in cash flows of the interest payments on debt due to an increase in the benchmark interest rate above a certain rate, the assessment of effectiveness should be limited to the extent of the change in cash flows of the debt resulting from increases in the benchmark interest rate above that specified rate. The assessment should not compare changes in the total cash flows of the derivative hedging instrument with total changes in the cash flows of the hedged forecasted transactions. To do so would introduce elements of the debt’s cash flows (such as changes in the benchmark interest rate below the specified level) that are not considered in the objective of the hedge, which was to offset cash flow changes in the interest payments on the debt due to increases in the benchmark interest rate above the specified rate.

RELATIONSHIP BETWEEN ASSESSING HEDGE EFFECTIVENESS AND MEASURING HEDGE INEFFECTIVENESS

28b.12 Once an entity concludes at inception that a hedging relationship is expected to be highly effective, it must periodically assess hedge effectiveness and measure ineffectiveness. Assessing effectiveness means determining the degree to which the change in the cash flows of the hedged forecasted transaction attributable to the risk being hedged has been and is expected to continue to be offset by the change in the cash flows of the derivative hedging instrument. This assessment is expressed in terms of a percentage of offset (e.g., within a range of 80 to 125%).

28b.13 The concept of effectiveness assessment is different from the measurement of ineffectiveness. In general, measuring ineffectiveness is the computation of the degree to which the cumulative changes in the fair value of the derivative hedging instrument (limited to those elements of cash flows included in the assessment of effectiveness as described in Appendix A to this section) exceed the cumulative changes in the expected cash flows of the hedged forecasted transaction attributable to the risk being hedged. Specifically, paragraph 30 of the Standard (ASC paragraph 815-30-35-3) indicates that the gain or loss on a hedging instrument within a cash flow hedging relationship should be reported in AOCI. However, the amount in AOCI associated with the hedged transaction is limited to the lesser of:

1. The cumulative gain or loss on the hedging instrument from inception of the hedging relationship less (a) components not included in the assessment of effectiveness; for example, the time value of an option, if applicable, and (b) the derivative’s gains or losses previously reclassified from AOCI as a result of applying either the cash flow hedge accounting requirements of the Standard or the impairment requirements of the Standard; and

2. The portion of the cumulative gain or loss on the hedging instrument necessary to offset the cumulative change in expected future cash flows on the hedged transaction from inception of the hedge less the derivative’s gains or losses previously reclassified from AOCI as a result of applying either the cash flow hedge accounting requirements of the Standard or the impairment requirements of the Standard.

28b.14 The distinction between assessing effectiveness and measuring ineffectiveness is significant because a hedging relationship might result in a high level of assessed effectiveness, but also result in significant amounts of measured ineffectiveness. That condition may result
from using regression analysis, which expresses effectiveness numerically by representing the
degree of the relationship between changes in the two variables, to assess effectiveness, while
measuring ineffectiveness using cumulative dollar-offset as required by the Standard. The
condition also may result for an entity that assesses effectiveness from period to period using the
dollar-offset method, but measures ineffectiveness, as required, based on cumulative changes in
cash flows.

28b.15 In addition, since the ineffectiveness measurement is limited to the lesser of the
cumulative gain or loss on the hedging instrument and the portion of that gain or loss necessary
to offset the cumulative change in expected future cash flows on the hedged transaction from
inception of the hedge, there may be situations in which there is no measured ineffectiveness
while the hedge is not perfectly effective or possibly even not highly effective to qualify for
hedge accounting. This could occur when the cumulative change in expected future cash flows
on the hedged transaction from inception of the hedge exceeds the cumulative gain or loss on the
hedging instrument. This is discussed further in Paragraphs 30.05-30.09 of this section.

28b.16 The measurement of ineffectiveness may be different from the amount that is recorded in
earnings as a consequence of applying hedge accounting because, as described in Appendix A to
this section, the Standard permits an entity to exclude certain gains and losses of the derivative
hedging instrument from the assessment of effectiveness (and, consequently, the measurement of
ineffectiveness). While those amounts may be excluded from the assessment of effectiveness and
the measurement of ineffectiveness, the Standard requires that changes in those excluded
components be recognized in earnings each period. Accordingly, an entity may, over the same
assessment period, experience a high level of assessed effectiveness, significant amounts of
ineffectiveness, and amounts reported in earnings that are different from the amount of measured
ineffectiveness.

REQUIREMENT TO CONSIDER MEASURED INEFFECTIVENESS

28b.17 If, during the hedge period, the entity measures significant ineffectiveness for a hedging
relationship, but the prospective and retrospective assessments of effectiveness based on
regression analysis (or other statistical methods) indicate that the relationship is highly effective,
an entity should investigate the results of its regression analysis to determine whether hedge
accounting can be continued. We believe that when entities undertake that investigation, they
may identify an aberration in the recent past in the relationship of the two elements being
regressed that causes the significant measured ineffectiveness. While we believe that entities
may find it relatively easy to identify a change in a market condition that has caused the
aberration (e.g., the sudden and unexpected collapse of a major market maker), significant
amounts of judgment are required in assessing the period over which the effect of that market
condition might persist and the relationship of that period to the remaining term of the hedging
relationship. For example, an entity may conclude that the effects of the market condition will
continue for more than one year while the remaining term of the hedging relationship is only
three months and, consequently, the entity would be required to prospectively discontinue hedge
accounting. As long as an entity investigates the results of its regression analysis and can
continue to conclude that the hedging relationship has been and is expected to be highly
effective, it can continue to apply hedge accounting.
Special Rule for Written Options

28c.01 When hedging with a written option in a cash flow hedge, the Standard requires that additional conditions be met along with all the other hedge criteria. Paragraph 28(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95) identifies these conditions:

28c. If a written option is designated as hedging the variability in cash flows for a recognized asset or liability or an unrecognized firm commitment the combination of the hedged item and the written option provides at least as much potential for favorable cash flows as exposure to unfavorable cash flows. That test is met if all possible percentage favorable changes in the underlying (from zero to 100%) would provide at least as much favorable cash flows as the unfavorable cash flows that would be incurred from an unfavorable change in the underlying of the same percentage. (Refer to paragraph 20(c)(1).)

DIG Issues related to this paragraph are E2 and E5. See DIG Issues Index.

28c.02 In general, an option is a contract that provides the holder with the right, but not the obligation, to buy or sell something, with that right received in exchange for payment of a premium. The premium compensates the writer of the option and is nonrefundable. The writer of the option receives the premium either through payment of cash, another asset, or through favorable (i.e., nonmarket) terms contained in the option contract. The writer of an option is considered to have a written option while the other party to the contract holds a purchased option. Certain contracts discussed below are combinations of options, and the combined derivative may be a net written option.

28c.03 The Board initially intended to prohibit hedge accounting for written options because written options serve to reduce the potential for gain in the hedged transaction while exposing the writer to unlimited loss. This is because the option holder has a right to exercise the option, which occurs only when the option has terms that are favorable to the holder, i.e., when the option has intrinsic value, which means it is adverse to the writer. When market conditions cause the option to have no intrinsic value to the holder, the option is not exercised. Consequently, only the holder of the option stands to gain from the intrinsic value of an option, while the writer is exposed to unlimited loss.

28c.04 After considering input received from various constituents, the Board determined that it would allow written options to be the derivative hedging instrument in very limited circumstances that generally involve written options used to hedge purchased options that are embedded in, but not bifurcated from, a host instrument.

28c.05 Written options may be used as a derivative hedging instrument in relationships that involve recognized assets and liabilities (i.e., on-balance-sheet financial and nonfinancial assets and liabilities) and unrecognized firm commitments. The Standard’s requirements for hedge accounting for strategies using written options are based on the symmetry of the gain and loss potential of the combined hedged position. Specifically, the Standard permits written options (and net written options) to qualify for hedge accounting when the combination of the hedged item and the written option provides at least as much potential for favorable cash flows resulting from a favorable change in the underlying as it provides exposure to unfavorable cash flows resulting from an unfavorable change in the underlying of the same percentage (referred to as the written option effectiveness test). This condition would be met when the hedged item is an
embedded purchased option and the written option has characteristics that offset those of the embedded purchased option. The purchased option must be one that is not required to be separated from the host contract because, for example, they are clearly and closely related. We believe that the written option effectiveness test should be performed by reference to the strike price contained in the written option contract, not by reference to the current price of the underlying. For example, if an entity enters into a hedging relationship that includes a written option with a strike price of $50 and the current price of the underlying is $20, the written option effectiveness test should be based on changes in prices of the underlying from $50 (the strike price of the option). If the written option effectiveness test were based on changes from the current price of the underlying, the test typically would be met when the written option is significantly out of the money and, therefore, hedge accounting would not be precluded.

28c.06 In a hedging relationship involving a written option, the written option effectiveness test is required only at the inception of the hedging relationship; the other hedge criteria must be met throughout the life of the hedging relationship. The requirement to consider that test only at inception exists because the price of the underlying may change during the hedging relationship in such a way that the written option approaches having intrinsic value, in which case the symmetry requirement would not be met. In addition, an entity may exclude the time value of a written option (or net written option) when applying the written option effectiveness test, provided that, in defining how hedge effectiveness will be assessed, the entity specifies that it will base its effectiveness assessment only on changes in the option’s intrinsic value. Thus, when applying the written option effectiveness test to determine whether there is symmetry of the potential for favorable and unfavorable cash flows of the combined hedged position for all possible percentage changes in the underlying, an entity is permitted to measure the change in the intrinsic value of the written option (or net written option) combined with the change in cash flows of the hedged item.

COMBINATIONS OF OPTIONS

28c.07 Entities may use hedging strategies that involve a combination of option contracts. For example, an entity may purchase a put option and write a call option, commonly referred to as a collar. This combination of options provides the entity with a desired amount of protection against changes in cash flows outside of a range of cash flows, while offsetting a portion of the cost of the purchased put option through the premium received on the written call option. In determining whether these combinations of options qualify for hedge accounting, an entity first must determine whether the combination of options is a net purchased option or a net written option that would be subject to the written option effectiveness test. For a combination of options in which the strike price and the notional amount in both the written option component and the purchased option component remain constant over the life of the respective component to be considered a net purchased option (and thus be eligible to be designated as a hedging instrument without consideration of the written option effectiveness test of paragraph 28(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95)), all of the following conditions must be met:

- No net premium is received (either through payment in cash, another asset, or through favorable terms contained in the contract) at inception or at any point during the life of the option contracts that the combination option comprises;
- The components of the combination option are based on the same underlying;
• The components of the combination option have the same maturity date; and
• The notional amount of the written option component is not greater than the notional amount of the purchased option component.

**28c.08** All of the above conditions must be met at the inception of the hedging relationship in order for the combination of options to not be considered a net written option in its entirety.

**28c.09** If either the written option component or the purchased option component for a combination of options has either strike prices or notional amounts that do not remain constant over the life of the respective component, whether that combination of options can be considered not to be a written option in its entirety under paragraph 28(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95) (i.e., whether a net premium in cash, another asset, or as a favorable rate or other term is received) should be assessed with respect to each date that either the strike prices or the notional amounts change within the contractual term of the instrument. Even though that assessment is made on the date that a combination of options is designated as a hedging instrument to determine the applicability of paragraph 28(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95), an entity must consider the receipt of a net premium (in cash, another asset, or as a favorable rate or other term) from that combination of options at each point in time that either the strike prices or the notional amounts change. In addition, if any of the four conditions discussed in Paragraph 28c.07 above are not met at any date that either the strike prices or notional amounts change, the entire contract is considered a net written option. Example 5.5 in Section 5 illustrates the evaluation of whether a combination of options is a net written option. (See DIG Issues E2 and E5 for further reference.)

**28c.10** A derivative instrument that combines a written option and a nonoption derivative (e.g., an indexed amortizing swap or a swap with a knock-out provision) is considered a written option and, thus, is required to meet the written option effectiveness test to qualify for hedge accounting.

**28c.11** Often, entities enter into interest rate swaps with notional amounts that amortize based on an index. These instruments are referred to as indexed amortizing swaps and are considered to be written options because they combine an interest rate swap (a nonoption derivative) with a written option, and are subject to the written option effectiveness test if an entity attempts to designate them in a hedging relationship. The written option is the option provided to one of the parties to reduce the amount on which interest payments will be exchanged based on a strike price (the relevant index). As the index level is met, the party calls a portion of the notional amount based on the terms of the derivative, and subsequent payment provisions of the swap are based on that new notional amount. When evaluating these instruments, entities must consider whether they are the writer or the purchaser of the option. The writer of the option receives at inception or over the life of the contract a net premium either through payment in cash, another asset, or through favorable terms contained in the contract.

**28c.12** Indexed amortizing swaps are different from amortizing swaps. The terms of amortizing swaps call for scheduled reductions in the notional amount on which the payment provisions are based and there is no optionality to that feature. Thus, amortizing swaps are neither net written options nor a combination of options.

**28c.13** In certain derivative contracts, such as interest rate swaps and foreign currency and commodity forward contracts, the terms of the instrument contain knock-out or knock-out/knock-
in provisions. These provisions allow the counterparty to cease or modify payments normally due under the derivative when the underlying exceeds a predetermined rate or price. These features lower the cost of the derivative to the customer by decreasing the possible gain that would be generated by the derivative in the absence of the feature that allows the counterparty to modify or cease payment.

28c.14 Take, for example, a transaction in which an entity enters into a pay-fixed, receive six-month LIBOR interest rate swap agreement with a fixed leg of 6% and a variable leg of LIBOR. The contract contains a knock-out/knock-in provision under which the net settlement payments under the contract are $0 when six-month LIBOR equals or exceeds 8%. If six-month LIBOR subsequently drops below 8%, payments resume. Thus, when the customer would be receiving a 200 or greater basis point spread, the net settlement becomes $0. If this provision were not included in the contract, the cost of the swap to the customer would be higher (e.g. the pay-fixed leg may have been more than 6%).

28c.15 These knock-out and knock-out/knock-in provisions are considered written options, because a net premium is received in the form of a favorable rate or other term in exchange for the provision. When the provision (written option) is combined with a no-option derivative (the interest rate swap in the example above) paragraph 28(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95) requires that the entire contract be considered a net written option.

28c.16 In the majority of derivative contracts that contain knock-out or knock-out/knock-in provisions, the written option provision reduces the favorable cash flows in the derivative when it is beneficial to the reporting entity. When this feature is combined with the hedged item’s concurrent unfavorable cash flows, the net result is an unfavorable cash flow on the combined derivative and hedged item position. However, when the derivative is detrimental to the reporting entity, there is no offsetting knock-out or knock-out/knock-in provision. Thus, when this lack of offset is combined with the hedged item’s concurrent favorable cash flows effect, the result is a neutral effect of the combined derivative and hedged item position. Thus, we believe that circumstances are rare in which a derivative contract containing a knock-out or knock-out/knock-in provision would meet the written option effectiveness test in paragraph 28(c) (ASC paragraphs 815-20-25-94 and 25-95) and qualify for hedge accounting treatment.

28c.17 There are a variety of other issues associated with assessing hedge effectiveness and measuring hedge ineffectiveness in hedging relationships involving option contracts. These issues are discussed in Appendix A to this section.

Special Rule for Basis Swaps

28d.01 Paragraph 28(d) of the Standard (ASC paragraphs 815-20-25-50 and 25-51) identifies additional hedge criteria that must be met when hedging with a basis swap in a cash flow hedge:

28d. If a hedging instrument is used to modify the interest receipts or payments associated with a recognized financial asset or liability from one variable rate to another variable rate the hedging instrument must be a link between an existing designated asset (or group of similar assets) with variable cash flows and an existing designated liability (or group of similar liabilities) with variable cash flows and be highly effective at achieving offsetting cash flows. A link exists if the basis (that is the rate index on which the interest rate is based) of one leg of an interest rate swap is the same as the basis of the interest receipts for the designated asset and
the basis of the other leg of the swap is the same as the basis of the interest payments for the
designated liability. In this situation the criterion in the first sentence in (paragraph 29(a)) is
applied separately to the designated asset and the designated liability.

DIG Issue related to this paragraph is G25. See DIG Issues Index.

28d.02 The objective of a cash flow hedge is to reduce the exposure to variability in expected
future cash flows that is attributable to a particular risk. In addition to fixing the cash flows
associated with an existing variable-rate financial asset or liability, an entity may wish to use
derivative instruments to change the interest rate characteristics of a variable-rate financial asset
or liability from one variable-rate index to another. Instruments that accomplish this change
commonly are known as basis swaps. Basis swaps may enable entities to better match the cash
flows between assets and liabilities and reduce basis risk. Basis risk arises, for example, when an
entity acquires a financial asset that is funded with a financial liability and both financial
instruments have variable rate cash flows but the variability of one position does not move in
unison with the variability of the other position.

28d.03 For example, an entity that has a one-month LIBOR-based asset funded by a U.S. Prime-
based liability has economic basis risk between LIBOR and U.S. Prime interest rates. If one-
month LIBOR rates decrease significantly and U.S. Prime rates remain unchanged, the entity
would experience a significant change in the margin between the interest rates associated with
the two positions. To mitigate this, entities may enter into a basis swap. However, a basis swap
does not reduce or eliminate variability of the individual asset’s or liability’s cash flows, which is
the fundamental objective of a cash flow hedge. Instead, a basis swap merely changes the
variability of the interest cash flows from one index to another. The following illustrates a typical
basis swap strategy.

Exhibit 6.2: Basis Swap Cash Flows

<table>
<thead>
<tr>
<th>Asset</th>
<th>Liability</th>
<th>Basis Swap</th>
<th>Net Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>—</td>
<td>Pay U.S. Prime</td>
<td>Receive U.S. Prime</td>
<td>Net receive zero</td>
</tr>
</tbody>
</table>

Receive one-month LIBOR + 300 bps
Pay one-month LIBOR + 175 bps
Net receive 125 bps
By using the basis swap, the entity is able to lock in a net margin of 125 basis points (bps).

**28d.04** Although basis swaps do not reduce or eliminate the variability of cash flows, those instruments may be designated as the hedging instrument in a cash flow hedging relationship if certain additional hedge criteria are met. The Board decided to permit the use of basis swaps in a hedging relationship that involves a combined asset-liability position because, in this circumstance, basis swaps may reduce the variability of future cash flows that are attributable to the combined position.

**IDENTIFYING THE HEDGING RELATIONSHIP AND HEDGED FORECASTED TRANSACTIONS**

**28d.05** A cash flow hedging relationship involving a basis swap is a single hedging relationship for purposes of applying the Standard. Paragraph 28(d) of the Standard indicates (ASC paragraphs 815-20-25-50 and 25-51) that the basis swap must be used to modify the interest receipts of the recognized financial asset and the interest payments of the recognized financial liability. As a result, an entity must identify the net interest cash flows (of the recognized financial asset and recognized financial liability) as the hedged forecasted transactions. That is, although each leg of the basis swap must be linked to the designated item with the same underlying separately, the hedged forecasted transactions are the net interest cash flows of those combined designated items. The ability to hedge the net interest cash flows of a recognized financial asset and liability attributable to changes in the identified hedged risk is not permitted anywhere else in the Standard.

**28d.06** The Standard requires that the financial asset and liability be recognized in the financial statements. In addition, the recognized financial asset, the recognized financial liability, and the related net interest cash flows being hedged must be specifically identified in the hedge documentation. Because the recognized financial asset and the recognized financial liability must be specifically identified, neither can be replaced during the hedging relationship. That is, an entity is not permitted to substitute the cash flows of another existing financial asset or liability with the cash flows of the existing financial asset or liability that it documented originally. DIG Issue G25 provides an exception to the prohibition on replacement of recognized assets and liabilities in certain hedging relationships involving portfolios of similar assets or similar liabilities (see Paragraphs 28d.13-28d.15 of this section for further discussion of this exception).

**28d.07** Paragraph 28(d) of the Standard (ASC paragraphs 815-20-25-50 and 25-51) states that an entity can apply cash flow hedge accounting to a hedging relationship involving a basis swap if each leg of the basis swap provides a link between the variable-rate interest receipts associated with a recognized financial asset and the variable-rate interest payments associated with a recognized financial liability. This requirement mandates that each leg of the basis swap be linked to a designated item with the same underlying. For example, an entity with existing one-month LIBOR-based assets funded by existing variable-rate debt that has an interest rate of U.S. Prime would be required to use a swap with one leg based on one-month LIBOR and one leg based on the U.S. Prime rate. However, a swap with one one-month LIBOR-based leg and one leg based on the BMA rate would be prohibited.
28d.08 The financial markets developed basis swaps for underlyings other than interest rates. For example, the spot price of oil can be swapped for the spot price of natural gas. While some entities may wish to extend the provisions in paragraph 28(d) of the Standard (ASC paragraphs 815-20-25-50 and 25-51) to basis swaps other than those involving exchanges of interest rates, we believe that paragraph 28(d) (ASC paragraphs 815-20-25-50 and 25-51) prohibits the use of basis swaps in a cash flow hedging relationship unless they are related to interest rates.

IDENTIFYING THE HEDGED RISK

28d.09 Because the hedging relationship is a single hedging relationship, an entity also must identify a single hedged risk. Given that the entity is hedging the net interest cash flows, an entity typically will attempt to hedge either the risk of overall changes in the net interest cash flows related to the existing financial asset and the existing financial liability or the risk of changes in the net interest cash flows related to the existing financial asset and financial liability attributable to changes in the benchmark interest rate. Because the hedging relationship is a single hedging relationship, an entity cannot identify the benchmark interest rate and a nonbenchmark rate as the hedged risk. In the U.S., the benchmark interest rate can be either LIBOR or the U.S. Treasury rate; or the Fed Funds rate for hedging relationships entered into or redesignated on or after July 17, 2013 in accordance with Accounting Standards Update 2013-10, Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes (ASU 2013-10) (see additional discussion of amendments made by ASU 2013-10 in Paragraphs 29h.13a, 29h.13b, 29h.15, 29h.16, A6.49, and A6.50). As a result, a U.S. entity can hedge interest rate risk on a variable-rate financial instrument only if the instrument is indexed to LIBOR or the U.S. Treasury rate; or the Fed Funds rate for hedging relationships entered into or redesignated on or after July 17, 2013 in accordance with ASU 2013-10. Since most, if not all, cash flow hedging relationships with a basis swap as the hedging instrument involve the hedging of the net interest cash flows of a variable-rate financial asset and a variable-rate financial liability that is not based solely on the benchmark interest rate, we believe most, if not all, cash flow hedging relationships with a basis swap must identify as the hedged risk the risk of overall changes in the net interest cash flows related to the existing financial asset and financial liability. When an entity hedges the risk of overall changes, the entity must consider all the changes in the net interest cash flows, including those related to credit and prepayment. (See Paragraphs 29h.07-29h.15 for further discussion of the benchmark interest rate.)

28d.10 To illustrate, assume an entity enters into a basis swap with a notional amount of $100,000 to receive interest at U.S. Prime and pay interest at one-month LIBOR plus 175 bps. Both rates reset at the beginning of each month and the swap settles at the end of each month. The entity identifies the basis swap as the hedging instrument for a $100,000 asset with a variable rate of one-month LIBOR plus 300 bps and a $100,000 liability with a variable rate of U.S. Prime. Both the asset and the liability rates reset at the beginning of each month and interest is required to be received or paid at the end of each month. The net interest cash flows from the asset and the liability are one-month LIBOR minus U.S. Prime plus 300 bps. As a result, the entity must hedge the overall cash flow changes of one-month LIBOR minus U.S. Prime plus 300 bps multiplied by $100,000 (the principal amount of the asset and the liability). As a result of this hedging relationship, the entity has locked in a net cash flow of 125 bps multiplied by $100,000. See Exhibit 6.2 of this section for an illustration of this hedging relationship.
ASSESSING EFFECTIVENESS AND MEASURING INEFFECTIVENESS

28d.11 When a basis swap is the hedging instrument in a cash flow hedging relationship, the hedging relationship must be highly effective in achieving offsetting cash flows attributable to the hedged risk. That is, the cash flows from the swap must be highly effective in achieving offsetting cash flows attributable to the hedged risk of the hedged forecasted net interest cash flows. As previously discussed, the hedged risk in most, if not all, cash flow hedging relationships involving a basis swap will be the risk of overall changes in the net interest cash flows related to the recognized asset and liability. To assess whether a cash flow hedging relationship is highly effective, both on a prospective and retrospective basis, we believe an entity should evaluate whether the net margin it attempted to lock in as a result of the hedging relationship (e.g., 125 bps in Exhibit 6.2 of this section) is expected to be within 80–125% of the actual cash flows of the hedging relationship.

28d.12 Although the underlying of each leg of a basis swap must be identical to the underlying of the recognized financial asset and liability, we believe the hedging relationship may not be perfectly effective in offsetting net interest cash flows attributable to the hedged risk. For example, if an entity is hedging overall changes in net interest cash flows of a recognized financial asset and a recognized financial liability, hedge ineffectiveness may result if changes in the net interest cash flows occur from credit events with the counterparty to the asset or the swap. Hedge ineffectiveness also may result if the recognized financial asset or liability, or both, and the basis swap reprice or have payments at different dates.

HEDGING NET INTEREST CASH FLOWS OF A PORTFOLIO OF SIMILAR ASSETS OR SIMILAR LIABILITIES

28d.13 The hedged forecasted net interest cash flows in a cash flow hedging relationship involving a basis swap may relate to a group of recognized financial assets (or liabilities) that comprises similar individual assets (or similar individual liabilities) with the same underlying. If the designated hedged forecasted net interest cash flows relate to a group of recognized individual assets (or liabilities), the criteria outlined in paragraph 29(a) of the Standard (ASC paragraph 815-20-25-15(a)) related to groups of designated hedged forecasted transactions must be met separately for the group of assets and/or the group of liabilities (see Paragraph 29a.01 of this section for a discussion of those criteria).

28d.14 As stated in Paragraph 28d.06 of this section, an entity generally is not permitted to substitute the cash flows of another existing financial asset or liability with the cash flows of the specifically identified existing financial asset or liability that it documented originally in a hedge using a basis swap. As a result, if an entity is hedging the net interest cash flows of a group of specifically identified existing assets or liabilities, or both, and one of the assets, liabilities, or both, is prepaid or its cash flows decrease due to a credit event, the entity is not permitted to replace that asset or liability with another existing asset or liability. Instead, the hedging relationship must be evaluated to determine whether it is expected to be highly effective going forward (after having considered the impact of the change in the composition of the portfolio) or it should be discontinued. Because of the inability to replace assets and liabilities in these relationships, we believe it generally will be difficult to use a basis swap to hedge the net cash flows of a group of assets or liabilities. However, certain replacement strategies are allowable based on the guidance provided in DIG Issue G25. In hedging relationships involving basis
swaps, the hedged net interest cash flows identified over the life of the relationship may be associated with differing assets or liabilities within a portfolio of identified similar assets or similar liabilities provided that (a) the hedged risk is the risk of overall changes in net interest cash flows, (b) the entity is using the first-payments-received technique to identify the hedged forecasted transactions, and (c) all identified hedged cash flows are associated with assets or liabilities that existed at the inception of the hedge. See Paragraphs 29h.04-29h.05 of this section for further discussion of the first-payments-received technique.

28d.15 The following examples illustrate the application of the basis swap provisions:

**Example 6.2: Basis Swap that Qualifies for Cash Flow Hedge Accounting**

Bank C has a five-year $10,000,000 variable-rate commercial loan that earns one-month LIBOR plus 4%. The loan is funded by a five-year, $10,000,000 debt obligation that pays interest at U.S. Prime plus 1%. To reduce its basis risk, Bank C enters into a five-year basis swap with a notional amount of $10,000,000 to receive interest at a variable rate equal to U.S. Prime and to pay interest at a variable rate equal to one-month LIBOR plus 2%. The rates and payment dates of the swap mirror those of the commercial loan and debt obligation.

Bank C identifies the basis swap as the hedging instrument in a hedging relationship to hedge the risk of overall changes in the net interest cash flows of the $10,000,000 debt obligation and the $10,000,000 commercial loan.

Bank C links the one-month LIBOR-based leg of the basis swap to the $10,000,000 commercial loan and the U.S. Prime-based leg of the basis swap to the $10,000,000 debt obligation.

If the other requirements for hedge accounting have been met (including high effectiveness), this basis swap would qualify for cash flow hedge accounting under paragraph 28(d) (ASC paragraphs 815-20-25-50 and 25-51) because:

- The underlying asset is an existing financial asset and the underlying liability is an existing financial liability, and both have been individually identified;
- The basis swap is used to modify the changes in overall cash flows of the net interest cash flows associated with the commercial loan and the debt obligation; and
- Each leg of the basis swap has been linked to a designated hedged item with the same underlying.
Example 6.3: Basis Swap that Does Not Qualify for Cash Flow Hedge Accounting

ABC Co. wants to obtain five-year, Prime-based funding. It can do so in several ways, including:

- Entering into a five-year debt obligation indexed to Prime;
- Borrowing at fixed rates while simultaneously entering into an interest rate swap that converts the fixed rate into Prime; or
- Borrowing at variable rates linked to another index while simultaneously entering into a basis swap that converts that other index to Prime.

After extensive analysis, ABC Co. issues a five-year, $10,000,000 debt obligation. The interest rate on the debt obligation is variable at one-month LIBOR. ABC Co. simultaneously enters into a five-year basis swap with a notional amount of $10,000,000 to receive interest at a variable rate equal to one-month LIBOR and to pay interest at a variable rate equal to Prime.

Based on the information presented, this strategy does not qualify for hedge accounting because the swap has only one leg that could be linked to a recognized financial asset or liability, not both legs. Among other requirements, for a basis swap to qualify for hedge accounting, each leg of the swap must be separately linked to a recognized financial asset and a recognized financial liability.

Proscription Against Cash Flow Hedges Involving Nonderivative Instruments

28.11 Paragraph 28 of the Standard (ASC paragraphs 815-20-25-71) states the following about nonderivative instruments:

28. A nonderivative instrument such as a Treasury note shall not be designated as a hedging instrument for a cash flow hedge.

28.12 From an economic perspective, entities can hedge their cash flow exposures in several ways. One way of doing so is to use financial instruments (i.e., recognized financial assets or liabilities such as investments or debt obligations) to mitigate the risk attributable to forecasted transactions. For example, an entity might want to designate a one-month LIBOR-based asset in a hedge of a one-month LIBOR-based liability because the forecasted cash flows of the two positions may be expected to offset. The accounting model for cash flow hedges discussed in this section relates only to hedging relationships that involve instruments that meet the characteristics-based definition of a derivative contained in paragraph 6 of the Standard (ASC paragraphs 815-10-15-71, 15-83, and 15-85). Nonderivative instruments used in economic hedges of forecasted transactions are required to be accounted for based on the relevant accounting requirements for those instruments.

28.13 The Board believes that accounting for a nonderivative instrument as a hedging instrument is inappropriate because:
Hedge accounting may result in overriding the established measurement principles for the nonderivative instrument simply because it is part of a hedging relationship; and

The accounting for nonderivative instruments is adequately addressed by existing accounting literature.

However, consistent with the provisions of Statement 52 (ASC Topic 830), nonderivative instruments that give rise to foreign currency transaction gains and losses may be designated as fair value hedging instruments of foreign-currency-denominated unrecognized firm commitments and hedges of net investments in foreign operations. See Paragraphs 37.08-37.10 and 42.04-42.05 of Section 7 for additional information.

ELIGIBILITY REQUIREMENTS OF THE FORECASTED TRANSACTION

29.01 In addition to the qualification requirements discussed in paragraph 28 of the Standard (ASC paragraphs 815-20-25-1, 25-3, 25-13, 25-15, 25-50, 25-51, 25-75, 25-76, 25-80, 25-94, and 25-95), paragraph 29 of the Standard (ASC paragraph 815-20-25-15) provides the following requirements that must be met for a forecasted transaction to be eligible for designation as the hedged forecasted transaction in a cash flow hedging relationship:

The hedged forecasted transaction:

• Is specifically identified as a single transaction or a group of individual transactions that share the same risk exposure for which they are designated as being hedged (see paragraph 29(a) of the Standard (ASC paragraph 815-20-25-15(a)));

• Is probable of occurring (see paragraph 29(b) of the Standard (ASC paragraph 815-20-25-15(b)));

• Is a transaction with a party external to the reporting entity and presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings (see paragraph 29(c) of the Standard (ASC paragraph 815-20-25-15(c)));

• Is prohibited from having certain characteristics (see paragraph 29(d) of the Standard (ASC paragraphs 815-20-25-15(d) and 25-15(e))); and

• Cannot involve business combinations subject to FASB Statement No. 141, Business Combinations (Statement 141), or involve certain equity investments or instruments (see paragraph 29(f) of the Standard) (ASC paragraph 815-20-25-15(g)).

The designated risk being hedged must meet specific conditions for the following hedged items:

• A forecasted transaction related to a held-to-maturity debt security (see paragraph 29(e) of the Standard (ASC paragraph 815-20-25-15(f)));

• A forecasted purchase or sale of a nonfinancial asset (see paragraph 29(g) of the Standard (ASC paragraph 815-20-25-15(i))); and

• A forecasted purchase or sale of a financial asset or liability or the variable cash flows of an existing financial asset or liability (see paragraph 29(h) of the Standard (ASC paragraph 815-20-25-15(j))).
Paragraph 29 of the Standard (ASC paragraph 815-20-25-15) discusses the eligibility requirements of the hedged forecasted transaction and begins with the following:

A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

DIG Issues related to this paragraph are G2, G5, G13, G14, G15, G25 and H4. See DIG Issues Index.

**Forecasted Transactions Must Share Same Risk Exposure**

Paragraph 29(a) of the Standard (ASC paragraph 815-20-25-15(a)) permits entities in certain circumstances to designate a group of forecasted transactions as the hedged item:

The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.

DIG Issues related to this paragraph are G17, G18, G22 and G23. See DIG Issues Index.

To qualify for cash flow hedge accounting, paragraph 29(a) of the Standard (ASC paragraph 815-20-25-15(a)) requires an entity to specifically identify the single forecasted transaction or group of transactions that give rise to the cash flow exposure that is being hedged. That information is necessary to (a) assess the likelihood that the transaction will occur, (b) determine whether the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the risk being hedged, (c) assess hedge effectiveness on an ongoing basis, and (d) measure hedge ineffectiveness.

The Board understands that there may be circumstances in which it is impractical (perhaps impossible) and not cost-effective to identify each individual transaction being hedged. Thus, the Standard permits entities to aggregate individual forecasted transactions for hedging purposes in limited circumstances. Similar to a hedge of a single forecasted transaction, an entity must identify the hedged transactions with sufficient specificity so that it is possible to determine which transactions are the hedged transactions when they occur. For example, an entity that expects to sell at least 300,000 widgets in its next fiscal quarter may designate sales of the first 300,000 widgets as the hedged transactions. Alternatively, it might designate the first 100,000 sales in each month as the hedged transactions. It could not, however, designate any sales of 300,000 widgets during the quarter as the hedged transaction because it then would be impossible to determine whether any individual sales transaction during the quarter was a hedged transaction. Similarly, an entity could not designate the last 300,000 sales of the quarter as the hedged item because it would not be possible to determine whether sales early in the quarter were hedged until the quarter had ended. The same first-payments-received technique applies in identifying the hedged forecasted transactions in relationships involving portfolios of interest payments. Refer to Paragraph 29h.04 of this section for further discussion. Although there is flexibility in identifying the hedged forecasted transactions, the assessment of effectiveness and measurement of ineffectiveness (discussed in Paragraphs 28b.01-28b.17, 30.01-30.14 and
Appendix A of this section) must consider the timing of the hedged forecasted transactions’ cash flows.

**USE OF LAYERING WITH FIRST-PAYMENTS-RECEIVED (PAID) APPROACH**

29a.03a In hedging groups of forecasted transactions using a first-payments-received (paid) approach, entities may choose to enter into multiple derivative contracts and layer these contracts such that each derivative will be designated in a separate individual hedging relationship. For example, assume an entity has a LIBOR-based loan portfolio in excess of $1 billion in principal. The entity currently has two swaps that it wishes to use to hedge the variability in some of the interest payments from the portfolio. While the entity intends to hold these two swaps to maturity, it may elect to add more swaps in the future as the principal of the portfolio grows or as the entity decides to hedge more interest payments from the existing portfolio. (Alternatively, as discussed in Paragraph 29h.04, the entity could have documented the hedging strategy without specifying a specific loan portfolio.) Assume Swap #1 has a $100 million notional and matures on December 31, 2007 and Swap #2 has a $150 million notional and matures on December 31, 2009. The entity could use a layering approach to identify the hedged forecasted transactions in two separate hedging relationships. The first relationship with Swap #1 as the hedging instrument would be hedging the first interest payments received each month on $100 million of principal of the entity’s LIBOR-based loan portfolio through December 31, 2007. The second relationship with Swap #2 as the hedging instrument would be hedging the first interest payments received each month on $150 million of principal through December 31, 2009 that have not been identified as hedged forecasted transactions in a previously designated hedging relationship (i.e., the relationship with Swap #1 as the hedging instrument). (Refer to further discussion and example below on how an entity may formally document the identification of the hedged forecasted transaction when using a layering approach.) Even though the discussion in this section is in the context of hedging interest receipts, it applies to other forecasted transactions such as forecasted sales or expenses in a foreign currency, sales of non-financial items, etc.

29a.03b We believe that using this layering approach meets all the requirements in the Standard to identify, for each of the individual hedging relationships, the hedged forecasted transactions with sufficient specificity so that you know a transaction is hedged when it occurs. We believe this approach also provides entities with the flexibility to add additional hedging relationships (i.e., add layers) as well as remove existing relationships (i.e., delete layers), without disturbing the other hedging relationships via dedesignation and redesignation because no change to the identification of the hedged forecasted transactions associated with those other relationships is required. This is the case because the designation of each relationship will always identify the hedged forecasted transactions as the first payments received after (a) those cash flows that have already been identified as hedged forecasted transactions in a previously designated hedging relationship that continues to be active and (b) those cash flows that were previously identified in a hedging relationship that has been terminated (i.e., is inactive) but are still at least reasonably possible of occurring such that some portion of the gain or loss on the dedesignated hedging relationship remains in AOCI. Adding a derivative to the existing layers will put that relationship at the end of the priority chain such that it will be designated as hedging the first forecasted transactions occurring after (a) and (b) discussed above without impacting the designation of those earlier relationships. Furthermore, if a derivative matures such that a relationship early in
the priority chain terminates, the identification of the forecasted transactions for the relationships later in the priority chain will not be impacted because they will continue to hedge the first payments received after (a) those that are already hedged in active hedging relationships and (b) those that were previously identified in a hedging relationship that has been terminated (i.e., is inactive) for which amounts remain in AOCI. If no amounts remain in AOCI related to the derivative that matured, the forecasted transactions that will be identified with the (i) active relationships and (ii) those inactive relationships that continue to have amounts in AOCI, will be the forecasted transactions occurring earlier in the priority chain than before. This is because those relationships will have moved up in priority due to the disappearance of the earlier layer as a result of the derivative’s maturity and the reclassification to earnings of its related amounts in AOCI. When a relationship moves up in the priority chain, the perfectly effective hypothetical (PEH) associated with that relationship will need to be adjusted to reflect the most recent best estimate of the forecasted transactions that are identified with that relationship. See Paragraphs A6.115-A6.119 for further discussion of the PEH.

29a.03c While we believe that this layering approach is a simple and effective methodology for identifying the hedged forecasted transactions for many hedging programs, entities cannot lose sight of the fact that each hedging relationship stands on its own; that is, entities cannot apply a hedge documentation approach that ignores the priority chain designation of forecasted transactions. Thus, complexities arise, and the level of documentation may be higher, in certain programs, particularly those in which an entity is actively managing groups of existing hedging relationships (e.g., terminating or redesiging derivatives prior to maturity) and is experiencing shortfalls of forecasted transactions. Below are a discussion and examples that provide our view on how to address such complex hedging situations. Consider a situation in which an entity that employs a layering approach with multiple derivatives discontinues a single hedging relationship before all the related hedged forecasted transactions affect earnings because it wishes to early terminate the hedging derivative. Because paragraph 33 of the Standard (ASC paragraphs 825-30-40-4 and 40-5) requires that the gain or loss related to a discontinued cash flow hedging relationship remain in AOCI unless the forecasted transaction is probable not to occur (refer to Paragraph 33.01 for further discussion), the question arises as to whether the hedging relationship that is next in line in the priority (and all the relationships after it in the priority chain) will automatically move up into the vacated space of the discontinued relationship, or if, because the forecasted transactions that have been previously identified with the discontinued relationship continue to be identified with that relationship for purposes of determining the reclassification of the designated derivative’s gain or loss out of AOCI, they are timed-out such that all the ongoing relationships occurring later in the priority chain maintain their position until all amounts associated with the discontinued relationship have been reclassified from AOCI.

29a.03d We believe that when an entity redesigates a hedging relationship while using this layering approach, the relationships that follow that layer in the priority chain maintain their position in the priority chain until all amounts have been reclassified out of AOCI for the redesignated relationship unless those ongoing relationships are specifically repositioned in the priority chain through a formal redesignation and redesignation. To automatically move up in priority in these situations may result in an entity that is experiencing a shortfall in forecasted transactions concluding that no amounts should be reclassified from AOCI related to the discontinued relationship and at the same time concluding that sufficient forecasted transactions
are probable of occurring for the ongoing relationships with no change to the existing hedge documentation.

29a.03e For example, assume that the entity in Paragraph 29a.03a early terminated Swap #1 because only interest payments on $150 million of principal remain probable of occurring. If Swap #2 automatically moved-up to the first tranche in the priority chain, the entity would conclude that (a) no reclassification of amounts from AOCI related to Swap #1 is necessary because the first payments received on $100 million of principal (determined based on Swap #1 original position in the priority chain) are still probable of occurring and (b) Swap #2’s relationship may continue undisturbed because interest payments on $150 million are still probable of occurring and the very first payments received can be attributed entirely to Swap #2 because it has moved up into Swap #1’s position in the priority chain. This view would therefore result in no reclassification from AOCI even though there will only be interest payments on $150 million of principal that were previously being hedged by $250 million of swap notional. Alternatively, if Swap #2 maintains its position because amounts remain in AOCI related to Swap #1, the entity would conclude that (a) no reclassification of amounts from AOCI related to Swap #1 is necessary because the first payments received on $100 million of principal (determined based on Swap #1 original position in the priority chain) are still probable of occurring and (b) Swap #2’s relationship must be discontinued because the relationship is no longer expected to be highly effective (the entity has a derivative with a notional of $150 million and only interest payments on $50 million in principal remain probable of occurring after the interest payments on the first $100 million of principal continue to be identified with Swap #1 to support retaining amounts in AOCI). Because DIG Issue G18 states that an entity is only required to discontinue hedge accounting for those specific hedged forecasted transactions that are no longer probable of occurring, if Swap #2 with a notional of $150 million continued to be highly effective at hedging interest receipts on the lower principal balance (i.e., factoring in the shortage in hedged forecasted interest receipts), the originally documented hedging relationship could continue but would generate increased ineffectiveness. In either situation, the entity would be required to reclassify amounts from AOCI to earnings for any specific forecasted transactions that are probable of not occurring.

29a.03f The entity in this example would however, be permitted to formally redesignate a new relationship using Swap #2 to hedge the first payments received on $150 million of principal without regard to the fact that the interest payments on $100 million of that $150 million in expected remaining principal are also supporting the retention of amounts in AOCI related to Swap #1. We believe that this strategy executed through formal redesignation is appropriate because (a) it requires recognition in the financial statements for the effect of a shortfall in forecasted transactions based on each relationship’s original position in the priority chain, (b) it does not allow an entity to cherry-pick which amounts from AOCI will be reclassified from the shortfall (a shortfall will always impact the last relationship in the priority chain first regardless of which swaps are terminated or dedesignated), and (c) requires an entity that must stop a hedging relationship due to a shortfall in forecasted transactions to formally redesignate that hedging relationship in order to continue hedge accounting.

29a.03g It is important to note that using this layering approach when a hedging relationship is dedesignated within a priority chain and amounts remain in AOCI for that relationship, in order for the entity to formally re-hedge the position that has been vacated (with a new or existing
derivative), it would need to redesignate all the relationships that follow the desig- nated relationship in the priority chain. In other words, it cannot re-order/re-position certain relationships within the priority chain without formally redesignating all the relationships from the point at which the chain was broken. For example, if there were three swaps in the above example and the entity wished to have two hedging relationships going forward with one of the remaining swaps in the position that Swap #1 vacated, assuming there were enough probable forecasted transactions, it would need to redesignate both Swaps #2 and #3 and then formally redesignate one or both. It is also important to note that if a new relationship is layered on to an existing priority chain, while that relationship may be designated to immediately follow the latest active relationship in the chain without disturbing any of the other relationships (i.e., it may rehedge a layer of forecasted transactions that was previously identified in a hedging relationship that was terminated for which amounts remain in AOCI provided that terminated relationship was designated later in the priority chain than the latest active hedging relationship), it will still remain behind relationships that were terminated for which amounts remain in AOCI that were designated earlier in the priority chain than the latest active relationship. This occurs because the latest active relationship has not been redesignated and thus it, and all the relationships before it in the prior chain (active and inactive for which amounts remain in AOCI), remain in their originally designated positions. For example, assume that the entity in the example above had started with just the two original swaps, had terminated Swap #1 but it was still probable it would have enough forecasted interest payments such that Swap #2 remained highly effective (keeping in mind its original position in the priority chain after terminated Swap #1 since amounts in AOCI remain for Swap #1). Assume also that it later elected to newly designate Swap #3. Swap #3 may be designated to immediately follow Swap #2 without disturbing Swap #2's relationship (even if there had been previous swaps designated after Swap #2 that before Swap #3's designation had been terminated for which amounts remained in AOCI), but it would also remain behind Swap #1. This occurs because Swap #2's relationship has not been redesignated and thus it and all the relationships before it (active and inactive for which amounts remain in AOCI - Swaps #1 and 2 in this case) remain in their originally designated positions in the priority chain. Accordingly, in order for Swap #3 to be eligible for hedge accounting, in addition to the other hedge accounting criteria, there must be probable forecasted interest payments on principal equal to or greater than the notional amounts of Swap #1, Swap #2 and Swap #3.

29a.03h The following example illustrates the above guidance in various scenarios.

**Example 6.3a Use of Layering Approach**

- Company ABC has five swaps. Each swap has a notional of $10 and the company wishes to hedge interest payments on $50 in total principal.

- Swap #1 is designated as hedging the first interest payments made on $10 of principal expected to occur each month for the next five years. At the inception of the hedge, Swap #1 is hedging interest payments on principal $1-$10.

- Swap #2 is designated as hedging the first interest payments made on $10 of principal expected to occur each month for the next five years that (a) are not
currently being hedged by a previously designated hedging relationship (i.e., hedged by a swap that is earlier in priority – in this case Swap #1) or (b) were not previously identified in a relationship originally designated earlier in the priority chain that has been terminated for which amounts remain in AOCI (no relationships currently fall into this category because no relationships designated earlier in priority have been discontinued after Swap #2’s designation). At the inception of the hedge, Swap #2 is hedging interest payments on principal $11-$20.

- Swaps #3, #4, and #5 are all designated similar to the designation for Swap #2.

**Scenario 1 – Swap #3 Matures**

- Hedging relationships involving Swaps #1, #2, #4 and #5 continue.
- Hedging relationships involving Swaps #4 and #5 move up in the priority chain and the PEHs for those ongoing hedging relationships are adjusted to reflect the most recent best estimate of the hedged forecasted cash flows (i.e., are adjusted to reflect Swaps #4 and #5’s move up in the priority chain).

When a swap in the priority chain matures and all amounts related to the instrument have been reclassified out of AOCI, all the swaps that follow in the priority chain move up automatically without being de-designated/redesignated. This is the case because the original identification of the forecasted transaction has been described with sufficient specificity to identify it when it occurs and has not changed as a result of the maturity. It is important to note, however, that if Swap #3 matures and all amounts related to that instrument have not been reclassified out of AOCI, all the swaps that follow in the priority chain do not move up automatically. This situation would be accounted for in the same manner as if Swap #3 had been terminated prior to maturity — refer to Scenario 2 for further discussion of this fact pattern.

If Swap #3 matures, Swap #4 is still hedging the first interest payments made on $10 of principal expected to occur each month for the next five years that (a) are not currently being hedged by a previously designated hedging relationship (in this case Swaps #1 and #2) or (b) were not previously identified in a relationship originally designated earlier in the priority chain that has been terminated for which amounts remain in AOCI (would not apply in this case because all amounts related to Swap #3 have been reclassified).

For purposes of building the PEH for the ongoing hedge relationships, Swap #4 will be hedging interest payments on principal $21-$30 and Swap #5 will be hedging interest payments on principal $31-$40. Because Swap #4 had previously been hedging interest on principal $31-$40 and Swap #5 had previously been hedging interest on principal $41-$50, both PEHs will require adjustment due to differing characteristics associated with the different tranches of interest payments.
Interest Payments on Principal | Before Swap #3 Matures | After Swap #3 Matures
--- | --- | ---
$1-10 | #1 | #1
11-20 | #2 | #2
21-30 | #3 | #4
31-40 | #4 | #5
41-50 | #5 | -

Scenario 2 – Swap #3 is Terminated; Interest on $50 of Principal Remains Probable of Occurring

- Hedging relationships involving Swaps #1, #2, #4 and #5 continue.
- Hedging relationship involving Swap #3 is discontinued and related amounts in AOCI are not immediately reclassified to earnings.
- Hedging relationships involving Swaps #4 and #5 do not move up in the priority chain and the PEHs for those ongoing hedging relationships are not adjusted.

Because all of the originally specified hedged forecasted transactions remain probable of occurring (and specifically interest payments on principal $21-$30 which were being hedged by Swap #3), no amounts will be reclassified from AOCI to earnings.

When a swap in the priority chain is terminated and all amounts related to that instrument have not been reclassified out of AOCI, all the swaps that follow in the priority will not move up automatically. Accordingly, in this case, if Swap #3 is terminated, Swap #4 continues to hedge the first interest payments made on $10 of principal expected to occur each month for the next five years that (a) are not currently being hedged by a previously designated hedging relationship (in this case Swaps #1 and #2) or (b) were not previously identified in a relationship originally designated earlier in the priority chain that has been terminated for which amounts remain in AOCI (in this case Swap #3 because amounts related to Swap #3 have not been reclassified).

For purposes of building the PEH for the ongoing hedge relationships, because Swap #4 will continue to hedge interest payments on principal $31-$40 and Swap #5 will continue to hedge interest payments on principal $41-$50, neither PEH will require adjustment because they continue to hedge the same tranche of forecasted transactions.
(a) The gain/loss for Swap #3 is reclassified from AOCI when interest payments on principal $21-$30 affect earnings.

Scenario 2a – Same Facts as Scenario 2 but Now Assume Company ABC Also Terminates Swap #5 and Wishes to Designate A New Swap #6

- Hedging relationships involving Swaps #1, #2, and #4 continue.
- Hedging relationship involving Swap #3 is discontinued and related amounts in AOCI are not immediately reclassified to earnings.
- Hedging relationship involving Swap #4 does not move up in the priority chain and the PEH for that ongoing hedging relationship is not adjusted.
- Hedging relationship involving Swap #5 is discontinued and related amounts in AOCI are not immediately reclassified to earnings.
- Hedging relationship involving Swap #6 is designated as hedging the first interest payments made on $10 of principal expected to occur each month for the next five years that (a) are not currently being hedged by a previously designated hedging relationship or (b) were not previously identified in a relationship originally designated earlier in the priority chain that has been terminated for which amounts remain in AOCI. Note that this results in Swap #6 hedging interest payments on principal $41-$50 because category (b) does not include those interest payments associated with terminated relationships that follow Swap #4 (the last active relationship) in the priority chain (Swap #5 in this case).

As discussed in Scenario 2 above, because all of the originally specified hedged forecasted transactions remain probable of occurring (and specifically interest payments on principal $21-$30 and $41-$50 which were being hedged by Swaps #3 and #5 respectively), no amounts will be reclassified from AOCI to earnings. Further, because all the swaps that follow in the priority will not move up automatically when a swap in the priority chain is terminated and all amounts related to that instrument have not been reclassified out of AOCI, Swap #4 continues to hedge interest payments on principal $31-$40 and its PEH will not be adjusted.

Designating Swap #6 in a new relationship in the priority chain requires Company ABC to add to the end of the existing priority chain. Company ABC would not be permitted to reposition the existing priority chain without dedesignating and redesignating the current hedging relationships that were originally designated as following the vacated tranche. For example, Company A would not be permitted to insert Swap #6 to hedge interest payments on principal $21-$30 (which is the tranche previously hedged by Swap #3) without dedesignating and redesignating Swap #4 because to do so would break the existing priority chain. Instead, Company ABC would identify Swap #6 as hedging the first interest payments made on $10 of principal expected to occur each month for the next five years.
that (a) are not currently being hedged by a previously designated hedging relationship (in this case Swaps #1, #2, and #4) or (b) were not previously identified in a relationship originally designated earlier in the priority chain that has been terminated for which amounts remain in AOCI. No relationships currently fall into category (b) because no relationships following Swap #4 have been discontinued after Swap #6’s designation. In other words, Swap #6 may fill in the position vacated by Swap #5 because while Swap #5 was terminated before Swap #6’s designation and related amounts remain in AOCI, it was originally designated later in the priority chain than the latest active relationship (Swap #4). However, Swap #6 remains behind relationships that were terminated for which amounts remain in AOCI that were designated earlier in the priority chain than Swap #4 (i.e., Swap #3 in this case). This occurs because Swap #4's relationship has not been dedesignated and thus it and all the relationships before it (active and inactive for which amounts remain in AOCI - Swaps #1-#3 in this case) remain in their originally designated positions in the priority chain. This designation would result in Swap #6 hedging interest payments on principal $41-$50.

<table>
<thead>
<tr>
<th>Interest Payments on Principal</th>
<th>Before Swaps #3 and #5 are Terminated/Swap #6 is designated</th>
<th>After Swaps #3 and #5 are Terminated/Swap #6 is designated</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1-10</td>
<td>#1</td>
<td>#1</td>
</tr>
<tr>
<td>11-20</td>
<td>#2</td>
<td>#2</td>
</tr>
<tr>
<td>21-30</td>
<td>#3</td>
<td>(a)</td>
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<tr>
<td>31-40</td>
<td>#4</td>
<td>#4</td>
</tr>
<tr>
<td>41-50</td>
<td>#5</td>
<td>#6(b)</td>
</tr>
</tbody>
</table>

(a) The gain/loss for Swap #3 is reclassified from AOCI when interest payments on principal $21-$30 affect earnings.
(b) The gain/loss for Swap #5 is reclassified from AOCI when interest payments on principal $41-$50 affect earnings.

**Scenario 3 – Swap #3 is Terminated; Interest on Only $40 of Principal Remains Probable of Occurring (Interest on $10 of Principal Is Not Probable of Occurring)**

- Hedging relationships involving Swaps #1 and #2 continue.
- Hedging relationship involving Swap #3 is discontinued and related amounts in AOCI are not immediately reclassified to earnings.
- Hedging relationship involving Swap #4 continues.
- Hedging relationship involving Swap #5 is discontinued; if interest payments on principal $41-$50 are probable not to occur, related amounts in AOCI are immediately reclassified to earnings.
Hedging relationship involving Swap #4 does not move up in the priority chain and the PEH for that ongoing hedging relationship is not adjusted.

Because Swap #3 has been terminated, the hedging relationship is discontinued. However, because Swap #3’s forecasted transactions (interest payments on principal $21-$30) are still probable of occurring, the amounts in AOCI related to Swap #3 will remain in AOCI. Those amounts will be reclassified as the interest payments on principal $21-$30 affect earnings.

As discussed in Scenario 2 above, because amounts remain in AOCI for Swap #3, Swap #4 will not move up in priority and thus continues to hedge interest payments on principal $31-$40. Similarly, Swap #5 continues to hedge interest payments on principal $41-$50. Because interest payments on principal $41-$50 are no longer probable of occurring, Company ABC must terminate the original hedging relationship for each of those specific non-probable forecasted transactions in accordance with DIG Issue G18. In this case, application of DIG Issue G18 will require a dedesignation of Swap #5 (and an immediate reclassification to earnings of AOCI for Swap #5 if interest on principal $41-$50 are probable not to occur, otherwise amounts will be reclassified from AOCI when interest payments on principal $41-$50 affect earnings). In other circumstances, DIG Issue G18 may not result in dedesignation of Swap #5, for example, if Swap #5 would continue to be highly effective based on the most recent best estimate of the forecasted cash flows. That could occur in this example if Company ABC believed that interest payments on principal of $49 were still probable of occurring. In that case, if Swap #5 (with a notional of $10) continues to be highly effective at hedging interest payments on $9 (i.e., the remaining principal that would be available to be hedged by Swap #5 after considering those interest payments on $40 in principal that have been or are currently being hedged by Swaps #1-#4), the hedging relationship would continue without the need to redesignate, but the shortage in interest payments would generate ineffectiveness. In either circumstance, an entity may elect to formally redesignate both Swap #4 and Swap #5 to hedge interest payments on principal $21-$30 and $31-$40, respectively. Refer to Scenario 3b for further discussion.

<table>
<thead>
<tr>
<th>Interest Payments on Principal</th>
<th>Before Swap #3 is Terminated</th>
<th>After Swap #3 is Terminated</th>
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</thead>
<tbody>
<tr>
<td>$1-10</td>
<td>#1</td>
<td>#1</td>
</tr>
<tr>
<td>11-20</td>
<td>#2</td>
<td>#2</td>
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<tr>
<td>21-30</td>
<td>#3</td>
<td>(a)</td>
</tr>
<tr>
<td>31-40</td>
<td>#4</td>
<td>#4</td>
</tr>
<tr>
<td>41-50</td>
<td>#5</td>
<td>(b)</td>
</tr>
</tbody>
</table>

(a) The gain/loss for Swap #3 is reclassified from AOCI when interest payments on principal $21-$30 affect earnings.
(b) Because interest payments on principal $41-$50 are not probable of occurring, Swap #5 must be dedesignated; its gain/loss in AOCI is immediately reclassified to earnings if interest payments on principal $41-$50 are probable of not occurring, otherwise amounts in AOCI are reclassified when interest payments on principal $41-$50 affect earnings.

Scenario 3a – Same Facts as Scenario 3 but Assume Swap #1 Matures Subsequent to the Termination of Swap #3

• Hedging relationships involving Swaps #2 and #4 continue.

• Hedging relationships involving Swaps #2 and #4 move up one spot in the priority chain and the PEHs for those ongoing hedging relationships are adjusted to reflect the most recent best estimate of the hedged forecasted cash flows (i.e., are adjusted to reflect Swaps #2 and #4’s move up in the priority chain).

• Hedging relationship involving Swap #3 had been discontinued and related amounts in AOCI had not been immediately reclassified to earnings (same as Scenario 3). After Swap #1 matures, amounts remaining in AOCI related to the discontinued hedging relationship involving Swap #3 move up the priority chain and thus will be reclassified when interest payments on principal $11-$20 affect earnings.

• Hedging relationship involving Swap #5 had been discontinued; if interest payments on principal $41-$50 had been probable not to occur, related amounts in AOCI would have been immediately reclassified to earnings (same as Scenario 3). After Swap #1 matures, if amounts had not been immediately reclassified related to Swap #5, those amounts move up the priority chain and thus will be reclassified when interest payments on principal $31-$40 affect earnings.

As discussed in Scenario #1, when a swap in the priority chain matures and all amounts related to the instrument have been reclassified out of AOCI, all the swaps that follow in the priority chain move up automatically without being dedesignated/redesignated. This results in Swap #2 moving up the priority chain to hedge interest payments on principal $1-$10 without being dedesignated/redesignated because it is still hedging the first interest payments made on $10 of principal expected to occur each month for the next five years that (a) are not currently being hedged by a previously designated hedging relationship (would not apply because there are no currently active hedging relationships previously designated due to the maturity of Swap #1) or (b) were not previously identified in a relationship originally designated earlier in the priority chain that has been terminated for which amounts remain in AOCI (would not apply because there are no relationships earlier in the priority chain that have been discontinued for which AOCI remains). For purposes of building the PEH for the ongoing hedge relationship, Swap #2 will be hedging interest...
payments on principal $1-$10. Because Swap #2 had previously been hedging interest on principal $11-$20, the PEH will require adjustment due to differing characteristics associated with the different tranches of interest payments.

Swap #3 and Swap #5 (assuming amounts remain in AOCI for Swap #5 — i.e., interest payments on principal $41-$50 were not probable not to occur) move up the priority chain in order to determine when remaining amounts should be reclassified from AOCI to earnings. Accordingly, the amounts remaining in AOCI related to Swap #3 will be reclassified when interest payments on principal $11-$20 affect earnings. Similarly, if amounts remain in AOCI related to Swap #5, those amounts will be reclassified when interest payments on principal $31-$40 affect earnings.

Like Swap #2, Swap #4 will move up the priority chain without being dedesignated/redesignated because Swap #4 is still hedging the first interest payments made on $10 of principal expected to occur each month for the next five years that (a) are not currently being hedged by a previously designated hedging relationship (in this case Swap #2) or (b) have previously been hedged in a relationship that has ended for which amounts remain in AOCI (in this case Swap #3). For purposes of building the PEH for the ongoing hedge relationship, Swap #4 will be hedging interest payments on principal $21-$30. Because Swap #4 had previously been hedging interest on principal $31-$40, the PEH will require adjustment due to differing characteristics associated with the different tranches of interest payments.

<table>
<thead>
<tr>
<th>Interest Payments on Principal</th>
<th>Before Swap #1 Matures</th>
<th>After Swap #1 Matures</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1-10</td>
<td>#1</td>
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<tr>
<td>11-20</td>
<td>#2</td>
<td>(c)</td>
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<tr>
<td>21-30</td>
<td>(a)</td>
<td>#4</td>
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<tr>
<td>31-40</td>
<td>#4</td>
<td>(d)</td>
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<tr>
<td>41-50</td>
<td>(b)</td>
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</tr>
</tbody>
</table>

(a) The gain/loss for Swap #3 is reclassified from AOCI when interest payments on principal $21-$30 affect earnings.

(b) Because interest payments on principal $41-$50 are not probable of occurring, Swap #5 must be dedesignated; its gain/loss in AOCI is immediately reclassified to earnings if interest payments on principal $41-$50 are probable of not occurring, otherwise amounts in AOCI are reclassified when interest payments on principal $41-$50 affect earnings.

(c) The gain/loss for Swap #3 is reclassified from AOCI when interest payments on principal $11-$20 affect earnings.
(d) If amounts remain in AOCI related to Swap #5 prior to its dedesignation (i.e., the interest payments on principal $41-$50 are not probable of not occurring), the gain/loss for Swap #5 is reclassified from AOCI when interest payments on principal $31-$40 affect earnings.

**Scenario 3b – Same Facts as Scenario 3 but Now Assume Company ABC Wishes to Redesignate Swap #4 and Swap #5**

- Hedging relationships involving Swaps #1 and #2 continue (same as Scenario 3).

- Hedging relationship involving Swap #3 had been discontinued and related amounts in AOCI had not been immediately reclassified to earnings (same as Scenario 3).

- Hedging relationship involving Swap #4 would be discontinued as a result of the decision to dedesignate and related amounts in AOCI are reclassified when interest payments on principal $31-$40 affect earnings.

- Hedging relationship involving Swap #5 had been discontinued; if interest payments on principal $41-$50 of principal had been probable not to occur, related amounts in AOCI would have been immediately reclassified to earnings (same as Scenario 3).

- Company ABC formally redesignates Swaps #4 and #5 (in whichever new priority it chooses) as hedging the first interest payments made on $10 of principal expected to occur each month for the next five years that (a) are not currently being hedged by a previously designated hedging relationship (e.g., Swaps #1 and #2 for Swap #4) or (b) were not previously identified in a relationship originally designated earlier in the priority chain that has been terminated for which amounts remain in AOCI. No relationships currently fall into category (b) because no relationships following Swap #2 in the priority chain have been discontinued after Swap #4 and Swap #5’s redesignations. However, if there were any relationships that had been designated earlier in the priority chain than Swap #2 that had been terminated for which amounts remained in AOCI, Swaps #4 and #5 would also remain behind those relationships because Swap #2's relationship has not been redesignated. If not redesignated, Swap #2's relationship and all the relationships designated before it in the priority chain (active and inactive for which amounts remain in AOCI) remain in their originally designated positions. This results in Swap #4 hedging interest payments on principal $21-$30 and Swap #5 hedging interest payments on principal $31-$40.
If Company ABC wishes to redesignate Swap #5 in a hedging relationship (note that in this case, formal redesignation would be required to apply any hedge accounting for Swap #5 because the previous hedge was desiguated as discussed in Scenario 3 above), it will need to redesignate all swaps prioritized later than the terminated Swap #3 (in this case, Swap #4) because the entity is unable to *leapfrog* (i.e., put Swap #5 in Swap #3’s position in the priority chain) the Swap #4 designation as discussed in Scenario 2a above. Assuming Company ABC redesignated Swaps #4 and #5 so that Swap #5 follows Swap #4 in the new priority chain, Swap #4 would be hedging interest payments on principal $21-$30 which was previously the tranche hedged by Swap #3 and Swap #5 would be hedging interest payments on principal $31-$40 which was previously the tranche hedged by Swap #4. Swap #4 as newly designated may re-hedge the tranche previously hedged by Swap #3 even though amounts remain in AOCI, but would not be able to re-hedge that tranche through an automatic move up the priority chain.

For purposes of building the PEHs for the ongoing hedge relationships, Swap #4 will be hedging interest payments on principal $21-$30 and Swap #5 will be hedging interest payments on principal $31-$40. Because Swap #4 had previously been hedging interest on principal $31-$40 and Swap #5 had previously been hedging interest payments on principal $41-$50, the PEHs will require adjustment due to differing characteristics associated with the different tranches of interest payments.

<table>
<thead>
<tr>
<th>Interest Payments on Principal</th>
<th>Before Swaps #4 and #5 are Redesignated</th>
<th>After Swaps #4 and #5 are Redesignated</th>
</tr>
</thead>
<tbody>
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<td>$1-10</td>
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<td>#5 (c)</td>
</tr>
<tr>
<td>41-50</td>
<td>(b)</td>
<td>(d)</td>
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</tbody>
</table>

(a) The gain/loss for Swap #3 is reclassified from AOCI when interest payments on principal $21-$30 affect earnings.
(b) Because interest payments on principal $41-$50 are not probable of occurring, Swap #5 must be desiguated; its gain/loss in AOCI is immediately reclassified to earnings if interest payments on principal $41-$50 are probable of not occurring, otherwise amounts in AOCI are reclassified when interest payments on principal $41-$50 affect earnings.
(c) The gain/loss for Swap #4 arising prior to its desiguation and redesignation is reclassified from AOCI when interest payments on principal $31-$40 affect earnings.
(d) If amounts remain in AOCI related to Swap #5 arising prior to its desiguation and redesignation (i.e., the interest payments on principal $41-$50 are not probable of not occurring), the gain/loss for Swap #5 is reclassified from AOCI when interest payments on principal $41-$50 affect earnings.
29a.04 To designate a group rather than an individual transaction as the hedged item, the transactions must share the same risk exposure for which they are being hedged. The analysis to determine whether transactions share the same risk exposure in a cash flow hedge is generally qualitative. A derivative instrument potentially could be designated as a hedging instrument in a cash flow hedge of the following groups of forecasted transactions:

- Forecasted sales (purchases) of a particular product to (from) numerous, or the same, customers (vendors) within a specified time period (e.g., a month or a quarter); or

- Forecasted interest payments (receipts) on several variable-rate debt obligations (investments) that vary based on the same interest rate index within a specified time period.

29a.05 Each transaction within the group must share the risk exposure for which the group is being hedged. In particular, if an entity is hedging interest payments for a group of variable-rate assets or liabilities for either the risk of overall changes in cash flows (e.g., a group of variable-rate payments based on a non-benchmark rate such as Prime) or the risk of changes in cash flows attributable to changes in the benchmark interest rate, each asset or liability within the group must vary with the same interest rate index to qualify for hedge accounting with a single derivative instrument. Thus, for example, three-month LIBOR-based interest receipts must be grouped with other three-month LIBOR-based interest receipts. They may not be aggregated with U.S. Prime-based interest receipts and hedged with a single derivative instrument. The same index is interpreted to be exactly the same index. For example, if a particular interest rate is published on a 30-day and a 60-day basis, an interest payment that varies on the 30-day rate and an interest payment that varies on a 60-day rate would not vary with the same index. These two payments would, therefore, not be eligible to be grouped as a single hedged item. Note that fixed-rate debt is not explicitly indexed and therefore a group of fixed-rate debt issuances may be designated in certain circumstances as the hedged item in a cash flow hedge if the entity can demonstrate that the issuances are quantitatively similar. (See Paragraphs 29h.17-29h.20 for further discussion.)

29a.06 While the Standard does not require forecasted transactions associated with forecasted purchases or sales of nonfinancial assets to be based on the same index or underlying price, the concept of sharing the same risk exposure within such a group is the same. We believe that in order for forecasted purchases and sales of nonfinancial assets to be considered similar, the purchases or sales must first involve the same asset of the same grade. For example, forecasted purchases or sales of individually unique assets would not qualify for aggregation. Further, the entity must demonstrate that the forecasted transactions are expected to be quantitatively similar based on the overall market price of the forecasted purchases or sales, including the effects of the asset’s physical location. See Example A6.2 in Appendix A for an example of a hedging strategy involving a portfolio of forecasted purchases of nonfinancial assets.

29a.07 In addition, the Board decided that a hedged group of transactions cannot include both cash inflows and cash outflows, such as forecasted sales and purchases. Although forecasted sales and purchases may be based on the same underlying, they have opposite exposures.

29a.08 The generally qualitative analysis discussed above is different from the quantitative analysis to determine whether an entity has a portfolio of similar items in a fair value hedge. That analysis is based on specific quantifiable criteria and is discussed in Paragraphs 21a.15-21a.16 of...
Section 5. Although each item in a group of transactions may share the same risk exposure for which the group is being hedged, we believe entities that identify a group of transactions as the hedged item in a cash flow hedging relationship will likely experience ineffectiveness that would be recognized in earnings or may result in the hedging relationship not being highly effective. For example, regardless of the risk being hedged, the timing of the individual cash flows of each transaction within a group of transactions typically will not be the same as the timing of the cash flow(s) of a single derivative used as the hedging instrument. An entity may also experience ineffectiveness due to basis differences. Basis differences occur when the underlying price/index of the hedging instrument is different from the price/index of the hedged item (e.g., the hedged forecasted transactions vary based on 30-day LIBOR and the hedging instrument varies on 90-day LIBOR). Even if the hedging instrument and the hedged item have the same underlying price or are indexed to the same rate, ineffectiveness may occur because of margin variability for those groups of transactions for which the entity is hedging overall changes in cash flows. Margin variability occurs when each individual forecasted transaction in a group is based on the same underlying price or index, but the spread above that price or index may be different due to various factors. Because the hedged risk is the overall changes in that group’s cash flows, the possible variability in the margin above the index will result in ineffectiveness.

**Forecasted Transaction Is Probable**

**29b.01** To qualify for hedge accounting, paragraph 29(b) of the Standard (ASC paragraph 815-20-25-15(b)) requires that:

> 29b. The occurrence of the forecasted transaction is probable.

DIG Issues related to this paragraph are G4, G10, G17 and G18. See DIG Issues Index.

**29b.02** The Standard requires that the forecasted transaction, or group of transactions, be probable of occurrence. The use of the term *probable* is consistent with its use in paragraph 3 (ASC Section 450-20-20) of FASB Statement No. 5, *Accounting for Contingencies* (ASC Topic 450, *Contingencies*) which describes probable as *likely to occur*. The term probable requires a significantly greater likelihood of occurrence than the term *more likely than not*.

**29b.03** An entity’s assessment of a transaction’s probability cannot be based solely on management’s intent. Rather, the Board believes a transaction’s probability should be supported by observable facts and attendant circumstances, such as:

- The frequency of similar past transactions;
- The financial and operational ability of the entity to carry out the transaction;
- Substantial commitments of resources to a particular activity (e.g., a manufacturing facility that can be used in the short run only to process a particular type of commodity);
- The extent of loss or disruption of operations that could result if the transaction does not occur;
• The likelihood that transactions with substantially different characteristics might be used to achieve the same business purposes (e.g., an entity that intends to raise cash may have several ways of doing so);
• The creditworthiness of the counterparty; and
• Other similar facts and circumstances.

29b.04 In addition, the length of time until a forecasted transaction is projected to occur and the quantity of the forecasted transaction that is projected to occur should be considered in determining probability. In the absence of other relevant factors, the farther into the future that the forecasted transaction is, the less likely that it would be considered probable, and the stronger the evidence that would be required to support that the occurrence of the forecasted transaction is probable. For example, a forecasted sale of manufactured goods projected to occur in five years may be less likely than a forecasted transaction expected to occur in one year. On the other hand, interest payments on variable-rate debt forecasted to occur over the next 20 years typically would be probable if supported by an existing contract.

29b.05 In addition to considering the period of time until a forecasted transaction is probable to occur, the greater the physical quantity or future value of a forecasted transaction, the less likely that it would be considered probable and the stronger the evidence needed to support an assertion that it is probable. For example, for an entity whose historical sales volumes were closer to 1,000 units per month, forecasted sales of 1,000 units in a particular month ordinarily would be more likely than forecasted sales of 2,500 units in that month.

29b.06 To qualify for cash flow hedge accounting, the forecasted transaction must be probable of occurring without considering the circumstances under which the transaction will be settled. For example, Company A purchases an option contract that gives it the right to purchase shares of a publicly-traded company at a fixed price. Company A would like to designate the option as a cash flow hedge of the variability in cash flows associated with the forecasted purchase of the shares. If Company A determines that the shares will be purchased only if the option is exercised, the forecasted transaction is not deemed probable. That is, because the acquisition of the shares is contingent on the market price per share, the forecasted purchase of the shares is not considered probable. For the transaction to be deemed probable of occurring, Company A must assert that the shares will be purchased regardless of the market price per share. (See DIG Issue G14 for further reference.)

CONSIDERATION OF COUNTERPARTY DEFAULT IN ASSESSMENT OF PROBABILITY

29b.07 A counterparty to a transaction may fail to comply with the contractual terms of an agreement because of credit problems or other reasons. In a cash flow hedging relationship, an entity must consider the possibility of counterparty default in two ways. First, an entity must consider the likelihood that the counterparty will comply with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity. For an entity to conclude on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows, the entity must assess whether it will collect the payments it would be owed under the contractual provisions of the derivative. Second, an entity also must assess the creditworthiness of the counterparty to the hedged forecasted transaction,
when known, in determining whether the forecasted transaction is probable, particularly when the hedged transaction involves deliveries or payments from the counterparty. (See DIG Issue G10 for further reference.) In addition, see Appendix A of this section for discussion of the impact on the hedging relationship of changes in the risk of the entity’s own nonperformance.

**PROBABILITY OF OCCURRENCE WITHIN A RANGE OF TIME**

29b.08 The Standard requires that documentation of a cash flow hedging relationship specify either the date on or period within which the forecasted transaction is expected to occur. For forecasted transactions with timing that involves uncertainty within a range, an entity may document a range of time to comply with this requirement. This flexibility allows some forecasted transactions that are uncertain as to timing to be considered probable of occurring within a range.

29b.09 The flexibility of documenting a range for the occurrence of the forecasted transaction is mitigated somewhat by the requirement to assess effectiveness and measure ineffectiveness. To perform the effectiveness assessments and ineffectiveness measurements, an entity must document and use its best estimate of the timing of the forecasted transaction. The best estimate of timing for assessing effectiveness and measuring ineffectiveness needs to be much more specific than the estimated period used to support the probability of the forecasted transaction’s occurrence. That is because, in those analyses, cash flow estimates need to involve estimating points in time when those cash flows will occur. Additionally, circumstances may change over time causing the expected timing used in effectiveness assessments and ineffectiveness measurements to change, even though the revised expected timing would still be within the original range. That change would be required to be considered and would likely affect the assessment of effectiveness and measurement of ineffectiveness. This could lead to situations in which, at some point during the hedging relationship, the forecasted transaction continues to be probable of occurring within the specified range, but the hedge generates reduced effectiveness. This effectiveness may be reduced so much that the hedge no longer is highly effective and would need to be discontinued. (See DIG Issue G16 for further reference.) See Paragraphs 33.01-33.09 for a discussion of when amounts must be reclassified from AOCI to earnings due to changes in the likelihood of occurrence of forecasted transactions.
Example 6.4: Designating the Forecasted Transaction When There is Uncertainty about Timing Within a Range

A general contractor enters into a long-term contract to build a power plant. The long-term contract is to be completed within five years. As part of the construction project, the general contractor expects to subcontract a portion of the construction to a foreign company with a functional currency different from the functional currency of the general contractor. Because the subcontractor will be paid in its functional currency, the general contractor will have a foreign currency exposure that it desires to hedge.

At the start of the project, the general contractor concludes it is probable that the subcontract work will be completed and paid for at the end of the second year. However, the general contractor knows that the timing of a subcontractor’s work and, thus, the foreign-currency-denominated payment for its work, may possibly be delayed even though it is probable that the overall project will remain on schedule in meeting the ultimate completion date.

The contractor intends to hedge the exposure by using a forward contract with a maturity date that coincides with the current expected date of payment (i.e., a two-year foreign currency forward) and the expected notional amount of the forecasted transaction. In this instance, the general contractor could document that the hedged forecasted transaction is the foreign-currency-denominated payment to the foreign subcontractor to be paid within the five-year contract period of the overall project. As long as it remains probable that the forecasted transaction will occur within the originally projected five-year period of the overall project, cash flow hedge accounting for that hedging relationship would continue if other hedge criteria are met. Consequently, if the subcontractor’s payment is delayed by less than three years, the forecasted transaction still would be considered probable of occurrence within the originally specified time period.

However, assessing effectiveness and measuring ineffectiveness require that the best estimate of the forecasted transaction’s timing be both documented and used. If the expected timing of the forecasted transaction changes, the general contractor will need to assess effectiveness based on its newly revised best estimate of the cash flows which may cause the general contractor to conclude that the hedging relationship is not highly effective, requiring the discontinuation of the hedging relationship, or result in significant ineffectiveness that would affect earnings.

ALL-IN-ONE HEDGES

29b.10 Many fixed-price contracts are firm commitments that involve the purchase or sale of assets and will meet the definition of a derivative instrument because, for example, these contracts contain net settlement provisions in the event of default or involve assets that are readily convertible to cash. In addition, some of these contracts will not be exempt from being accounted for as derivatives under paragraphs 10 and 11 of the Standard (ASC paragraphs 815-10-15-13, 15-15 through 15-17, 15-22, 15-26, 15-30, 15-37, 15-38, 15-40 through 15-42, 15-45, 15-52 through 15-54, 15-58 through 15-60, 15-68, 15-69, 15-74, 15-75, and 15-82). Accordingly, entities are required to account for these contracts at fair value through earnings. However, if the derivative instrument (i.e., the contract) is expected to be settled gross, entities may designate the derivative instrument as a hedge of the implicit forecasted transaction that created the need for...
the fixed-price contract in the first place, as explained below (i.e., an all-in-one hedge) under the cash flow hedging model (assuming all other cash flow hedging criteria are met).

29b.11 An entity that is concerned about variability in cash flows from its forecasted purchases or sales can economically fix the price of those purchases or sales by entering into a fixed-price contract. If the fixed-price purchase or sale contract is a derivative instrument, it is eligible to be a hedging instrument. The reverse also is true. That is, if an entity entered into a fixed-price purchase or sale contract, it may hedge the forecasted purchase or sale that implicitly caused it to enter into the fixed-price contract. The implicit forecasted purchase or sale meets the definition of a forecasted transaction in paragraph 540 of the Standard (ASC Section 815-20-20) and, if it is probable of occurring, meets the criteria for designation as a hedged transaction. The forecasted purchase or sale is eligible for cash flow hedge accounting because the total consideration that would be paid or received is variable. The total consideration paid or received for accounting purposes is the sum of the fixed amount of cash paid or received under the fixed-price contract and the fair value of the fixed-price purchase or sale contract, which is a derivative instrument recognized as an asset or liability, and which can vary over time. (See DIG Issue G2 for further reference.)

29b.12 All-in-one hedges may be used with forecasted transactions related to nonfinancial or financial assets. To illustrate the application to a nonfinancial asset, consider that gold producers may manage the price risk associated with forecasted sales of gold. To do so, they may enter into forward contracts to sell gold at a fixed price. When a forward gold sales contract contains a net settlement provision, the contract meets the definition of a derivative instrument under the Standard. As a derivative instrument, the forward gold sales contract must be marked to fair value with changes in fair value reported in earnings currently. However, the forward gold sales contract may be designated as a cash flow hedge of the forecasted sale of gold in accordance with the Standard (i.e., as an all-in-one hedge of price risk) provided the contract is expected to be settled gross. Thus, the effective portion of the changes in the fair value of the forward gold sales contract will be reported in OCI until the forecasted sale of gold is reported in earnings.

29b.13 To illustrate the application to a financial asset, consider that many financial institutions must manage the price risk associated with forecasted sales of loans that they originate. To do so, they may enter into forward loan sale agreements to sell mortgage loans at a fixed price. When the loans to be delivered in a forward loan sale agreement are readily convertible to cash, the contract meets the definition of a derivative under the Standard. As a derivative instrument, the forward loan sale agreement must be marked to fair value with changes in fair value reported in earnings currently. However, the forward loan sale agreement may be designated as a cash flow hedge of the forecasted sale of loans in accordance with the Standard (i.e., as an all-in-one hedge of price risk), provided the contract is expected to be settled gross. Thus, the effective portion of changes in the fair value of the forward loan sale agreement will be reported in OCI until the forecasted sale of loans is reported in earnings.

29b.14 Provided the hedging relationship is appropriately documented, we believe 100% of the changes in the fair value of the derivative instrument in an all-in-one hedge would be reported in OCI until the forecasted transaction is reported in earnings because the contract is 100% effective in hedging the inherent forecasted transaction for the designated risk assuming that the hedging relationship is designated at the inception of the fixed price contract and the contract was at market terms. That is, if the risk being hedged is changes in cash flows related to all
changes in the entire purchase or sales price of the nonfinancial or financial asset, the change in
the fair value of the derivative instrument (i.e., the contract) will entirely offset the change in the
present value of the expected future cash flows attributed to the change in the entire price of the
hedged item (if the entity documents at the inception of the hedge that the assessment of hedge
effectiveness and measurement of ineffectiveness will be determined based on changes in the
entire fair value of the derivative instrument). If the hedging relationship is not designated at the
inception of the fixed price contract, the entity will have some ineffectiveness resulting from the
fair value of the derivative that is likely to exist at the designation date. Ineffectiveness will also
result if the fixed price contract was off-market at its inception. See Appendix A for discussion
of assessing effectiveness and measuring ineffectiveness when critical terms are the same (e.g.,
in this case, when the forward contract does not have a fair value of zero at the inception of the
hedging relationship).

29b.15 The following example illustrates the accounting for an all-in-one hedge:

**Example 6.5: All-in-One Hedge for the Purchase of Equipment**

On January 1, 20X1 ABC Co. forecasts that it will purchase equipment on April 1, 20X1. The
equipment currently costs $100. ABC Co. is concerned that the price of the equipment will rise
in the next three months and enters into a forward purchase contract with XYZ Co. to buy the
equipment for $102 (the at-market price for the equipment to be purchased in three months).
The forward purchase contract is binding on both ABC Co. and XYZ Co., specifies all
significant terms, and includes a disincentive for nonperformance that is sufficiently large to
make performance probable. Thus, it meets the definition of a firm commitment. Further,
although ABC Co. expects to settle the contract gross, the forward purchase contract includes a
clause that requires net settlement under its default provisions. Thus, it also meets the
definition of a derivative instrument. ABC Co. designates the forward purchase contract as a
hedge of the variability in cash flows attributable to price risk associated with the forecasted
purchase of equipment.

On March 31, 20X1, the equipment currently is selling for $110 and the fair value of the
forward purchase contract is $8. ABC Co. records the following journal entry on March 31,
20X1:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward purchase contract (B/S)</td>
<td>$8</td>
<td>OCI</td>
</tr>
<tr>
<td>OCI</td>
<td>$8</td>
<td></td>
</tr>
</tbody>
</table>

On April 1, 20X1, ABC Co. takes delivery of the equipment and records the following journal
entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment(B/S)</td>
<td>110</td>
<td></td>
</tr>
<tr>
<td>Cash(B/S)</td>
<td>102</td>
<td></td>
</tr>
<tr>
<td>Forward Purchase contract(B/S)</td>
<td>8</td>
<td></td>
</tr>
</tbody>
</table>

**Observations**

The equipment is recorded at the aggregate of the cash cost of the equipment under the
forward purchase contract ($102) and the fair value of the contract ($8) (i.e., its carrying
amount is the current price of the equipment). However, the $8 reported in AOCI is reclassified into earnings as the equipment depreciation is reported in earnings. That is, it will offset depreciation expense on the equipment so that the net accumulated depreciation charged to earnings over the estimated useful life of the equipment will equal $102, the forward purchase price of the machine.

Forecasted Transactions Are With a Party External to the Reporting Entity

29c.01 To qualify for hedge accounting, paragraph 29(c) of the Standard (ASC paragraph 815-20-15-15(c)) requires the following:

29c.02 Paragraph 29(c) (ASC paragraph 815-20-15-15(c)) requires that the designated forecasted transaction have the following attributes:

- It is a transaction;
- It must be with a party external to the reporting entity; and
- It must present an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

TRANSACTION

29c.03 FASB Concepts Statement No. 6, Elements of Financial Statements, defines a transaction as an external event that involves the transfer of something of value (future economic benefit) between two (or more) entities. That definition was intended to clearly differentiate a transaction from an internal cost allocation or an event that happens within an entity. Thus, an internal accounting allocation (e.g., forecasted depreciation expense) is not a hedgeable item as it does not represent a transaction.

PARTY EXTERNAL TO THE REPORTING ENTITY

29c.04 Forecasted transactions between members of a consolidated entity would not qualify as hedgeable exposures because these transactions are not with parties external to the reporting entity. Thus, forecasted transactions between a parent and its consolidated subsidiaries are not hedgeable exposures. In its separate, stand-alone financial statements, a subsidiary may, however, apply cash flow hedge accounting to a hedge of a forecasted intercompany transaction if those transactions are with a party external to the reporting entity in the stand-alone financial statements.

29c.05 In an exception to the general rule, the Board made a provision to accommodate cash flow hedges of the foreign currency risk inherent in forecasted intercompany foreign-currency-denominated transactions that relate to transactions that are expected to occur. Additionally, as further discussed in Paragraph 29c.07 below, the Board decided to permit cash flow hedges of...
the foreign-currency risk inherent in recognized intercompany foreign-currency-denominated assets and liabilities. These hedging transactions are discussed more fully in Section 7.

29c.06 We believe that the term party external to the reporting entity limits the prohibition on hedging forecasted transactions to only transactions with entities that are controlled or consolidated by the reporting entity. As a result, we believe transactions with parties such as equity method investees, affiliates, unconsolidated joint ventures, shareholders, and directors are not excluded as forecasted transactions unless the effects of the forecasted transaction will be eliminated or the forecasted transaction is specifically prohibited by the Standard (e.g., forecasted sale of an equity method investment).

EXPOSURE TO VARIATIONS IN CASH FLOWS FOR THE HEDGED RISK THAT COULD AFFECT REPORTED EARNINGS

29c.07 Some transactions may subject an entity to variations in cash flows but lack the potential to affect reported earnings. Those transactions may not be designated as hedged items in a cash flow hedge. For example, the Standard does not permit hedge accounting for the forecasted issuance or repurchase of common stock because changes in the market value of an entity’s common stock do not affect the reported earnings of the issuing entity. In addition, hedges of intercompany transactions for which the hedged risk would be eliminated in consolidation cannot be hedged in the consolidated financial statements. For example, the risk of variable cash flows attributable to interest rate risk related to a variable-rate intercompany debt could not be hedged because earnings of the consolidated entity are not affected by the transaction. In contrast, the risk of variable cash flows attributable to foreign exchange risk related to a subsidiary’s intercompany debt denominated in a foreign currency could be hedged because the earnings of the consolidated entity are affected by the resulting foreign currency remeasurement gain or loss related to the debt. Entities should be aware that there are unique considerations when a cross-currency interest rate swap is used in an intercompany hedging relationship related to interest rate and foreign exchange risks because both the cash flows associated with interest rates (which would be eliminated) and currencies (which would not be eliminated) would be part of the exposure (see the additional discussion of hedging intercompany foreign-currency denominated debt using the hypothetical derivative method at Paragraph 41.14a).

CASH FLOW VARIABILITY NOT REQUIRED TO BE PROBABLE

29c.08 The cash flow hedging model does not require that it be probable that variability in the hedged transaction will actually occur and affect earnings. Paragraph 29(b) of the Standard (ASC paragraph 815-20-25-15(b)) only requires that the forecasted transaction is probable to occur and that the variability in cash flows is possible and would affect earnings. As a result, the exposure to variations in cash flow for the hedged risk that could affect reported earnings must only be possible. For example, if an insurance company wanted to hedge the possibility that it may need to voluntarily increase the interest rate used to credit interest on certain contract liabilities, the insurance company would not be precluded by paragraph 29 of the Standard (ASC paragraphs 815-20-25-15 and 25-43) from designating the future interest to be credited on its contracts (either existing or newly written) provided that the interest-related cash flows are probable and there is a possibility that there will be variability in those cash flows that would affect earnings. Notwithstanding this, it may be difficult for the insurance company to identify a derivative that
will qualify for cash flow hedge accounting because interest rates in the marketplace may not be highly effective at offsetting the company’s discretionary adjustment to the interest rate on the contract liabilities. (See DIG Issue G4 for further reference.)

HEDGING A STOCK APPRECIATION RIGHT OBLIGATION

29c.09 Entities issue stock appreciation rights (SAR) to their employees as a form of compensation. The SAR entitles employees to receive cash, stock, or a combination of cash and stock in an amount equivalent to any excess of the market value over a stated price of a stated number of shares of the employer’s stock. Various factors, including the method of settlement, determine whether the issuer accounts for the SAR under FASB Statement No. 123 (revised 2004), Share-Based Payment (ASC Subtopic 718-10, Compensation, Stock Compensation -- Overall), as a liability or an equity instrument. For a public company, a SAR that is accounted for as a liability is adjusted to fair value each reporting period rather than to an amount equivalent to the excess of the then current fair value of the stated number of shares over a stated price, or intrinsic value (nonpublic companies can make a policy election of whether to measure liabilities under share-based payment arrangements at fair value or intrinsic value). A SAR award also generally has vesting provisions, for example, pro-rata vesting over a specified service period or vesting at a single date (cliff vesting) and thus results in the recognition of related compensation expense over a service period. Entities often desire to hedge this compensation expense through the use of a purchased call option on their own stock.

29c.10 A purchased option may be designated as the hedging instrument of the cash flow variability of the expected future obligations associated with the SAR if vesting of the SAR is probable, the option is accounted for as a derivative subject to Statement 133 and the designated hedged forecasted transaction is the unrecognized, nonvested SAR obligation. In order to conclude that the purchased call option is a derivative it must be classified as an asset in the company’s financial statements (in accordance with FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (ASC Subtopic 480-10, Distinguishing Liabilities from Equity -- Overall), and EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock” (ASC Subtopic 815-40, Derivatives and Hedging -- Contracts in Entity's Own Equity)). Classification of the option as an asset is necessary because an option classified in the equity section of the issuer’s financial statements would not be considered a derivative under paragraph 11(a) of the Standard (ASC paragraph 815-10-15-74(a)), and a nonderivative instrument cannot be designated as the hedging instrument. An unrecognized nonvested SAR obligation presents exposure to cash flow variability of expected future obligations that affects reported earnings and it is eligible to be designated as the hedged forecasted transaction in a cash flow hedge. Once a SAR is recognized as a liability, it may not be hedged because the recognized liability is remeasured at fair value through earnings (see Paragraphs 29d.01-29d.03 below). This creates complexity in hedging an unrecognized SAR obligation since the recognition of the SAR liability occurs before vesting. While entities commonly seek to hedge SAR obligations, there may be difficulties in asserting that the hedging relationship will be highly effective. Accordingly, cash flow hedges of SAR obligations are uncommon. (See DIG Issue G1 for further reference.)
Certain Forecasted Transactions Prohibited from Being Designated as Hedged Items

29d.01 Paragraph 29(d) of the Standard (ASC paragraphs 815-20-25-15(d) and 25-15(e)) prohibits certain forecasted transactions from designation as hedged items:

29d. The forecasted transaction is not the acquisition of an asset or incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings. If the forecasted transaction relates to a recognized asset or liability the asset or liability is not remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.

29d.02 The Standard specifically prohibits the following transactions from being designated as the hedged forecasted transaction in a cash flow hedge:

- The acquisition (incurrence) of an asset (liability) that after acquisition (incurrence) will be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings. Thus, for example, an entity would be prohibited from designating the forecasted purchase of a trading security as a forecasted transaction in a cash flow hedge. On the other hand, the forecasted acquisition of an available-for-sale security may qualify for hedge accounting because changes in the fair value of an available-for-sale security are not reported in earnings each period, but rather are accumulated in a separate component of equity (i.e., AOCI).

- If the forecasted transaction relates to a recognized asset or liability, the asset or liability to which the forecasted transaction relates is remeasured with changes in fair value attributable to the hedged risk reported currently in earnings. Thus, for example, an entity would be prohibited from hedging the variability in the fair value of a recognized SAR liability in a cash flow hedge.

29d.03 The first criterion in paragraph 29(d) of the Standard (ASC paragraphs 815-20-25-15(d) and 25-15(e)) is intended to prevent entities from reporting derivative instrument gains and losses in OCI if the related asset or liability will be measured at fair value on acquisition or incurrence. The second criterion in paragraph 29(d) of the Standard (ASC paragraphs 815-20-25-15(d) and 25-15(e)) reflects the Board’s belief that hedge accounting should not provide an opportunity to change the accounting for an asset or liability that would otherwise be reported at fair value with changes therein recognized currently in earnings.

APPLICABILITY TO ASSETS AND LIABILITIES REMEASURED UNDER STATEMENT 52 (ASC TOPIC 830)

29d.04 The criteria in paragraph 29(d) of the Standard (ASC paragraphs 815-20-25-15(d) and 25-15(e)) do not preclude recognized and forecasted transactions that become recognized foreign-currency-denominated assets or liabilities from being designated as the hedged item under the Standard if foreign exchange is the hedged risk. The Board determined that remeasurement to functional currency at spot rates under Statement 52 (ASC Topic 830) is not a fair value remeasurement as contemplated by paragraph 29(d) of the Standard (ASC paragraphs 815-20-25-15(d) and 25-15(e)). This issue is discussed further in Section 7. It should be noted
that paragraph 29(c) of the Standard (ASC paragraph 815-20-25-15(c)) requires that the forecasted transaction that becomes a recognized foreign-currency-denominated asset or liability must present an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

**APPLICABILITY TO ASSETS CARRIED AT LOWER OF COST OR MARKET**

29d.05 The Standard does not prohibit entities from designating items that are (or will be) carried at the lower of cost or market (LOCOM) as the hedged item in a cash flow hedge (e.g., the forecasted purchase or sale of inventory). While these items may affect earnings as a result of the risk being hedged, such as in the case of a hedge of the risk of decrease in the cash flows of the forecasted sale of inventory, the item, when recognized, is carried at market price if the market value declines below cost. Consequently, they are not remeasured (up and down) with changes in the fair value attributable to the hedged risk reported currently in earnings. Accordingly, an entity is not precluded from designating items that will be carried at LOCOM as the forecasted transaction in a cash flow hedging relationship as a result of the criteria in paragraph 29(d) of the Standard (ASC paragraphs 815-20-25-15(d) and 25-15(e)).

**Prohibition Against Hedging Forecasted Transactions Related to Held-to-Maturity Debt Securities**

29e.01 Paragraph 29(e) (ASC paragraph 815-20-25-15(f)) precludes held-to-maturity debt securities from being designated as hedged items except in the following circumstances:

29e. If the variable cash flows of the forecasted transaction relate to a debt security that is classified as held to maturity under Statement 115, the risk being hedged is the risk of changes in its cash flows attributable to credit risk, foreign exchange risk, or both. For those variable cash flows, the risk being hedged cannot be the risk of changes in its cash flows attributable to interest rate risk.

29e.02 Except in certain specified circumstances, entities may choose to hedge the variability in cash flows attributable to the overall market price risk of an entire financial asset or liability, interest rate risk, foreign currency risk, or credit risk. The Board restricted the nature of the risks that may be hedged when the variability in cash flows of the forecasted transaction relates to a held-to-maturity debt security. The Board concluded that the designation of a derivative instrument as a hedge of the variable cash flows attributable to interest rate risk and price risk in a debt security classified as held-to-maturity undermines the intent of the held-to-maturity classification. That is, specific accounting (i.e., amortized cost) is required for securities classified as held-to-maturity because entities have indicated their intent to hold the security to maturity, regardless of changes in interest rates or market values. The Board believes that entering into a derivative instrument as a hedge of the variable cash flows attributable to interest rate risk or price risk in a debt security classified as held-to-maturity is inconsistent with the assertion that amortized cost is the appropriate measurement basis for a held-to-maturity security. However, we believe entities are not precluded from entering into a derivative instrument as a hedge of the variability in cash flows attributable to interest rate risk or price risk for a forecasted purchase of a debt security that will be classified as held-to-maturity at acquisition if all cash flow hedge criteria are met. That type of hedge is not inconsistent with the
The assertion that amortized cost is the appropriate measurement basis for a held-to-maturity security since the security is not yet recognized.

29e.03 The Standard permits entities to hedge the risk of changes in the cash flows of a recognized held-to-maturity debt security attributable to credit risk, foreign currency risk or both. Credit risk is permitted to be a designated hedged risk because it is not inconsistent with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (Statement 115) (ASC Subtopic 320-10, Investments-Debt and Equity Securities -- Overall), which allows a sale or transfer of a held-to-maturity debt security in response to a significant deterioration in the credit quality of the issuer. Also, since special accounting is provided in Statement 52 (ASC Topic 830) for reporting the effect of changes in foreign exchange rates, even for held-to-maturity securities, and the Standard continues much of that accounting, the Board concluded that the risk of changes in expected cash flows due to changes in foreign exchange rates of these securities qualifies as a hedged risk. See Section 7 for a discussion of foreign currency hedging.

Forecasted Transactions Involving Certain Equity Investments or Instruments

29f.01 Paragraph 29(f) of the Standard (ASC paragraphs 815-20-25-15(g) and 25-15(h)) prohibits certain equity investments and transactions from being designated as hedged items in the following circumstances:

29f. The forecasted transaction does not involve a business combination subject to the provisions of Statement 141 and is not a transaction (such as a forecasted purchase, sale, or dividend) involving (1) a parent company’s interests in consolidated subsidiaries, (2) a minority interest in a consolidated subsidiary, (3) an equity method investment, or (4) an entity’s own equity instruments.

29f.02 The Standard prohibits designating certain types of forecasted transactions as hedged items in a cash flow hedge. These items are discussed below:

- A business combination subject to the provisions of Statement 141. For example, Acquisition Co. will deliver shares, cash, or both, in a purchase business combination to acquire XYZ. Acquisition Co. may not apply hedge accounting for a derivative instrument used to lock in the cost of acquiring XYZ.

- A parent company’s interests in consolidated subsidiaries. For example, Parent wishes to dispose of its 60% investment in Subsidiary. Parent may not apply hedge accounting for a derivative instrument used to lock in the forecasted sales price of Subsidiary. Note, however, that an entity may continue to designate an investment in a foreign operation as a hedged item in a hedge of foreign currency risk (see discussion in Section 7).

- An equity-method investment. For example, Investor Co. may not apply hedge accounting to a derivative instrument used to lock in its forecasted purchase price of Equity Investee Co. by entering into a derivative instrument to fix the price of its forecasted purchase of 30% of Equity Investee Co.
The Board believes that entities should be precluded from hedge accounting for the types of forecasted transactions described in the preceding paragraph because, in those instances, entities are in substance selling or acquiring an interest in a group of dissimilar assets and liabilities. Thus, entities would be unable to demonstrate that the hedging relationship is highly effective in achieving offsetting cash flows attributable to a hedged risk associated with a group of dissimilar assets and liabilities.

Although paragraph 29(f) of the Standard prohibits (ASC paragraphs 815-20-25-15(g) and 25-15(h)) prohibit cash flow hedge accounting of a forecasted transaction to enter into a business combination or to acquire a subsidiary or minority interest or equity-method investee, questions have arisen about hedging forecasted transactions that occur concurrent with, and as a result of, a business combination. For example, many entities issue debt to finance the acquisition of another company or business. While those debt issuances are contingent on a business acquisition, they do not form part of the actual acquisition. The DIG has discussed the ability to designate a forecasted transaction contingent on consummating a business combination as the hedged item in a cash flow hedge. Although the FASB staff has not reached a definitive conclusion on the appropriate accounting treatment for this type of transaction, we believe that it is acceptable to hedge a forecasted transaction that is contingent on the consummation of a business combination if the forecasted transaction does not directly affect the purchase price or the purchase accounting treatment associated with the acquisition, and meets the criteria for being the hedged item as defined by paragraph 29 of the Standard (ASC paragraphs 815-20-25-15 and 25-43). The forecasted issuance of debt in the functional currency of an acquirer that provides the acquirer with the consideration necessary to effect a business combination does not directly affect the purchase price or the purchase accounting associated with the acquisition. Rather, it is considered a financing transaction separate from the acquisition. If the enterprise determines that it is probable that the business combination will be consummated, the forecasted transaction is probable of occurring, and all the other relevant hedging criteria in paragraphs 28 and 29 of the Standard (ASC paragraphs 815-20-25-3, 25-13, 25-15, 25-50, 25-51, 25-75, 25-76, 25-80, 25-94, and 25-95) have been met, cash flow hedge accounting would be appropriate for the forecasted transaction. It is important to note that the facts and circumstances related to the forecasted business combination need to be evaluated to determine whether the transaction is probable of occurring.

To the extent that an entity concludes that a business combination is probable of occurring for purposes of hedging a forecasted transaction contingent on the consummation of the business combination, an entity also would conclude that the business combination is probable of occurring for purposes of SEC Rule 3-05 of Regulation S-X. This regulation provides, in part, that audited financial statements of a significant business acquired or to be acquired prepared in accordance with Regulation S-X may be required if the consummation of a business combination is considered probable.

Paragraph 29(f) of the Standard (ASC paragraphs 815-20-25-15(g) and 25-15(h)) also prohibits designating the following as hedged items in a cash flow hedge:

- **A minority interest in a consolidated subsidiary.** For example, Consolidated Co. may not apply hedge accounting for a derivative instrument used to fix the variability in cash flows attributable to the forecasted purchase of a minority interest arising from a consolidated subsidiary.
- **An entity’s own equity instruments.** For example, ABC Co. may not apply hedge accounting for a derivative instrument used to lock in the expected proceeds of issuance of its common stock by entering into a forward contract whose underlying is the market price of ABC Co. common stock.

29f.07 Equity instruments issued by an entity and classified in stockholders’ equity do not meet the definition of a liability. Thus, these items are prohibited from being designated as hedged items in a cash flow hedge. In addition, we believe that items classified as temporary or mezzanine equity (e.g., minority interests) may not be designated as hedged items because they do not meet the definition of a liability. (DIG Issue C2 concluded that temporary equity is considered stockholders’ equity even though it is displayed outside of permanent equity.)

29f.08 At the June 2007 EITF meeting, the SEC staff announced revisions to EITF D-98, "Classification and Measurement of Redeemable Securities" (ASC paragraph 480-10-S99-3) related to the release of Statement 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (ASC Subtopic 825-10, *Financial Instruments -- Overall*). The SEC staff announced that it will no longer accept liability classification for financial instruments that meet the conditions for temporary equity classification under ASR 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"* and EITF D-98 (ASC paragraph 480-10-S99-3). Registrants that do not choose retrospective application should apply the announcement prospectively to all affected instruments that are entered into, modified, or otherwise subject to a remeasurement event in the registrant's first fiscal quarter beginning after September 15, 2007. Subsequent to initial adoption of this guidance, registrants should not initially apply hedge accounting for an affected financial instrument (or host contract) that continues to be classified as a liability. That is, while an existing financial instrument (or host contract) that otherwise meets the conditions for classification as temporary equity may continue to be classified as a liability when this guidance is adopted prospectively, the financial instrument (or host contract) would not be eligible for initial adoption of hedge accounting in fiscal quarters beginning after September 15, 2007. However, previously established hedge relationships may continue.

**Hedging Risks Associated with Forecasted Transactions Related to Nonfinancial Assets**

29g.01 Except for certain foreign currency circumstances that are discussed in Paragraphs 29g.06-29g.07 of this section, paragraph 29(g) of the Standard (ASC paragraph 815-20-25-15(i)) prohibits an entity from disaggregating the risk profile of a nonfinancial asset and designating one component of the profile as the hedged risk as follows:

29g. If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged is (1) the risk of changes in the functional currency equivalent cash flows attributable to changes in the related foreign currency exchange rates or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset reflecting its actual location if a physical asset (regardless of whether that price and the related cash flows are stated in the entity’s functional currency or a foreign currency), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient. Thus, for example, in hedging the exposure to changes in the cash flows relating to the purchase of its bronze bar inventory, an entity may not designate the
RISK OF CHANGES IN CASH FLOWS RELATED TO ALL CHANGES IN THE PRICE OF THE ASSET

29g.02 Paragraph 29(g) of the Standard (ASC paragraph 815-20-25-15(i)) permits hedge accounting for nonfinancial assets when the designated hedged risk is the risk of changes in cash flows related to all changes in the purchase price or sales price of the asset, and when the purchase or sale involves a physical asset, reflecting its actual location.

29g.03 Entities may hedge any one (or more) risk exposure(s) of a forecasted transaction that involves financial assets or liabilities. For example, a variable-rate, foreign-currency-denominated available-for-sale debt security subjects the holder to overall market price risk, credit risk, interest rate risk, and foreign exchange risk. A forecasted transaction that involves nonfinancial assets may also expose an entity to numerous risks. For example, a forecasted sale of chocolate bars exposes the seller to cash flow price risk associated with each major ingredient (e.g., cocoa, sugar, butter, and milk) that goes into manufacturing a chocolate bar plus exposures to other items, such as new competition and marketing efforts. The aggregate components encompass the risk of all changes in the cash flows related to the sales price of the chocolate bar. The distinction between hedging financial and nonfinancial items is pronounced because the Standard prohibits an entity from designating a component risk of the forecasted purchase price or sales price of a nonfinancial asset as the hedged item. The Board decided not to permit designating only a component risk exposure of a nonfinancial asset, such as the market price risk of a major ingredient or other component as the hedged item, because (i) each ingredient or component does not generate individual cash flows that would offset those of the derivative hedging instrument and (ii) the nature of the nonfinancial asset makes the reaction to changes in the market price of a component of that asset, or to other exposures, unpredictable and not separately determinable. Instead, the Standard requires changes in the cash flows related to all changes in the purchase price or sales price of the hedged forecasted transaction to be designated as the hedged risk in a hedging relationship involving nonfinancial assets. In the example above, to qualify for hedge accounting, a seller would be permitted to designate as the hedged risk only the risk of changes in the cash flows related to all changes in the sales price of the chocolate bar.

29g.04 Notwithstanding the discussion in the preceding paragraph, an entity may recognize amounts in its financial statements as a result of applying cash flow hedge accounting that are similar to those it would have achieved had it been permitted to hedge a component of the price risk of a nonfinancial asset in a cash flow hedge by designating a derivative instrument with an underlying that is a significant component of the nonfinancial asset as hedging total changes in the cash flows of the nonfinancial asset. To qualify for hedge accounting, the entity would have to demonstrate that the hedging relationship at inception and on an ongoing basis is expected to be highly effective at achieving offsetting cash flows attributable to the hedged risk. For example, an entity may be able to conclude that a hedging relationship is expected to be highly effective when it designates a derivative hedging instrument with cocoa as its underlying when hedging the forecasted sale of chocolate bars where the risk being hedged is changes in the cash flows related to all changes in the sales price. (See DIG Issue G5 for further reference.)
RISK OF CHANGES IN CASH FLOWS REFLECTING THE ASSET’S PHYSICAL LOCATION

29g.05 Paragraph 29(g) of the Standard (ASC paragraph 815-20-25-15(i)) also requires that entities incorporate the characteristics of the hedged item, including its physical location, when measuring changes in the expected future cash flows of a forecasted transaction that involves a physical asset as the hedged item. As a consequence, if the underlying of the hedged item is in a different location from the underlying of the derivative hedging instrument, entities may not assume that changes in the cash flows of the hedged item will equal changes in the cash flows of the derivative hedging instrument. For example, if an entity decides to hedge its forecasted sale of Brazilian coffee with a Colombian coffee futures contract, the entity may not assume that changes in the cash flows of a Colombian coffee futures contract will equal changes in the cash flows related to all changes in the sales price of its Brazilian coffee.

CERTAIN FOREIGN CURRENCY EXCEPTIONS TO THE RULE

29g.06 When an entity has a forecasted transaction to acquire a nonfinancial asset and the purchase price is denominated in a foreign currency, paragraph 29(g) of the Standard (ASC paragraph 815-20-25-15(i)) permits the entity to designate that foreign currency risk as the hedged item in a cash flow hedge. In these circumstances, the Standard permits the currency risk of the forecasted transaction to be disaggregated from other risks inherent in the forecasted transaction. For example, an entity may designate foreign currency risk as the risk being hedged in the forecasted purchase of equipment in which the purchase price is denominated in a foreign currency.

29g.07 The Standard allows an entity, when hedging the risk of changes in the cash flows related to all changes in the purchase or sales price of a nonfinancial asset, to exclude the foreign-currency component of a hedged forecasted transaction from its hedge strategy (and from the assessment of effectiveness and measurement of ineffectiveness). For example, an Australian dollar-functional-currency gold producer could use a gold futures contract denominated in U.S. dollars (which are more readily available) to hedge its U.S. dollar denominated forecasted gold sales and designate the risk being hedged as to all changes in cash flows excluding the component of the cash flows related to changes in U.S. dollar/Australian dollar exchange rates. This would enable the Australian dollar-functional-currency gold producer to hedge its forecasted gold sales and experience a higher level of assessed effectiveness because the assessment of effectiveness would exclude the effect of changes in currency exchange rates (and instead would likely be based primarily on changes in gold prices). If the entity was required to hedge the risk of changes in its functional-currency-equivalent cash flows (i.e., all cash flows), high effectiveness may be difficult to achieve.

ABILITY TO DESIGNATE FORECASTED TRANSACTIONS RELATED TO NORMAL PURCHASES AND NORMAL SALES CONTRACTS IN A CASH FLOW HEDGE

29g.08 Agreements to purchase nonfinancial assets may meet the characteristics-based definition of a derivative but qualify for the normal purchases and normal sales exception in paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-13, 15-22, 15-37, 15-38, 15-40 through 15-42, and 15-45) (see Paragraphs 10b.01-10b.58 of Section 2). The purchase or sale under a variable-price contract that qualifies for the normal purchases and normal sales exception may be
designated as the hedged item in a cash flow hedge for the forecasted purchase or sale of the asset underlying the contract. For example, an entity that enters into a contract to buy a specified amount of chocolate on a specified date at a variable price based on the price of sugar may be permitted to designate the forecasted purchase of chocolate under the contract as the hedged forecasted transaction in a cash flow hedging relationship if the price of sugar is considered clearly and closely related to the price of chocolate. (See DIG Issue E17 for further reference.)

**Hedging Risks Associated with Forecasted Transactions Related to Financial Assets or Liabilities**

29h.01 Paragraph 29(h) of the Standard (ASC paragraphs 815-20-25-6, 25-15(j) and 25-43(d)) discusses the types of risks that may be designated as being hedged in cash flow hedges of financial assets and liabilities. ASU 2013-10 amended that discussion by removing one sentence as noted below effective July 17, 2013 (see additional discussion of amendments made by ASU 2013-10 in Paragraphs 29h.13a, 29h.13b, 29h.15, 29h.16, A6.49, and A6.50).

29h. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability (or the interest payments on that financial asset or liability) or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is

(1) the risk of overall changes in the hedged cash flows related to the asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity’s functional currency or a foreign currency),

(2) the risk of changes in its cash flows attributable to changes in the designated benchmark interest rate (referred to as interest rate risk),

(3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates (referred to as foreign exchange risk) (refer to paragraphs 40, 40A, 40B, and 40C), or

(4) the risk of changes in its cash flows attributable to default, changes in the obligor’s creditworthiness, and changes in spread over the benchmark interest rate with respect to the related financial asset’s or liability’s credit sector at inception of the hedge (referred to as credit risk).

Two or more of the above risks may be designated simultaneously as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In a cash flow hedge of a variable-rate financial asset or liability, either existing or forecasted, the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the specifically identified benchmark interest rate if the cash flows of the hedged transaction are explicitly based on a different index, for example, based on a specific bank’s prime rate, which
cannot qualify as the benchmark rate. However, the risk designated as being hedged could potentially be the risk of overall changes in the hedged cash flows related to the asset or liability, provided that the other criteria for a cash flow hedge have been met. An entity may not designate prepayment risk as the risk being hedged (refer to paragraph 21(f)).

DIG Issues related to this paragraph are G19, G22, G23, G25, G26 and J14. See DIG Issues Index.

29h.02 When hedging a forecasted transaction associated with a financial asset or liability, the Standard allows an entity to hedge only certain risks that give rise to an exposure to variability in cash flows. Only the following risks of changes in expected future cash flows may be designated as being hedged:

- **Market price risk.** This risk includes changes in the total cash flows of a forecasted transaction resulting from a change in the market price of the underlying of the transaction, regardless of whether the price and the related cash flows are stated in the entity’s functional currency or a foreign currency.

- **Interest rate risk.** For financial assets and liabilities, changes in interest rates may affect the right to receive (or obligation to pay or transfer) cash or other financial instruments in the future. The time value of money is a broadly accepted concept that is incorporated into generally accepted accounting principles (e.g., in APB Opinion No. 21, *Interest on Receivables and Payables* (ASC Subtopic 835-30, *Interest -- Imputation of Interest*), and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (ASC Subtopic 310-20, *Receivables - Nonrefundable Fees and Other Costs*)), and the marketplace has developed techniques to delineate and extract interest rate risk from financial instruments. Because of these factors, the Board decided that the risk of changes in interest rates affects the cash flows of the hedged item and, thus, warrants being identified as a risk that may be designated as being hedged in a cash flow hedge. However, in reaching this decision, the Board decided to limit the risk being hedged to changes in cash flows attributable to the benchmark interest rate as further discussed in Paragraphs 29h.07-29h.21 of this section.

- **Foreign exchange risk.** The cash flows (expressed in the entity’s functional currency) of a transaction denominated in a currency other than the entity’s functional currency are exposed to changes in foreign exchange rates. Accordingly, the Board decided that the risk of changes in foreign exchange rates on cash flows of hedged transactions warrants being identified as a risk that may be designated as being hedged in a cash flow hedge. When hedging foreign exchange risk there are additional factors that must be considered (see Section 7 for a discussion of foreign currency hedges).

- **Credit risk.** Some financial assets involve future performance by a counterparty, such as a counterparty’s obligation to deliver cash or another financial instrument. Accordingly, entities are subject to the credit risk and resulting nonperformance of the counterparty (counterparty risk). This risk directly affects expected cash flows resulting from the financial asset. In addition, the counterparty’s sector (e.g., industry,
geography, and location), that is, its credit sector risk, also directly affects the expected cash flows of the financial asset. The Board decided that the combination of these risks (i.e., credit risk) may be designated as the risk being hedged in a cash flow hedge.

29h.03 The Standard focuses on these risks because a change in one of these risks ordinarily will directly affect the cash flows of a forecasted transaction in a determinable or predictable manner. Changes in cash flows resulting from other risks may not be as determinable or predictable. Although entities may engage in various activities to control or reduce other types of economic risks (e.g., strategic risk), cash flows of a financial asset or liability related to risks other than those in paragraph 29(h) of the Standard (ASC paragraphs 815-20-25-15(j) and 25-43(d)) are not eligible for cash flow hedge accounting.

IDENTIFYING THE HEDGED FORECASTED TRANSACTION AND THE HEDGED RISK

29h.04 If the hedged transaction is the forecasted purchase or sale of a financial asset or liability (or the interest payments on that financial asset or liability) or the variable cash inflow or outflow of an existing financial asset or liability, an entity must carefully document the details of the hedged transaction. When the designated risk being hedged is the risk of overall changes in cash flows (in limited circumstances discussed below), the risk of change in cash flows attributable to changes in the benchmark interest rate, or the risk of change in the functional-currency-equivalent cash flows attributable to change in the related foreign currency exchange rates, the entity can document the specific asset or liability for which the forecasted transaction relates or the entity can document the first cash flows received or paid to a specified amount in a particular period without documenting the specific asset or liability. Regardless of the risk being hedged, the designation and documentation of the hedged forecasted transaction is critical because if the original hedging relationship, or portion of the relationship, is terminated, an evaluation may need to be performed to determine whether cash flow hedge accounting can continue to be applied. (See DIG Issues G13 and G25 for further reference.) The following examples illustrate this concept.

**Example 6.6: Hedging the Variable Interest Payments on a Group of Three-Month LIBOR-indexed Floating-rate Loans**

Company A makes three-month LIBOR-indexed floating-rate loans to its customers for which interest payments are due at the end of each calendar quarter and the three-month LIBOR-based interest rate resets at the end of each quarter for the interest payment that is due at the end of the following quarter. Company A determines that it will always have at least $100 million of those three-month LIBOR-indexed floating-rate loans outstanding throughout the next three years, even though the composition of loans likely will change to some degree due to prepayments, loan sales, and potential defaults.

Company A wishes to hedge its interest rate exposure to changes in the quarterly interest receipts on $100 million principal of three-month LIBOR-indexed floating-rate loans by entering into a three-year interest rate swap that provides for quarterly net settlements based on Company A receiving a fixed interest rate on a $100 million notional amount and paying a floating three-month LIBOR-based rate on a $100 million notional amount. In a cash flow
hedge of the benchmark interest rate risk (three-month LIBOR), Company A may identify the
heded forecasted transactions as the first three-month LIBOR-based interest payments
received by Company A during each four-week period that begins one week before each quarterly due date for the next three years that, in the aggregate for each quarter, are payments on $100 million principal of its then existing three-month LIBOR-indexed floating-rate loans. Because Company A designated the hedging relationship as hedging the risk of changes attributable to changes in the three-month LIBOR benchmark interest rate in Company A’s first three-month LIBOR-based interest payments received, any prepayment, sale, or credit difficulties related to an individual three-month LIBOR-indexed floating-rate loan would not affect the designated hedging relationship. Provided Company A determines it is probable that it will continue to receive three-month LIBOR-based interest payments on at least $100 million principal, Company A can conclude that the hedged forecasted transactions in the documented cash flow hedging relationships are probable of occurring. Company A will need to assess effectiveness and measure ineffectiveness at least quarterly during the relationship. When assessing effectiveness and measuring ineffectiveness, at a minimum, Company A must consider the timing of the hedged cash flows vis-à-vis the swap’s cash flows.

Example 6.7: Hedging the Variable Interest Payments on a Specific Group of Three-Month LIBOR-indexed Floating-rate Loans

Company B makes three-month LIBOR-indexed floating-rate loans to its customers for which interest payments are due at the end of each calendar quarter and the three-month LIBOR-based interest rate resets at the end of each quarter for the interest payment that is due at the end of the following quarter.

Company B wishes to hedge its interest rate exposure to changes in the quarterly interest receipts on $100 million principal of three-month LIBOR-indexed floating-rate loans by entering into a three-year interest rate swap that provides for quarterly net settlements based on Company B receiving a fixed interest rate on a $100 million notional amount and paying a floating three-month LIBOR-based rate on a $100 million notional amount. If Company B initially designates cash flow hedging relationships of benchmark interest rate risk (three-month LIBOR) and identifies as the related hedged forecasted transactions each of the variable interest receipts on a specified group of individual three-month LIBOR-indexed floating-rate loans aggregating $100 million principal but then some of those loans (a) experience prepayments, (b) are sold, or (c) experience credit difficulties, the original cash flow hedging relationships do not remain intact if the composition of the group of loans whose interest payments are the hedged forecasted transactions is changed by replacing the principal amount of the specified loans with similar floating-rate interest-bearing loans. Changing the composition of the specified individual loans within the group of floating-rate interest-bearing loans due to prepayment, a loan sale, or an unexpected change in a loan’s expected cash flows due to credit difficulties reflects a change in the identified hedged forecasted transactions for the hedging relationships related to the individual loans removed from the group of floating-rate interest-bearing loans. Consequently, the hedging relationships for future interest payments that are no longer probable of occurring must be terminated.
Example 6.8: Hedging the Variable Interest Payments on a Group of Prime-indexed Floating-rate Loans

Company C makes floating-rate loans to its customers based on its own individual prime rate for which interest payments are due at the end of each calendar quarter and the prime-based interest rate resets at the end of each quarter for the interest payment that is due at the end of the following quarter. Company C determines that it will always have at least $100 million of those prime-indexed floating-rate loans outstanding throughout the next three years, even though the composition of the loans will likely change to some degree due to prepayments, loan sales, and potential defaults.

Company C wishes to hedge its interest rate exposure to changes in the quarterly interest receipts on $100 million principal of those prime-indexed floating-rate loans by entering into a three-year interest rate swap that provides for quarterly net settlements based on Company C receiving a fixed interest rate on a $100 million notional amount and paying a floating rate on a $100 million notional amount based on the Prime rate specified in the Federal Reserve Statistical Release H-15.

Because Company C wishes to hedge its exposure to changes in the quarterly interest receipts on its prime-indexed loans, the entity is prohibited from designating interest rate risk as the hedged risk because the cash flows are explicitly based on an index different from the benchmark interest rate. Thus, the entity is limited to designating the hedged risk as the risk of overall changes in the hedged cash flows. In a hedge of overall changes in cash flows, Company C may identify the hedged forecasted transactions as the first prime-rate-based interest payments received by Company C during each four-week period that begins one week before each quarterly due date for the next three years that, in the aggregate for each quarter, are payments on $100 million principal of its then existing prime-indexed floating-rate loans.

Because Company C designated the hedging relationship as hedging the risk of overall changes in cash flows from Company C’s first prime-rate-based interest payments received, any prepayment, sale, or credit difficulties related to an individual prime-indexed floating-rate loan would not affect the designated hedging relationship. Provided Company C determines it is probable that it will continue to receive prime-rate-based interest payments on at least $100 million principal, Company C can conclude that the hedged forecasted transactions in the documented cash flow hedging relationship are probable of occurring. Company C will need to assess effectiveness and measure ineffectiveness at least quarterly during the relationship. Consequently, at a minimum, Company C must consider the following factors when assessing effectiveness and measuring ineffectiveness:

1. Timing of the hedged cash flows vis-à-vis the swap’s cash flows;
2. Basis differences resulting from the underlying interest rate index of the swap (e.g., the Prime rate specified in the Federal Reserve Statistical Release H-15) differing from the underlying interest rate index of the rolling portfolio of similar interest-bearing assets or similar interest-bearing liabilities (e.g., Company C’s individual prime rate); and
(3) Margin variability resulting from differences in the spread over the index rate received (e.g., the first payment received is prime plus 200bps, the second payment received is prime plus 400bps, and so on).

29h.05 When the risk being hedged is designated as the risk of overall changes in cash flows, the above approach to identifying the hedged forecasted transactions (i.e., as the first cash flows received up to a specified amount in a particular period) fails to recognize some of the risk of decreases in interest payment inflows attributable to credit default by excluding those variable interest payments that are contractually due but not paid by the debtor from being identified as the hedged forecasted transactions. The use of this technique is permitted by DIG Issue G25 as an exception to the general principles of the Standard and is only applicable for cash flow hedging relationships of the overall changes in variable non-benchmark-based interest cash flows for a rolling portfolio of interest-bearing financial assets or liabilities. This technique may also be applied in cash flow hedging relationships involving basis swaps subject to some additional conditions. See Paragraphs 28d.13-28d.15 of this section for further discussion of this issue.

Note that when the designated risk being hedged is the risk of changes in cash flows solely attributable to credit, the entity must document the specific asset or liability for which the forecasted transaction relates. In other words, no replacement or substitution would be permitted without affecting the original hedging relationship. See Paragraphs 32.01-33.11 of this section for a further discussion of discontinuation of hedge accounting.

SIMULTANEOUS HEDGES

29h.06 Cash flow hedge accounting under the Standard focuses on the change in cash flows of the hedged forecasted transaction that is attributable to the risk being hedged. As a result, entities generally are not precluded from hedging more than one risk at a time. We believe, however, that when the designated hedged risk is the risk of overall changes in the hedged cash flows related to a financial asset or liability, entities are precluded from designating another risk associated with the same forecasted transaction. This proscription exists because to do otherwise would result in the same risk being hedged more than once. For example, an entity may not hedge the risk of overall changes in the forecasted purchase of an available-for-sale debt security if another risk also is designated as a hedged risk. That is, the other permissible risks (i.e., interest rate, foreign currency, and credit) are components of the overall changes in the cash flows and, thus, by designating the overall changes in cash flows together with one of its components, an entity would be hedging a particular component more than once. The following example illustrates this concept.

Example 6.9: Hedging More than One Risk at a Time

Investor Co., a U.S. dollar-functional-currency entity, expects to purchase variable-rate (three-month LIBOR) debt securities denominated in a foreign currency three months from today. Investor Co. expects to classify these debt securities as available-for-sale securities under Statement 115 (ASC Subtopic 320-10).

Assuming all hedge criteria have been met, Investor Co. may designate any one or more of the following risks of changes in cash flows attributable to changes in:
• Interest rate risk (benchmark interest rate);
• Foreign currency exchange rates; or
• Credit risk.

Thus, Investor Co. could (i) enter into an interest rate agreement to lock in the amount of cash flows expected from interest earned on the securities; (ii) purchase a foreign currency forward to lock in the U.S. dollar cost of the securities; or (iii) enter into a derivative instrument to compensate Investor Co. if the issuer’s credit deteriorates.

If, however, Investor Co. designates the risk of changes in the cash flows related to the purchase price of the debt securities in its entirety, it cannot also designate simultaneously one of the above risks as a hedged risk for the same forecasted transaction. Given that the risk of change in cash flows related to all changes in the purchase price of the financial asset reflects the aggregation of all separately identifiable risks, if it were permitted to do so, Investor Co. effectively would be hedging the same risk twice.

BENCHMARK INTEREST RATE

29h.07 The stated interest rate in a financial asset or liability typically contains two components, a risk-free rate and a credit spread. The risk-free rate represents the rate of interest required to compensate an investor for its investment without consideration of default. Generally, the risk-free rate is a government borrowing rate (e.g., in the United States, the risk-free rate would be the U.S. Treasury rate) due to its limited default risk. The credit spread represents the additional interest needed to compensate an investor for the increased credit risk of a nonrisk-free borrower. This credit spread has two components: a component related to counterparty risk and a component related to credit sector risk. The Board decided that, with respect to the separation of interest rate risk and credit risk for hedging purposes, the risk of changes in credit sector spread and any credit spread attributable to a specific borrower should be encompassed in credit risk rather than interest rate risk. Thus, interest rate risk would encompass only changes in the risk-free rate.

29h.08 During its previous deliberations on interest rate risk, the Board decided that, in the United States, the interest rate on direct Treasury obligations of the U.S. government provides the best measure of the risk-free rate. Thus, the Board considered defining interest rate risk based only on U.S. Treasury rates in the United States. However, at that time, the Board decided to make an exception and extend the definition of interest rate risk in the United States to include interest rate swap rates based on LIBOR. At that time, the Board made this decision based on its understanding that:

• LIBOR-based interest rate swaps are the most commonly used hedging instruments for the U.S. financial markets in hedges of interest rate risk;
• There are technical factors (such as supply and demand) that may affect the rates on direct obligations of any single issuer, even the U.S. government; and
• Financial markets in the U.S. consider LIBOR rates as inherently liquid, stable, and a reliable indicator of interest rates and, if the rate for hedging interest rate risk was
limited to U.S. Treasury rates, many common hedging relationships using LIBOR-based swaps might not qualify for hedge accounting.

29h.09 Because the Board decided to permit a rate that is not fully risk-free to be the designated risk in a hedge of interest rate risk, it developed the general notion of benchmark interest rate to encompass both risk-free rates and rates based on the LIBOR swap curve in the United States. Consequently, when the designated risk being hedged is the risk of changes in interest rate risk, an entity must specifically designate and document the benchmark interest rate it is hedging (e.g., as either U.S. Treasury rates or LIBOR swap rates).

29h.10 Appendix F of the Standard (ASC Section 815-20-20 and paragraph 815-20-25-6A) defines the benchmark interest rate ASU 2013-10 amended that definition by removing the sentences as noted below effective July 17, 2013 (see additional discussion of amendments made by ASU 2013-10 in Paragraphs 29h.13a, 29h.13b, 29h.15, 29h.16, A6.49, and A6.50.

A widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high credit quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest rate related transactions.

In theory, the benchmark interest rate should be a risk free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate. In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government and, for practical reasons, the LIBOR swap rate are considered to be benchmark interest rates. In each financial market, only the one or two most widely used and quoted rates that meet the above criteria may be considered benchmark interest rates.

29h.11 The Board considered the practical application of the definition of the benchmark interest rate in global financial markets. The Board acknowledged that, in some foreign markets, the rate of interest on sovereign debt is considered the benchmark interest rate; that is, market participants consider that rate free of credit risk. However, in other markets, the relevant interbank offered rate may be the best reflection of the benchmark interest rate. The Board decided that the definition of the benchmark interest rate should allow for one or two rates to be considered benchmark interest rates not only in the United States, but also in foreign financial markets. We believe that the borrowing rate of the national government of euro currency countries may be used as the benchmark rate in addition to the Euro Interbank Offered Rate (Euribor swap rate). In Canada, the Canadian Treasury Rate, in addition to the Bankers' Acceptance Canadian Deposit Offering Rate (BA CDOR), may be used as the benchmark rate. In the United Kingdom, the Bank of England borrowing rate, in addition to the LIBOR swap rate, may be used as the benchmark rate.

29h.12 The Board determined that the definition of the benchmark interest rate should be flexible enough to withstand potential future developments in financial markets. For example, the Board decided that the current definition would result in the ability to replace the LIBOR swap rate with a more relevant benchmark interest rate if changes in the financial markets render the use of LIBOR swap rates obsolete.
During its previous deliberations on interest rate risk, the Board considered whether other rates, such as the commercial paper rate and the Fed Funds rate, in the U.S. financial markets should be included in the definition of benchmark interest rate and whether those rates should be permitted to be designated as the hedged risk in a hedge of interest rate risk. The Board also considered defining the benchmark interest rate as the portion of an instrument’s overall interest rate that is used as the underlying basis for pricing a financial instrument. For example, numerous indices or auction rates such as the Fed Funds rate, the Prime rate, the FNMA Par Mortgage rate, and the BMA rate are used as the underlying basis for pricing a financial instrument. At the time of those deliberations, the Board decided that allowing more than two benchmark rates to define interest rate risk was unnecessary and would make the resulting financial statements more difficult to understand.

As a result of the financial crisis in 2008, the exposure to and the demand for hedging the Fed Funds rate (also referred to as the Fed Funds Effective Swap Rate, Overnight Index Swap Rate or OIS), increased significantly. That demand was driven by an increased focus by banks on their sources of funding (including an increased focus on overnight interbank borrowings of surplus balances held at the Federal Reserve), the greater (and sometimes volatile) spread between LIBOR and Fed Funds rate, and an increase in the collateralization of derivatives transactions. On July 17, 2013, the FASB issued ASU 2013-10, which permits the Fed Funds rate to be used as a benchmark interest rate for hedge accounting purposes in addition to U.S. Treasury rates and LIBOR. ASU 2013-10 is effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013.

As discussed in paragraph 21f.14b of Section 5, the addition of the Fed Funds rate as a benchmark interest rate addressed a source of ineffectiveness in fair value hedges (i.e., when the Fed Funds rate is used as the discount rate for determining the fair value of the derivative hedging instrument, but another rate, such as LIBOR, is the benchmark interest rate designated as the hedged risk). This ineffectiveness was not as significant in cash flow hedges because, for a cash flow hedge of a benchmark interest rate, an entity may use the same credit risk adjustment for determining the fair value of the hedging derivative and for the hedged cash flows if the likelihood that the counterparty to the derivative or the entity will not default is probable. Further, if an entity changes the discount rate used to determine the fair value of the derivative hedging instrument, it would be permitted to change the discount rate for the hedged cash flows (e.g., from LIBOR to the Fed Funds rate) without dedesignating and redesignating the hedging relationship. See paragraphs A6.23-A6.23e of this section for additional guidance.

An entity is permitted to designate the risk of changes in the benchmark interest rate as the hedged risk, and the spread above that rate would be deemed to reflect credit risk. The Board concluded that considering all the effects of credit risk together was more understandable because it is consistent with market conventions and hedging practices. As discussed in Paragraph 29h.02 of this section, credit risk includes two components: a component related to counterparty risk and a component related to credit sector risk.

Paragraph 62 of the Standard (ASC paragraphs 815-20-25-80 and 25-81) requires an entity to assess effectiveness for similar hedges in a similar manner. Consistent with that notion, paragraph 29(h) of the Standard (ASC paragraph 815-20-25-6) stated that ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges and that the use of different benchmark interest rates for similar hedges should be rare and
should be justified. ASU 2013-10 removed the requirement that the use of different benchmark interest rates for similar hedges be justified and that the occurrence of such be rare. In other words, for hedging relationships entered into or redesignated before July 17, 2013 an entity could not enter into the same type of hedging relationship (e.g., hedging the interest rate risk associated with two separate LIBOR-based debt obligations) and designate the benchmark interest rate risk as U.S. Treasury rates for one hedging relationship and designate the benchmark interest rate as LIBOR swap rates for the other hedging relationship unless that occurrence is justified in the specific circumstances. For hedging relationships entered into or redesignated on or after July 17, 2013 an entity can enter into two hedging relationships of the same type whereby, for example, LIBOR is the designated hedged risk for one and the Fed Funds rate is the designated hedged risk for the other.

IDENTIFYING THE HEDGED RISK IN A CASH FLOW HEDGE

29h.16 Paragraph 29(h) of the Standard (ASC paragraphs 815-20-25-15(j) and 25-43(d)) states that in a cash flow hedge of a variable-rate asset or liability, either existing or forecasted, the designated risk being hedged cannot be the risk of changes in cash flows associated with the benchmark interest rate if the cash flows of the hedged transaction are explicitly based on another index. Accordingly, when the benchmark interest rate cannot be the designated hedged risk, entities may hedge the risk of changes in total cash flows if all the other criteria for a cash flow hedge are met. For example, if the interest receipts or payments on an existing variable-rate financial asset or liability are based on a benchmark interest rate (e.g., the U.S. Treasury rate or the LIBOR swap rate), then the entity can hedge interest rate risk. However, if the interest receipts or payments on an existing variable-rate financial asset or liability are based on a nonbenchmark interest rate (e.g., Prime, or the BMA rate), then the entity must hedge the risk of overall changes in the forecasted interest receipts or payments. (Refer to Paragraphs 29h.07-29h.15 of this section for additional information.) The following exhibit illustrates the appropriate hedged risk designation based on the interest rate index of the hedged item and the derivative hedging instrument:

<table>
<thead>
<tr>
<th>Interest Rate Index of Hedged Item</th>
<th>Interest Rate Index of Derivative Hedging Instrument</th>
<th>Appropriate Hedged Risk Designation</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Prime Rate</td>
<td>U.S. Prime Rate</td>
<td>Change in all cash flows</td>
</tr>
<tr>
<td>U.S. Prime Rate</td>
<td>LIBOR</td>
<td>Change in all cash flows</td>
</tr>
<tr>
<td>LIBOR</td>
<td>LIBOR</td>
<td>Change in LIBOR</td>
</tr>
<tr>
<td>LIBOR</td>
<td>U.S. Treasury</td>
<td>Change in LIBOR</td>
</tr>
<tr>
<td>LIBOR</td>
<td>Prime Rate</td>
<td>Change in LIBOR</td>
</tr>
<tr>
<td>LIBOR</td>
<td>Fed Funds rate</td>
<td>Change in LIBOR</td>
</tr>
<tr>
<td>U.S. Treasury</td>
<td>LIBOR</td>
<td>Change in U.S. Treasury</td>
</tr>
<tr>
<td>Fed Funds Rate</td>
<td>Fed Funds rate</td>
<td>Change in Fed Funds rate*</td>
</tr>
</tbody>
</table>

* The Fed Funds rate may be designated as the hedged risk for hedging relationships entered into or redesignated on or after July 17, 2013.

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Auction Rate Notes and Financial Instruments with Two Variable Indices

29h.16a Paragraph 29(h) of the Standard (ASC paragraphs 815-20-25-15(j) and 25-43(d)) states that the risk being hedged in a cash flow hedge cannot be the risk of changes in cash flows attributable to changes in a specifically identified benchmark interest rate if the cash flows of the hedged transaction are explicitly based on a different index, such as the Prime rate, which cannot qualify as a benchmark rate.

29h.16b DIG Issue G26 clarifies that the risk being hedged can be changes in cash flows due to changes in the benchmark interest rate only if the cash flows of the hedged transaction are explicitly based on the same benchmark interest rate. Thus, if the cash flows of the hedged transaction are based on a non-benchmark interest rate, even though it is not deemed to be an index, such as an auction rate, the risk being hedged must be total changes in cash flows. Auction rate notes generally have long-term nominal maturities and interest rates that reset periodically through a Dutch auction process, typically every 7, 28, or 35 days. At an auction, existing holders of auction rate notes and potential buyers enter into a competitive bidding process through a broker-dealer, specifying the number of shares (units) to purchase with the lowest interest rate they are willing to accept. Generally, the lowest bid rate at which all shares can be sold at the notes' par value establishes the interest rate, also known as the clearing rate, to be applied until the next auction. (See DIG Issue G26 for further reference.)

29h.16c Some may characterize an auction rate as being composed of two variables: a benchmark interest rate component and a credit component. In addition, there are variable-rate instruments in the market that have two such variables described in the instruments’ indentures. In these instances, the hedged risk can be only the benchmark component by applying the concept of transparent separation between benchmark interest rate risk and credit risk. This concept is discussed in the basis for conclusion in paragraph 15 of Statement 138. In Statement 138 (ASC Topic 815), the Board decided that, with respect to the separation of benchmark interest rate risk and credit risk, the risk of changes in credit sector spread and any credit spread attributable to a specific borrower should be encompassed in credit risk rather than benchmark interest rate risk. Under that approach, an entity would be permitted to designate the risk of changes in the benchmark interest rate as the hedged risk, and any spread above that rate would be deemed to reflect credit risk.

29h.16d In the case of an auction process, the clearing rate established through the bidding process does not provide for transparent separation between benchmark interest rate risk and credit risk. Regardless of whether the auction rate is described as a benchmark interest rate plus or minus an adjustment specified by the bidders, the clearing rate is derived by an auction process for the entire rate, not individual components. The rate is driven by more than just benchmark interest and credit, as it also encompasses the investors’ assumptions about the market forces surrounding the issuer and the actual instrument being issued. Therefore, an entity would not be able to meet the transparent separation threshold in an auction rate scenario and would need to identify the hedged risk as total changes in cash flows. DIG Issue G26 provides transition for entities that had hedged changes in the auction rate. Otherwise qualifying hedge relationships must be redesignated prospectively as of the effective date of this DIG Issue (the first day of the entity's first fiscal quarter beginning after January 8, 2007). The derivative's gain or loss for the period prior to the effective date remains in accumulated other comprehensive...
income and is reclassified into earnings consistent with the provisions of paragraphs 32 and 33 of the Standard (ASC paragraphs 815-30-40-1 through 40-5).

29h.16e In the case of an instrument with two variable indices, the concept of transparent separation would allow the hedged risk to be only the benchmark component. For example, assume an entity issues debt that is indexed to a benchmark interest rate plus a specific margin. Further, the margin is based upon a table of values, with each specific value tied to corresponding decreases/increases in the entity’s credit rating. The entity could document the hedging relationship as a hedge of the changes in cash flows due to changes in the benchmark interest rate. Thus, the entity would be permitted to hedge only the changes in cash flows associated with fluctuations in the benchmark rate, and exclude changes in cash flows which may result from changes in the margin. Because the margin is designed to provide the lender with a premium related to the entity’s credit quality, any changes in the margin should be considered to be changes due to credit risk which can be isolated from changes due to changes in the benchmark rate. This scenario is not unlike a portfolio of benchmark-based interest receipts for which the first-payments received technique is employed (pursuant to DIG Issue G13) where margin variability due to credit is excluded from the hedged risk.

29h.16f In addition, because the table of values in the example above was established at the onset of the liability, and presumably took into account the then current credit/rate environment, the values would not need to be adjusted for subsequent changes to the general credit/rate environment.

29h.16g In a situation where the entity has no formal credit rating, an entity specific metric may be used as a proxy for its credit rating. Specific metrics could include debt to equity ratios, operating cash flow levels, etc. Although, the specific metric designated as a proxy to an entity’s credit is a matter of judgment, there should be a documented, reasonable basis to support its use. The use of a proxy may not be appropriate in situations where the entity is rated on a frequent basis.

HEDGING INTEREST RATE RISK FOR THE FORECASTED ISSUANCES OF FIXED-RATE DEBT (ROLLOVER STRATEGIES)

29h.17 Paragraph 29(h) of the Standard (ASC paragraphs 815-20-25-15(j) and 25-43(d)) prohibits designating as the hedged risk the changes in cash flows associated with the benchmark interest rate if the interest rate of the hedged item is explicitly based on another index. For example, the Standard precludes a hedge of risks associated with changes in LIBOR when the hedged item is exposed to variability in cash flows related to changes in the published Prime rate. This prohibition does not, however, apply to cash flow hedges of forecasted issuances of fixed-rate debt. Examples of debt issuances for which a cash flow hedge is commonly undertaken include rollovers of short-term, fixed-rate debt such as commercial paper or certificates of deposit issued by banks. Those cash flow hedging relationships seek to hedge the variability in cash flows that will or are expected to occur when fixed-rate instruments mature and are reissued at prevailing, fixed rates of interest (i.e., rolled over). The prohibition does not extend to these instruments because the interest rate established on issuance of that fixed-rate debt is based on current market interest rates for a specific debtor and the debt’s future interest payments will not vary. The restriction against hedging the risk of changes in cash flows associated with the benchmark interest rate risk in paragraph 29(h) of the Standard (ASC
paragraphs 815-20-25-15(j) and 25-43(d)) similarly is not intended to apply to cash flow hedging relationships that involve the forecasted purchase of fixed-rate instruments.

29h.18 The conclusion in the preceding paragraph is significant because if the restriction of paragraph 29(h) of the Standard (ASC paragraphs 815-20-25-15(j) and 25-43(d)) were applied to those forecasted transactions, entities would be required to identify the risk being hedged as the risk of overall changes in cash flows. That hedging strategy likely would generate significant amounts of ineffectiveness and, perhaps, not qualify for hedge accounting because the relationship would not be highly effective. This is because derivatives used for these hedging relationships typically are based on benchmark interest rates and would not effectively offset overall changes in interest cash flows of the forecasted issuance of debt.

29h.19 While paragraph 29(h) (ASC paragraphs 815-20-25-15(j) and 25-43(d)) does not prohibit an entity from designating benchmark interest rate risk in cash flow hedging relationships involving rollovers of fixed-rate debt (because fixed-rate debt does not vary on an explicit index), there may be other complexities associated with these hedging relationships, particularly in commercial paper programs. Commercial paper programs typically involve a series of issuances of short-term fixed-rate borrowings with varying maturities (e.g., 7 to 270 days) that are expected to rollover at each maturity date. While the maturity of the individual commercial paper borrowings may vary, the entity may expect a virtually constant average maturity across its entire portfolio of commercial paper borrowings over the life of the program, for example 30 days. In order to hedge the cash flow variability associated with that portfolio of future issuances of commercial paper, or the interest thereon, the entity may enter into a pay fixed, receive variable interest rate swap that reprices every 30 days (in order to match the average rollover period). The complexities associated with these relationships include determining whether the portfolio of commercial paper issuances (or interest payments thereon) share the same risk exposure for which they are being hedged (i.e., the hedged forecasted transactions are similar) and identifying a proper method for assessing effectiveness and measuring ineffectiveness. These issues, among others, are discussed in a draft DIG Issue referred to as Agenda Item 13-11 & 13-12 (the Agenda Item). Despite the fact that the Agenda Item was never finalized, many entities using rollover strategies have applied its guidance in practice. With respect to similarity, the Agenda Item requires that an entity demonstrate that the implicit index of each individual commercial paper borrowing within the portfolio (based upon its maturity) is highly correlated with the benchmark interest rate designated as being hedged. The Agenda Item also describes potential methods for calculating the changes in cash flows of the hedged portfolio. While the views set forth in the Agenda Item were never finalized or formally reconciled to all aspects of the Standard, they have been widely used in practice and we believe they are reasonable interpretations of Statement 133.

29h.20 In applying the conclusions in Paragraph 29h.17, certain entities may attempt to characterize their variable-rate debt as fixed-rate debt that, at each interest reset date, is effectively rolled over to another fixed-rate instrument that has a new fixed rate until the next reset date. For example, assume an entity has existing variable-rate debt that resets monthly based on a specified bank’s Prime rate as of the beginning of each month and matures in five years. Although the variable-rate debt has, after each reset, a fixed rate for each monthly period, it is inappropriate to characterize that debt as a series of forecasted issuances of fixed-rate debt not indexed to a nonbenchmark interest rate. When each reset occurs, it is not a new issuance of
fixed-rate debt based on current market interest rates for that debtor; instead, it is a contractual continuation of a debtor-creditor relationship and the fixed-rate for each month is explicitly (and contractually) based on a specific index that is different from the benchmark interest rate. Any other characterization would misapply the requirements of paragraph 29(h) of the Standard (ASC paragraphs 815-20-25-15(j) and 25-43(d)). (See DIG Issue G19 for further reference.)

29h.20a In discussing the application of paragraph 29(h) (ASC paragraphs 815-20-25-15(j) and 25-43(d)) and DIG Issue G19 with the SEC staff, it has come to our attention that they believe, and we concur, that deposit/investment arrangements without contractually stipulated maturity dates, such as money market deposits, NOW accounts and savings accounts, cannot be characterized as a series of daily, or other periodic, rollovers of fixed-rate instruments (even if such arrangements permit both the financial institution and the investor to cancel the arrangement at any time), but rather represent ongoing variable-rate arrangements. In other words, the daily, or other periodic, rollover of the arrangement is a contractual continuation of a single debtor-creditor relationship. Accordingly, because the interest rates on these arrangements typically do not vary explicitly on a benchmark interest rate index, the risk being hedged would be limited to overall changes in cash flows. While our discussions with the SEC staff were in the context of deposit liabilities (i.e., from the issuer's point of view), we believe this guidance is equally applicable to depositors/investors in deposit products or other products that function in a similar manner. The SEC staff has agreed that entities that have historically designated these products in otherwise qualifying cash flow hedging relationships of benchmark interest rate risk should discontinue hedge accounting and apply the transition guidance provided for in DIG Issue G26 as of the first day of the first fiscal quarter beginning after January 8, 2007 (April 1, 2007 for calendar year-end entities). Entities that have previously issued financial statements for the period including the transition date (for example, second quarter financial statements for calendar year-end registrants) should assess the materiality of not having appropriately applied the transition provisions of DIG Issue G26 in those previously filed financial statements to determine whether restatement is necessary. Although an entity may be permitted to designate the risk being hedged as overall changes in cash flows in a newly designated relationship after applying the transition provisions of DIG Issue G26, there may be a low likelihood of being able to demonstrate an expectation of high effectiveness due to the nature of the rate-setting process for these products. Interest rates for these products may be set based on factors other than changes in the interest rate index of the derivative instrument. For example, the rates may be set based on the need for funds, to calibrate the mix of the sources of funds, celebration of a branch opening or other competitive factors. In addition, the timing of the products' rate-setting process may not coincide with the derivative's.

HEDGING PREPAYMENT RISK

29h.21 The Standard prohibits designating prepayment risk as the hedged risk in a cash flow hedge of a forecasted transaction that involves a financial asset or liability. This prohibition arises because the Standard does not permit designating a subcomponent of market price risk, interest rate risk, foreign exchange risk, or credit risk as the risk being hedged. Having said this, the Board recognizes that in limited circumstances what is normally considered a component of interest rate risk (i.e., the prepayment option) may be a separately identifiable risk and, therefore, hedgeable in a fair value hedge. See Paragraphs 21f.06-21f.07 of Section 5 for further discussion of this issue.
CASH FLOW HEDGE OF INTEREST PAYMENTS OF YOU PICK ‘EM DEBT

29h.22 You Pick ‘Em debt is a type of variable-rate debt instrument with an option that allows the debtor, on specified dates, to change the interest rate index (e.g., one-month LIBOR, three-month LIBOR, U.S. Treasury, or Prime) on which its interest payments are based.

29h.23 Entities may hedge the interest rate risk associated with these debt instruments with an interest rate swap, and designate the relationship as a cash flow hedge of the variability in the debt instrument’s interest payments due to changes in the benchmark interest rate. As with any hedge of interest rate risk, an entity must document and designate a benchmark interest rate (i.e., LIBOR, U.S. Treasury, or Overnight Index Swap Rate (OIS)).

29h.24 The interest rate optionality of these debt instruments raises the following considerations when applying the cash flow hedging model:

- The specificity of the interest rate documented as the hedged risk at the inception of the hedging relationship (e.g., cash flows based on three-month LIBOR versus LIBOR); and
- The effect of changing the interest rate index used to calculate variable-rate interest payments on the debt instrument during the hedged period (e.g., selecting one-month LIBOR in one period and selecting three-month LIBOR in another period).

29h.25 In terms of the specificity of the interest rate documented as the hedged risk, as discussed in paragraph 29a.05, we generally believe that different tenors of LIBOR are different indices. For example, if a particular interest rate is published on a 30-day and a 60-day basis, an interest payment that varies on the 30-day rate and one that varies on a 60-day rate would be considered separate interest rates. However, based on conversations with the FASB staff, when an entity designates a cash flow hedge of the risk of changes in interest rates on a specifically defined You Pick ‘Em debt instrument, the entity may choose to identify the hedged interest rate broadly (e.g., as LIBOR-based interest payments) or specifically (e.g., three-month LIBOR-based interest payments). Entities should clearly document the designation in their contemporaneous hedge documentation.

29h.26 The identification of the hedged interest rate (either broadly or specifically) is a critical decision that will affect (1) the accounting consequence of changing the interest rate used to calculate payments on the debt instrument during the hedged period and (2) the effectiveness of the hedging relationship. If an entity identifies the hedged interest rate broadly (i.e., LIBOR-based interest payments), and chooses to reset the interest rate during the hedge period from three-month LIBOR to one-month LIBOR, the reset would not be considered a dedesignation event and the hedging relationship may continue.

29h.27 In contrast, if the entity identifies the hedged interest rate specifically (i.e., three-month LIBOR-based interest payments) and chooses to reset the interest rate during the period from three-month LIBOR to one-month LIBOR, the reset would be considered a dedesignation event. Although this event would result in the dedesignation of the hedging relationship, the FASB staff indicated that no amounts are required to be reclassified from AOCI into earnings (even though the hedged forecasted transactions (three-month LIBOR interest payments) are now probable of not occurring), except for amounts required to be reclassified based on the entity’s final measurement of ineffectiveness.
**29h.28** If an entity chooses to identify the hedged interest rate broadly (i.e., LIBOR-based interest payments), the fact that it has the option to select a different benchmark rate (e.g., one-month LIBOR or three-month LIBOR) should be included as a feature of the perfectly effective hypothetical (PEH) derivative used to assess effectiveness and measure ineffectiveness. Because the actual derivative instrument will likely not include that optionality, the hedging relationship will not be perfectly effective and the entity would need to recognize some amount of ineffectiveness in earnings.

**29h.29** The following exhibit summarizes the accounting effect of an entity’s choice to specifically or broadly designate the hedged interest rate risk in a cash flow hedging relationship of You Pick ‘Em debt.

<table>
<thead>
<tr>
<th><strong>Exhibit 6.3a: Effect of the Specificity of the Benchmark Interest Rate Related to You Pick ‘Em Debt</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assume an entity issues You Pick ‘Em debt and at each reset date, it may select the one-month LIBOR rate, three-month LIBOR rate, or the Prime rate. The entity enters into a receive three-month LIBOR, pay fixed rate swap to hedge the variable interest payments.</strong></td>
</tr>
<tr>
<td><strong>Specific (as three-month LIBOR)</strong></td>
</tr>
<tr>
<td><strong>Documentation of rate selection</strong></td>
</tr>
<tr>
<td><strong>Perfectly effective hypothetical (PEH) derivative</strong></td>
</tr>
<tr>
<td><strong>Entity selects a different LIBOR tenor at reset date</strong></td>
</tr>
</tbody>
</table>
29h.30 This guidance was based on conversations with the FASB staff related to the forecasted interest payments for a specifically identified You Pick ‘Em debt instrument and may not be applied by analogy to any other variable rate debt instruments or any borrowing program, rollover strategy, layering strategy, or portfolio strategy.

ACCOUNTING FOR A CASH FLOW HEDGE

30.01 Paragraph 30 of the Standard (ASC paragraph 815-30-35-3) discuss the basic accounting requirements for a cash flow hedge as follows:

30. The effective portion of the gain or loss on a derivative designated as a cash flow hedge is reported in other comprehensive income, and the ineffective portion is reported in earnings. More specifically, a qualifying cash flow hedge shall be accounted for as follows:

a. If an entity’s defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in paragraph 63 in Section 2 of Appendix A), that excluded component of the gain or loss shall be recognized currently in earnings. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option’s intrinsic value, the changes in the option’s time value would be recognized in earnings. Time value is equal to the fair value of the option less its intrinsic value.

b. Accumulated other comprehensive income associated with the hedged transaction shall be adjusted to a balance that reflects the lesser of the following (in absolute amounts):

(1) The cumulative gain or loss on the derivative from inception of the hedge less (a) the excluded component discussed in paragraph 30(a) above and (b) the derivative’s gains or losses previously reclassified from accumulated other comprehensive income into earnings pursuant to paragraph 31.

(2) The portion of the cumulative gain or loss on the derivative necessary to offset the cumulative change in expected future cash flows on the hedged transaction from inception of the hedge less the derivative’s gains or losses previously reclassified from AOCI into earnings.
reclassified from accumulated other comprehensive income into earnings pursuant to paragraph 31.

That adjustment of accumulated other comprehensive income shall incorporate recognition in other comprehensive income of part or all of the gain or loss on the hedging derivative, as necessary. If hedge accounting has not been applied to a cash flow hedging relationship in a previous effectiveness assessment period because the entity’s retrospective evaluation indicated that the relationship had not been highly effective in achieving offsetting changes in cash flows in that period, the cumulative gain or loss on the derivative referenced in this subparagraph would exclude the gains or losses occurring during that period. Similarly, the cumulative change in expected future cash flows on the hedged transaction would exclude the changes related to that period when hedge accounting has not been applied. That situation may arise if the entity had previously determined, for example, under a regression analysis or other appropriate statistical analysis approach used for prospective assessments of hedge effectiveness, that there was an expectation in which the hedging relationship was highly effective in future periods. Consequently, the hedging relationship continued even though hedge accounting was not permitted for a specific previous effectiveness assessment period.

c. A gain or loss shall be recognized in earnings, as necessary, for any remaining gain or loss on the hedging derivative or to adjust other comprehensive income to the balance specified in paragraph 30(b) above.

d. If a non-option-based contract is the hedging instrument in a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 15 of Statement 52, an amount that will both offset the related transaction gain or loss arising from that remeasurement and adjust earnings for that period’s allocable portion of the initial spot-forward difference associated with the hedging instrument (cost to the purchaser or income to the seller of the hedging instrument) shall be reclassified each period from other comprehensive income to earnings if the assessment of effectiveness and measurement of ineffectiveness are based on total changes in the non-option-based instrument’s cash flows. If an option contract is used as the hedging instrument in a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 15 of Statement 52 to provide only one-sided offset against the hedged foreign exchange risk, an amount shall be reclassified each period to or from other comprehensive income with respect to the changes in the underlying that result in a change in the hedging option’s intrinsic value. In addition, if the assessment of effectiveness and measurement of ineffectiveness are also based on total changes in the option’s cash flows (that is, the assessment will include the hedging instrument’s entire change in fair value—its entire gain or loss), an amount that adjusts earnings for the amortization of the cost of the option on a rational basis shall be reclassified each period from other comprehensive income to earnings.
Section 2 of Appendix A illustrates assessing hedge effectiveness and measuring hedge ineffectiveness. Examples 6 and 9 of Section 1 of Appendix B illustrate the application of this paragraph.

* The guidance in this subparagraph is limited to foreign currency hedging relationships because of their unique attributes. That accounting guidance is an exception for foreign currency hedging relationships.

DIG Issues related to this paragraph are E8, E19, G1, G7, G16, G20, G21, G23, H15, J15, J16 and K4. See DIG Issues Index.

30.02 The Board concluded that special accounting for cash flow hedges of certain forecasted transactions is needed because of differences in the way derivative instruments and forecasted transactions are recognized and measured. Without hedge accounting, changes in the fair value of derivative instruments would be reported in a different period than the earnings effect of the hedged forecasted transaction.

30.03 In developing the cash flow hedge accounting requirements, the Board wanted to:

- Avoid recognizing the changes in fair value (i.e., gains or losses) on the derivative hedging instrument as separate assets or liabilities;
- Make the gains or losses transparent to financial statement users; and
- Include in earnings any ineffectiveness.

30.04 In general, for hedges of cash flow exposures, the Standard provides that the change in the fair value of the derivative hedging instrument that is effective (i.e., the gains and losses arising from changes in cash flows that are effective in offsetting changes in the cash flows of the hedged forecasted transaction) is recognized in OCI, while the ineffective portion of the change in the fair value of the derivative is recognized in earnings. This approach can be summarized as follows:

**Exhibit 6.4: Cash Flow Hedge Accounting Model**

![Diagram of Cash Flow Hedge Accounting Model]

(1) Amounts are subsequently transferred out of OCI as the hedged item is reported in earnings (e.g., interest, cost of sales, depreciation).
Cash Flow Ineffectiveness

30.05 The accounting for a cash flow hedge requires an entity to record the derivative hedging instrument at fair value in the statement of financial position as an asset or liability, with the effective portion of the offsetting change in that derivative’s fair value reported in OCI and the ineffective portion reported in earnings. If an entity decides to exclude a specific component of the change in cash flows of a derivative hedging instrument from the hedge effectiveness assessment, that component should be included currently in earnings and not included in the measurement of ineffectiveness.

30.06 Paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) creates parameters for when a portion of the change in the fair value of the derivative hedging instrument is ineffective. Paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) indicates that hedge ineffectiveness in a cash flow hedge occurs only when the cumulative gain or loss on the derivative hedging instrument exceeds the cumulative change in the expected future cash flows on the hedged forecasted transaction. Thus, the derivative hedging instrument is expected to provide cash flows in excess of the expected cash flows of the forecasted transaction (i.e., overhedge). This ineffectiveness must be reported in earnings because the derivative hedging instrument is expected to provide cash flows that are not effective at offsetting changes in the expected cash flows of the hedged forecasted transaction. Gains and losses from the derivative hedging instrument that are less than changes in expected cash flows from the hedged forecasted transaction are not accounted for in the same way. That is, there is no reported ineffectiveness when the cumulative change in the expected cash flows on the hedged forecasted transaction exceeds the cumulative gain or loss on the derivative hedging instrument (i.e., underhedge). There is no ineffectiveness in this instance because there are no expected cash flows to be provided by the derivative hedging instrument that will not provide offset to the change in expected cash flows of the hedged forecasted transaction. While no ineffectiveness is reported in an underhedge, it does represent a lack of effectiveness, and an entity must continue to assess hedge effectiveness and ensure that the hedging relationship is highly effective. If high effectiveness is not achieved, the hedge no longer qualifies for hedge accounting; after the provisions of paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) are applied at the date the hedging relationship is discontinued, all subsequent changes in the derivative’s fair value must be reported currently in earnings. The approach for recognizing ineffectiveness in the cash flow model is different from the approach in the fair value model in which ineffectiveness is recognized in earnings for both overhedges and underhedges.

30.06a Refer to Paragraph 32.12 of this section for a discussion of situations when hedge accounting has not been applied to a cash flow hedging relationship in a previous assessment period because the entity’s retrospective evaluation indicated that the relationship had not been highly effective but there is an expectation of high effectiveness in future periods as envisioned in paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)).

30.07 An entity is required to use the fair value of the derivative hedging instrument to calculate the gain or loss on that instrument for purposes of applying the provisions of paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)). However, the Standard does not prescribe a required method to be used to calculate the change in the expected future cash flows on the hedged forecasted transaction when applying the provisions of paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)). Because the focus of the measurement of ineffectiveness of a
A cash flow hedging relationship is on cash flows, the timing of those expected future cash flows must be taken into consideration. As a result, when determining the change in the expected future cash flows of the hedged forecasted transaction attributable to the hedged risk, a present value methodology generally should be incorporated in the calculation. The discount rate to be used in that present value methodology would be the discount rate applicable to those expected future cash flows to arrive at fair value (i.e., the relevant curve for those expected future cash flows) as if the expected future cash flows represent a derivative instrument with cash flows identical to those of the hedged forecasted transaction. While we believe that discounting should be incorporated, the discount rate incorporated within the calculation of fair value of the derivative hedging instrument and the discount rate incorporated within the calculation of the changes in the expected future cash flows of the hedged forecasted transaction attributable to the hedged risk may not be the same as a result of the timing of the respective cash flows, the credit risk of the counterparty to the derivative, and other relevant factors. However, if the effectiveness tests are based on the changes in cash flows of the derivative hedging instrument and the hedged forecasted transaction, instead of their changes in fair value, an entity may use the same credit risk adjustment that is used to determine the fair value of the derivative to calculate the change in the cash flows of the hedged forecasted transaction, as long as the likelihood that the counterparty to the derivative or the entity will not default is probable.

30.08 Some entities may choose to pursue a cash flow hedging strategy to underhedge the exposure to variability in cash flows so that the cumulative change in the future expected cash flows on the hedged forecasted transaction always is expected to exceed the cumulative gain or loss on the derivative hedging instrument. This strategy may result in no ineffectiveness being recorded in earnings; however, since the exposure to variability is not fully hedged, there may be volatility in cash flows when the forecasted transaction occurs. Additionally, since the assessment of effectiveness considers the effects of cash flows related to underhedges and overhedges, entities may experience a reduced level of effectiveness in connection with those strategies, perhaps to a degree that would preclude applying hedge accounting under paragraph 28(b) of the Standard (ASC paragraphs 815-20-25-75, 25-76, and 25-80).

30.09 The following example illustrates the application of paragraph 30 of the Standard (ASC paragraphs 815-30-25-1, 815-30-35-3, 35-4, and 35-7) in an overhedge and underhedge situation.

**Example 6.10: Accounting for a Cash Flow Hedge**

Brown Corp. has a $1,000,000 investment in a variable-rate (three-month LIBOR) corporate debt security. Brown Corp. enters into a futures contract to hedge the variability in cash flows attributable to interest receipts due on the debt securities. Assume Brown Corp. meets all the hedging requirements of the Standard and the hedging relationship is highly effective. Also assume that from the inception of the hedging relationship, cumulative gains (losses) on the futures contract and the hedged transactions are as follows:

| Futures contract | $110,000 |
| Hedged transaction | $(100,000) |

The following journal entry would be made:
Brown Corp. recognized a hedge ineffectiveness gain of $10,000 in earnings that represents the extent to which the cumulative gains on the futures contract are not offset by the cumulative losses on the hedged transaction, and the derivative is recorded at its fair value.

Now assume the following cumulative gain (loss) (ignoring impairment issues):

<table>
<thead>
<tr>
<th>Futures contract</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI</td>
<td>$100,000</td>
</tr>
<tr>
<td>Earnings</td>
<td>10,000</td>
</tr>
</tbody>
</table>

The following journal entry would be made:

<table>
<thead>
<tr>
<th>Futures contract (B/S)</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

There is no reported hedge ineffectiveness. The Standard requires that, on a cumulative basis, only ineffectiveness due to excess gains or losses on the derivative hedging instrument should be reported in earnings. If the cumulative change in expected future cash flows on the hedged transaction exceeds the cumulative gains or losses on the derivative hedging instrument (i.e., the excess gains and losses from the hedged item), the excess is not reported in earnings as hedge ineffectiveness.

**CUMULATIVE MEASUREMENT OF CASH FLOW INEFFECTIVENESS**

**30.10** The Board discussed whether cash flow ineffectiveness should be measured on a period-by-period basis or on a cumulative basis since the inception of the hedge. The Board adopted a cumulative basis approach because, under the period-by-period approach, retained earnings would not reflect total hedge ineffectiveness and comprehensive income would not reflect total hedge effectiveness during the hedging relationship.

**30.11** The following example illustrates the difference between a period-by-period and a cumulative basis approach.

### Example 6.11: Illustration of the Difference Between the Period-by-Period and the Cumulative Basis Approach

To illustrate the difference between the period by period basis and the cumulative basis, assume:

<table>
<thead>
<tr>
<th>Period</th>
<th>Hedging Instrument Gain (Loss)</th>
<th>Hedged Transaction Gain (Loss)</th>
<th>Hedge Ineffectiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Period</td>
<td>Cumulative</td>
<td>Period</td>
</tr>
<tr>
<td></td>
<td>$75</td>
<td>$75</td>
<td>$70</td>
</tr>
<tr>
<td></td>
<td>70</td>
<td>145</td>
<td>(70)</td>
</tr>
<tr>
<td></td>
<td>(75)</td>
<td>(145)</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>Period-by-Period</td>
<td>Cumulative</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>$5 Gain</td>
<td>$0</td>
<td>0</td>
</tr>
</tbody>
</table>

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Other comprehensive income $ 140 Gain $ 145 Gain

If the period-by-period approach were permitted, at the end of period 2 retained earnings would include a $5 gain even though total ineffectiveness since inception of the hedge was zero; and other comprehensive income would reflect a $140 gain even though the derivative hedging instrument’s effectiveness from inception was $145.

1 No ineffectiveness is recognized because the change in the cash flows of the hedging instrument is less than the change in the cash flows on the hedged forecasted transaction.

30.12 When cumulative cash flow hedge ineffectiveness is measured, it should be based on the best estimate, at that time, of the forecasted transaction. In other words, if the forecasted transaction’s terms, as estimated currently, are different from those at inception of the hedging relationship or the previous hedge ineffectiveness measurement, if any, the cumulative hedge ineffectiveness measurement must be based on the most current and best estimate of the forecasted transaction’s terms. In essence, this process requires a catch-up adjustment in the period a change is made to the best estimate of the forecasted transaction’s terms so that amounts in AOCI reflect the cumulative changes in the hedging derivative’s fair value that are effective at offsetting the changes in cash flows of the forecasted transaction for the risk being hedged, based on its most current and best estimated terms.

CUMULATIVE MEASUREMENT – FOREIGN CURRENCY CASH FLOW HEDGES

30.13 A change in exchange rates between an entity’s functional currency and the currency in which a transaction is denominated increases or decreases the expected amount of functional-currency-equivalent cash flows on settlement of a foreign-currency-denominated transaction. An increase or decrease in expected functional currency cash flows related to a recognized asset or liability is a foreign currency transaction gain or loss. Statement 52 (ASC Topic 830) generally requires those transaction gains or losses to be included in determining net income for the period in which the exchange rates change. As a result, a recognized foreign-currency-denominated asset or liability is required to be remeasured to spot rates at each reporting date, regardless of whether the recognized foreign-currency-denominated asset or liability is designated in a hedging relationship. The Standard requires a derivative instrument to be measured on the statement of financial position at fair value, regardless of whether the derivative instrument is designated in a hedging relationship. Since the fair value of a foreign currency derivative generally incorporates other components (e.g., a forward contract incorporates the spot rate in addition to an interest rate; an option contract incorporates the spot rate in addition to a time value component), the cash flow hedging model would not provide any benefit to hedging relationships involving the variability of functional-currency-denominated assets or liabilities since the income statement effect would be similar to not using hedge accounting.

30.14 The Board decided to permit cash flow hedge accounting for recognized foreign-currency-denominated assets and liabilities because it believes that the effects on earnings related to the use of different measurement criteria for the hedged transaction and the hedging instrument could be eliminated. As a result, paragraph 30(d) of the Standard (ASC paragraphs 815-30-35-3(d) through 35-3(f)) permits a special application of cash flow hedge accounting for recognized foreign-currency-denominated assets and liabilities when an entity assesses effectiveness and
measures ineffectiveness based on total changes in the hedging instrument’s cash flows. Paragraphs 41.05-41.13 in Section 7 discuss this application. It is important to note that the approach in paragraph 30(d) of the Standard (ASC paragraphs 815-30-35-3(d) through 35-3(f)) is an exception to the cash flow accounting model. It cannot be analogized to in any other hedging relationship.

APPLICATION OF PARAGRAPH 30 OF THE STANDARD (ASC PARAGRAPHS 815-30-35-3, 35-4, AND 35-7)

30.15 An entity accounts for a highly effective cash flow hedging relationship as follows:

Exhibit 6.5: Steps to Account for a Cash Flow Hedge

The six step process enumerated below may be used to account for a cash flow hedge when the cumulative change in the actual derivative hedging instrument and the cumulative change in the present value of the expected future cash flows on the hedged transaction move in an offsetting manner (see Scenarios 5 and 6 in Paragraph 30.17 for guidance to address circumstances in which those two variables do not move in an offsetting manner):

Step 1. Determine the change in fair value of the derivative hedging instrument and the change in the present value of the expected future cash flows on the hedged transaction according to the documented method of measuring ineffectiveness.

Step 2. Determine the cumulative changes in fair value of the derivative hedging instrument and the cumulative changes in the present value of the expected future cash flows on the hedged transaction.

Step 3. Determine the lesser of the absolute values of the two amounts in Step 2.

Step 4. Determine the change during the period in the lesser of the absolute values.

Step 5. Adjust the derivative hedging instrument to reflect its change in fair value and adjust AOCI by the amount determined in Step 4. The difference, if any, is reported in earnings.

Step 6. If hedging the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability remeasured at spot exchange rates under Statement 52 (ASC Topic 830) and assessing effectiveness and measuring ineffectiveness based on total changes in the derivative’s cash flows, refer to Paragraphs 41.05-41.13 of Section 7.

30.16 The following example illustrates the steps in accounting for a cash flow hedge:

Example 6.12: Accounting for a Cash Flow Hedge

On January 1, 20X1, Mistral Co. enters into a qualifying cash flow hedge of a forecasted transaction that is expected to occur on or about May 1, 20X1. Mistral’s defined risk
management strategy does not exclude any portion of the derivative hedging instrument’s gain or loss from the assessment of hedge effectiveness. Mistral also decided to use the cumulative dollar-offset method to assess whether the hedging relationship is highly effective at achieving cash flow offset attributable to the hedged risk and to measure ineffectiveness. In its documentation, Mistral indicated that the acceptable range of cumulative change between the hedged item and the hedging instrument is within 80 to 125%. The following illustrates how Mistral would determine the amount of gains or losses attributable to the derivative hedging instrument that should be reported in AOCI.

**Assumptions**

<table>
<thead>
<tr>
<th></th>
<th>1/31/X1</th>
<th>2/28/X1</th>
<th>3/31/X1</th>
<th>4/30/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Gain) loss on derivative hedging instrument: Current period (A)</td>
<td>$ (10,000)</td>
<td>$ (5,000)</td>
<td>$ 11,000</td>
<td>$ 14,000</td>
</tr>
<tr>
<td>Cumulative (B)</td>
<td>(10,000)</td>
<td>(15,000)</td>
<td>(4,000)</td>
<td>10,000</td>
</tr>
<tr>
<td>Change in expected future cash flows on the hedged forecasted transaction: Current period (C)</td>
<td>$ 9,000</td>
<td>$ 7,000</td>
<td>$ (11,000)</td>
<td>$ (14,000)</td>
</tr>
<tr>
<td>Cumulative (D)</td>
<td>9,000</td>
<td>16,000</td>
<td>5,000</td>
<td>(9,000)</td>
</tr>
<tr>
<td>Cumulative dollar-offset test of high effectiveness: Cumulative dollar-offset</td>
<td>111%</td>
<td>94%</td>
<td>80%</td>
<td>111%</td>
</tr>
</tbody>
</table>

At the end of each period, the cumulative dollar-offset is within the defined acceptable range. The hedging relationship is highly effective in achieving cash flow offset attributable to the hedged risk.

The amount of gain or loss on the derivative hedging instrument that is reported in AOCI is limited to the lesser of the absolute value of (B) and (D) (i.e., the lesser in absolute amounts of the cumulative gain (loss) on derivative hedging instrument and the cumulative change in expected future cash flows of the hedged forecasted transaction):

<table>
<thead>
<tr>
<th></th>
<th>1/31/X1</th>
<th>2/28/X1</th>
<th>3/31/X1</th>
<th>4/30/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>AOCI closing balance</td>
<td>$ 9,000</td>
<td>$ (15,000)</td>
<td>$ (4,000)</td>
<td>$ 9,000</td>
</tr>
<tr>
<td>Journal entries – debit (credit): Derivatives (B/S)</td>
<td>$ 10,000</td>
<td>$ 5,000</td>
<td>$ (1,000)</td>
<td>$ (14,000)</td>
</tr>
<tr>
<td>Loss (gain) on derivative (P&amp;L)</td>
<td>(1,000)</td>
<td>1,000</td>
<td>-</td>
<td>1,000</td>
</tr>
<tr>
<td>OCI</td>
<td>(9,000)</td>
<td>(6,000)</td>
<td>11,000</td>
<td>13,000</td>
</tr>
</tbody>
</table>

If the cumulative change in expected future cash flows on the hedged transaction exceeds the cumulative gain or loss on the derivative hedging instrument, that excess is not reflected in earnings as hedge ineffectiveness. On the other hand, if the cumulative gain or loss on the derivative hedging instrument exceeds the cumulative change in the expected future cash flows on the hedged transaction, the excess is reported in earnings as hedge ineffectiveness.

<table>
<thead>
<tr>
<th></th>
<th>1/31/X1</th>
<th>2/28/X1</th>
<th>3/31/X1</th>
<th>4/30/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Analysis of the derivative’s effect on AOCI – debit (credit): Opening balance</td>
<td>$ 0</td>
<td>$(9,000)</td>
<td>$(15,000)</td>
<td>$(4,000)</td>
</tr>
<tr>
<td>Current-period derivative loss (gain)</td>
<td>$(9,000)</td>
<td>$(5,000)</td>
<td>11,000</td>
<td>14,000</td>
</tr>
</tbody>
</table>

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Loss (gain) on derivative previously recognized in earnings, reversed to OCI in current period
Gain (loss) on derivative previously recognized in OCI, reversed to earnings in current period
Closing balance

<table>
<thead>
<tr>
<th></th>
<th>0</th>
<th>(1,000)</th>
<th>0</th>
<th>0</th>
</tr>
</thead>
</table>

Analysis of the derivative’s effect on retained earnings – debit (credit):

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th></th>
<th>$</th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>0</td>
<td>$15,000</td>
<td>0</td>
<td>0</td>
<td>$1,000</td>
</tr>
<tr>
<td>Current-period derivative loss (gain)</td>
<td>$1,000</td>
<td>0</td>
<td>0</td>
<td>$1,000</td>
<td></td>
</tr>
<tr>
<td>Closing balance</td>
<td>$1,000</td>
<td>0</td>
<td>0</td>
<td>$1,000</td>
<td></td>
</tr>
</tbody>
</table>

Observations

Overall, the derivative hedging instrument is carried in the statement of financial position at fair value. Also, AOCI includes total hedge effectiveness and retained earnings reflects total hedge ineffectiveness. The portion of the cumulative gain or loss on the derivative hedging instrument in excess of the cumulative change in expected future cash flows on the hedged transaction is reported currently in earnings. For example, at 4/30/X1, the $1,000 debit (i.e., loss) in retained earnings represents the difference between the $10,000 cumulative loss on the derivative hedging instrument and the $9,000 cumulative gain in the expected future cash flows on the hedged transaction.

Limitations on Amounts That Can Be Deferred in OCI

30.17 Paragraph 30.06 highlights the approach followed for recognizing ineffectiveness for cash flow hedges and indicates that for cash flow hedges, hedge ineffectiveness occurs only when the cumulative gain or loss on the derivative hedging instrument exceeds the cumulative change in the expected future cash flows on the hedged transaction (i.e., overhedge). In contrast, there is no reported ineffectiveness when the cumulative change in the expected cash flows on the hedged transaction exceeds the cumulative gain or loss on the derivative hedging instrument (i.e., underhedge).

The following table illustrates the provisions related to the amount of gains or losses on the derivative hedging instrument that should be recognized in earnings and deferred in OCI respectively. The following assumptions have been made for this illustration:

- The fair value of the derivative hedging instrument at the inception of the hedging relationship is zero;
- The assessment of effectiveness and measurement of ineffectiveness does not exclude any component of the derivative hedging instruments’ gain or loss;
- The cumulative gain or loss calculation has considered amounts previously reclassified from AOCI into earnings; and
- The hedging relationship is deemed to be highly effective.
<table>
<thead>
<tr>
<th>Scenarios</th>
<th>Derivative Instrument</th>
<th>Hedged Transaction</th>
<th>Earnings</th>
<th>OCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,000</td>
<td>$ (950)</td>
<td>$ 50</td>
<td>$ 950</td>
</tr>
<tr>
<td>2</td>
<td>$1,000</td>
<td>(1,050)</td>
<td>0</td>
<td>1,000</td>
</tr>
<tr>
<td>3</td>
<td>(1,000)</td>
<td>950</td>
<td>(50)</td>
<td>(950)</td>
</tr>
<tr>
<td>4</td>
<td>(1,000)</td>
<td>1,050</td>
<td>0</td>
<td>(1,000)</td>
</tr>
<tr>
<td>5</td>
<td>1,000</td>
<td>950</td>
<td>0</td>
<td>1,000</td>
</tr>
<tr>
<td>6</td>
<td>(1,000)</td>
<td>(950)</td>
<td>0</td>
<td>(1,000)</td>
</tr>
</tbody>
</table>

Scenarios 5 and 6 present unusual situations where the gain or loss on the actual derivative hedging instrument and the gain or loss on the hedged transaction do not change in an offsetting manner. While that circumstance would be expected to be relatively rare (and could result in a loss of hedge accounting if the retrospective or prospective assessment of hedge effectiveness no longer qualifies for hedge accounting) it could occur in certain limited circumstances without the loss of hedge accounting. For example, early in a hedging relationship the value of the underlying corresponding to the hedged risk may not have changed, but other sources of ineffectiveness present in a hedging derivative may have caused its value to move in the wrong way. If retrospective and prospective assessments of effectiveness are performed using regression, this initial wrong way movement in the fair value of the derivative may not require the hedging relationship to terminate, provided the hedging relationship is expected to be highly effective over its life based on the regression analysis. Where the fair value of the derivative has changed in the same direction as the gain or loss on the hedged transaction and the relationship still qualifies for hedge accounting, we believe it would be acceptable to view the gain or loss on the derivative hedging instrument to be less than the cumulative change in the expected cash flows on the hedged transaction. On that basis, the relationship could be considered to be an underhedge and no ineffectiveness would be recorded in earnings. For example, in Scenario 5 the hedged transaction resulted in a cumulative gain of $950. The portion of the cumulative gain/loss on the derivative hedging instrument necessary to offset the hedged transaction’s cumulative gain will be a cumulative loss of $(950). However, in this scenario there is a cumulative gain of $1,000 on the hedging derivative instrument. This change is effectively less than the amount that would have offset the change in the hedged transaction (which also resulted in a gain), and therefore could be considered to be an underhedge. For cash flow hedges, no ineffectiveness is recognized in earnings when there is an underhedge; therefore, in this example the entire gain of $1,000 on the derivative hedging instrument would be deferred in OCI.

**Subsequent Accounting for Amounts in AOCI**

31.01 Paragraph 31 of the Standard (ASC paragraphs 815-30-35-38 through 35-41) provides the following guidance on the subsequent accounting for amounts in AOCI for cash flow hedges:

31. Amounts in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings (for example when a forecasted sale actually occurs). If the hedged transaction results in the acquisition of an asset or the incurrence of a liability the gains and losses in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during
which the asset acquired or liability incurred affects earnings (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 continued reporting of a loss in accumulated other comprehensive income would lead to recognizing a net loss on the combination of the hedging instrument and the hedged transaction (and related asset acquired or liability incurred) in one or more future periods a loss shall be reclassified immediately into earnings for the amount that is not expected to be recovered. For example a loss shall be reported in earnings for a derivative that is designated as hedging the forecasted purchase of inventory to the extent that the cost basis of the inventory plus the related amount reported in accumulated other comprehensive income exceeds the amount expected to be recovered through sales of that inventory. (Impairment guidance is provided in paragraphs 34 and 35)

DIG Issues related to this paragraph are E22, G1, H13 and H15. See DIG Issues Index.

31.02 Paragraph 31 of the Standard (ASC paragraphs 815-30-35-38 through 35-41) requires amounts reported in AOCI to be reclassified into earnings in the same period(s) that the forecasted hedged transaction is reported in earnings. For example, if an entity is hedging the forecasted acquisition of a depreciable asset, the related net gain or loss in AOCI continues to be reported in AOCI after the acquisition of the asset and is reclassified into earnings in the same periods that the entity recognizes depreciation expense on the acquired asset. Although not specifically addressed in the Standard, we believe, in this example, the method used to reclassify the amount of gain or loss on the derivative hedging instrument related to the depreciable asset should be consistent with the accounting policy used to recognize the related depreciation expense on that asset.

31.03 If an entity is hedging a forecasted purchase of inventory, the related net gain or loss reported in AOCI on the derivative hedging instrument should be reclassified into earnings in the same period(s) as the sale of the inventory whose purchase was hedged is reported in earnings. Although not specifically addressed in the Standard, we believe entities should reclassify into earnings the gain or loss on the derivative hedging instrument in a manner that is consistent with the accounting policies related to the inventory whose purchase was hedged (e.g., LIFO or FIFO). If an entity is hedging the forecasted interest receipt or payment on a financial asset or liability, the amounts in AOCI would be reclassified into earnings when interest is accrued on the hedged item.

31.04 When an entity is hedging the variability of a single cash flow with a single hedging instrument, the reclassification from AOCI into earnings is relatively straightforward. However, when an entity is hedging the variability of multiple cash flows with a single hedging instrument, the reclassification from AOCI into earnings is more complex. If a single derivative is used to hedge the variability in multiple cash flows, an entity should reclassify an amount out of AOCI into earnings only when the hedged forecasted transaction affects earnings, and the amount that is reclassified should equal the net derivative gain or loss within AOCI that will offset the changes in the specific hedged forecasted transaction for the risk being hedged to the extent the hedge is effective.
Example 6.12a: Reclassification from AOCI When Variable-Rate Debt Is Hedged with an Interest Rate Swap That Has an Increasing Fixed Leg

Company R designates a pay-fixed, receive-floating interest rate swap as a cash flow hedge of interest payments on variable-rate debt. The interest rate on the pay-fixed leg of the swap increases at fixed intervals over the life of the instrument, which is anticipated to result in lower cash outflows during the early periods of the swap and better match the upward sloping yield curve of market interest rates at inception of the instrument. The swap is expected to be highly effective at offsetting changes in interest payment cash flows throughout the life of the hedging relationship.

In the fact pattern, the hedged transaction is a series of interest payments on variable rate debt. If each swap payment were related to each interest payment individually, applying hedge accounting would result in an increasing rate of interest expense over the course of the hedging relationship. Alternatively, an effective interest rate could be derived on the series of interest and swap payments to be applied on a constant basis over the life of the hedging relationship.

Assuming all other hedge accounting criteria are met, we believe that amounts deferred in AOCI should be reclassified to earnings over the life of the hedging relationship using the interest method, resulting in a constant rate of interest expense. This treatment is consistent with ASC paragraphs 470-10-35-1 and 35-2, which require debt with a fixed increasing interest rate to be accounted for under the effective interest method using the contractual cash flows over the estimated term of that debt.

We believe it would not be appropriate to view each interest payment as a separate hedging relationship given the inherently interrelated nature of the hedged interest payments and the swap instrument.

Example 6.12b: Reclassification from AOCI When Variable-Rate Debt Is Hedged with Multiple Hedging Instruments That Are Documented in Separate Hedging Relationships

Company R issues variable-rate debt with a maturity of three years. R separately enters into three derivative instruments: a one-year interest rate swap, a forward-starting one-year interest rate swap that starts one year in the future, and a forward-starting one-year interest rate swap that starts two years in the future. The rates on the fixed legs of the three derivative instruments differ (i.e., the longer duration derivatives have higher fixed rates).

R documents each derivative in a separate hedging relationship (i.e., three hedging relationships in total), with each derivative hedging a different year of variable-rate interest payments on R's debt. Each swap is expected to be highly effective at offsetting changes in interest payment cash flows throughout the life of its separate hedging relationship.
In this fact pattern, assuming all other hedge accounting criteria are met, we believe that amounts deferred in AOCI should be reclassified to earnings over the life of the hedging relationship using the interest method on an individual hedge relationship-by-relationship basis. The net result of applying hedge accounting for the three individual relationships would result in an increasing rate of interest expense over the course of the hedging relationship. This result differs from that in Example 6.12a because it is the result of three separately documented hedge accounting relationships with three separate derivatives.

31.05 As discussed in Paragraphs 30.13-30.14 above, when hedging the variability of the functional-currency-equivalent cash flows related to changes in foreign exchange rates that involve recognized foreign-currency-denominated assets or liabilities, the Standard requires, in certain cases, that there be reclassifications from AOCI that depend on the derivative hedging instrument and the hedge strategy. See Section 7 for a discussion of foreign currency hedging.

31.06 If it is expected that continued reporting of a loss in AOCI would lead to recognizing a net loss on the combination of the hedging instrument and hedged transaction (and related asset acquired or liability incurred) in one or more future periods, the loss must be reclassified immediately into earnings for the amount that is not expected to be recovered on the occurrence of the forecasted transaction. For example, an entity would be required to immediately reclassify into earnings losses in AOCI that are associated with the hedge of a forecasted purchase of inventory to the extent that the sum of the losses reported in AOCI and cost basis of the inventory to be acquired will not be recovered through its sale. See additional discussion of the impairment provisions of the Standard in Paragraphs 34.01-34.06 and 35.01-35.05 of this section.

EFFECT OF CASH FLOW HEDGING ON INTEREST CAPITALIZATION

31.07 Entities often enter into hedging relationships to hedge debt associated with long-term projects that are subject to FASB Statement No. 34, Capitalization of Interest Cost (ASC Subtopic 835-20, Interest -- Capitalization of Interest). As discussed in EITF Issue No. 99-9, "Effect of Derivative Gains and Losses on the Capitalization of Interest" (ASC paragraphs 815-25-35-14; 55-52; 815-30-35-45), if variable-rate interest on a specific borrowing is associated with an asset under construction and capitalized as a cost of that asset, the amounts in AOCI related to a cash flow hedge of the variability of that interest should be reclassified into earnings over the depreciable life of the constructed asset since that depreciable life coincides with the amortization period for the capitalized interest cost on the debt (i.e., the manner in which the hedged risk affects earnings). This guidance pertains only to the amount in AOCI attributable to interest incurred during the construction period. If the debt and the hedging derivative remain outstanding after completion of the construction project, the reclassification from AOCI for subsequent variability in interest is made when the hedged variable interest is reported in earnings. We believe any ineffectiveness that results from these hedging relationships should be recognized in earnings as it occurs over the hedging relationship.

Examples of Cash Flow Hedges

31.08 The following examples illustrate the application of paragraphs 30 and 31 of the Standard (ASC paragraphs 815-30-35-1, 35-3, 35-4, 35-7, and 815-30-35-38 through 35-41). To simplify...
the examples, we have ignored the effect of commissions and transaction costs, initial margin, and income taxes:

- Cash flow hedge of variable-rate debt with an interest rate swap. See Paragraphs A6.58-A6.70 of Appendix A to this section for a discussion of the various methods provided in DIG Issue G7 for measuring ineffectiveness.

- Cash flow hedge of a variable-rate loan with an interest rate swap (shortcut method). See Paragraphs A6.36-A6.57 of Appendix A to this section for a discussion of the shortcut method.


- Cash flow hedge of a forecasted purchase of inventory with a forward contract (critical terms match – forward value method). See Paragraphs A6.73-A6.76 of Appendix A to this section for a discussion of hedge effectiveness considerations when the critical terms of a forward (or futures) contract and a hedged forecasted transaction match in a cash flow hedge.


- Cash flow hedge of variable-rate, long-term debt with an interest rate cap (critical terms match – terminal value method). See Paragraphs A6.81-A6.94 of Appendix A to this section for a discussion of the terminal value method.

**Example 6.13: Cash Flow Hedge of a Variable-Rate Debt with an Interest Rate Swap**

On January 1, 20X1, Company A issues a three-year, $10,000,000 debt instrument that matures on December 31, 20X3. The interest rate on the debt instrument is variable at six-month LIBOR. Company A is concerned that six-month LIBOR will increase above the current level, thus, on January 1, 20X1 Company A enters into a three-year interest rate swap with a notional amount of $10,000,000 to pay interest at a fixed rate equal to 7% and receive interest at a variable rate equal to six-month LIBOR. The terms of the swap indicate that the variable rate to be paid to Company A is capped at 12% and has a floor of 1%. The debt reprices and requires payments to be made on January 1 of each year. The swap reprices and requires payments to be made or received on January 1 of each year. No premium is paid or received to enter into the interest rate swap. Company A has designated the swap as a cash flow hedge of the variability in interest payments on the debt instrument attributable to the changes in the benchmark interest rate (six-month LIBOR).
\textbf{Assumptions}

All criteria for cash flow hedge accounting have been met. Note that the variable leg of the interest rate swap is capped at 12% and has a floor of 1%, whereas the variable leg of the debt instrument does not contain similar features. Before designating the interest rate swap as the hedging instrument of the changes in cash flows of the interest payments on the debt instrument due to changes in the benchmark interest rate (six-month LIBOR), Company A determined that the interest rate swap is not a net written option and that the changes in cash flows of the interest rate swap are expected to be highly effective in offsetting changes in cash flows of the interest payments of the debt instrument attributable to interest rate risk taking into account the effect of the interest rate cap and floor on the swap. That is, at inception and at each assessment period during the hedging relationship, Company A determined that the interest rate cap and floor are expected to be out-of-the-money based on a probability-weighted analysis of the range of possible changes in interest rates, the cap and floor are expected to have minimal effect on changes in cash flows of the swap, and the hedging relationship meets the requirement for an expectation of high effectiveness at inception of the hedging relationship. Company A notes that it could have entered into the same interest rate swap on January 1, 20X1 without the cap and floor and without paying or receiving a premium.

Based on statistical analysis, Company A concluded and documented that the hedging relationship is expected to be highly effective at inception and on an ongoing basis (i.e., the changes in the cash flows on the interest rate swap and the changes in the present value of the expected future cash flows of the forecasted interest payment on the debt are expected to be highly effective in achieving offset).

Company A measures ineffectiveness of the hedging relationship using the hypothetical derivative method. The hypothetical swap is a three-year interest rate swap with a notional amount of $10,000,000 to pay interest at a fixed rate equal to 7% and receive interest at a variable rate equal to six-month LIBOR, whereby the payments are made or received and six-month LIBOR will reprice on January 1 of each year. There is no cap or floor in the hypothetical derivative.

\begin{tabular}{lcccc}
\hline
\textbf{Six-month LIBOR for Year} & \textbf{(A)} & \textbf{(B)} & \textbf{(A) + (B)} \\
\hline
1/1/X1 & 7\% & $0 & $700,000 & $700,000 \\
1/1/X2 & 6\% & 100,000 & 600,000 & 700,000 \\
1/1/X3 & 5\% & 200,000 & 500,000 & 700,000 \\
\hline
\end{tabular}

The fair value of the interest rate swap and changes therein at the end of each accounting period after cash settlement are as follows:

\begin{tabular}{lcc}
\hline
\textbf{Change in Fair Value} & \textbf{Value Gain} \\
\textbf{Liability} & (Loss) \\
12/31/X1 & $(300,000)$ & $(300,000)$ \\
\hline
\end{tabular}
The fair value of the hypothetical derivative and changes therein at the end of each accounting period after cash settlement are as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Fair Value Liability</th>
<th>Change in Fair Value Gain (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/X1</td>
<td>$(293,000)</td>
<td>$(293,000)</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>(122,000)</td>
<td>171,000</td>
</tr>
<tr>
<td>12/31/X3</td>
<td>-</td>
<td>122,000</td>
</tr>
</tbody>
</table>

The change in the fair value of the hypothetical swap is regarded as a proxy for the present value of the cumulative change in expected cash flows on the hedged transactions. As a result, the actual swap will be recorded at fair value on the balance sheet and AOCI will be adjusted to a balance that represents the lesser of either the cumulative change in the fair value of the actual swap or the cumulative change in the fair value of the hypothetical swap.

The following journal entries are made on January 1, 20X1 and December 31, 20X1, 20X2, and 20X3 (ignore interim reporting):

a) There are no entries on January 1, 20X1, as the swap is entered into at market rates and no cash was exchanged at inception. The origination of the debt instrument on January 1, 20X1 is ignored for purposes of the illustration.

b) The journal entries on December 31, 20X1:
   1. Interest expense (P&L) $700,000
      Cash (B/S) $700,000
      (To record the interest paid on the six-month LIBOR debt)
   2. Unrealized loss on swap (OCI) 293,000
      Unrealized loss on swap (P&L) 7,000
      Interest rate swap (B/S) 300,000
      (To record the interest rate swap in the statement of financial position at fair value, recognizing ineffectiveness of $7,000 in the income statement)

c) The journal entries on December 31, 20X2:
   1. Interest expense (P&L) 600,000
      Cash (B/S) 600,000
(To record the interest paid on the six-month LIBOR debt)

2. AOCI 100,000
   Cash (B/S) 100,000

(To record the cash paid on the settlement of the interest rate swap in AOCI)

3. Interest expense (P&L) 100,000
   AOCI 100,000

(To reclassify into earnings amounts in AOCI as a result of the hedge. This is the adjustment required to bring interest expense on the debt to $700,000)

4. Interest rate swap (B/S) 175,000
   Unrealized gain on swap (P&L) 4,000
   Unrealized gain on swap (AOCI) 171,000

(To adjust the carrying value of the interest rate swap to fair value, recognizing ineffectiveness of $4,000 in the income statement)

d) The journal entries on December 31, 20X3:

1. Interest expense (P&L) 500,000
   Cash (B/S) 500,000

(To record the interest paid on the six-month LIBOR debt)

2. AOCI 200,000
   Cash (B/S) 200,000

(To record the cash paid on the settlement of the interest rate swap in AOCI)

3. Interest expense (P&L) 200,000
   AOCI 200,000

(To reclassify into earnings amounts in AOCI as a result of the hedge. This is the adjustment required to bring interest expense on the debt to $700,000)

4. Interest rate swap (B/S) 125,000
   Unrealized gain on swap (P&L) 3,000
   Unrealized gain on swap (AOCI) 122,000

(To adjust the carrying value of the interest rate swap to fair value, recognizing ineffectiveness of $3,000 in the income statement)

**Observations**
As a result of entering into the hedging relationship, Company A locked in a 7% rate for the term of the debt. However, the company’s financial statements reflect the requirement to report the derivative hedging instrument in the statement of financial position at fair value thereby resulting in volatility in both Company A’s AOCI and earnings. This is evidenced by the following:

**AOCI:**

<table>
<thead>
<tr>
<th>(debit) credit</th>
<th>12/31/X1</th>
<th>12/31/X2</th>
<th>12/31/X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>$</td>
<td>–</td>
<td>$(293,000)</td>
</tr>
<tr>
<td>Cash settlement</td>
<td>–</td>
<td>–</td>
<td>$(1000,000)</td>
</tr>
<tr>
<td>Gain (loss) on swap*</td>
<td>$(293,000)</td>
<td>171,000</td>
<td>122,000</td>
</tr>
<tr>
<td>Reclass to earnings</td>
<td>–</td>
<td>100,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Closing balance</td>
<td>$</td>
<td>$(122,000)</td>
<td>$ –</td>
</tr>
<tr>
<td>Ineffectiveness reported in earnings – gain (loss)</td>
<td>$(7,000)</td>
<td>$ 4,000</td>
<td>$ 3,000</td>
</tr>
</tbody>
</table>

* Effective portion of gain/loss on interest rate swap.

---

**Example 6.14: Cash Flow Hedge of a Variable-Rate Loan with an Interest Rate Swap (Shortcut Method)**

As of January 1, 20X1, Bank A originates a three-year, $10,000,000 loan receivable that matures on December 31, 20X3. The interest rate earned on the loan is variable at six-month LIBOR plus 2%. Because it is concerned that six-month LIBOR will decline, Bank A simultaneously enters into a three-year interest rate swap with a notional amount of $10,000,000 to receive interest at a fixed rate equal to 7% and pay interest at a variable rate equal to six-month LIBOR. The combination of the swap and the loan receivable results in a net cash inflow of 9%. Both the loan receivable and interest rate swap require payments to be made or received and to reprice on December 31. Bank A designates the swap as a cash flow hedge of the variability in interest payments received on the loan attributable to the changes in the benchmark interest rate (six-month LIBOR).

**Assumptions**

All criteria for cash flow hedge accounting have been met. All conditions in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) for use of the shortcut method have been met.

Six month LIBOR and related amounts are as follows:

<table>
<thead>
<tr>
<th>Rate for Year</th>
<th>Swap Net Receipt for the year</th>
<th>Loan Interest for the year</th>
<th>Net Interest for the year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>7% $</td>
<td>$900,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>1/1/X2</td>
<td>6% $ 100,000</td>
<td>$800,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>1/1/X3</td>
<td>5% $ 200,000</td>
<td>$700,000</td>
<td>$900,000</td>
</tr>
</tbody>
</table>
The fair value of the interest rate swap and changes therein at the end of each accounting period after cash settlement are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair Value</th>
<th>Change in Fair Value Gain (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/X1</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>125,000</td>
<td>(175,000)</td>
</tr>
<tr>
<td>12/31/X3</td>
<td>-</td>
<td>(125,000)</td>
</tr>
</tbody>
</table>

The following journal entries are made on January 1, 20X1, and December 31, 20X1, 20X2, and 20X3 (ignore interim reporting):
a) There are no entries on January 1, 20X1, as the swap is entered into at market rates and no cash was exchanged at inception. The origination and repayment of the loan is ignored for purposes of the illustration.
b) The journal entries on December 31, 20X1:
   1. Cash (B/S) $900,000
      Interest income (P&L) $900,000
      (To record the interest received on the six-month LIBOR plus 2% loan)
   2. Interest rate swap (B/S) 300,000
      Unrealized gain on swap (AOCI) 300,000
      (To record the interest rate swap in the statement of financial position at fair value)
c) The journal entries on December 31, 20X2:
   1. Cash (B/S) 800,000
      Interest income (P&L) 800,000
      (To record the interest received on the six-month LIBOR plus 2% loan)
   2. Cash (B/S) 100,000
      Interest income (P&L) 100,000
      (To record payment from the swap counterparty and adjust interest income on the loan to $900,000)
   3. Unrealized loss on swap (AOCI) 175,000
      Interest rate swap (B/S) 175,000
      (To adjust the carrying value of the interest rate swap to current fair value)
d) The journal entries on December 31, 20X3:
   1. Cash (B/S) 700,000
      Interest income (P&L) 700,000
      (To record the interest received on the six-month LIBOR plus 2% loan)
2. Cash (B/S) 200,000
   Interest income (P&L) 200,000

   (To record payment from the swap counterparty and adjust interest income on the loan to $900,000)

3. Unrealized loss on swap (AOCI) 125,000
   Interest rate swap (B/S) 125,000

   (To adjust the carrying value of the interest rate swap to current fair value)

**Observations**

As a result of entering into the hedging relationship, Bank A locked in a 9% rate for the term of the loan. However, the company’s financial statements reflect the requirement to report the derivative hedging instrument in the statement of financial position at fair value thereby resulting in volatility in Bank A’s AOCI. This is evidenced by the following:

<table>
<thead>
<tr>
<th>AOCI:</th>
<th>12/31/X1</th>
<th>12/31/X2</th>
<th>2/31/X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>$ –</td>
<td>$ 300,000</td>
<td>$ 125,000</td>
</tr>
<tr>
<td>Gain (loss) on swap*</td>
<td>(300,000)</td>
<td>(175,000)</td>
<td>(125,000)</td>
</tr>
<tr>
<td>Closing balance</td>
<td>$ (300,000)</td>
<td>$ (125,000)</td>
<td>$ –</td>
</tr>
</tbody>
</table>

* Effective portion of gain/loss on interest rate swap.

**Example 6.15: Cash Flow Hedge of Variable-Rate, Long-Term Debt with an Interest Rate Cap (Critical Terms Match - Intrinsic Value Method)**

On January 1, 20X1, CBC Inc. issues a three-year, $10,000,000 debt obligation. The interest rate on the debt obligation is variable at a rate of six-month LIBOR plus 2%. CBC is concerned that six-month LIBOR may rise during the three-year term of the debt obligation, but wants to retain the ability to benefit when six-month LIBOR is below 8%. To protect itself from this exposure, CBC purchases for $300,000 an out-of-the-money interest rate cap from Bank A. The interest rate cap pays interest to CBC when six-month LIBOR exceeds 8%. The amount paid to CBC by Bank A is equal to $10,000,000 multiplied by (six-month LIBOR minus 8%) in those years in which six-month LIBOR exceeds 8%. The combination of the cap and the debt obligation result in CBC paying interest at a variable rate (six-month LIBOR plus 2%) not to exceed 10%. The variable-rate debt obligation and interest rate cap both require payments to be made on December 31 of each year. The variable-rate on the debt obligation and purchased interest rate cap reset on January 1 of each year. CBC designates the purchased interest rate cap as a cash flow hedge of the benchmark interest rate risk attributable to the forecasted interest payments related to changes in six-month LIBOR that exceed 8%.
Assumptions

All criteria for cash flow hedge accounting have been met.

Given that the critical terms of the cap are identical to those of the debt obligation, at inception of the hedge CBC has concluded and documented that the hedging relationship is expected to be highly effective (in this instance, 100% effective) in achieving offsetting cash flows attributable to changes in six-month LIBOR when six-month LIBOR is greater than 8%. On an ongoing basis, CBC will ascertain and document that the critical terms of the cap and the debt obligation have not changed, including that there have been no adverse developments concerning the risk of default by the counterparty to the cap or its own nonperformance risk, thus not causing a different conclusion about hedge effectiveness. (As the cap is being used to purchase one-way protection against an increase in six-month LIBOR, CBC does not need to assess effectiveness if six-month LIBOR is less than 8%.)

Changes in the time value of the option have been excluded from the assessment of the hedge’s effectiveness; thus changes in the fair value of the purchased cap related to these amounts must be recognized currently in earnings.

Given that the hedging relationship is expected to be 100% effective both at inception and on an ongoing basis, it may be assumed that the cumulative gains or losses on the interest rate cap, adjusted to remove time value gains and losses, will equal the cumulative change in expected future cash flows on the debt obligation when six-month LIBOR exceeds 8%.

Six-month LIBOR and related amounts are as follows:

<table>
<thead>
<tr>
<th>Rate for Year</th>
<th>Cap Receipt for the year (A)</th>
<th>Debt Interest for the year (B)</th>
<th>Net Interest for the year (A) + (B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>7% $ -</td>
<td>$ 900,000</td>
<td>$ 900,000</td>
</tr>
<tr>
<td>1/1/X2</td>
<td>9% $(100,000)</td>
<td>$ 1,100,000</td>
<td>$ 1,000,000</td>
</tr>
<tr>
<td>1/1/X3</td>
<td>10% $(200,000)</td>
<td>$ 1,200,000</td>
<td>$ 1,000,000</td>
</tr>
</tbody>
</table>

The fair value of the interest rate cap and changes therein at the end of each accounting period before cash settlement are as follows:

<table>
<thead>
<tr>
<th>Fair Value</th>
<th>Change in Fair Value Gain(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>$ 300,000</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>$ (20,000)</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>$ (70,000)</td>
</tr>
<tr>
<td>12/31/X3</td>
<td>$ (150,000)</td>
</tr>
</tbody>
</table>

The fair value of the interest rate cap and changes therein at the end of each accounting period before cash settlement are as follows:

<table>
<thead>
<tr>
<th>(A)</th>
<th>(B)</th>
<th>(A)-(B)</th>
<th>Change In Time Value Recognized in Earnings</th>
</tr>
</thead>
</table>

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Before Settlement

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair Value</th>
<th>Intrinsic Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>$280,000</td>
<td>$280,000</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>$350,000</td>
<td>200,000</td>
</tr>
<tr>
<td>12/31/X3</td>
<td>$200,000</td>
<td>200,000</td>
</tr>
</tbody>
</table>

(1) The Standard does not specify how to compute the intrinsic value of a cap option if the option involves a series of payments. In this example, we have assumed that the intrinsic value of the cap is equal to the expected future cash flows holding constant the cap’s current period cash flow of 1% (i.e., 9% - 8%) for the remaining term of the hedge. Alternatively, we believe an entity may estimate the intrinsic value of the cap for each period based on the market’s expectations of movements in six-month LIBOR using the six-month LIBOR forward yield curve.

The origination and repayment of the debt are ignored for purposes of the illustration.

The following journal entries are made on January 1, 20X1, and December 31, 20X1, 20X2, and 20X3 (ignore interim reporting):

a) The journal entry on January 1, 20X1:
   1. Interest Rate Cap (B/S) $300,000
   Cash (B/S) $300,000
   (To record the purchase of the interest rate cap at fair value)

b) The journal entries on December 31, 20X1:
   1. Interest expense (P&L) 900,000
      Cash (B/S) 900,000
      (To recognize interest expense on six-month LIBOR plus 2% debt obligation)
   2. Unrealized loss on interest rate cap (P&L) 20,000
      Interest rate cap (B/S) 20,000
      (To record the change in the fair value of the interest rate cap. The change relates in its entirety to the component excluded from the assessment of hedge effectiveness (i.e., the time value of the interest rate cap); therefore, it is reported in earnings currently)

c) The journal entries on December 31, 20X2:
   1. Interest expense (P&L) 1,100,000
      Cash (B/S) 1,100,000
      (To recognize interest expense on six-month LIBOR plus 2% debt obligation)
   2. Unrealized loss on interest rate cap (P&L) 130,000
      Interest rate cap (B/S) 70,000
      (To record the change in the fair value of the interest rate cap. The change relates in its entirety to the component excluded from the assessment of hedge effectiveness (i.e., the time value of the interest rate cap); therefore, it is reported in earnings currently)
<table>
<thead>
<tr>
<th>Entry</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Interest expense (P&amp;L)</td>
<td>1,200,000</td>
<td>1,200,000</td>
</tr>
<tr>
<td></td>
<td>Cash (B/S)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Unrealized loss on interest rate cap (P&amp;L)</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Unrealized gain on interest rate cap (OCI)</td>
<td></td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>Interest rate cap (B/S)</td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>3.</td>
<td>Cash (B/S)</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest rate cap (B/S)</td>
<td></td>
<td>200,000</td>
</tr>
</tbody>
</table>

(To record the change in the fair value of the interest rate cap. The $130,000 represents the portion of the change in the cap’s fair value that is excluded from the assessment of hedge effectiveness (i.e., its time value) and, thus, is reported in earnings currently. The remaining $200,000 represents the increase in the interest rate cap’s intrinsic value during the current period of $100,000 related to the current period receipt and $100,000 related to the projected receipt for the next period)
(To record cash received on the annual settlement of the cap)

<table>
<thead>
<tr>
<th></th>
<th>AOCI</th>
<th>Interest expense (P&amp;L)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>200,000</td>
<td>200,000</td>
</tr>
</tbody>
</table>

(To reclassify into earnings the amount in AOCI that hedged the variable interest expense recognized in earnings)

**Observations**

As a result of entering into the hedging relationship, CBC Inc. effectively capped its interest expense at 10% on the three-year debt obligation. Specifically, during those periods in which the contractual terms of this debt obligation would result in an interest expense greater than 10% or $1,000,000 (i.e., if six-month LIBOR exceeded 8%), the payments received from the interest rate cap effectively reduced interest expense to 10% as illustrated below. However, recognition in earnings of changes in the fair value of the cap due to changes in time value resulted in variability of total expenses:

<table>
<thead>
<tr>
<th></th>
<th>12/31/X1</th>
<th>12/31/X2</th>
<th>12/31/X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on six-month LIBOR plus 2% debt</td>
<td>$900,000</td>
<td>$1,100,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Reclassification from AOCI</td>
<td>-</td>
<td>(100,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Interest expense</td>
<td>$900,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Change in time value of cap</td>
<td>20,000</td>
<td>130,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Total expense</td>
<td>$920,000</td>
<td>$1,130,000</td>
<td>$1,150,000</td>
</tr>
</tbody>
</table>

**Example 6.16: Cash Flow Hedge of a Forecasted Purchase of Inventory with a Forward Contract (Critical Terms Match – Forward Value Method)**

ORO Inc. purchases gold to use in its manufacturing process. On January 1, 20X1, ORO determined that it will not be able to increase its sales prices during the next year and, therefore, may suffer losses when it sells its product if the price of gold rises. ORO estimates that it has sufficient gold inventory to meet its manufacturing needs for only the next six months and wants to hedge the forecasted purchase of 10,000 ounces of gold that it expects to purchase on June 30, 20X1. To hedge against an increase in the market price of gold, on January 1, 20X1, ORO enters into a forward contract to purchase gold. The forward contract settles in cash for the difference between the price stated in the contract and the spot price of gold on June 30, 20X1. The price stated in the forward contract is $310 per ounce for 10,000 ounces of gold. The spot price of gold as of January 1, 20X1 is $300 per ounce. ORO designates the forward contract as a hedge of variability of cash flows attributable to its forecasted purchase of 10,000 ounces of gold on or around June 30, 20X1.

**Assumptions**

All criteria for cash flow hedge accounting have been met.
ORO will assess hedge effectiveness based on the changes in the forward price of gold. Given that the critical terms of the forward contract and the forecasted purchase are the same, at inception ORO concluded and documented that the hedging relationship is expected to be highly effective (in this instance, 100% effective) in achieving offsetting cash flows attributable to changes in the forward price of gold. On an ongoing basis, ORO will ascertain and document that the critical terms of the forward contract and the forecasted purchases have not changed, including that there have been no adverse developments concerning the risk of default by the counterparty to the forward contract or its own nonperformance risk, thus not causing a different conclusion about hedge effectiveness.

Because the hedge is expected to be 100% effective, it may be assumed that the cumulative gains or losses on the forward contract will equal the cumulative change in expected future cash flows on the forecasted purchase of gold.

The forward contract is at market rates; therefore, no cash was exchanged at inception of the contract.

The spot and forward prices of gold and the fair value of the forward contract are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Spot Price</th>
<th>Forward Price</th>
<th>Fair Value Asset (Liability)</th>
<th>Change In Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X1</td>
<td>$300</td>
<td>$310</td>
<td>$ -</td>
<td>-</td>
</tr>
<tr>
<td>March 31, 20X1</td>
<td>310</td>
<td>315</td>
<td>49,008†</td>
<td>49,008</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>330</td>
<td>-</td>
<td>200,000</td>
<td>150,992</td>
</tr>
</tbody>
</table>

† The present value of the change in expected future cash flows discounted at the risk-free rate.

The forward contract settles on June 30, 20X1, with ORO receiving $200,000 ((10,000) * ($330 - $310)).

The following journal entries are made on January 1, March 31, and June 30, 20X1:

a) A memorandum entry is made on January 1, 20X1 to document the designation of the hedging relationship. The financial records of ORO Inc. would not otherwise be affected as no cash changed hands at inception of the forward contract.

b) The journal entry as of March 31, 20X1:

1. Forward contract (B/S) $49,008
   Unrealized gain on forward contract (OCI) $49,008
   (To recognize in OCI the change in the fair value of the forward contract attributable to the changes in the forward price of gold)

c) The journal entries as of June 30, 20X1:

1. Forward contract (B/S) 150,992
   Unrealized gain on forward contract (OCI) 150,992
(To recognize in OCI the change in the fair value of the forward contract attributable to the changes in the forward price of gold)

2. 
   Cash (B/S)  
   Forward contract (B/S)  
   200,000  
   200,000

   (To record the settlement of the forward contract at June 30, 20X1)

3. 
   Gold inventory (B/S)  
   Cash (B/S)  
   3,300,000  
   3,300,000

   (To record the purchase of 10,000 ounces of gold on June 30, 20X1 at market price of $330 per ounce)

Observations

ORO Inc. was concerned that gold prices would increase between January 1 and June 30, 20X1 (the date of the forecasted purchase of 10,000 ounces of gold). Using a forward contract as a hedging instrument ensured that the cost of its gold inventory was not subject to fluctuations in the price of gold. The $200,000 gain on the forward contract will remain in AOCI until the gold inventory whose purchase was hedged is sold, at which point the gain will be credited to the cost of the gold sold. Thus, the cost of gold sales related to the hedged forecasted purchase of inventory will be reported in the income statement at $3,100,000.

Example 6.17: Cash Flow Hedge of Forecasted Purchase of Inventory with a Call Option (Critical Terms Do Not Match – Intrinsic Value Method)

Gas Inc. expects to purchase 10,000 units of commodity B on December 31, 20X1. Gas Inc. is concerned that the market price of commodity B will increase in the interim, but wants to retain the ability to benefit if the market price falls. On January 1, 20X1, Gas Inc. purchases for $10,000 an at-the-money call option with commodity A as the underlying. Gas Inc. purchased the call option on commodity A because it is more economical than purchasing a call option on commodity B. The call option is settled in net cash and enables Gas Inc. to purchase 10,000 units of commodity A at a strike price of $10.00 per unit on December 31, 20X1. Gas Inc. designates the purchased call option as a cash flow hedge of the market price risk attributable to its forecasted purchase of 10,000 units of commodity B which is expected to occur on December 31, 20X1.

Assumptions

All criteria for cash flow hedge accounting have been met.

Changes in the time value of the option will be excluded from the assessment of effectiveness and the measurement of ineffectiveness, thus the changes in the time value of the option will be recognized in earnings currently. Based on statistical analysis, Gas Inc. concluded and documented that the hedging relationship is expected to be highly effective at inception and on an ongoing
basis (i.e., the changes in the spot rates of commodity A are highly effective at offsetting the changes the cash flows of the purchase price (at spot) of commodity B).

Gas Inc. measures ineffectiveness of the hedging relationship using the hypothetical derivative method and considers only the changes in the intrinsic value of that hypothetical derivative. The hypothetical derivative is an at-the-money call option with commodity B as the underlying. The hypothetical derivative is settled in net cash and enables Gas Inc. to purchase 10,000 units of commodity B at a strike price of $15.00 per unit on December 31, 20X1. Note that the difference between the strike price in the hypothetical derivative and the actual derivative results from the different underlyings (i.e., there is a basis difference between the hypothetical and actual derivatives).

The spot price, fair value, intrinsic value, time value and change in time value of the call option related to commodity A are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot Price</th>
<th>Fair Value Before Settlement</th>
<th>Intrinsic Value Before Settlement</th>
<th>Time Value</th>
<th>Change in Time Value Recognized in Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>$ 10.00</td>
<td>$ 10,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>3/31/X1</td>
<td>10.10</td>
<td>9,000</td>
<td>1,000</td>
<td>8,000</td>
<td>2,000</td>
</tr>
<tr>
<td>6/30/X1</td>
<td>12.10</td>
<td>26,000</td>
<td>21,000</td>
<td>5,000</td>
<td>3,000</td>
</tr>
<tr>
<td>9/30/X1</td>
<td>12.30</td>
<td>24,000</td>
<td>23,000</td>
<td>1,000</td>
<td>4,000</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>14.80</td>
<td>48,000</td>
<td>48,000</td>
<td>0</td>
<td>1,000</td>
</tr>
</tbody>
</table>

The spot price, fair value, intrinsic value, and time value of the hypothetical call option related to commodity B are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot Price</th>
<th>Fair Value Before Settlement</th>
<th>Intrinsic Value Before Settlement</th>
<th>Time Value</th>
<th>Change in Time Value Recognized in Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>$ 15.00</td>
<td>$ 10,500</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>3/31/X1</td>
<td>15.11</td>
<td>9,600</td>
<td>1,100</td>
<td>8,500</td>
<td>2,000</td>
</tr>
<tr>
<td>6/30/X1</td>
<td>17.10</td>
<td>26,000</td>
<td>21,000</td>
<td>5,000</td>
<td>3,000</td>
</tr>
<tr>
<td>9/30/X1</td>
<td>17.29</td>
<td>24,000</td>
<td>22,900</td>
<td>1,100</td>
<td>4,000</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>19.78</td>
<td>47,800</td>
<td>47,800</td>
<td>0</td>
<td>1,000</td>
</tr>
</tbody>
</table>

The change in the intrinsic value of the hypothetical call option is regarded as a proxy for the present value of the cumulative change in expected cash flows on the hedged transaction. As a result, the change in the fair value of the actual call option will be recorded at fair value on the balance sheet, the changes in the time value of that call option will be recorded in earnings, and AOCI will be adjusted to a balance that represents the lesser of either the cumulative change in the intrinsic value of the actual call option or the cumulative change in the intrinsic value of the hypothetical call option.

<table>
<thead>
<tr>
<th>Increase (Decrease) in Intrinsic Value of Actual Derivative</th>
<th>Increase (Decrease) in Intrinsic Value of Hypothetical Derivative</th>
</tr>
</thead>
</table>
The following journal entries are made on January 1, March 31, June 30, September 30, and December 31, 20X1:

a) The journal entry as of January 1, 20X1:
   1. Call option (B/S) $10,000
      Cash (B/S) $10,000

      (To record the purchase of the call option on commodity A)

b) The journal entry as of March 31, 20X1:
   1. Unrealized loss on call option (P&L) 2,000
      Call option (B/S) 1,000
      Unrealized gain on call option (OCI) 1,000

      (To record the change in the fair value of the option:
      - $2,000 ($10,000-$8,000) decrease in the time value charged to earnings
      -1,000 ($1,000 - $0) increase in intrinsic value credited to OCI)

c) The journal entry as of June 30, 20X1:
   1. Call option (B/S) 17,000
      Unrealized loss on call option (P&L) 3,000
      Unrealized gain on call option (OCI) 20,000

      (To record the change in the fair value of the option:
      - $3,000 ($8,000-$5,000) change in time value charged to earnings
      - $20,000 ($21,000 - $1,000) lesser of the cumulative change in intrinsic value credited to OCI)

d) The journal entry as of September 30, 20X1:
   1. Unrealized loss on call option (P&L) 4,000
      Call option (B/S) 2,000
      Unrealized gain on call option (OCI) 1,900
      Unrealized gain on call option (P&L) 100

      (To record the change in the fair value of the option:
      - $4,000 ($5,000-$1,000) change in time value charged to earnings
      - $1,900 ($22,900-$21,000) lesser of the cumulative change in intrinsic value credited to OCI)
- $100 representing hedge ineffectiveness credited to earnings)
e) The journal entries as of December 31, 20X1:

1. Call option (B/S) 24,000  
   Unrealized loss on call option (P&L) 1,000  
   Unrealized gain on call option (OCI) 24,900  
   Unrealized gain on call option (P&L) 100

   (To record the change in the fair value of the option:
   - $1,000 ($1,000-0) change in time value charged to earnings
   - $24,900 ($47,800-$22,900) lesser of the cumulative change in intrinsic value credited to OCI
   - $100 representing hedge ineffectiveness credited to earnings)

2. Cash (B/S) 48,000  
   Call Option (B/S) 48,000

   (To record the settlement of the call option on December 31, 20X1)

Observations

The following tables summarize the changes in the fair value of the derivative hedging instrument, AOCI and retained earnings. The summary of AOCI movements illustrates the volatility associated with the cash flow hedge model:

Summary of changes in fair value of the option:

<table>
<thead>
<tr>
<th>Debit (credit)</th>
<th>3/31/X1</th>
<th>6/30/X1</th>
<th>9/30/X1</th>
<th>12/31/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening fair value</td>
<td>$10,000</td>
<td>$9,000</td>
<td>$26,000</td>
<td>$24,000</td>
</tr>
<tr>
<td>Change in time value</td>
<td>(2,000)</td>
<td>(3,000)</td>
<td>(4,000)</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Change in intrinsic value</td>
<td>1,000</td>
<td>20,000</td>
<td>2,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Ending fair value(E)</td>
<td>$9,000</td>
<td>$26,000</td>
<td>$24,000</td>
<td>$48,000</td>
</tr>
</tbody>
</table>

(E) Before settlement

Summary of changes in AOCI:

<table>
<thead>
<tr>
<th>Debit (credit)</th>
<th>3/31/X1</th>
<th>6/30/X1</th>
<th>9/30/X1</th>
<th>12/31/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>$ -</td>
<td>$ (1,000)</td>
<td>$ (21,000)</td>
<td>$ (22,900)</td>
</tr>
<tr>
<td>Current-period loss (gain)</td>
<td>(1,000)</td>
<td>(20,000)</td>
<td>(1,900)</td>
<td>(24,900)</td>
</tr>
<tr>
<td>Closing balance</td>
<td>$ (1,000)</td>
<td>$ (21,000)</td>
<td>$ (22,900)</td>
<td>$ (47,800)</td>
</tr>
</tbody>
</table>

Summary of changes in retained earnings:

<table>
<thead>
<tr>
<th>Debit (credit)</th>
<th>3/31/X1</th>
<th>6/30/X1</th>
<th>9/30/X1</th>
<th>12/31/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>$ -</td>
<td>$ 2,000</td>
<td>$ 5,000</td>
<td>$ 8,900</td>
</tr>
<tr>
<td>Amount excluded from hedge effectiveness</td>
<td>2,000</td>
<td>3,000</td>
<td>4,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Hedge ineffectiveness</td>
<td>-</td>
<td>-</td>
<td>(100)</td>
<td>(100)</td>
</tr>
</tbody>
</table>
The effect of the hedging relationship on the income statement is a $9,800 net debit to retained earnings equal to the sum of a $10,000 loss on the time value of the option and a $200 credit representing hedge ineffectiveness. The $47,800 gain on the call option remains in AOCI until the hedged commodity B inventory is sold. When the inventory is sold, the $47,800 is reclassified into earnings, thereby reducing the inventory’s cost of goods sold.

**Example 6.18: Cash Flow Hedge of Variable-Rate Long-Term Debt with an Interest Rate Cap (Critical Terms Match – Terminal Value Method)**

On January 1, 20X1, CBC Inc. issues a three-year, $10,000,000 debt obligation. The interest rate on the debt obligation is variable at a rate of six-month LIBOR plus 2%. CBC is concerned that six-month LIBOR may rise during the three-year term of the debt obligation, but wants to retain the ability to benefit when six-month LIBOR is below 8%. To protect itself from this exposure, CBC purchases for $300,000 an out-of-the-money interest rate cap from Bank A. The interest rate cap pays interest to CBC when six-month LIBOR exceeds 8%. The amount paid to CBC by Bank A is equal to $10,000,000 multiplied by (six-month LIBOR minus 8%) in those years in which six-month LIBOR exceeds 8%. The combination of the cap and the debt obligation result in CBC paying interest at a variable rate (six-month LIBOR plus two percent) not to exceed 10%. The variable-rate debt obligation and interest rate cap both require payments to be made on December 31 of each year. The variable-rate on the debt obligation and purchased interest rate cap reset on January 1 of each year. CBC designates the purchased interest rate cap as a cash flow hedge of the benchmark interest rate risk attributable to the forecasted interest payments related to changes in six-month LIBOR that exceed 8%.

**Assumptions**

All criteria for cash flow hedge accounting have been met.

CBC Inc. determines (a) the critical terms of the interest rate cap completely match the related terms of the hedged forecasted transactions, (b) the strike price of the interest rate cap matches the specified level beyond which the entity’s exposure is being hedged, (c) the interest rate cap’s inflows at its periodic settlement dates completely offset the changes in the hedged transaction’s cash outflows for the risk being hedged, and (d) the interest rate cap can be exercised only at its contractual dates.

The assessment of effectiveness is documented as being based on total changes in the purchased option’s cash flows (i.e., the assessment will include the purchased option’s entire change in fair value); accordingly, the assessment of effectiveness and measurement of ineffectiveness will focus on the purchased option’s terminal value in accordance with DIG Issue G20. As a result, the entity concludes that the hedging relationship is considered to be perfectly effective and all changes in the purchased option’s fair value will be recorded in AOCI.

Six-month LIBOR and related amounts are as follows:

<table>
<thead>
<tr>
<th></th>
<th>$2,000</th>
<th>$5,000</th>
<th>$8,900</th>
<th>$9,800</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closing balance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Rate for Year | Cap Receipt for the year (A) | Debt Interest for the year (B) | Net Interest for the year (A) + (B)
--- | --- | --- | ---
1/1/X1 | 7% | $900,000 | $900,000
1/1/X2 | 9% | (100,000) | 1,100,000 | 1,000,000
1/1/X3 | 10% | (200,000) | 1,200,000 | 1,000,000

The debt’s interest rate for a payment period is set at the beginning of the period and paid at the end of the period. That is, the first interest payment on 12/31/X1 is based on six-month LIBOR in effect at 1/1/X1. Accordingly, the first interest payment on 12/31/X1 has no variability at the inception of the hedging relationship and is not being hedged. At inception of the hedging relationship, the interest rate cap consists of three individual caplets with fair values that total the $300,000 premium paid for the cap. The fair value of each of those caplets on 1/1/X1 is as follows:

<table>
<thead>
<tr>
<th>Caplet</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/X2</td>
<td>$140,000</td>
</tr>
<tr>
<td>12/31/X3</td>
<td>$160,000</td>
</tr>
</tbody>
</table>

Total fair value of cap at inception $300,000

The fair value of the interest rate cap and changes therein at the end of each accounting period before cash settlement are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Fair Value</th>
<th>Change in Fair Value Gain(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>$300,000</td>
<td>$ -</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>280,000</td>
<td>(20,000)</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>350,000</td>
<td>70,000</td>
</tr>
<tr>
<td>12/31/X3</td>
<td>200,000</td>
<td>(150,000)</td>
</tr>
</tbody>
</table>

The intrinsic value and the time value components of the interest rate cap (the total equals the interest rate cap’s fair value) are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Intrinsic Value Before Settlement</th>
<th>Change in Intrinsic Value</th>
<th>Time Value Before Settlement</th>
<th>Change in Time Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>$ -</td>
<td>$ -</td>
<td>$300,000</td>
<td>$ -</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>-</td>
<td>-</td>
<td>280,000</td>
<td>20,000</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>200,000</td>
<td>200,000</td>
<td>150,000</td>
<td>130,000</td>
</tr>
<tr>
<td>12/31/X3</td>
<td>200,000</td>
<td>-</td>
<td>-</td>
<td>150,000</td>
</tr>
</tbody>
</table>

(1) The Standard does not specify how to compute the intrinsic value of a cap option if the option involves a series of payments. In this example, we have assumed that the intrinsic value of the cap is equal to the expected future cash flows holding constant the cap’s current period cash flow of 1% (i.e., 9% - 8%) for the remaining term of the hedge. Alternatively, we believe an entity may estimate the intrinsic value of the cap for each period based on the market’s expectations of movements in six-month LIBOR using the six-month LIBOR forward yield curve.

The origination and repayment of the debt are ignored for purposes of illustration. The following journal entries are made on January 1, 20X1, and December 31, 20X1, 20X2, and 20X3 (ignore interim reporting):

a) The journal entry on January 1, 20X1:
1. Interest rate cap (B/S) $ 300,000
   Cash (B/S) $300,000
   (To record the purchase of the interest rate cap at fair value)

b) The journal entries on December 31, 20X1:
   1. Interest expense (P&L) 900,000
      Cash (B/S) 900,000
      (To recognize interest expense on six-month LIBOR plus 2% debt obligation)
   2. Unrealized loss on interest rate cap (OCI) 20,000
      Interest rate cap (B/S) 20,000
      (To record the change in the fair value of the interest rate cap)

c) The journal entries on December 31, 20X2:
   1. Interest expense (P&L) 1,100,000
      Cash (B/S) 1,100,000
      (To recognize interest expense on six-month LIBOR plus 2% debt obligation)
   2. Unrealized loss on interest rate cap (OCI) 130,000
      Interest rate cap (B/S) 70,000
      Unrealized gain on interest rate cap (OCI) 200,000
      (To record the change in the fair value of the interest rate cap. The $130,000 represents the portion of the change in the cap’s fair value attributable to time value. The $200,000 represents the increase in the interest rate cap’s intrinsic value during the current period of $100,000 related to the current period receipt and $100,000 related to the projected receipt for the next period)
   3. Cash (B/S) 100,000
      Interest rate cap (B/S) 100,000
      (To record cash received on the annual settlement of the interest rate cap)
   4. AOCI 100,000
      Interest expense (P&L) 100,000
      (To reclassify into earnings the amount in AOCI that hedged the variable interest expense recognized in earnings)
   5. Unrealized loss on interest rate cap (P&L) 140,000
      AOCI 140,000
      (To reclassify the original fair value of the first caplet from AOCI to earnings as the debt interest payment being hedged is reported in earnings)

d) The journal entries on December 31, 20X3:
   1. Interest expense (P&L) 1,200,000
Cash (B/S) 1,200,000

(To recognize interest expense on six-month LIBOR plus 2% debt obligation)

2. Unrealized loss on interest rate cap (OCI) 150,000

Interest rate cap (B/S) 50,000

Unrealized gain on interest rate cap (OCI) 100,000

(To record the change in the fair value of the cap. The $150,000 represents the portion of the change in the cap’s fair value that is attributable to time value. The $100,000 represents the increase in the intrinsic value from $100,000 after settlement on December 31, 20X2 and the actual intrinsic value of $200,000 at December 31, 20X3)

3. Cash (B/S) 200,000

Interest rate cap (B/S) 200,000

(To record cash received on the annual settlement of the cap)

4. AOCI 200,000

Interest expense (P&L) 200,000

(To reclassify into earnings the amount in AOCI that hedged the variable interest expense recognized in earnings)

5. Unrealized loss on interest rate cap (P&L) 160,000

AOCI 160,000

(To reclassify the original fair value of the first caplet from AOCI to earnings as the debt interest payment being hedged is reported in earnings)

Observations

As a result of entering into the hedging relationship, CBC Inc. effectively capped its interest expense at 10% on the three-year debt obligation. Specifically, during those periods in which the contractual terms of this debt obligation would result in an interest expense greater than 10% or $1,000,000 (i.e., if six-month LIBOR exceeded 8%), the payments received from the interest rate cap effectively reduced interest expense to 10% as illustrated below. However, recognition in earnings of each caplet at its expiration date resulted in variability of total expenses:

<table>
<thead>
<tr>
<th></th>
<th>12/31/X1</th>
<th>12/31/X2</th>
<th>12/31/X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on six-month LIBOR plus 2% debt</td>
<td>$900,000</td>
<td>$1,100,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Reclassified from AOCI</td>
<td>-</td>
<td>(100,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Interest expense</td>
<td>$900,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Caplet expense</td>
<td>-</td>
<td>140,000</td>
<td>160,000</td>
</tr>
<tr>
<td>Total expense</td>
<td>$900,000</td>
<td>$1,140,000</td>
<td>$1,160,000</td>
</tr>
</tbody>
</table>
DISCONTINUATION OF HEDGE ACCOUNTING

32.01 Paragraph 32 of the Standard (ASC paragraphs 815-30-40-1 through 40-3) provides guidance on the accounting for the discontinuance of a cash flow hedge:

32. An entity shall discontinue prospectively the accounting specified in paragraphs 30 and 31 for an existing hedge if any one of the following occurs:

   (a) Any criterion in paragraphs 28 and 29 is no longer met.

   (b) The derivative expires or is sold, terminated, or exercised.

   (c) The entity removes the designation of the cash flow hedge.

In those circumstances, the net gain or loss shall remain in accumulated other comprehensive income and be reclassified into earnings as specified in paragraph 31. Furthermore, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in paragraphs 32(a) and 32(c), a different hedged transaction or a hedged item if the hedging relationship meets the criteria specified in paragraphs 28 and 29 for a cash flow hedge or paragraphs 20 and 21 for a fair value hedge.

DIG Issues related to this paragraph are E22, G13 and G25. See DIG Issues Index.

32.02 An entity is required to discontinue hedge accounting prospectively if it fails to meet any of the hedge accounting criteria in paragraphs 28 and 29 of the Standard (ASC paragraphs 815-20-25-1, 25-3, 25-13 through 25-15, 25-43, 25-50, 25-51, 25-75, 25-76, 25-80, 25-94, 25-95; and ASC Section 815-20-20). Typically, this occurs when the hedging relationship no longer is highly effective or when the forecasted transaction no longer is probable of occurring as described in the original hedge documentation. Additionally, an entity is required to cease applying hedge accounting if the derivative hedging instrument expires or is sold, terminated, or exercised, or if the entity removes the designation of the cash flow hedge (i.e., the designation that was formally documented at inception of the hedge in accordance with paragraphs 28 and 29 of the Standard (ASC paragraphs 815-20-25-1, 25-3, 25-13, 25-15, 25-43, 25-50, 25-51, 25-75, 25-76, 25-80, 25-94, and 25-95). Discontinuation of hedge accounting is also required if the forecasted transaction is no longer eligible for designation as a hedged transaction. This would occur, for example, when an entity acquires, or otherwise must consolidate, the counterparty to the forecasted transaction resulting in that transaction no longer being with a party external to the reporting entity or when an entity sells, will sell, or otherwise must deconsolidate, a subsidiary resulting in a forecasted transaction of that subsidiary being considered no longer probable of occurring from the reporting entity’s (parent company) perspective.

32.03 If an entity determines that a hedging relationship had been retrospectively highly effective at the current assessment date, the entity must apply the provisions of paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) at that date, regardless of whether the entity believes the hedging relationship will be prospectively highly effective or whether the entity is discontinuing hedge accounting prospectively. If an entity prospectively discontinues a hedging relationship at the current assessment date (for example because the timing of the forecasted transaction has changed) and the hedging relationship retrospectively was highly effective, the

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entity could report a significant amount of ineffectiveness in earnings (in essence, a catch-up adjustment) because paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) requires recognition of cumulative ineffectiveness. That is, the final measurement under paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) should be based on the best estimate of the hedged forecasted transaction and the fair value of the hedging instrument as of the date that a cash flow hedge is discontinued prospectively.

32.04 After the final measurement required under paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) is performed and the cash flow hedge is discontinued prospectively, any net derivative gain or loss that remains in AOCI related to a forecasted transaction subject to the discontinued hedging relationship that is probable of not occurring within the original period specified in the hedge documentation or within an additional two-month period (as discussed in paragraph 33 of the Standard (ASC paragraphs 815-30-40-4 and 40-5)) is required to be reclassified from AOCI to earnings. Otherwise, any amounts remaining in AOCI related to the hedging relationship should remain in AOCI and be reclassified into earnings as specified in paragraph 31 of the Standard (ASC paragraphs 815-30-35-38 through 35-41). Note that DIG Issue E22 addresses the accounting for amounts in AOCI associated with hedging relationships required to be discontinued as a result of adopting FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, as originally issued or as revised (FIN 46) (ASC Subtopic 810-10, Consolidation -- Overall). See Section 10 for further discussion.

32.05 If the derivative instrument remains outstanding after the discontinuation of cash flow hedge accounting and it is not redesignated as part of a new hedging relationship, it would be considered a speculative derivative instrument prospectively. Accordingly, any changes in its fair value after discontinuance of hedge accounting must be recognized currently in earnings. An entity is permitted to redesignate the derivative instrument as a part of a new fair value or cash flow hedge provided the relevant hedge accounting criteria are met.

32.06 The following examples illustrate the application of paragraph 32 (ASC paragraphs 815-30-40-1 through 40-3):

Example 6.19: Termination of an Interest Rate Swap Used in a Cash Flow Hedge

Three years ago, Williams Co. entered into a five-year interest rate swap to receive interest at a variable rate (U.S. Treasury rates) and to pay interest at a fixed rate. The swap was designated as a hedge of the risk of changes in its cash flows attributable to changes in the U.S. Treasury rates on a specific five-year, variable-rate debt obligation. Since that time, interest rates have declined and Williams Co. has recognized a liability of $1,000,000 related to this interest rate swap (unrealized net loss), with an offsetting charge of $1,000,000 reported in AOCI. Williams Co. pays the swap counterparty $1,000,000 to terminate the interest rate swap and derecognizes the $1,000,000 liability related to the swap. However, the loss remaining in AOCI after applying paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) at the date of discontinuation of the cash flow hedging relationship continues to be reported in AOCI until the forecasted transaction affects earnings or when it becomes probable that the forecasted transaction will not occur by the end of the originally specified time period or within an additional two-month period. Thus, in this instance, any remaining amount in AOCI
related to the discontinued hedging relationship is recognized in earnings (e.g., using the interest method) over the remaining two-year life of the specific debt obligation.

**Example 6.20: Termination of Cash Flow Hedge When Hedge Designation is Removed**

Three years ago, Williams Co. entered into a five-year interest rate swap to receive interest at a fixed rate and to pay interest at a variable rate (six-month LIBOR). The swap was designated as a hedge of the risk of changes in its cash flows attributable to changes in the six-month LIBOR swap rate on a specific five-year, variable-rate (six-month LIBOR) available-for-sale debt security. Since that time, interest rates decreased and Williams Co. recognized an asset of $1,000,000 relating to this interest rate swap (an unrealized net gain), with an offsetting credit of $1,000,000 reported in AOCI. Williams Co. removes the hedging designation.

The gain remaining in AOCI after applying paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) at the date of discontinuation of the cash flow hedging relationship continues to be reported in AOCI until the forecasted transaction affects earnings (i.e., when interest payments on the security are received) or when it becomes probable that the forecasted transaction will not occur by the end of the originally specified time period or within an additional two-month period. Thus, in this instance, any remaining amount in AOCI related to the discontinued hedging relationship is recognized in earnings (e.g., using the interest method) over the remaining two-year life of the specific debt security. As of the date the hedging designation is removed, Williams should either (i) account for the swap as a nonhedging derivative instrument with all subsequent changes in its fair value recognized currently in earnings, or (ii) elect to designate prospectively a new hedging relationship with a different hedged item or transaction if it meets the criteria specified for a fair value hedge or for a cash flow hedge.

32.07 If an event or change in circumstances results in a fair value hedging relationship not being retrospectively highly effective for the current period and the date that event or change in circumstances occurred can be identified, the entity must apply fair value hedge accounting through that date. The Standard does not contain similar language for a cash flow hedge. However, based on discussions with the FASB staff, a similar analysis should be performed for cash flow hedges. If an entity determines that a hedging relationship had not been retrospectively highly effective at the current assessment date, the entity must discontinue hedge accounting; it does not apply the provisions of paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) at that current assessment date. That is, regardless of whether the entity believes the hedging relationship will be prospectively highly effective, the entity must discontinue hedge accounting for that hedging relationship and should not apply the provisions of paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) if the hedging relationship had not been retrospectively highly effective as of the current assessment date. If the entity is able to identify the event or change in circumstances that resulted in the cash flow hedging relationship being discontinued for the current period, the entity must apply the provisions of paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) as of the date of that event or change in circumstance.
and all subsequent changes in fair value of the derivative that occurred from that date to the
current date are reported in earnings. If the entity is not able to identify the event or change in
circumstances that resulted in the cash flow hedging relationship being discontinued for the
current period, all changes in the fair value of the derivative during the period are reported in
earnings.

32.08 In some circumstances, an entity will be required to discontinue a cash flow hedging
relationship because the hedging relationship is not highly effective due to changes in the
creditworthiness of the counterparty to the derivative or the entity's own nonperformance risk. In
those cases, a careful analysis should be performed to determine the date of discontinuance of the
hedging relationship. That is, since deterioration in credit can occur over a period of time, it may
not be appropriate to assume the date a counterparty declares insolvency or discloses significant
financial difficulties in a public announcement as the last date of high effectiveness. Rather,
entities should review the financial markets to determine when the total changes in the cash
flows of the derivative hedging instrument began to deviate from the changes in the cash flows
of the hedged item due to changes in the hedged risk. Identification of the date when it was no
longer probable that a derivative counterparty or the entity itself will not default requires
significant judgment.

32.09 For example, assume the credit spread in the credit derivative market for an entity that is a
counterparty to a derivative instrument began to widen on October 15 due to negative
perceptions in the financial markets about the financial stability of the counterparty. Thirty days
later, the counterparty declares insolvency and its credit is downgraded by the national rating
agencies. Because the cash flows of a derivative hedging instrument should consider the credit
risk of the counterparty and the entity's own nonperformance risk, the date for which cash flow
hedge accounting should be discontinued related to a derivative with this counterparty may be
the date the credit spread for the company began to widen, i.e., October 15, rather than the date
of insolvency 30 days later.

32.10 To illustrate, assume that on September 30, 20X1, Company A has a highly effective cash
flow hedging relationship that involves a derivative in an asset position with a fair value of $18.
Also assume there was no ineffectiveness; therefore, the cumulative change in the derivative’s
fair value (i.e., $18) is in AOCI at September 30, 20X1. Due to credit deterioration of the
derivative counterparty, the fair value of the derivative hedging instrument decreased to $1 at
December 31, 20X1 and, as a result, Company A determined that the cash flow hedging
relationship was not highly effective for the three months ended December 31, 20X1 and is not
expected to be highly effective on a prospective basis. Company A determines that the fair value
of the derivative was $16 on October 14, 20X1 but decreased overnight to $2 on October 15,
20X1 due to a severe increase in the credit spread of the counterparty. Company A determines
that the hedging relationship was highly effective through October 14, 20X1 and, thus, applies
hedge accounting through that date (Company A applies the provisions of paragraph 30(b) of the
Standard (ASC paragraph 815-30-35-3(b)) on October 14, 20X1 – the date the hedging
relationship must be discontinued). In addition, all changes in the fair value of the derivative
after that date should be reflected in earnings.

32.11 If the risk of counterparty default (or the entity's own nonperformance risk) theoretically
would cause the entity to discontinue a cash flow hedge for which the hedging instrument is in
an asset (liability) position, the entity should discontinue a cash flow hedge for a hedging

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derivative with that counterparty in a liability position (or in an asset position if the cash flow hedge is discontinued due to the entity's own nonperformance risk). That is, the possibility that a change in the underlying could cause the derivative to move into an asset position before settlement or maturity cannot be ignored, and typically would render the hedging relationship not highly effective on a prospective basis.

32.12 An entity may determine in its retrospective assessment of hedge effectiveness that a cash flow hedge was not highly effective for the current period, but prospectively it expects the relationship to be highly effective. When this occurs, we believed that the designated hedging relationship must be discontinued using the guidance in Paragraph 32.07 above. However, in January 2010 the FASB issued FASB Accounting Standards Update No. 2010-08, Technical Corrections to Various Topics, which amended paragraph 30(d) of the Standard to state that if an entity’s retrospective evaluation indicated that the hedging relationship had not been highly effective in achieving offsetting changes in cash flows in the previous effectiveness assessment period, but there is an expectation that the hedging relationship will be highly effective in future periods, the hedging relationship may be continued even though hedge accounting was not permitted for the previous effectiveness assessment period. We believe that this amendment is inconsistent with the basic premise that hedge accounting is permitted to be applied only when a hedging relationship has been highly effective at achieving offsetting changes in cash flows in the previous period, and is expected to be highly effective in future periods. We would expect entities to apply the guidance in ASU 2010-08 in limited circumstances (e.g., where the entity can provide sufficient evidence to support the conclusion that the hedging relationship was not highly effective in a previous effectiveness assessment period due to an unusual, discrete event that is not intended to occur in future effectiveness assessment periods). In all other circumstances, we believe the designated hedging relationship must be discontinued. However, the entity may be able to redesignate the derivative to a new cash flow hedging relationship that is identical to the remaining term of the previous hedging relationship. In that circumstance, when applying the provisions of paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) in subsequent periods for which hedge accounting is permitted for the newly designated hedging relationship, the entity should apply the cumulative provisions by including the changes during only the periods in which hedge accounting was applied for the redesignated hedging relationship. This is illustrated in the following example:

Example 6.21: Failure to Qualify for Cash Flow Hedge Accounting in One Period

On January 1, 20X1, LAO, Inc. enters into a hedging relationship and documents that it will use a regression analysis approach for its prospective assessment of effectiveness and the period-by-period, dollar-offset method for its retrospective assessment of effectiveness. In addition, LOA documents that it will use the hypothetical derivative method to measure ineffectiveness. On March 31, 20X1, the first assessment period, LAO concluded that the hedging relationship was highly effective retrospectively and is expected to continue to be highly effective prospectively. On June 30, 20X1, the second assessment period, LAO concludes that the hedging relationship was not highly effective retrospectively but is expected to be highly effective prospectively. LAO did not identify any specific event during the period that caused the hedging relationship not to be highly effective on a prospective basis. As a result, hedge accounting may not be applied in the period just ended, and the hedging
relationship must be terminated. On June 30, 20X1, LAO immediately redesignated the derivative to a new hedging relationship with terms identical to the previous hedging relationship (retrospective and prospective assessments of effectiveness will be based on regression analyses). On September 30, 20X1, and December 31, 20X1, LAO concluded that the hedging relationship was highly effective retrospectively and is expected to continue to be highly effective prospectively.

Assume the following:

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<th>Cumulative change</th>
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<td>6/30/X1</td>
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<td>9/30/X1</td>
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<td>12/31/X1</td>
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The following journal entries are made on March 31, June 30, September 30, and December 31, 20X1:

a) The journal entry as of March 31, 20X1:
   1. Unrealized loss on derivative (OCI) $95
   1. Unrealized loss on derivative (P&L) 5
   1. Derivative (B/S) $100

   (To record the change in the fair value of the derivative during the period as a result of applying hedge accounting from 1/1/X1 – 3/31/X1)

b) The journal entry as of June 30, 20X1:
   1. Unrealized loss on derivative (P&L) 20
   1. Derivative (B/S) 20

   (To record the change in the fair value of the derivative during the period for which hedge accounting is not applied)

c) The journal entry as of September 30, 20X1:
   1. Derivative (B/S) 200
   1. Unrealized gain on derivative (OCI) 200

   (To record the change in the fair value of the derivative during the period as a result of applying hedge accounting from 7/1/X1 – 9/30/X1. The amount credited to OCI reflects the lesser of the cumulative changes of the fair value of the actual derivative and the hypothetical derivative for the period since the new hedging relationship was established)

d) The journal entry as of December 31, 20X1:
   1. Unrealized loss on derivative (OCI) 50
   1. Derivative (B/S) 50

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Observations
Since the original hedging relationship was not highly effective under the retrospective assessment of effectiveness during the second assessment period, the entire change in fair value of the derivative for that period is recognized in earnings for that period. Application of paragraph 30 of the Standard (ASC paragraphs 815-30-35-3, 35-4, and 35-7) to the new hedging relationship established subsequently includes cumulative changes in the derivative and the forecasted transaction for the new hedging period (i.e., 7/1/X1 – 12/31/X1) but not all cumulative changes in the derivative and the forecasted transaction for which hedge accounting was applied for the current and previous hedging periods (i.e., 1/1/X1 – 3/31/X1 and 7/1/X1 – 12/31/X1).

32.13 Adding to or deleting from (i.e., rebalancing) a portfolio of derivative hedging instruments identified in a cash flow hedging relationship represents a change in the cash flow hedging relationship. For example, a rebalancing of the portfolio of derivative hedging instruments in a dynamic hedging relationship involving a tailing strategy (discussed in Paragraph A6.77 in Appendix A to this section) often is necessary for the hedging relationship to be highly effective on a prospective basis. In connection with a rebalancing, an entity would be required to dedesignate the current cash flow hedging relationship and designate a new cash flow hedging relationship. During that process, the entity is required to apply the provisions of paragraph 32 of the Standard (ASC paragraphs 815-30-40-1 through 40-3).

32.14 Similarly, deleting from or adding to the composition of the portfolio of hedged forecasted transactions identified in a cash flow hedging relationship represents a change in the cash flow hedging relationship. In connection with a deletion or addition, an entity would be required to dedesignate the current cash flow hedging relationship related to those forecasted transactions. During that process, the entity is required to apply the provisions of paragraph 32 of the Standard (ASC paragraphs 815-30-40-1 through 40-3). We believe if certain forecasted transactions in a portfolio are no longer probable of occurring, those transactions are not considered to have been deleted in the context herein. For example, if an entity is hedging the variability in cash flows of 40 interest payments related to the issuance of a variable rate debt obligation and some of those interest payments become not probable of occurring, the entity would not need to dedesignate the relationship unless it concluded that the relationship would not be highly effective. This assessment of high effectiveness would need to consider the original notional amount of the hedging derivative instrument and the interest payments that remain probable of occurring.

WHEN IT IS PROBABLE A FORECASTED TRANSACTION WILL NOT OCCUR

33.01 Paragraph 33 of the Standard (ASC paragraphs 815-30-40-4 and 40-5) provides guidance on the accounting for the discontinuance of a cash flow hedge including when it is probable that the original forecasted transaction will not occur as follows:
33. The net derivative gain or loss related to a discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income unless it is probable that the forecasted transaction will not occur by the end of the originally specified time period (as documented at the inception of the hedging relationship) or within an additional two month period of time thereafter, except as indicated in the following sentence. In rare cases, the existence of extenuating circumstances that are related to the nature of the forecasted transaction and are outside the control or influence of the reporting entity may cause the forecasted transaction to be probable of occurring on a date that is beyond the additional two month period of time, in which case the net derivative gain or loss related to the discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income until it is reclassified into earnings pursuant to paragraph 31. If it is probable that the hedged forecasted transaction will not occur either by the end of the originally specified time period or within the additional two month period of time and the hedged forecasted transaction also does not qualify for the exception described in the preceding sentence, that derivative gain or loss reported in accumulated other comprehensive income shall be reclassified into earnings immediately.

DIG Issues related to this paragraph are G3, G16, G17 and G18. See DIG Issues Index.

33.02 Paragraph 33 of the Standard (ASC paragraphs 815-30-40-4 and 40-5) addresses the accounting for the net derivative gain or loss that remains in AOCI after a cash flow hedging relationship has been discontinued (i.e., after the requirements of paragraphs 30(b) (ASC paragraph 815-30-35-3(b)) and 32 of the Standard (ASC paragraphs 815-30-40-1 through 40-3) have been applied) and requires that the gain or loss remain in AOCI unless it is probable that the forecasted transaction will not occur by the end of the originally specified time period or within a two-month period thereafter, or the original hedged transaction affects earnings.

33.03 Under the provisions of paragraph 33 of the Standard (ASC paragraphs 815-30-40-4 and 40-5), an entity is required to continuously assess whether it is probable that the forecasted transaction will not occur by the end of the originally specified time period or within a two-month period thereafter. If, during those subsequent assessments, an entity determines that it is probable that the forecasted transaction will not occur by the end of the originally specified time period or within a two-month period thereafter, the entity must reclassify into earnings the net derivative gain or loss remaining in AOCI related to that discontinued hedging relationship.

33.04 Paragraph 33 of the Standard (ASC paragraphs 815-30-40-4 and 40-5) indicates that the net derivative gain or loss related to the discontinued cash flow hedging relationship should remain in AOCI unless the forecasted transaction is probable not to occur. While the Board considered it inappropriate to continue to apply cash flow hedge accounting to a derivative instrument’s gains and losses that arise after a hedged forecasted transaction, as originally documented, is deemed no longer probable, the Board believed that if the occurrence of the forecasted transaction still is reasonably possible, it is appropriate to continue to report in AOCI gains and losses that arose before the date that the forecasted transaction is deemed no longer probable. The Board was concerned that requiring gains and losses in AOCI to be reclassified into earnings when a forecasted transaction no longer is probable but still reasonably possible would provide an entity with the opportunity to manipulate earnings by changing its estimate of probability. For these reasons, the Board required reclassification into earnings of amounts in
AOCI only when an entity has discontinued a hedging relationship and determines it is probable that the forecasted transaction will not occur by the end of the originally specified time period or within a two-month period thereafter. (See DIG Issue G3 for further reference.)

33.05 The additional two-month period discussed in paragraph 33 of the Standard (ASC paragraphs 815-30-40-4 and 40-5) is relevant only after the entity discontinues a cash flow hedging relationship and the entity is evaluating whether to reclassify into earnings from AOCI the net gain or loss amount related to the discontinued hedging relationship. That is, an entity should not factor the additional two months into its consideration when determining whether a cash flow hedging relationship must be discontinued in accordance with paragraph 32 of the Standard (ASC paragraphs 815-30-40-1 through 40-3). In addition, when analyzing whether the net derivative gain or loss should remain in AOCI after discontinuing a cash flow hedging relationship, an entity must consider this two-month period, i.e., it is not optional. Notwithstanding this, the Standard does provide flexibility for documenting, at inception of the hedging relationship, when the forecasted transaction will occur when the timing of the forecasted transaction involves some uncertainty within a range – see Paragraphs 29b.08-29b.09 of this section.

33.06 As indicated above, when analyzing whether the net derivative gain or loss should remain in AOCI after discontinuing a cash flow hedging relationship, an entity must consider the additional two-month period. Applying this provision can be complicated when an entity enters into separate derivative contracts to hedge forecasted transactions that will occur over several months, and after entering into those separate hedging relationships some of the forecasted transactions are not expected to occur as originally documented. For example, if an entity expects to sell 80 units of inventory on March 31, 20 units of inventory on April 30, and 30 units of inventory on May 31, the entity may enter into three separate forward contracts to lock in the price of the respective sales. Those forward contracts have notional amounts equal to 80 units, 20 units, and 30 units and mature on March 31, April 30 and May 31, respectively. If an entity expects to sell only 60 units on March 31, and determines that the first hedging relationship is not highly effective, the entity must discontinue that hedging relationship; however, the entity should not automatically reclassify any remaining gain or loss in AOCI related to that first hedging relationship. The expected sale of 60 units instead of the 80 units originally documented represents a shortfall of 20 units. Before the entity reclassifies any amount remaining in AOCI related to the forward contract that matures on March 31 (after terminating the first hedging relationship), the entity must determine whether it is probable that the 20 units would not be sold by May 31 (the original specified time period of March 31 plus two months). It is likely that the entity would conclude that 20 units would be sold by May 31 and, accordingly, any remaining amounts in AOCI related to that hedging relationship would not be reclassified to earnings immediately. However, the entity must consider the change in the timing of the forecasted transaction to measure the cumulative ineffectiveness of the first hedging relationship as required by paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) (i.e., the final ineffectiveness measurement for the March 31 relationship will be based upon the entity’s revised estimate of when the 80 units are expected to be sold, for example 60 units in March and 20 units in April). In addition, the entity must consider that analysis (the fact that the first 20 units sold through May 31 will relate to the first hedging relationship that was terminated) when determining whether the sale of 20 units in the second hedging relationship and the sale of 30 units in the third hedging relationship remain probable of occurring as originally documented.
and whether the timing of the remaining forecasted transactions’ cash flows related to the second and third hedging relationships have changed enough to affect the amounts in AOCI related to those transactions. Finally, the entity must consider the effect of any forecasted transactions being considered probable not to occur as discussed in Paragraphs 33.08-33.09 below.

33.07 In certain instances, the additional two months discussed in paragraph 33 of the Standard (ASC paragraphs 815-30-40-4 and 40-5) may be extended due to the existence of extenuating circumstances that are related to the nature of the forecasted transaction and are outside the control or influence of the entity. In these cases, the derivative’s gain or loss related to the discontinued cash flow hedge generally should continue to be reported in AOCI until it is reclassified to earnings under paragraph 31 of the Standard (ASC paragraphs 815-30-35-38 through 35-41) or, if earlier, when the entity determines it is probable that the forecasted transaction will not occur by the end of the original specified period plus the additional extended period. While the FASB staff has not provided additional guidance for determining when this exception may be used, we believe the application would be rare. In addition, we believe the extenuating circumstances should be identified at the inception of the hedge and should not relate to subsequent economic circumstances that have the effect of delaying the date of occurrence of the forecasted transaction. For instance, the building and selling of locomotives takes a significant amount of time and significant delays may occur that are outside the control of the builder/seller. Estimating when a locomotive will be completed and sold is difficult even if an entity considers an additional two-month period beyond its best estimate. For purposes of the entity’s analysis under paragraph 33 of the Standard (ASC paragraphs 815-30-40-4 and 40-5), the entity hedging the forecasted sale of a locomotive can extend the two-month period to something more in line with the process of building and selling locomotives, as long as the period and extenuating circumstances are documented at the inception of the hedging relationship.

Example 6.22: Reclassification from AOCI to Earnings on the Discontinuation of a Cash Flow Hedge

On January 1, 20X1, Hilbert Co. forecasts that it will sell 100 barrels of oil on September 30, 20X1. To hedge the variability in overall changes in cash flows of the forecasted sale, Hilbert Co. enters into a net cash-settled forward contract to fix the amount of proceeds it will receive on the sale of the oil on September 30, 20X1. Assume that all the cash flow hedging requirements of the Standard are met at inception of the hedge. On March 31, 20X1, the first assessment period, Hilbert Co. concluded that the hedging relationship was highly effective retrospectively and is expected to continue to be highly effective prospectively. After applying the provisions of paragraph 30 of the Standard (ASC paragraphs 35-3, 35-4, and 35-7), Hilbert Co. has an unrealized loss in AOCI in the amount of $100,000. On June 30, 20X1, the second assessment period, Hilbert Co. concludes that the hedging relationship was not highly effective retrospectively and is not expected to be highly effective prospectively because there has been a significant increase in the supply of oil in the marketplace. Hilbert Co. did not identify a specific event during the period that caused the hedging relationship not to be highly effective on a retrospective basis. As a result, hedge accounting may not be applied in the period just ended and the hedging relationship must be discontinued prospectively.

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On discontinuance of the cash flow hedging relationship, Hilbert Co. concludes that it is probable that the forecasted sale of 100 barrels of oil will not occur by September 30, 20X1 or within a two-month period thereafter (i.e., November 30, 20X1) because of the significant projected oversupply of oil in the marketplace during that period. In addition, although the delay in the final sale of the oil was caused by events outside the control of Hilbert Co., the delay is not related to the nature of the forecasted transaction. That is, the forecasted sale date of 100 barrels of oil is, by nature, not difficult to estimate. However, the forecasted sale is delayed because of economic factors that arose after the inception of the hedging relationship. As a result, any amounts remaining in AOCI after applying paragraphs 30(b) and 32 of the Standard (ASC paragraphs 815-30-35-3(b) and 815-30-40-1 through 40-3) related to the cash flow hedging relationship should be reclassified to earnings on June 30, 20X1.

33.08 We believe that instances in which it is probable that a forecasted transaction will not occur should be rare. The Board believes that a pattern of determining that hedged forecasted transactions are probable of not occurring by the end of the originally specified time period or within the two months thereafter would call into question an entity’s ability to predict future transactions and the propriety of using cash flow hedge accounting in the future for similar forecasted transactions.

33.09 We understand that the SEC staff will challenge management’s previous and future assertions about forecasted transactions when registrants display a pattern of determining that hedged forecasted transactions are probable of not occurring. Determining what constitutes a pattern is a matter of judgment based on individual facts and circumstances. However, the following should be considered when determining whether a pattern that forecasted transactions are probable of not occurring is present:

- The business or operating circumstances that led the entity to its conclusion
- Whether the entity experienced other instances with similar forecasted transactions; when and what were those business or operating circumstances; whether the current circumstances are different from the previous instance
- Whether the circumstances or events that led to the conclusion were within the control of the entity
- Whether the entity anticipates a similar forecasted transaction within the near future

33.10 Applying paragraphs 32 and 33 of the Standard (ASC paragraphs 815-30-40-1 through 40-5) can be complex. The following flowchart summarizes the requirements of the Standard, as explained in this section, when a cash flow hedging relationship involving a single forecasted transaction is discontinued:
START

Is the originally documented hedging relationship being discontinued under paragraph 32 of the Standard?

Apply the provisions of paragraph 30(b) of the Standard using the originally documented hedging strategy and the newly revised best estimate of the cash flows of the forecasted transaction.

Continue

Discontinue the cash flow hedging relationship.

Continue

No

Do any amounts remain in AOCI related to the discontinued hedging relationship?

Yes

Are there extenuating circumstances that are related to the nature of the forecasted transaction that resulted in the originally documented forecasted transaction being probable of not occurring within the original period specified in the hedge documentation or within a two-month period thereafter?

No

Reclassify the amount remaining in AOCI related to the forecasted transaction into earnings.

Yes

Was there a change in control of the entity?

No

This should be very rare.

No

Are there extenuating circumstances that are related to the nature of the forecasted transaction that resulted in the originally documented forecasted transaction being probable of not occurring within the original period specified in the hedge documentation or within a two-month period thereafter?

Yes

Were these extenuating circumstances outside the control or influence of the entity?

No

END

Yes

This should be very rare.

END

Yes

Reclassify the amount remaining in AOCI related to the forecasted transaction into earnings.

No

A pattern of discontinuing hedge accounting in this circumstance calls into question an entity's ability to predict future transactions and the propriety of using cash flow hedge accounting in the future for asserted forecasted transactions.

No

END

Yes

Was there a change in control of the entity?

No

Were these extenuating circumstances outside the control or influence of the entity?

This should be very rare.

33.11 As discussed in Paragraph 29h.04 of this section, the designation and documentation of the hedged forecasted transaction is critical because if the original documented hedging relationship, or portion of that documented hedging relationship, is terminated, the entity may need to determine whether cash flow hedge accounting can continue to be applied for the entire hedging relationship or a portion thereof. The following examples illustrate the application of paragraphs 32 and 33 of the Standard (ASC paragraphs 815-30-40-1 through 40-5) to situations in which the hedged risk is the variability in cash flows attributable to changes in the benchmark interest rate:

**Example 6.23: Hedging the Variability in Interest Payments Attributable to Changes in the Benchmark Interest Rate Related to a Five-Year Borrowing Program (See DIG Issue G13 for further reference.)**

MNO Company plans to borrow $5 million for a period of five years and, because MNO Company does not plan initially to enter into a five-year fixed-rate debt obligation, the interest payments over that five-year period have variability. MNO Company enters into a three-month LIBOR-based interest rate swap to hedge the variability in the quarterly interest payments on the five-year borrowing program attributable to changes in the three-month LIBOR benchmark interest rate. MNO documents that the forecasted transactions are the quarterly interest payments from the five-year borrowing program. Initially, MNO Company plans to accomplish its five-year borrowing program by sequentially issuing 90-day notes over the total period and the interest on each note will be determined based on three-month LIBOR at the time each note is issued. MNO Company is aware that changes in market conditions may prompt it to accomplish its five-year borrowing program by other means, such as a fixed-rate borrowing for the remainder of the five-year period. The swap requires settlement every 90 days, and the variable interest rate is reset immediately following each payment. MNO pays a fixed rate of interest (6.5%) and receives interest at three-month LIBOR. MNO neither pays nor receives a premium at inception of the swap. The notional amount of the contract is $5 million, and it expires in five years.

At the end of the second year of the five-year hedging relationship, MNO discontinues its practice of issuing 90-day notes. Instead, MNO issues a three-year, $5 million note with a fixed rate of interest (7.5% annually) payable each quarter. Issuing a note with a fixed interest rate eliminates the variability of the future interest payments. Thus, the swap no longer qualifies for cash flow hedge accounting under paragraph 32 of the Standard (ASC paragraphs 815-30-40-1 through 40-3). As a result, MNO must apply the provisions of paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) using the originally documented hedging strategy and the new, revised best estimate of the cash flows of the remaining forecasted transaction (i.e., quarterly interest payments of the annual 7.5% interest for the next three years compared with the original forecasted transactions of quarterly interest payments at three-month LIBOR for the next three years) and reclassify from AOCI into earnings any resulting cumulative ineffectiveness. After the hedging relationship is discontinued, MNO must determine whether the amounts still remaining in AOCI, if any, should remain. MNO concludes that although the variability of the interest payments has been eliminated, it still is probable that the interest payments (i.e., the forecasted transactions) will occur. Since MNO Company originally designated that it was hedging its interest rate risk exposure to changes in the quarterly interest payments on its $5 million borrowing program over the next five years,
and MNO Company will continue to be obligated to make quarterly interest payments on its $5 million borrowing program for the remainder of the five-year period, no immediate additional reclassification of the amounts remaining in AOCI, after the original hedging relationship is terminated and the reclassification from AOCI into earnings of any cumulative ineffectiveness based on the application of paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)), into earnings is required (or permitted) under paragraph 33 of the Standard (ASC paragraphs 815-30-40-4 and 40-5).

Instead, as each fixed interest payment is recorded over the next three years, MNO should reclassify a portion of the amount remaining in AOCI on discontinuing the original hedging relationship that was specifically related to each respective fixed interest payment.

Example 6.24: Hedging the Variability in Interest Payments Attributable to Changes in the Benchmark Interest Rate Related to a 10-year Borrowing Program (See DIG Issue G17 for further reference.)

PTG Consulting, Inc. expects to borrow $100 million over a 10-year period beginning in six months. PTG Consulting, Inc. initially plans to issue $100 million of 10-year, fixed-rate debt at or near par at the then current market interest rate; consequently, PTG Consulting, Inc. will be exposed to variability in cash flows in the future quarterly interest payments on $100 million of debt due to changes in credit risk and interest rate risk that occur during this six-month period before issuance. To hedge the risk of changes in these 40 quarterly interest payments attributable to changes in the benchmark interest rate for the six-month period, the entity enters into a forward starting interest rate swap and documents that it is hedging the variability in the 40 future quarterly interest payments, attributable to changes in the benchmark interest rate risk over the next 10 years related to its 10-year, $100 million borrowing program that begins in six months. The entity documents that it will assess effectiveness of the hedging relationship every month. Due to market conditions, the entity decides at the end of the fifth month of the hedging relationship that it will issue $100 million of fixed-rate debt with a five-year maturity and quarterly interest payments instead of fixed-rate debt with a 10-year maturity and quarterly interest payments. PTG Consulting, Inc. also expects that at maturity of the soon-to-be-issued fixed-rate debt with a five-year maturity, it will borrow additional fixed-rate amounts under the original 10-year borrowing program and incur quarterly interest payments.

When PTG Consulting, Inc. performs its monthly assessment of effectiveness on a retrospective and prospective basis, the entity must take into account whether the hedging instrument has been and will be highly effective at hedging its current forecasted transactions. That is, the entity may conclude at the end of the fifth month that the hedging relationship no longer is considered highly effective under paragraph 28(b) of the Standard (ASC paragraphs 815-20-25-75, 25-76, and 25-80) in part because the actual variability in the hedged interest payments for years one through five is now based on a five-year borrowing rate and not on a 10-year rate as expected at the inception of the hedge when the terms of the forward starting swap were selected.
When PTG Consulting, Inc. performs its monthly assessment of effectiveness at the end of the fifth month of the hedging relationship, assume it determines that the hedging relationship no longer is highly effective. As a result, the hedging relationship must be discontinued under the provisions of paragraph 32 of the Standard (ASC paragraphs 815-30-40-1 through 40-3).

Even though PTG Consulting, Inc. discontinues the cash flow hedging relationship, it must apply the provisions of paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) at the date of discontinuance. In applying those provisions, PTG Consulting, Inc. should use the current fair value of the actual hedging instrument (the forward starting swap) and its current best estimate of the change in expected future cash flows on the hedged transactions. The current best estimate of the change in expected future cash flows on the hedged transactions must take into consideration the issuance of a five-year, fixed-rate interest for years one through five of the original hedging relationship and the best estimate of the change in expected future cash flows for years six through 10 of the original hedging relationship. After the entity applies the provisions of paragraph 30(b) of the Standard (ASC paragraph 815-30-35-3(b)) and the reclassification from AOCI into earnings of any resulting cumulative ineffectiveness, the entity must discontinue the original cash flow hedging relationship. After the hedging relationship is discontinued, the entity must determine whether the amounts still remaining in AOCI, if any, should remain. Because PTG Consulting, Inc. estimates that at maturity of the soon-to-be-issued fixed-rate debt with a five-year maturity it will borrow additional fixed-rate amounts under the original 10-year borrowing program and incur quarterly interest payments, it concludes that the variability of the quarterly interest payments on $100 million of debt related to its borrowing program over the next 10 years continues to exist and it is still probable that all the originally documented forecasted interest payments will occur on the dates originally forecasted. That is, PTG Consulting, Inc. estimates that the original 40 forecasted interest payments will occur as originally documented – the first 20 forecasted interest payments will occur as a result of the soon-to-be-issued five-year fixed rate borrowing and the remaining 20 forecasted interest payments will occur as a result of the entity’s assertion that it expects to borrow additional fixed-rate amounts under the original 10-year borrowing program in years six through 10 and incur quarterly interest payments (see Paragraph 29b.04 of this section for potential issues related to PTG Consulting, Inc.’s assertion).

As a result, after the hedging relationship is discontinued any remaining amounts in AOCI related to the discontinued hedging relationship should be recognized in earnings when the originally hedged forecasted transactions are reported in earnings. That is, at the date the original hedging relationship is discontinued, the remaining amount in AOCI should be allocated to each of the 40 forecasted transactions and the respective amount should be recognized in earnings when the respective forecasted transaction is reported in earnings. If, however, the entity determines that it is probable that one or more of the originally documented forecasted transactions will not occur either by the end of the date originally specified or within an additional two months thereafter, at the date of discontinuing the hedging relationship, or after that date, the entity should reclassify into earnings from AOCI the amount of the net derivative gain or loss, if any, specifically related to those non-occurring forecasted transactions.

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Example 6.25: Hedging the Variability in Total Proceeds Attributable to Changes in the Benchmark Interest Rate Related to a Specific Borrowing (See DIG Issue G18 for further reference.)

CAB Resources, Inc. expects to borrow $100 million of 10-year, 9% debt in six months. Because the debt will have a fixed interest rate of 9%, the entity will not be exposed to variability in the future quarterly interest payments; rather, it will be exposed to variability in the cash flows received as principal proceeds on the debt due to changes in credit risk and interest rate risk that occur during the six-month period before issuance. To hedge the risk of changes in the total proceeds attributable to changes in the benchmark interest rate for the six-month period, the entity enters into a short position in U.S. Treasury note futures contracts and documents that it is hedging the variability in the principal proceeds attributable to changes in the benchmark interest rate risk to be received from the 9%, fixed-rate debt it will issue in six months. The entity documents that it will assess effectiveness of the hedging relationship every month. At the date the debt was scheduled to be issued, the entity decides to delay the issuance of the 10-year debt for three months.

Because the hedging relationship involves a single forecasted transaction specified to occur in six months and the single forecasted transaction no longer is probable of occurring by the date originally specified or within a two-month period thereafter, applying paragraphs 30(b), 32 and 33 of the Standard (ASC paragraphs 815-30-35-3(b), and 815-30-40-1 through 40-5) would result in all amounts previously reported in AOCI related to the hedging relationship being reclassified into earnings. In addition, the nonoccurrence of the hedged forecasted transaction potentially could jeopardize the entity’s ability to use cash flow hedge accounting in the future for the situation described.

ASSESSING IMPAIRMENT

34.01 Paragraph 34 of the Standard (ASC paragraph 815-30-35-42) provides the following guidance on impairment testing when using cash flow hedge accounting:

34. Existing requirements in generally accepted accounting principles for assessing asset impairment or recognizing an increased obligation apply to an asset or liability that gives rise to variable cash flows (such as a variable rate financial instrument), for which the variable cash flows (the forecasted transactions) have been designated as being hedged and accounted for pursuant to paragraphs 30 and 31. Those impairment requirements shall be applied each period after hedge accounting has been applied for the period, pursuant to paragraphs 30 and 31 of this Statement. The fair value or expected cash flows† of a hedging instrument shall not be considered in applying those requirements. The gain or loss on the hedging instrument in accumulated other comprehensive income shall, however, be accounted for as discussed in paragraph 31.

† Refer to footnote * to paragraph 17 of Statement 133.

34.02 Paragraph 34 of the Standard (ASC paragraph 815-30-35-42) requires an entity to apply the existing requirements in generally accepted accounting principles (GAAP) for assessing asset
impairment or recognizing an increased obligation to an existing asset or liability for which the variable cash flows have been or currently are designated as being hedged. For example:

- If an entity previously hedged the forecasted purchase of inventory in a cash flow hedge and currently recognizes that inventory as an asset in its balance sheet, it is required to assess the impairment of that inventory using the lower of cost or market principles under Section 4, *Inventory Pricing*, of Accounting Research Bulletin No. 43 (ASC paragraphs 330-10-35-1 and 35-2).

- If an entity currently is hedging the forecasted sale of a fixed asset in a cash flow hedge and currently recognizes that fixed asset in its balance sheet, it is required to assess the impairment of that fixed asset under FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (ASC Subtopic 360-10, Property, Plant, and Equipment - Overall).

- If a lender currently is hedging the variability in cash flows associated with a specific variable-rate commercial loan receivable, it is required to assess the impairment of that commercial loan under FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (ASC Subtopic 310-10, Receivables - Overall).

34.03 Before applying the existing requirements in GAAP for assessing asset impairment or recognizing an increased obligation to an existing asset or liability for which the variable cash flows have been or currently are designated as being hedged, an entity is required to apply the provisions of the Standard. That is, if an entity previously hedged the purchase or incurrence of a forecasted transaction that is now recognized as an asset or liability, the requirements of paragraph 31 of the Standard (ASC paragraphs 815-30-35-38 through 35-41) should be applied to any amounts remaining in AOCI related to that previous hedging relationship. If an entity currently is hedging a forecasted transaction related to the existing asset or liability, the requirements of paragraphs 28-32 of the Standard (ASC paragraphs 815-20-25-1, 25-3, 25-13 through 25-15, 25-43, 25-50, 25-51, 25-75, 25-76, 25-80, 25-94, 25-95; paragraphs 815-30-35-3, 35-4, 35-7, 35-38 through 35-41; and 815-30-40-1 through 40-3) should be applied.

34.04 After applying the provisions of the Standard to the previous or current hedging relationship, the existing requirements in GAAP for assessing asset impairment or recognizing an increased obligation should be applied. When applying those existing requirements, the fair value or expected cash flows of the related derivative instruments as well as any amounts within AOCI related to the hedging relationship should not be considered.³

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³ Rule 4-10(c)(4) of Regulation S-X (ASC paragraph 932-10-S99-1) issued by the U.S. Securities and Exchange Commission provides that capitalized costs, net of accumulated depreciation and amortization, and deferred income taxes, should not exceed an amount (the cost center ceiling) equal to the sum of various components that include the present value of estimated future net revenues computed by applying current prices of oil and gas reserves (with consideration of price changes only to the extent provided by contractual arrangements) to estimated future production of proved oil and gas reserves as of the date of the latest balance sheet presented, less estimated future expenditures (based on current costs) to be incurred in developing and producing the proved reserves computed using a discount factor of ten percent and assuming continuation of existing economic conditions,” for purposes of applying the full cost method of accounting by oil and gas producing activities pursuant to the Federal securities laws and the Energy Policy and Conservation Act of 1975. SEC Staff Accounting Bulletin No. 103 (Topic 12:D.3b) (ASC paragraph 932-360-S99-2) indicates that the company must use the prices to be received after taking into

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34.05 Notwithstanding the requirements of paragraph 34 of the Standard (ASC paragraph 815-30-35-42), paragraph 31 of the Standard (ASC paragraphs 815-30-35-38 through 35-41) indicates that an entity should review any amount in AOCI related to the current or previous hedging relationship that represents a net loss. That is, if an entity expects at any time that continued reporting of a loss in AOCI would lead to recognizing a net loss on the combination of the hedging instrument and the hedged transaction (and related asset or liability) in one or more future periods, a loss should be reclassified immediately into earnings for the amount that is not expected to be recovered.

34.06 It should be noted that hedges of forecasted transactions not related to an existing asset or liability normally are not subject to impairment assessments until the assets are acquired or the liabilities have been incurred. This is because forecasted transactions or events occur, by definition, at the prevailing market price. However, paragraph 31 of the Standard (ASC paragraphs 815-30-35-38 through 35-41) may result in recognition of an impairment loss before the forecasted transaction occurs. See Paragraph 31.06 of this section for further discussion.

RECOGNITION OF IMPAIRMENT LOSS AND RECOGNITION OF RECOVERY

35.01 Paragraph 35 of the Standard (ASC paragraph 815-30-35-43) provides guidance on applying impairment testing when using cash flow hedge accounting:

35. If under existing requirements in generally accepted accounting principles an impairment loss is recognized on an asset or an additional obligation is recognized on a liability to which a hedged forecasted transaction relates any offsetting net gain related to that transaction in accumulated other comprehensive income shall be reclassified immediately into earnings. Similarly if a recovery is recognized on the asset or liability to which the forecasted transaction relates any offsetting net loss that has been accumulated in other comprehensive income shall be reclassified immediately into earnings.

35.02 In addition to the guidance in paragraph 34 of the Standard (ASC paragraph 815-30-35-42), paragraph 35 of the Standard (ASC paragraph 815-30-35-43) requires that:

- If an impairment loss or additional obligation is recognized on an existing asset or liability, any related offsetting net gain in AOCI is reclassified immediately into earnings; and
- If a recovery is recognized, any related offsetting net loss in AOCI should be reclassified immediately into earnings.

35.03 Reclassification of amounts in AOCI in these circumstances is necessary because the Board concluded that the recognition of an impairment (or a recovery) on an existing asset in one period with the reclassification of an existing offsetting net gain (or net loss) in a subsequent period from a derivative hedging instrument is not appropriate. The Board’s conclusion in this area is based on the principle that the net effect on earnings should be the same as if the

account the hedging arrangements (i.e., hedge-adjusted prices) in calculating the current price of the quantities of its future production of oil and gas reserves covered by the hedges as of the reported balance sheet date.

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derivative gain or loss were included in the basis of the asset or liability to which the hedged forecasted transaction relates.

35.04 As discussed in Paragraph 31.06 of this section, if it is expected that continued reporting of a loss in AOCI would lead to recognizing a net loss on the combination of the hedging instrument and hedged transaction (and related asset acquired or liability incurred) in one or more future periods, the loss must be reclassified immediately into earnings for the amount that is not expected to be recovered on the occurrence of the forecasted transaction. In addition, if an entity is hedging forecasted transactions related to an existing asset or liability (e.g., the variability in interest payments on existing variable-rate debt), or has hedged forecasted transactions related to an existing asset or liability or the forecasted acquisition or occurrence of an asset or liability that is now recognized (e.g., the variability in the forecasted purchase of inventory that is now a recognized asset), paragraph 35 of the Standard (ASC paragraph 815-30-35-43) requires the entity to consider the amounts in AOCI related to the current or previous hedging relationship if an impairment loss is recognized on the related existing asset or an additional obligation is recognized on the related existing liability.

35.05 If an impairment loss is recognized on an existing asset or an additional obligation is recognized on an existing liability to which a current or previous hedged forecasted transaction relates, any offsetting net gain related to that transaction in AOCI should be reclassified to earnings. However, before any offsetting net gain in AOCI is reclassified to earnings under paragraph 35 of the Standard (ASC paragraph 815-30-35-43), an entity must ascertain that the net gain directly relates to that asset or liability being measured for impairment and the measure for that impairment results from the risk being hedged. If an entity is required to recognize an impairment on an existing asset or an additional obligation on an existing liability to which a current or previous hedged forecasted transaction related, an entity must evaluate whether any net loss or portion of the net loss in AOCI related to that existing or previous cash flow hedging relationship must immediately be reclassified into earnings in accordance with paragraph 31 of the Standard (ASC paragraphs 815-30-35-38 through 35-41). In that circumstance, we believe it would be unlikely that a net loss could remain in AOCI after applying paragraph 31 of the Standard (ASC paragraphs 815-30-35-38 through 35-41).

APPENDIX A—CASH FLOW HEDGING: ASSESSING EFFECTIVENESS AND MEASURING INEFFECTIVENESS

A6.01 This appendix discusses the concepts behind assessing effectiveness and measuring ineffectiveness for a cash flow hedging relationship, as required by the Standard. This appendix explains the meaning of assessing effectiveness, distinguishes that concept from the Standard’s requirements to measure ineffectiveness, identifies how those concepts differ from amounts that are recorded in earnings each period, and identifies specific issues that entities need to consider when assessing effectiveness. The appendix should be considered in conjunction with the guidance related to effectiveness and ineffectiveness discussed in this section.

A6.02 The first section of this appendix (Paragraphs A6.05-A6.30) answers the following questions:

- What is meant by a highly effective hedging relationship?
- How often must an effectiveness assessment be performed?
• How does the designation of the hedged risk affect earnings?
• Is it possible to exclude some of the changes in cash flows of the derivative hedging instrument from the assessment of effectiveness and what is the resulting effect on earnings?
• How is the effectiveness assessment performed?
• How is the measurement of ineffectiveness performed?
• What other considerations are required?
• Is it possible to make an assumption of perfect effectiveness and, thus, no ineffectiveness?

A6.03 The second section of this appendix (Paragraphs A6.31-A6.121) discusses certain effectiveness matters specific to swaps, forward and futures contracts, and options. In addition, this section discusses the impact on the assessment of hedge effectiveness and the measurement of ineffectiveness of master netting agreements that cover derivative instruments included in cash flow hedging relationships.

A6.04 The last sections of this appendix (Paragraphs A6.122-A6.123 and Q&A) provide examples of detailed hedge documentation for two hedging strategies illustrating the complexities associated with the assessment of effectiveness and measurement of ineffectiveness as well as discussion of specific application matters.

Meaning of a Highly Effective Hedging Relationship

A6.05 Entities commonly think of a highly effective hedging relationship from an economic point of view, that is, whether the derivative provides the desired risk management effect. Often, that view is consistent with the Standard’s notion that high effectiveness is achieved when the changes in the cash flows of a derivative hedging instrument are highly effective at offsetting changes in the cash flows of the hedged forecasted transaction attributable to the hedged risk. Generally speaking, when applying the Standard’s cash flow approach, a hedge is considered highly effective when the derivative’s change in cash flows provides for offset in a range between 80% and 125% when compared with the change in the cash flows of the hedged forecasted transaction for the risk being hedged. The distinction between an effective economic hedge and a hedge that is permitted hedge accounting under the Standard is significant because hedge accounting is permitted only if the specific criterion of effectiveness and the Standard’s other eligibility criteria are met.

Periodic Effectiveness Assessment

A6.06 To qualify for cash flow hedge accounting, the Standard requires an entity to assess effectiveness in two different ways. The first is a prospective assessment that is forward looking. The second is a retrospective assessment that focuses on actual performance. Thus, we believe the following step-by-step methodology to assess hedge effectiveness should be used:

(1) At inception of the hedging relationship, entities should use regression or other statistical analysis of past changes in cash flows, based on historical data as well as other relevant information, to determine whether the relationship is expected to be
highly effective over future periods in achieving offsetting changes in cash flows (i.e., prospective assessments). Dollar-offset may also be used in this assessment based on historical data.

(2) During the hedging relationship, entities should periodically (at least quarterly):

(a) Assess whether the hedging relationship has been highly effective in achieving offsetting changes in cash flows through the date of the periodic assessment (i.e., retrospective assessment). The assessment can be based on regression or other statistical analysis of past changes in cash flows or may be based on other relevant information (e.g., dollar-offset may be used in this assessment based on historical data); and

(b) Determine whether the relationship is expected to continue to be highly effective over future periods in achieving offsetting changes in cash flows, based on regression or other statistical analysis of past changes in cash flows as well as other relevant information (i.e., prospective assessment). Again, dollar-offset may be used in this assessment, if that method was chosen in step 1 above. (This prospective assessment updates step 1).

The prospective assessment, both at inception and ongoing, justifies the expectation that the hedge will be highly effective, which is a requirement to qualify for hedge accounting. The retrospective assessment confirms that high effectiveness, in fact, has been achieved and, thus, cash flow hedge accounting for the period can be applied. (See DIG Issue E7 for further reference.)

A6.07 As noted above, the assessment of effectiveness should be performed at the inception of the hedging relationship and at least quarterly during the relationship. If the hedging relationship is shorter than three months (such as daily or weekly, which is not unusual when rebalancing a portfolio of hedged forecasted transactions as described in Paragraphs 32.13-32.14 of this section), the effectiveness assessment must be performed to match the hedge period. In other words, if the hedge period is daily, the effectiveness assessment must be performed daily and must be based on daily changes in cash flows of the derivative and portfolio of hedged forecasted transactions.

How the Designation of the Hedged Risk Affects Earnings

A6.08 In establishing a hedging relationship, entities may limit their hedging relationship to changes in the cash flows of the hedged item that are attributable to specific risks. For example, an entity may seek to hedge only decreases in the variable cash flows from an interest-earning asset. In that case, the entity would be required to identify a hedging instrument that will provide offset to the designated risk. When applying cash flow hedge accounting, an entity recognizes the derivative hedging instrument at its fair value, with gains and losses resulting from changes in its cash flows that are effective in offsetting changes in the cash flows of the hedged forecasted transaction attributable to the hedged risk included in OCI, with all other changes reflected in earnings. As a result of applying cash flow hedge accounting, the amounts included in earnings are affected by the characterization of the hedged risk because the hedging instrument selected by the entity may not have cash flows that respond in the exact opposite manner to the cash flows of the hedged forecasted transaction attributable to the hedged risk.
That difference results in reduced levels of assessed effectiveness, which may lead to increased amounts of measured ineffectiveness that are required to be recognized each period in earnings. This consequence is more pronounced when the hedged risk is very narrowly defined because it then becomes less likely that a derivative instrument will have cash flows that are similarly affected. As a result, how an entity defines the hedged risk has the potential to affect amounts reported in earnings in a cash flow hedging relationship. However, the changes in the derivative’s cash flows must still be highly effective at offsetting the changes in the cash flows of the hedged forecasted transaction for the risk being hedged.

**Gains and Losses in the Derivative Hedging Instrument Included in the Effectiveness Assessment**

**A6.09** Similar to the Standard’s flexibility about the designated hedged risk, the Standard provides that entities may exclude from the assessment of effectiveness some of the elements of the changes in the fair value (i.e., cash flows) of the derivative hedging instrument. Specifically, because the fair value of a derivative instrument usually has a component attributed to the time value of money, but some or all of that component may not be relevant to an entity’s risk management objective, the Standard permits entities to exclude all or part of the time value component of a hedging derivative’s fair value from that assessment. If an entity assesses hedge effectiveness by excluding all or some changes in the time value of the derivative hedging instrument, changes in the excluded component still would be included currently in earnings, together with any hedge ineffectiveness that results under the defined method of measuring hedge ineffectiveness. While this may cause earnings volatility, the flexibility to exclude certain gains or losses is important because it may be the only means an entity has available to establish an expectation of a highly effective hedging relationship and, thus, be able to apply hedge accounting. However, we would expect entities to assess effectiveness and measure ineffectiveness for most cash flow hedges by including all of the changes in cash flows of the derivative hedging instrument, if permitted, to minimize ineffectiveness as well as the volatility in earnings that otherwise results.

**A6.10** Paragraphs A6.11-A6.13 address when entities elect to include all gains and losses in the fair value of the derivative hedging measurement and when entities elect to exclude all or some of the changes related to the instrument’s time value, and the effect of those decisions on the assessment of effectiveness and the amount of measured ineffectiveness.

**INCLUSION OF GAINS AND LOSSES**

**A6.11** An entity may decide to include the entire change in the cash flows of the derivative hedging instrument in the assessment of hedge effectiveness. If so, determining whether the hedge has been and is expected to be highly effective in achieving offset implies that an entity compare the total change in cash flows of the hedging derivative with changes in the cash flows of the hedged forecasted transaction attributable to the hedged risk. If an entity includes all gains or losses on the derivative hedging instrument, it may experience reduced levels of effectiveness (and may experience increased levels of measured ineffectiveness) if the time value of money incorporated into the cash flows of the derivative does not correspond exactly to the changes in the cash flows of the hedged forecasted transaction attributable to the hedged risk. For example, if the expected timing of the hedged forecasted transaction does not match the timing of the cash flows of the derivative, the hedge may not be as effective as intended, leading to increased ineffectiveness.
flows associated with the hedging derivative, there will be a reduced level of assessed effectiveness, which may result in an increased level of measured ineffectiveness.

EXCLUSION OF GAINS AND LOSSES ATTRIBUTABLE TO CHANGES IN TIME
VALUE (THE INTRINSIC VALUE METHOD)

A6.12 When an entity elects to exclude the entire time value component of the fair value of the derivative hedging instrument from the assessment of effectiveness, paragraph 63 of the Standard (ASC paragraphs 815-20-25-81 through 25-83) provides the following guidance:

- When the derivative hedging instrument is an option and hedge effectiveness is based on changes in cash flows attributable to changes in the option’s intrinsic value, an entity may exclude the change in cash flows attributable to the time value of the option from the assessment of hedge effectiveness;
- When the derivative hedging instrument is an option and hedge effectiveness is based on changes in the option’s minimum value, that is, its intrinsic value after the effect of discounting, an entity may exclude the volatility value of the option from the assessment of hedge effectiveness; and
- When the derivative hedging instrument is a forward or futures contract and hedge effectiveness is based on changes in cash flows attributable to changes in spot prices, an entity may exclude the change in cash flows of the contract attributable to the difference between the spot price and the forward or futures price from the assessment of hedge effectiveness.

A6.13 In addition to excluding all changes in the time value from the assessment of hedge effectiveness, the Standard permits an entity to exclude certain aspects of the change in an option’s time value (i.e., changes in time value attributable to either the passage of time, volatility, or interest rates) from the assessment of hedge effectiveness when using the intrinsic value method. See Paragraphs A6.104-A6.105 for a discussion of this issue. Entities typically seek to exclude some or all of those components because including them would reduce assessed effectiveness in hedging relationships if the hedged forecasted transaction’s cash flows are not affected by (or not affected to the same extent as) the same component.

Common Techniques for Assessing Effectiveness

A6.14 Two common techniques for assessing hedge effectiveness are the dollar-offset method and regression analysis. The technique to be used to assess effectiveness on a prospective and retrospective basis must be documented at inception of the hedging relationship. Either technique can be used in the prospective or the retrospective hedge effectiveness assessment. In addition, it is permissible to use one technique for the prospective assessment and a different technique for the retrospective assessment. However, an entity is not permitted to document that it will use a

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4 As with footnote 1 to Paragraph 28b.02 of this section, when discussing the assessment of effectiveness in this appendix, the Standard permits entities to exclude certain elements of the total cash flows of the derivative hedging instrument from the effectiveness assessment because those excluded components may be irrelevant to an entity’s risk management objective. Accordingly, unless otherwise stated, when discussed in this appendix, the cash flows of the derivative hedging instrument are meant to include or exclude components of cash flows as designated by the entity.
variety of different techniques for the prospective analysis or a variety of different techniques for the retrospective analysis, depending on the circumstances. For example, while an entity may believe that the effectiveness of the hedging relationship may significantly change if there are unexpected movements in the cash flows of the hedged transactions or the hedging instrument, it cannot devise and document a variety of effectiveness tests whereby one technique would be performed in certain cases while another technique would be performed in other cases. Regardless of the approach documented and used for the prospective and retrospective assessments, the selected approach must be applied consistently throughout the hedging relationship.

A6.15 The dollar-offset method compares the dollar amount of the change in cash flows of the hedging instrument with the dollar amount of the changes in cash flows of the hedged forecasted transaction for the risk being hedged over the assessment period. This method is simple to apply, but may not achieve high effectiveness when the changes in the cash flows of the hedging instrument and the hedged forecasted transaction involve small dollar amounts but large percentages.

A6.16 When using the dollar-offset method periodically to assess whether a cash flow hedging relationship has been highly effective in the retrospective evaluations, an entity may use either a period-by-period approach or a cumulative approach for individual cash flow hedges. The period-by-period approach involves comparing the changes in the hedging instrument’s cash flows that have occurred during the period being assessed with the changes in the hedged forecasted transaction’s cash flows attributable to the hedged risk that have occurred during the same period. The period for this assessment can be as short as an entity chooses (and documents), but cannot exceed three months. The cumulative approach involves comparing the cumulative changes in the hedging instrument’s cash flows to the cumulative changes in the hedged transaction’s cash flows attributable to the hedged risk since inception of the hedging relationship. The selected approach should be determined and documented at hedge inception. The defined and documented approach must be applied consistently throughout the hedging relationship. Further, the selection of an approach should be consistent with the approach selected for similar hedging relationships. (See DIG Issue E8 for further reference.)

A6.17 We believe that most entities that choose dollar-offset for the retrospective assessment of effectiveness will elect the cumulative approach instead of the period-by-period approach. The cumulative approach provides more periods of data and may minimize the effects of a temporarily-reduced level of effectiveness in a hedging relationship.

A6.18 While regression analysis and other statistical analysis methods can be used for assessing effectiveness on a retrospective or prospective basis, or both, applying those methods to assess effectiveness is complex. Appropriate interpretation and an understanding of the statistical inferences of statistical methods are critical in applying those methods. In particular, depending on the facts and circumstances, regression needs to be applied to either the changes in the two variables over time or the variables themselves. When using statistical analysis methods, such as regression analysis, it is important to keep in mind that the objective of the assessment is to conclude that the hedging relationship has been or is expected to be highly effective or both (i.e., the change in the cash flows of the hedging instrument will be highly effective at offsetting changes in the cash flows of the hedged forecasted transaction attributable to the hedged risk). Thus, entities should analyze data that support that conclusion. Therefore, one would expect that
a regression analysis would evaluate the relationship between changes in the cash flows of the derivative and the hedged forecasted transaction instead of the cash flows themselves. A detailed discussion of regression analysis and other statistical methods for assessing hedge effectiveness is beyond the scope of the Handbook. Entities should ensure that they involve personnel with the requisite knowledge to apply the methods properly. These individuals may be internal or external specialists. If external specialists are used, we believe they should be independent parties (e.g., a party that is not a party to the derivative or other similar transactions with the entity). Additionally, auditors should refer to professional standards related to the use of specialists.

A6.18a In some circumstances, the variables to be regressed (e.g., the change in fair value of the hedging derivative and the change in fair value of the hypothetical perfect derivative) may be known at inception to always be identical (e.g., the terms of the actual hedging derivative and the hypothetical perfect derivative exactly match). In those circumstances (and only those circumstances), we believe that the entity need not perform the actual regression calculation, because when the corresponding values to be regressed are identical, the results of the regression are known with mathematical certainty without performing the full calculation. Instead, we believe that an entity may satisfy the requirement to initially assess effectiveness by documenting this fact and may continue to assess effectiveness in future periods in this manner if the facts and circumstances have not changed. The entity should also document how the regression would be performed and assessed over the course of the hedging relationship if circumstances do change and the values to be regressed are no longer identical.

A6.19 The SEC staff indicated that while the use of regression analysis is not problematic for assessing effectiveness, the statistical validity of that analysis must be adequately considered. That is, the entity must consider all the relevant outputs from a regression analysis used to determine whether the hedging relationship has been and is expected to be highly effective. While the assessment of whether a hedging relationship has been and is expected to be highly effective will be determined based on the facts and circumstances of that specific relationship, the SEC staff believes that, at a minimum, certain regression outputs such as the coefficient of determination (R-squared), the slope coefficient, and the t or F-statistic should be considered. Additionally, depending on the specifics of the hedging strategy, other regression outputs may need to be considered. The SEC staff indicated that it expects entities that use statistical techniques to assess hedge effectiveness to understand how to use and appropriately evaluate those techniques, which may necessitate the use of specialists.

A6.20 We observe that entities typically choose to use regression analysis in their retrospective and prospective assessments of effectiveness. While it is more difficult to apply regression analysis and more difficult to understand the related results, that method provides a significant benefit because regression analysis allows an entity to use historical data for periods before the inception of the hedge for both the initial and ongoing effectiveness assessments. In contrast, in applying the dollar-offset method for the ongoing retrospective effectiveness assessment, only data from the hedge period are considered. For example, assume an entity is retrospectively assessing hedge effectiveness at the first reporting period after inception of a cash flow hedge (i.e., one quarter after inception) and the changes in the cash flows of the hedging instrument did not effectively offset the changes in the cash flows of the hedged forecasted transaction as anticipated. If the entity initially chose to use a dollar-offset method in its retrospective assessment, the entity would be required to conclude that the designated hedging relationship
does not qualify for hedge accounting for the period just ended. However, if the entity initially chose to use a statistical analysis based on a trailing-12 month average, which at the end of the first quarter after hedge inception, includes three months of the hedge period and nine months before the hedge period, it may be able to conclude that the designated hedging relationship qualifies for hedge accounting for the period just ended because the results of the earlier nine months may negate the unfavorable hedge results of the most recent three months. That result is neither uncommon nor inappropriate, but serves to highlight that, even with the same derivative hedging instrument, hedged item, and hedging strategy, the Standard’s provisions that provide for flexibility in assessing effectiveness are important. In one instance hedge accounting would be precluded for the period just ended, and in the other it may not be precluded.

Methodology for Measuring Ineffectiveness

A6.21 Measuring ineffectiveness is the computation of the degree to which the cumulative changes in the cash flows of the derivative hedging instrument (limited to those elements of cash flows included in the assessment of effectiveness) exceed the cumulative changes in the cash flows of the hedged forecasted transaction that are attributable to the risk being hedged. In measuring ineffectiveness, entities must employ a technique to ascribe changes in cash flows to the hedged forecasted transaction. Methodologies that enable entities to develop estimates of the cash flows of the hedged forecasted transaction limited to the hedged risk were discussed, in general, in Paragraph 30.07 of this section and are discussed, in more detail, in this appendix. Refer to the paragraphs that follow related to hedging relationships involving swaps (Paragraphs A6.33-A6.70), forward and futures contracts (Paragraphs A6.71-A6.77), and options (Paragraphs A6.78-A6.111) for a discussion of these methodologies. The Standard requires that the approach to measuring hedge ineffectiveness for a particular hedging relationship be consistent with the entity’s risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship. In other words, if the assessment of effectiveness excludes all of the time value components of a derivative, the measurement of ineffectiveness also should exclude those components.

Other Considerations

EXTENT OF PERIOD USED IN ASSESSING HEDGE EFFECTIVENESS

A6.22 Regardless of the technique used to assess hedge effectiveness to support that an effective hedging relationship is expected, we believe entities should document the historical relationship between changes in the cash flows of both the hedged item and the derivative hedging instrument over an appropriate period. The appropriate period is subject to judgment. However, entities should consider that the objective of the prospective effectiveness assessment is to conclude that the hedging relationship is expected to be highly effective. For example, if an entity is considering a two-year potential foreign currency hedging relationship dealing with U.S. dollars and euros, we would expect that the entity would not limit its prospective assessment of effectiveness to changes in the U.S. dollar/euro exchange rate for the last month. These changes for the last month may not be indicative of the potential changes in the exchange rate that are reasonably expected to occur over the next two years. If an entity elects at the inception of a hedging relationship to use the same regression analysis approach for both prospective and
retrospective assessments of effectiveness, those regression analysis calculations generally should incorporate the same number of data points during the term of that hedging relationship.

**CONSIDERATION OF COUNTERPARTY CREDIT RISK AND THE ENTITY’S OWN NONPERFORMANCE RISK**

A6.23 The cash flows of a derivative may be affected by the creditworthiness of the counterparty to the contract and the entity's own nonperformance risk (which includes credit risk). That effect stems from the performance requirements of the contract. Refer to Section 4 for additional discussion of the impact of FASB Statement No. 157, Fair Value Measurements (Statement 157) (ASC Subtopic 820-10) on the valuation of derivative instruments. In hedging relationships that involve derivative instruments that are acquired on a regulated exchange, an entity is subject to the credit risk of the exchange, not of the counterparty.

A6.23a As cash flow hedging focuses on offsetting the changes in the cash flows of the hedging derivative and hedged forecasted transaction for the risk being hedged, one of the items an entity must analyze and monitor is whether the counterparty to the derivative will default by failing to make contractually required payments to the entity as scheduled in the derivative instrument. In making that assessment, the entity should also consider the effect of any related collateralization and financial guarantees. Concluding that the counterparty will not default is integral for an entity to determine that the hedging relationship will be highly effective in achieving offsetting changes in the cash flows for the risk being hedged. This general concept is further clarified in the guidance in various DIG Issues, including DIG Issue G10. This Issue states that for cash flow hedges, an entity must consider the likelihood of the counterparty’s compliance with the terms of the derivative, and analyze the impact of counterparty credit risk on the assessment of effectiveness. It further states that although a change in the counterparty’s creditworthiness would not necessarily indicate that it would default on its obligation, this change would warrant additional evaluation. Also, if the likelihood that the counterparty will not default ceases to be probable, an entity would be unable to conclude that the cash flow hedging relationship is expected to be highly effective in achieving offsetting cash flows. (In contrast, changes in credit risk of the counterparty or an entity's own nonperformance risk have a direct and immediate effect on whether the derivative instrument’s gain or loss in a fair value hedging relationship will effectively offset the gain or loss of the hedged item.)

A6.23b Based on the general concept of cash flow hedges under Statement 133, as clarified by guidance in DIG Issue G10, as long as the likelihood of the counterparty not defaulting is assessed as probable, changes in counterparty credit risk would not impact the assessment of effectiveness. Therefore, if there is a change in counterparty credit risk but it is still probable that the counterparty will not default, the change in counterparty credit risk would not cause the contractual cash flows related to the derivative instrument to change. In addition, an entity may ignore the impact of: (1) an entity’s own nonperformance risk in the assessment of effectiveness and (2) counterparty credit risk and an entity’s own nonperformance risk in the measurement of ineffectiveness, if the likelihood of the counterparty or the entity not defaulting is assessed as probable.

A6.23c Therefore, changes in counterparty credit risk and an entity’s own nonperformance risk would not have an impact on the assessment of effectiveness or measurement of ineffectiveness for cash flow hedges, as long as it is still probable that the derivative counterparty or the entity
will not default. Assuming there are no other sources of ineffectiveness, the total changes in the
fair value of the derivative instrument (including changes in counterparty credit risk and an
entity’s own nonperformance risk) would be included in accumulated other comprehensive
income (AOCI). However, if the likelihood of the counterparty or the entity not defaulting is
assessed as no longer probable, the entity must measure the amount of ineffectiveness to be
recorded currently in earnings and assess whether the hedging relationship has been and is
expected to continue to be highly effective. DIG Issue G10 presumes that the high effectiveness
criterion would not be met under those circumstances. We expect that it would be rare for there
to be sufficiently strong evidence to overcome that presumption.

A.6.23d The likelihood of counterparty default should also be considered in a cash flow hedge
for which the derivative hedging instrument is currently in a liability position, but has the
potential to become an asset in the future. That is, the possibility that a change in the underlying
could cause the derivative to move into an asset position before settlement or maturity cannot be
ignored, and may render the hedging relationship not highly effective on a prospective basis.

A6.23e In addition, the creditworthiness of the counterparty to the hedged forecasted transaction
must be assessed to determine whether the forecasted transaction is probable, as required by
paragraph 29(b) of the Standard (ASC paragraph 815-20-25-15(b)), particularly if the hedged
transaction involves payments under a contractual obligation of the counterparty. Accordingly, at
a minimum, an entity must assess the creditworthiness of the counterparty to the derivative
hedging instrument and the entity's own nonperformance risk as part of its original and ongoing
assessment of hedge effectiveness, consider the creditworthiness of the counterparty to the
derivative hedging instrument and the entity's own nonperformance risk in the measurement of
ineffectiveness, and assess the creditworthiness of the counterparty to the hedged forecasted
transaction. (See DIG Issue G10, Paragraph 28b.05, and Paragraph 17.07 of Section 4 for
additional guidance).

DOCUMENTATION REQUIREMENTS

A6.24 The Standard requires that entities document their assessment of hedge effectiveness at
inception of a hedging relationship and on an ongoing basis. That is, entities must provide
documentation supporting why and how they expect changes in the cash flows of the derivative
hedging instrument to offset changes in the cash flows of the hedged item attributable to the
hedged risk. In addition, in periodic assessments, an entity must document how the derivative is
expected to be and has been highly effective in offsetting changes in cash flows.

CONSIDERATION WHEN HEDGED FORECASTED TRANSACTION EXPOSURE IS
LIMITED BUT HEDGING DERIVATIVE'S EXPOSURE IS NOT

A6.25 An entity may designate a derivative hedging instrument in a cash flow hedging
relationship that does not have a limited exposure comparable to the limited exposure of the
hedged forecasted transaction if the hedging relationship is expected to be highly effective in
achieving offsetting cash flows attributable to the hedged risk during the period the hedge is
designated. That relationship may meet the Standard’s requirement of high effectiveness because
even though the assessment must consider all the possible changes in cash flows of the derivative
and forecasted transaction (and those possible changes are not limited to the likely or expected
changes in cash flows of the hedging instrument for the period being assessed), those changes in
cash flows should be probability-weighted. That is, the process of formulating an expectation about the effectiveness of a proposed hedging relationship involves a probability-weighted analysis of the possible changes in cash flows of the derivative for the hedge period. Therefore, a probable change in cash flows will be more heavily weighted than a reasonably possible change. That calculation technique is consistent with the definition of expected cash flow in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements. (See DIG Issue E11 for further reference.)

A6.26 To illustrate, assume Company A issues 10-year, floating-rate debt that reprices based on six-month LIBOR. The interest rate on the debt is capped at 9%. Company A decides to convert the interest payments on the debt from floating-rate to fixed-rate by entering into a receive-floating, pay-fixed interest rate swap. There is no cap on the floating rate leg of the interest rate swap. From Company A’s perspective, if interest rates decrease, there will be a cumulative reduction in the expected future cash outflows on the debt and a cumulative reduction in the expected future cash inflows on the swap. If interest rates increase, there will be a cumulative increase in the expected future cash outflows on the debt and a cumulative increase in the expected future cash inflows on the swap; however, if interest rates increase and the floating rate on the swap is greater than 9%, the cumulative increase in the expected future cash inflows on the swap will exceed the cumulative increase in the expected future cash outflows on the debt because of the interest rate cap on the debt. Before designating the interest rate swap as the hedging instrument of the changes in cash flows of the debt due to changes in the benchmark interest rate (i.e., six-month LIBOR), Company A must decide whether the changes in cash flows of the interest rate swap would be expected to be highly effective, during the period that the hedge is designated, in offsetting changes in cash flows of the debt attributable to interest rate risk taking into account the effect of the interest rate cap. If the interest rate cap is expected to be out-of-the-money based on a probability-weighted analysis of the range of possible changes in interest rates, then the cap may be expected to have minimal effect on changes in cash flows of the debt, and the hedging relationship could meet the requirement for an expectation of high effectiveness at inception of the hedging relationship.

A6.27 However, it would be inappropriate for an entity to designate a derivative as the hedging instrument when the entity expects that the derivative will not be highly effective in achieving offsetting changes in cash flows attributable to the hedged risk during the period that the hedge is designated in a cash flow hedging relationship unless the entity documented that it uses a dynamic hedging strategy in which it is committed to an ongoing repositioning strategy for its hedging relationship. See Paragraph A6.77 of this appendix for an example of that strategy.

CONSIDERATION WHEN THE HEDGED FORECASTED TRANSACTION PERIOD IS DIFFERENT FROM THE HEDGING DERIVATIVE’S TERM

A6.28 Paragraph 28(b) of the Standard (ASC paragraphs 815-20-25-75, 25-76, and 25-80) requires that the hedging relationship be expected to be highly effective in achieving offsetting cash flows that are attributable to the hedged risk during the term of the hedging relationship. There is no requirement in the Standard that in a cash flow hedging relationship the derivative must expire or terminate on the same date that the forecasted transaction is expected to occur or that the cash inflows (outflows) from the derivative must occur at the same time as the cash outflows (inflows) from the forecasted transaction. As a result, in a cash flow hedging
relationship an entity is not precluded from using a derivative with a shorter or longer term than the term of the hedged forecasted transaction. However, whenever the timing of the derivative differs from the timing of the forecasted transaction but the hedging relationship is still expected to be highly effective, one or more of the following may apply:

- The hedging relationship results in ineffectiveness because the entity includes the entire change in the cash flows of the derivative hedging instrument in assessing effectiveness and measuring ineffectiveness (see Paragraph A6.11 for additional information).
- The entity assesses effectiveness and measures ineffectiveness by excluding some elements of the changes in cash flows of the derivative hedging instrument (e.g., the time value) and recognizes the changes in those excluded elements currently in earnings (see Paragraphs A6.12 - A6.13 for additional information).
- The entity enters into a hedging strategy for which the derivative instrument will be rebalanced by terminating the preexisting hedging relationship and entering a new hedging relationship (assuming that the forecasted transaction continues to be probable to occur as originally documented) so that the existing hedging relationship is highly effective.
- The entity enters into a hedging strategy for which the notional amount of the derivative instrument is different from the notional amount of the hedged forecasted transaction but the changes in cash flows of the derivative instrument offset the changes in cash flows of the forecasted transaction so that the relationship is expected to be highly effective throughout the term of the hedge.

A6.28a Some forecasted transactions give rise to a receivable or payable (e.g., a forecasted sale of widgets expected to occur on September 30, 20X1 that will give rise to an accounts receivable that will settle on October 31, 20X1). In that situation, the occurrence of the sale (the identified forecasted transaction) and its cash settlement are deemed to occur on September 30, 20X1. Thus, a derivative instrument that hedges the forecasted sale of the widgets and expires on September 30, 20X1 has the same cash settlement date as the forecasted sale transaction. In other words, on September 30, 20X1, there is, in effect, a cash inflow from the sale of the widgets and a simultaneous cash outflow for the financing of the sale. The financing of the sale is a different transaction from the forecasted sale transaction and thus the timing of the settlement of the financing does not result in ineffectiveness for the hedging relationship.

A6.28b If the derivative has a longer term than the term of the forecasted transaction, the hedging relationship’s term can only be to the date the forecasted transaction is expected to occur. Thus, it is the changes in cash flows of the forecasted transaction during the term of the hedging relationship that are being hedged. However, because the derivative’s cash flows occur later, the relationship may result in ineffectiveness depending on whether the entity excludes some of the elements of the change in cash flows of the derivative hedging instrument (e.g., time value) when assessing effectiveness and measuring ineffectiveness. For example, assume a forecasted sale of widgets is expected to occur and settle in cash on September 30, 20X1 while the derivative hedging instrument will settle on October 31, 20X1. All other features of the derivative and the forecasted sale would not be a source of ineffectiveness (same underlying, same quantity, forward contract has a fair value of $0 at inception, etc.). If an entity has included...
the entire change in cash flows of the derivative in its assessment and then assesses effectiveness and measures ineffectiveness using the forward rate, ineffectiveness will result because the change in cash flows of the forecasted sale will be determined based on changes in the September 30, 20X1 forward price for widgets while the change in cash flows of the derivative instrument will be based on the October 31, 20X1 forward price for widgets. Even if those forward prices were the same, ineffectiveness would result from computing the present value of the implied settlement of the change in the forward price over different periods for the derivative (through October 31, 20X1) and the hedged forecasted transaction (through September 30, 20X1). In some instances, an entity may choose to assess effectiveness and measure ineffectiveness by excluding some elements of the changes in cash flows of the derivative hedging instrument (e.g., the time value) and recognizing the changes in those excluded elements currently in earnings (see Paragraphs A6.12 - A6.13 for additional information). In the example above, the entity included the entire change in cash flows of the forward contract in its assessment. However, it could have elected to assess hedge effectiveness and measure ineffectiveness based on changes in spot prices. Under this approach, the entity would exclude from its assessment of effectiveness and measurement of ineffectiveness any changes in the fair value of the forward contract that are attributable to changes in the difference between the spot price and the forward price (the spot-forward difference). Accordingly, that portion of the change in fair value of the forward contract that has been excluded will be recognized in earnings, but not considered to be ineffectiveness. Whether hedge ineffectiveness results from the different periods for the derivative (through October 31, 20X1) and the hedged forecasted transaction (through September 30, 20X1), depends on whether the approach taken by an entity includes discounting of the spot price (see Paragraphs 28b.05 and 28b.05a) for additional discussion of changes in cash flows and the different approaches that may be taken by entities when excluding the spot-forward difference.

A6.28c Similarly, if the derivative has a shorter term than the term of the forecasted transaction, the hedging relationship’s term can be only to the maturity date of the derivative. Thus, changes in the cash flows of the forecasted transaction are being hedged through the maturity date of the derivative. Because the derivative’s cash flows occur earlier, the relationship may result in ineffectiveness. As discussed above, this ineffectiveness manifests itself differently depending on whether the entity excludes some of the elements of the change in cash flows of the derivative hedging instrument (e.g., time value) when assessing effectiveness and measuring ineffectiveness. For example, assume the forecasted sale of widgets is expected to occur and settle in cash on December 31, 20X1 while the derivative hedging instrument will settle on November 30, 20X1. All other features of the derivative and the forecasted sale would not be a source of ineffectiveness (same underlying, same quantity, forward contract has a fair value of $0 at inception, etc.). If an entity has included the entire change in cash flows of the derivative in its assessment, ineffectiveness will result (both when assessing effectiveness and measuring ineffectiveness) because the change in cash flows of the forecasted sale will be determined based on changes in the December 31, 20X1 forward price for widgets (the risk being hedged must be identified as changes in cash flows over the entire forecasted transaction period notwithstanding that the hedging relationship ends at an earlier date when the derivative expires) while the change in cash flows of the derivative instrument will be based on the November 30, 20X1 forward price for widgets. Even if those forward prices were the same, ineffectiveness would result from computing the present value of the implied settlement of the change in the forward
price over different periods for the derivative (through November 30, 20X1) and the hedged forecasted transaction (through December 31, 20X1) (i.e., the time value of money). As noted in the previous paragraph, an entity may choose to assess effectiveness and measure ineffectiveness by excluding some elements of the changes in cash flows of the derivative hedging instrument (e.g., the time value) and recognize the changes in those excluded elements currently in earnings (see Paragraphs A6.12 - A6.13 for additional information). In the example in this paragraph, the entity included the entire change in cash flows of the forward contract in its assessment. However, it could have elected to assess effectiveness and measure ineffectiveness based on changes in spot prices. Under this approach, the entity would exclude from its assessment of effectiveness and measurement of ineffectiveness any changes in the fair value of the forward contract that are attributable to changes in the spot-forward difference. Accordingly, that portion of the change in fair value of the forward contract that has been excluded will be recognized in earnings, but not considered to be ineffectiveness. Whether hedge ineffectiveness results from the different periods for the derivative (through November 30, 20X1) and the hedged forecasted transaction (through December 31, 20X1), depends on whether the approach an entity takes includes discounting of the spot price (see Paragraphs 28b.05 and 28b.05a for additional discussion of changes in cash flows and the different approaches that an entity may take when excluding the spot-forward difference.

A6.29 Often, entities attempt to enter into a cash flow hedging relationship related to several forecasted transactions that occur over a period of time, rather than on a single date. If the cash flows of the derivative instrument do not occur at the same time as each of those forecasted transactions, the entity is not precluded from applying cash flow hedge accounting to the relationship. However, the entity must be able to assert that the hedging relationship is expected to be highly effective at achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. For example, assume that on January 1, 20X1 Company A believes that it will purchase 100 units of a commodity on March 31, 20X1, 50 units of that commodity on June 30, 20X1, and 50 units of that commodity on September 30, 20X1. Also assume that on January 1, 20X1 Company A wishes to minimize the price fluctuations of those purchases by entering into a single derivative contract. If the entity wishes to apply cash flow hedge accounting to the relationship, the hedging relationship must be expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. That is, if the derivative does not provide cash flows on March 31, 20X1, June 30, 20X1 and September 30, 20X1 equivalent to the price fluctuations of the actual purchases on those dates (i.e., 100 units, 50 units, and 50 units, respectively), the entity should review the guidance in the previous paragraph to determine whether cash flow hedge accounting is appropriate based on the derivative’s contractual settlement and the expected cash flows of the hedged forecasted transaction.

An Assumption of No Ineffectiveness

A6.30 After considering the requirements of the above sections, an entity’s assessment of effectiveness and measurement of ineffectiveness may be significantly simplified under certain circumstances. If the criteria for the shortcut method are met when the hedging instrument is an interest rate swap or the critical terms of the derivative hedging instrument and the hedged forecasted transaction match when the hedging instrument is a forward contract; a futures contract; a purchased option; or a receive-fixed, pay-fixed cross currency interest rate swap, an
entity’s assessment of effectiveness and measurement of ineffectiveness in a cash flow hedge may be simplified as follows:

- If a hedging relationship of the benchmark interest rate risk that involves an interest rate swap and a recognized interest-bearing asset or liability (or a firm commitment as discussed in Paragraph A6.36) meets the conditions in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71), an entity may assume no ineffectiveness. This approach is referred to as the shortcut method. Under the shortcut method, initial and ongoing effectiveness assessments are not necessary, and there is no measurement of ineffectiveness. However, an entity must consider the credit risk of the counterparty to the derivative and the entity's own nonperformance risk due to the contractual obligations to make either fixed or variable-rate payments.

If a hedging relationship involves a derivative hedging instrument other than an interest rate swap or a hedged item other than a recognized interest-bearing financial asset or liability (or a firm commitment as discussed in Paragraph A6.36) or the risk is other than, or in addition to, the benchmark interest rate risk, the relationship is not eligible for the shortcut method. However, if the critical terms of the derivative hedging instrument (e.g., forward or futures contract; purchased option; or a receive-fixed, pay-fixed cross currency interest rate swap) and the hedged forecasted transaction match, an entity may conclude that changes in cash flows of the hedged forecasted transaction attributable to the risk being hedged are expected to be completely offset by the changes in cash flows of the hedging derivative, except for amounts excluded from the assessment of effectiveness and measurement of ineffectiveness, as further discussed in this appendix. An initial effectiveness assessment must be performed and documented. The extent of that assessment is based on judgment and would vary depending on the complexity of the derivative and forecasted transaction. Subsequent assessments can be performed by verifying and documenting whether the critical terms of the hedging instrument and the hedged forecasted transaction changed during the period under review and whether there have been adverse developments related to counterparty credit risk or the entity’s own nonperformance risk related to the derivative hedging instrument that could affect the assessment of effectiveness and the assumption of no ineffectiveness. If the entity concludes that there have been no changes in critical terms (including the creditworthiness of the counterparty to the derivative and the entity’s own nonperformance risk), the entity can document and conclude that the hedging relationship has been perfectly effective and that there is no ineffectiveness to measure. (See DIG Issue G9 for further reference).

A6.31 Guidance for assessing effectiveness and measuring ineffectiveness developed for specific hedging relationships. Because entities commonly consider the Standard’s requirement to assess hedge effectiveness and measure ineffectiveness in the context of the type of derivative hedging instrument that is being used, this section of the appendix is organized by type of derivative instrument.

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5 If all of the required conditions to apply the simplified hedge accounting approach are met, a private company may assume that there is no ineffectiveness in a cash flow hedging relationship involving a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap. The simplified hedge accounting approach and the conditions that need to be met to qualify for the approach are discussed beginning at Paragraph A6.70a.
A6.32 Specifically, this section of the appendix addresses:

- Swaps
- Forwards / Futures
- Options

In addition, this section discusses the impact on the assessment of hedge effectiveness and the measurement of ineffectiveness of master netting agreements that cover derivative instruments included in cash flow hedging relationships.

Swaps

A6.33 There are several types of swaps currently offered in the marketplace and new types of swaps are constantly being created. The basic types of swaps are interest rate swaps, currency swaps, commodity swaps, equity swaps, and cross-currency swaps. The most widely used swap is the interest rate swap. For that reason, the Standard provides more specific hedge effectiveness guidance for interest rate swaps than for any other type of hedging instrument.

Interest Rate Swaps

A6.34 An interest rate swap is a contractual agreement between two parties to exchange one type of interest-rate-based cash flows for another type of interest-rate-based cash flows on specified dates in the future. One type of interest rate swap that is typically used in a cash flow hedging relationship is a fixed-for-floating interest rate swap. This type of swap involves the exchange of fixed-rate cash flows for floating interest rate cash flows that change with a specific reference or index (e.g., six-month LIBOR, commercial paper, and Prime). The fixed rate of the swap is typically set for the entire term of the swap, whereas the floating rate is reset on specified reset dates. The frequency with which the floating rate is reset usually is at the discretion of the two parties. To determine the net settlements of a fixed-for-floating interest rate swap, the applicable fixed rate and floating rate as of the reset date are multiplied by the notional amount in effect at that date. The computed swap payments (i.e., the computed difference) are then paid to or received from the counterparty, as applicable, on designated settlement dates.

A6.35 A cash flow hedging relationship that involves an interest rate swap as the hedging instrument may be assessed for hedge effectiveness and ineffectiveness may be measured in different ways depending on the type of hedged forecasted transaction and the designated hedged risk. The following methods are used to assess hedge effectiveness and measure ineffectiveness for hedging relationships that involve an interest rate swap:

- If a cash flow hedging relationship of the benchmark interest rate risk that involves a recognized interest-bearing financial asset or liability (or a firm commitment as discussed in Paragraph A6.36) and an interest rate swap meets the conditions in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) (as discussed in Paragraph A6.36-A6.57 below), an entity may assume no ineffectiveness (referred to as the shortcut method). As a result, the entity need not perform a detailed assessment of effectiveness at either inception or on an ongoing basis. In addition, there is no ineffectiveness to measure. Thus, the change in the fair value of the interest rate swap is used as a proxy to measure the
change in the cash flows of the hedged forecasted transactions with no effect on net income. However, in applying the shortcut method for hedges of interest rate risk with interest rate swaps, an entity must consider the credit risk of the counterparty to the derivative and the entity's own nonperformance risk due to the contractual obligations to make either fixed or variable-rate payments.

- If a cash flow hedging relationship involves an interest rate swap and a recognized interest-bearing financial asset or liability (or a firm commitment as discussed in Paragraph A6.36) and the provisions of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) are not met, or an interest rate swap and an interest-bearing financial asset or liability to be acquired or incurred (except for a firm commitment as discussed in Paragraph A6.36), an entity may assess effectiveness and measure ineffectiveness by applying one of the following methods:
  - The change in variable cash flows method;
  - The hypothetical derivative method; and
  - The change in fair value method.

(See the discussion of these methods in Paragraphs A6.58-A6.70 of this appendix.)

However, if the hedging relationship does not qualify for the shortcut method or any of these three methods, an entity is required to assess effectiveness and measure ineffectiveness by estimating the changes in the cash flows of the hedged forecasted transaction that are attributable to the hedged risk by using a variety of techniques that have emerged in practice6. See Paragraphs A6.112-A6.121 of this appendix for a discussion of those techniques. We believe the critical-terms-match approach discussed in Paragraph A6.73 of this appendix cannot be applied in relationships involving interest rate swaps. The shortcut method is specifically intended for interest rate swaps, and the criteria under the shortcut method should be evaluated to determine whether interest rate swaps are potentially eligible for that method. As discussed beginning at Paragraph A.6.77c, we believe the critical-terms-match approach may be applied in relationships involving receive-fixed, pay-fixed cross currency interest rate swaps.

**SHORTCUT METHOD**

**A6.36** If a cash flow hedging relationship of the benchmark interest rate risk that involves a recognized interest-bearing financial asset or liability (or a firm commitment arising on the trade date to purchase or issue an interest-bearing asset or liability), and an interest rate swap meets the conditions in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71), an entity may assume no ineffectiveness. In the case of a firm commitment, the shortcut method can be applied to the hedging relationship only if the trade date of the interest-bearing financial asset or liability differs from its settlement date due to generally established conventions in the marketplace in which the transaction is executed. In the context of

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6 If all of the required conditions to apply the simplified hedge accounting approach are met, a private company may assume that there is no ineffectiveness in a cash flow hedging relationship involving a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap. The simplified hedge accounting approach and the conditions that need to be met to qualify for the approach are discussed beginning at Paragraph A6.70a.

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a variable rate financial asset or liability, the difference between the trade date and the settlement date is a firm commitment that exposes the entity to variability in cash flows. Unless otherwise stated, subsequent references in this appendix (related to the criteria for the shortcut method) to a recognized interest-bearing financial asset or liability includes a firm commitment as discussed above. We believe that an entity’s documentation at inception of the hedging relationship should identify how those criteria are met.

A6.36a Paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) previously stated that the shortcut method could be applied only to a hedging relationship that involved a recognized interest-bearing asset or liability as the hedged item. However, an implementation issue arose as it is common for entities to designate a hedging relationship on the trade date of both the swap and the hedged item, even though the hedged item is not recognized until its settlement date (for example, when hedging a debt obligation). In these situations, there was concern that the shortcut method could not be applied, as the hedged item would not be a recognized financial asset or liability upon the designation of the hedge. DIG Issue E23 addressed the inconsistency between this practice and paragraph 68 (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) by revising the guidance to clarify that these types of relationships would qualify for the shortcut method, assuming that the length of time between the trade date and the settlement date of the hedged item is within generally established conventions in the marketplace in which the transaction is executed. Entities will have to apply judgment when determining if the trade date and settlement date of the hedged item differ due to established market conventions and would need to consider the facts and circumstances of the specific transaction and the market in which the transaction is being executed in order to make this determination. In certain markets, where transactions may be executed on a less frequent basis, it may be more difficult to determine if the length of time between the trade date and settlement date is within established conventions for that marketplace.

A6.36b Consider an example in which an entity enters into a hedging relationship to hedge the risk of changes in cash flows due to changes in the benchmark interest rate related to variable rate debt issued on the trade date that will settle five days later. The interest rate swap in the hedging relationship is entered into on the trade date of the debt at a zero fair value. All changes in the fair value of the swap would be included in AOCI. On the settlement date, the debt instrument would be recognized and the entity would continue accounting for the relationship under the shortcut method going forward. (See DIG Issue E23 for further reference.)

A6.37 The shortcut method may be applied only to a hedging relationship that involves a recognized interest-bearing asset or liability and an interest rate swap. That specific asset or liability must be identified and documented at inception of the hedging relationship. As a result, an entity is not permitted to substitute, replace, or change the recognized interest-bearing asset or liability during the hedging relationship and therefore would be prohibited from using the shortcut method to hedge forecasted fixed interest rate debt issuances, such as short-term debt rollovers (which would not include a firm commitment as discussed in Paragraph A6.36).

A6.38 The criteria of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) that are applicable to cash flow hedges are:
a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged.

b. If the hedging instrument is solely an interest rate swap, the fair value of that swap at the inception of the hedging relationship must be zero, with one exception. The fair value of the swap may be other than zero at the inception of the hedging relationship only if the swap was entered into at the relationship's inception, the transaction price of the swap was zero in the entity's principal market (or most advantageous market), and the difference between transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction. If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in paragraph 68(d), the premium for the mirror-image call or put option must be paid or received in the same manner as the premium on the call or put option embedded in the hedged item. That is, the reporting entity must determine whether the implicit premium for the purchased call or written put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium) or is being paid over the life of the hedged item (through an adjustment of the interest rate). If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition, the fair value of the hedging instrument at the inception of the hedging relationship must be equal to the fair value of the mirror-image call or put option. In contrast, if the implicit premium for the call or put option embedded in the hedged item is principally being paid over the life of the hedged item, fair value of the hedging instrument at the inception of the hedging relationship must be zero (except as discussed previously regarding differing prices due to the existence of a bid-ask spread).

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 indicated in the following sentences. 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 instrument is a compound derivative composed of an interest rate swap and a mirror-image call option. The call option is considered a mirror image of the call option embedded in the hedged item if (1) 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 (2) the entity is the writer of one call option and the holder (or purchaser) of the other call option. Similarly, 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 instrument is a compound derivative composed of an interest rate swap and a mirror-image put option.

dd. The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.*
e. 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.

Conditions applicable to cash flow hedges only

i. 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.

j. 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 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. (For this purpose, comparable does not necessarily mean equal. For example, if a swap’s variable rate is LIBOR and an asset’s variable rate is LIBOR plus 2%, a 10% cap on the swap would be comparable to a 12% cap on the asset.)

k. The repricing dates match those of the variable-rate asset or liability.

A6.39 As previously indicated, the shortcut method can be applied only to hedging relationships of benchmark interest rate risk that involve a recognized interest-bearing asset or liability and an interest rate swap. Accordingly, the shortcut method may not be applied to a cash flow hedge of the variability in lease payments for an interest-rate-indexed operating lease because that lease is not a recognized interest-bearing asset or liability. (See DIG Issue G12 for further reference.) Similarly, the shortcut method may not be applied to a cash flow hedge of the variability in interest payments on the forecasted issuance of fixed rate debt because the debt is not a recognized interest-bearing liability at the inception of the hedge (unless it meets the conditions set forth in Paragraph A6.36 related to a firm commitment). If any other derivative is used in the hedging relationship, including a forward starting interest rate swap, or the entity is hedging a risk other than, or in addition to, the benchmark interest rate risk, the shortcut method cannot be used. (See DIG Issue E4 for further reference.)

NOTIONAL AMOUNT OF SWAP MATCHES PRINCIPAL AMOUNT OF THE INTEREST-BEARING ASSET OR LIABILITY

A6.40 The first criterion of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106; 815-20-55-71) is that the notional amount of the swap must match the principal amount of the interest-bearing asset or liability that is being hedged. When an entity is...
hedging the interest rate risk of an entire financial asset or liability, this condition is easy to evaluate. Similarly, a hedging relationship that identifies a proportion of a financial asset or liability (e.g., $50 million of a $100 million three-month LIBOR-based debt obligation) as the hedged forecasted transaction meets the requirement of paragraph 68(a) of the Standard (ASC paragraph 815-20-25-104(a)) if the notional amount of the interest rate swap designated as the hedging instrument matches the proportion of the financial asset or liability that is designated as being hedged. The entity should be specific in its identification of the proportion of the financial asset or liability being hedged. In other words, in the example above, the hedged item cannot be the remaining $50 million of a $100 million three-month LIBOR-based debt obligation, after scheduled payments. An acceptable approach would be to identify the $50 million debt by specific certificates. Likewise, a hedging relationship that identifies a proportion of an interest rate swap (e.g., $50 million notional of a $100 million notional swap) as the hedging instrument and a financial asset or liability (or proportion thereof) with a balance of $50 million also would meet the requirement of paragraph 68(a) of the Standard (ASC paragraph 815-20-25-104(a)). Additionally, a hedging relationship that identifies a portfolio of similar interest-bearing assets or liabilities (or proportions thereof) meets the requirements of paragraph 68(a) of the Standard (ASC paragraph 815-20-25-104(a)) if the notional amount of the interest rate swap matches the aggregate notional amount of the portfolio that is designated as being hedged. However, each individual item in the portfolio must meet the remaining criteria in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) for use of the shortcut method to be appropriate. That is, it is appropriate to apply the shortcut method to portfolios that meet the requirements of paragraph 29(a) of the Standard (ASC paragraph 815-20-25-15(a)) only if the individual assets or liabilities in the portfolio meet the same stringent criteria within paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71). As a practical matter, these requirements result in the need for the characteristics of the individual items in the portfolio to be the same except for the notional amount. Thus, opportunities for portfolio hedging using the shortcut method are limited. (See DIG Issue E10 for further reference.)

FAIR VALUE OF THE SWAP AT INCEPTION OF THE HEDGING RELATIONSHIP

A6.41 The second criterion of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) is that if the hedging instrument is an interest rate swap, the fair value of that swap at the inception of the hedging relationship must be zero, with one exception. This exception relates to the interaction of paragraph 68(b) of the Standard (ASC paragraphs 815-20-25-104(b) and 25-104(c)), which required the swap's fair value to be zero at the inception of the hedging relationship, and the revised definition of fair value under Statement 157 (ASC Subtopic 820-10). Before Statement 157 (ASC Subtopic 820-10), the fair value of an interest rate swap that was entered into in an entity’s principal market was generally considered to be the transaction price, which is an entry price. The fair value of a swap at initial recognition under Statement 157 (ASC Subtopic 820-10) is based on an exit price that likely would be other than zero because of a bid-ask spread. Therefore, DIG Issue E23 clarified that paragraph 68(b) (ASC paragraphs 815-20-25-104(b) and 25-104(c)) would be met for an interest rate swap with all of the following characteristics:

- It is entered into at the inception of the hedging relationship.
• It has a transaction price of zero (exclusive of commissions and other transaction costs as described in paragraph 9 of Statement 157 (ASC paragraphs 820-10-35-7 and 35-8)) in the entity’s principal or most advantageous market (as applicable).

• The difference between the transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction.

Unless otherwise stated, subsequent references in this appendix (related to the criteria for the shortcut method) to the fair value of the swap being equal to zero includes a swap with a non-zero fair value if it meets the criteria as discussed above.

A6.41a If the hedging instrument is a compound derivative that comprises an interest rate swap and mirror-image call or put option as discussed in paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)) (an instrument often used to hedge prepayable instruments), the premium for the mirror-image call or put option must be paid or received in the same manner as the premium on the call or put option that is embedded in the recognized interest-bearing asset or liability. That is, the entity must determine whether the implicit premium for the call or put option embedded in the recognized interest-bearing asset or liability was principally paid at inception-acquisition (through an original issue discount or premium) or is being paid over the life of the recognized interest-bearing asset or liability (through an adjustment of the interest rate). That determination would be made by way of a comparison with the terms of an instrument with terms that are equivalent to the terms of the hedged item, except for the embedded option. If the implicit premium for the call or put option that is embedded in the recognized interest-bearing asset or liability was principally paid at inception-acquisition, the fair value of the hedging instrument at the inception of the hedging relationship must be equal to the fair value of the mirror-image call or put option. In contrast, if the implicit premium for the call or put option embedded in the recognized interest-bearing asset or liability is principally being paid over the life of the recognized interest-bearing asset or liability, the fair value of the hedging instrument at the inception of the hedging relationship must be zero.

A6.42 Entities must consider the interrelationship of negotiating the terms of the swap and related hedged item to ensure that day one fair value of the swap has been properly identified even if value is included in payment made by means other than upfront cash exchange between the entity and the swap counterparty. For example, banks that accept deposits acquired through a broker (brokered certificates of deposit or brokered CDs) may finance the related broker’s commission as an inherent element of a related interest rate swap arrangement. In such an arrangement, the swap counterparty pays the broker’s commission upfront on behalf of the bank, and then recoups that loan by adjusting the payments it will receive on the swap, typically by 20 to 25 basis points. Thus, the swap has an embedded financing component and the swap’s initial fair value is equal to the amount of the broker’s commission that was financed by the swap counterparty. The terms of the swap usually are designed to match the related terms of the CD, and the swap typically is designated as a hedge of changes in the fair value or cash flows of the CD. Since the fair value of the swap is not zero at the inception of the hedging relationship (due to the embedded financing arrangement), the swap does not qualify for the shortcut method.
ACCOUNTING BY THE ACQUIROR OF EXISTING HEDGES ACCOUNTED FOR BY THE TARGET USING THE SHORTCUT METHOD IN A PURCHASE BUSINESS COMBINATION

A6.43 In a purchase business combination, the acquiror may not automatically continue to use the shortcut method after the business combination unless (1) the applicable hedging relationship meets the requirements in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) at the date of the business combination (which would be highly unlikely since the swap’s fair value rarely would be zero at that date) and (2) the combined entity chooses to designate the swap and the hedged item in a hedging relationship to be accounted for under the shortcut method. The inability to continue to use the shortcut method in a purchase business combination results from the acquiror individually purchasing the assets and liabilities of the target, including any existing derivatives. Accordingly, any pre-existing hedging relationships of the acquired entity are required to be designated anew by the combined entity at the date of the business combination in accordance with the relevant requirements of the Standard. The post-acquisition hedging relationship designated by the acquiror is a new relationship that has a new inception date. Therefore, in order for the shortcut method to be applied by the combined entity, all of the paragraph 68 (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) shortcut method criteria would need to be met at the inception of the new hedging relationship, including the requirements with regard to the fair value of the swap at the inception of the hedging relationship (i.e., the swap has a fair value of zero if the hedging instrument is not a compound derivative and the premium is paid or received in the same manner as the mirror-image option premium embedded in the hedged item if the swap is a compound derivative). We believe that the prohibition against continuation of the shortcut method in a purchase business combination also applies to the post-acquisition separate financial statements of a subsidiary that has been acquired, regardless of whether push down accounting is applied. (See DIG Issue E15 for further reference.) See Section 10 for a discussion of the continuation of the shortcut method when an entity is required to discontinue a hedging relationship previously accounted for under the shortcut method as a result of the adoption of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, or No. 46 (revised December 2003), Consolidation of Variable Interest Entities.

FORMULA FOR COMPUTING NET SETTLEMENT

A6.44 The third criterion of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) is that the formula for computing net settlements of the swap must be the same for each net settlement. A swap that contains an initial stub period (during which net settlements in that period are calculated in a manner inconsistent with the remaining net settlements under the swap) does not violate this condition provided that the stub rate is the floating rate that corresponds with the length of the stub period. A stub period is simply a market convention that is necessary to determine the prices of interest rate swaps that are traded on dates that do not coincide with swap reset dates; the period is not inconsistent with the Board’s overall objective of limiting the shortcut method to situations in which no ineffectiveness is expected to result from the hedging relationship. (See DIG Issue E12 for further reference.)
INTEREST-BEARING ASSET OR LIABILITY MAY NOT BE PREPAYABLE

A6.45 The fourth criterion of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) is that the interest-bearing financial asset or liability may not be prepayable except in limited situations. A hedged item may contain an embedded call or put option and qualify for the use of the shortcut method, as long as the interest rate swap contains a mirror-image option (i.e., it is a compound derivative). An interest-bearing asset or liability should be considered prepayable under the provisions of paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)) when one party to the contract has the right to cause the payment of principal before the scheduled payment dates unless (1) the debtor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always greater than the then fair value of the contract without that right or (2) the creditor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always less than the then fair value of the contract without that right. A right to cause a contract to be prepaid at its then fair value would not cause the interest-bearing asset or liability to be considered prepayable under paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)) since that right would have a fair value of zero at all times and essentially would provide only liquidity to the holder. In connection with variable-rate financial instruments, the periodic repricing of an interest rate to the then current market rate would not necessarily cause the financial instrument’s fair value to be at the then fair value. This is because, while the interest rate has repriced to market, other conditions, for example, changes in credit risk, may affect the fair value of the variable-rate financial instrument. Accordingly, entities should not assume that a variable-rate instrument always will have a fair value equal to its par value at the time that the interest rate resets to the applicable interest rate index. For example, variable-rate debt that is callable at par would fail to meet the requirement of paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)) that the instrument be callable at its fair value because the par value may be different from the fair value of the financial instrument due to changes in variables other than interest rates. Notwithstanding the above, any term, clause, or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent on the occurrence of a specific event related to the debtor’s credit deterioration or other change in the debtor’s credit risk (e.g., the debtor’s failure to make timely payment, thus making it delinquent; its failure to meet specific covenant ratios; its disposition of specific significant assets (such as a factory); a declaration of cross-default; or a restructuring by the debtor) should not be considered a prepayment provision under the provisions of paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)). Likewise, any term, clause or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent on the occurrence of a specific event that (a) is not probable at the time of debt issuance, (b) is unrelated to changes in benchmark interest rates or any other market variable, and (c) is related either to the debtor’s or creditor’s death or to regulatory actions, legislative actions, or other similar events that are beyond the control of the debtor or creditor, should not be considered a prepayment provision under the provisions of paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)). (See DIG Issue E6 for further reference.)

A6.46 Based on the guidance above, the following should be noted:

- A variable-rate debt instrument that permits the debtor to call the debt at a fixed amount (e.g., at par or at a specified premium over par) is considered prepayable for
purposes of applying paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)).

- A variable-rate mortgage note that is secured by certain property that permits the lender to accelerate the maturity of the note if the borrower sells the property is not considered prepayable for purposes of applying paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)).

- A variable-rate debt instrument that permits the debtor to call the debt at fair value or a premium over fair value is not considered prepayable for purposes of applying paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)).

- A variable-rate debt instrument that provides that in the event of certain changes in tax law that would subject the investor to additional incremental taxes, the coupon interest rate of the debt increases and the debtor (issuer) can call the debt at par is not considered prepayable for purposes of applying paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)). However, the impact of the feature that increases the interest rate of the debt must be evaluated against the remaining criteria for the shortcut method.

A6.47 As noted above, when an interest-bearing asset or liability is prepayable, the criterion of paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)) cannot be considered met unless the hedging interest rate swap contains an embedded mirror-image option and the criterion of paragraph 68(b) of the Standard (ASC paragraph 815-20-25-104(e)), as discussed above in Paragraph A6.41, also is met. The terms of the two call options should match (including matching maturities, strike price, notional amounts, timing and frequency of payments and dates on which the instruments may be called) and the entity should be the writer of one option and the holder (or purchaser) of the other option.

A6.48 The carrying amount of a debt instrument often is different from its redemption amount at maturity because of deferred debt issuance costs or because the instrument was issued at a premium or discount. If the debt is callable, its carrying amount may be different from the strike price of the call option; however, the carrying amount of the debt has no effect on whether the swap contains a mirror-image call option under paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)). As a result, the strike price (in the context of paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e))) should be understood to mean the amount for which the debt instrument can be called. One means of determining whether the strike prices are the same would be to (a) impute the yield to maturity at a price equal to the call price for a non-callable/non-puttable debt instrument that is otherwise identical to the hedged debt instrument and (b) compare that yield with the yield on the call or put embedded in the swap. (See DIG Issue E20 for further reference.)

INDEX OF SWAP MATCHES INDEX OF HEDGED FORECASTED TRANSACTION

A6.49 The fifth criterion of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) is that the index on which the variable leg of the swap is based exactly matches the benchmark interest rate that is designated as the interest rate risk that is being hedged in that hedging relationship. For example, if the variable leg of an interest rate swap is indexed to three-month LIBOR and the benchmark interest rate designated as the interest
rate risk being hedged is six-month LIBOR, the relationship would not qualify for the shortcut method.

A6.50 A U.S. entity would not be able to use the shortcut method for a variable-rate instrument indexed to rates other than the LIBOR swap rate or the U.S. Treasury rate (or the Fed Funds rate for hedging relationships entered into or redesignated on or after July 17, 2013). Therefore, the shortcut method is not permitted in cash flow hedges in which cash flows of the hedged forecasted transaction and the hedging instrument are based on the same index but that index is not the benchmark interest rate (e.g., Prime rate). However, an entity may obtain results similar to the results obtained if the shortcut method were used when a specific existing asset or liability is identified and documented as the hedged item. See further discussion beginning in Paragraph A6.58 of this appendix.

ALL OTHER TERMS OF THE FINANCIAL INSTRUMENT AND SWAP SHOULD BE TYPICAL AND THOSE TERMS DO NOT INVALIDATE THE ASSUMPTION OF NO INEFFECTIVENESS

A6.51 The sixth criterion of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) is that all other terms in the interest-bearing financial instrument or interest rate swap should be typical of those instruments and should not invalidate the assumption of no ineffectiveness. The Board included this criterion to ensure that all terms of the hedging relationship are considered in evaluating the appropriateness of the shortcut method. The second part of this criterion is important because it highlights that implicit in the ability to use the shortcut method is an assumption of no ineffectiveness. However, the Standard discusses two sources of ineffectiveness that would not affect the assumption of no ineffectiveness in the shortcut method. The first is comparable credit risk of the parties at the inception of the hedge. To achieve perfect offset requires that the same discount rate be used to determine the fair value of the swap and of the hedged forecasted transaction. To use the same discount rate, the credit risk related to both parties to the swap as well as the party to the hedged forecasted transaction would have to be the same. The FASB concluded that, because of the complication caused by the interaction of interest rate risk and credit risk, that are not easily separable, comparable creditworthiness is not considered a necessary condition to assume no ineffectiveness in a hedge of interest rate risk. The second, that is applicable in fair value hedges, is that the fixed rate on the hedged item need not exactly match the fixed component on the swap. See further discussion in Paragraph A5.52 in Section 5 on this issue.

A6.52 Convertible debt (i.e., debt convertible into common stock of the issuer) cannot be hedged for changes in cash flows due to changes in the benchmark interest rate using the shortcut method. The FASB staff has noted that the interaction between equity prices and interest rates on convertible debt adds a level of complexity not envisioned by the FASB in the shortcut method. Similarly, we believe that other debt instruments with complex features, such as interest deferral features in debt obligations commonly issued by financial institutions under trust preferred structures, cannot be hedged using the shortcut method. These interest deferral features allow the entity to defer the payment of interest at its option for up to 20 quarters in any period during which the entity is not in default. The deferred amounts themselves bear interest. This feature would generate ineffectiveness if the interest rate swap did not include a mirror feature. Alternatively, if the swap had the mirror feature, it would not meet the third criterion for the
shortcut method that requires that the swap’s formula for computing net settlement be the same for each net settlement.

A6.53 Interest rate swaps are contractual arrangements that require the periodic exchange of two cash flows (usually in a net-settled fashion) – one related to the fixed interest rate leg of the swap and the other related to the variable interest rate leg of the swap. In plain-vanilla interest rate swaps, the fixed interest rate leg does not change; however, the variable interest rate of the leg of the swap is determined (i.e., reset) at the beginning of each period with payment of the swap generally occurring at the end of that period. However, some interest rate swaps have variable interest rate legs that reprice in arrears; meaning that the variable rate is determined at the end of the period and applied retrospectively to calculate the swap settlement payment for that period. The use of the shortcut method is not precluded for hedging relationships that involve interest rate swaps-in-arrears as long as all other applicable conditions of paragraph 68 (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) are met. (See DIG Issue E16 for further reference.)

OTHER CASH FLOW HEDGE REQUIREMENTS

A6.54 The Board also included additional criteria for using the shortcut method that apply only to cash flow hedges. These are:

- 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. Thus, in a cash flow hedging relationship that involves variable-rate debt and an interest rate swap, if the debt has a maturity date that exceeds the maturity date of the interest rate swap, an entity is not precluded from using the shortcut method. In other words, the shortcut method can be applied to cash flow hedges of the interest payments on only a portion of the term of the debt.

- 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 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. (For this purpose, comparable does not require that terms be identical. For example, if a swap’s variable rate is six-month LIBOR and an asset’s variable rate is six-month LIBOR plus 2%, a 10% cap on the swap would be comparable to a 12% cap on the asset because the asset’s cap and the swap’s cap would comparably affect the cash flows of the asset and the swap, respectively, when six-month LIBOR is above 10%).

- The repricing dates of the swap match those of the variable-rate asset or liability.

A6.55 Because the shortcut method is an exception to the requirements of the Standard to assess effectiveness and measure ineffectiveness (i.e., entities can assume no ineffectiveness, the assessment of effectiveness is less onerous and the accounting is simplified), the term match (as used in paragraph 68 (ASC paragraph 815-20-25-102)) is defined narrowly and is intended to mean be exactly the same as or correspond exactly. Therefore, for example, for purposes of apply the provisions of paragraph 68(k) of the Standard (ASC paragraph 815-20-25-106(d)), if the repricing of the swap is based on arrears, then the repricing of the hedged forecasted transaction also must be based on arrears. The SEC staff has indicated that the circumstances in
A6.56 As noted in Paragraph A6.51, the Standard addresses an inherent difficulty with the assumption of no ineffectiveness. That is, the discount rates used to determine the changes in cash flows of the swap may be different from the hedged forecasted transaction due to differences in credit risk. As a result, the Standard provides that comparable credit risk at the inception of the hedging relationship is not necessary to assume no ineffectiveness even though achieving perfect offset would require that the same discount rate be used to determine the changes in cash flows of the interest rate swap and the hedged forecasted transaction. Notwithstanding that provision, an entity must consider the likelihood of noncompliance with the contractual terms of the interest rate swap that require the counterparty or the entity to make either fixed interest payments (resulting from the fixed leg of the swap) or payments based on changes in the benchmark interest rate (resulting from the variable leg of the swap). As discussed above, implicit in the criteria for use of the shortcut method is an assumption of no ineffectiveness. Adverse changes in creditworthiness of the counterparty to the derivative hedging instrument or the entity's own nonperformance risk may invalidate the assumption of no ineffectiveness.

A6.56a DIG Issue E4 “Application of the Shortcut Method” states that if a hedging relationship qualifies for the shortcut method, a change in the creditworthiness of the counterparty of the swap would not require recognition of ineffectiveness in earnings or preclude the continued use of the shortcut method. We believe that it is appropriate to apply this guidance to the entity's own nonperformance risk.

A6.56b We also believe that, consistent with DIG Issue G10, no ineffectiveness would be recognized and the shortcut method may continue to be used as long as the likelihood that the counterparty or the entity will not default continues to be probable. Therefore, changes in counterparty credit risk and the entity’s own nonperformance risk will not have an impact on the assessment of effectiveness or measurement of ineffectiveness and the changes in the fair value of the derivative instrument related to counterparty credit risk and an entity’s own nonperformance risk would be included in AOCI. However, if the likelihood of the counterparty or the entity not defaulting is assessed as no longer probable, the use of the shortcut method must be discontinued. If the entity can identify the event or change in circumstances that caused the likelihood of the counterparty or the entity not defaulting to no longer be probable, hedge accounting would stop and all subsequent changes in fair value of the derivative that occurred from that date to the current date are reported in earnings. If the entity cannot identify the event or changes in circumstances during the assessment period that caused the likelihood of the counterparty or the entity not defaulting to no longer be probable, all changes in the fair value of the derivative during the entire assessment period would be reported in earnings. However, the hedging relationship may be able to be redesignated using the long-haul method. DIG Issue G10 presumes that an entity would be unable to conclude that the hedging relationship in a cash flow hedge is expected to be highly effective in achieving offsetting cash flows when it is no longer probable that the derivative counterparty will not default. We expect that it would be rare for there to be sufficiently strong evidence to overcome that presumption.
A6.57 If all of the requirements in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) are met for a cash flow hedging relationship, the entity does not need to perform effectiveness testing at inception or during the life of the hedging relationship, unless the credit risk of the counterparty to the derivative or the entity's own nonperformance risk changes such that it is no longer probable that the counterparty or entity will not default and, as a result, the entity cannot assume no ineffectiveness. In addition, a measurement of hedge ineffectiveness does not need to be performed. It is important to note that even if the shortcut method is used, the creditworthiness of the counterparty to the hedged transaction must be assessed to determine whether the transaction is probable, as required by paragraph 29(b) (ASC paragraph 815-20-25-15(b)) and further discussed in Paragraph A6.23 above. The following steps represent the accounting for a cash flow hedging relationship that qualifies for the shortcut method:

Step 1. Compute the difference between the variable rate to be paid (received) on the swap and the variable rate to be received (paid) on the hedged item.
Step 2. Combine that difference with the fixed rate to be received (paid) on the swap.
Step 3. Compute and recognize interest income or expense using that combined rate and the variable-rate asset’s or liability’s principal amount. (Amortization of any purchase premium or discount on the asset must also be considered, although that complication is not incorporated here.)
Step 4. Determine the fair value of the interest rate swap.
Step 5. Adjust the carrying amount of the swap to its fair value and adjust OCI by an offsetting amount.

See Example 6.14 in this section for an illustration of the accounting for a cash flow hedge using the shortcut method.

ASSESSING EFFECTIVENESS AND MEASURING INEFFECTIVENESS WHEN THE SHORTCUT METHOD IS NOT PERMITTED

A6.58 When a cash flow hedging relationship that involves an interest rate swap and the variability in the interest receipts or payments of a recognized interest-bearing financial asset or liability does not meet the requirements of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) for use of the shortcut method, an entity must perform periodic assessments of effectiveness and measurements of ineffectiveness because it cannot be assumed that the hedge results in no ineffectiveness. In addition, a cash flow hedging relationship that involves an interest rate swap and the variability of an interest-bearing asset or liability to be acquired or incurred could never meet the requirements of paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-20-55-71) for use of the shortcut method; consequently, an entity must perform periodic assessments of effectiveness and measurements of ineffectiveness because it cannot be assumed that the hedge results in no ineffectiveness. For example, relationships that involve hedges of the benchmark interest rate related to a recognized interest-bearing asset or liability under paragraph 29(h)(2) of the Standard (ASC paragraph 815-20-25-15(j)(2)) may not meet all of the requirements of paragraph 68 of the

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7 Private companies may be eligible to apply the simplified hedge accounting approach and assume no ineffectiveness if certain conditions are met. Refer to section A6.70a for additional discussion of the simplified hedge accounting approach.

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- A hedging relationship in which the risk of overall changes in the cash flows relates to a recognized interest-bearing asset or liability;
- A hedging relationship in which the risk of changes in the benchmark interest rate relates to the forecasted issuance or acquisition of a fixed-rate interest-bearing asset or liability; and
- A hedging relationship in which the risk of overall changes in the cash flows relates to the forecasted issuance or acquisition of a fixed-rate interest-bearing asset or liability.

A6.59 While an entity is able to choose the methodology that it will use to periodically assess effectiveness on a retrospective and prospective basis provided it is consistent with the method used to measure ineffectiveness, the following three methodologies can be used by an entity when measuring ineffectiveness under paragraph 30(b) of the Standard (ASC paragraph 815-30-25-3(b)) provided that an interest rate swap is the hedging derivative and the hedged item and hedging relationship is one of those described in Paragraph A6.58 (see DIG Issue G7 for further reference):

- Change in variable cash flows method.
- Hypothetical derivative method.
- Change in fair value method.

An entity using a swap in a relationship in which the hedged item and hedging relationship is not one of those described in Paragraph A6.58 must determine the change in the cumulative cash flows of the hedging derivative instrument and the forecasted transaction using a variety of techniques that have developed in practice. See discussion of these techniques in Paragraphs A6.112-A6.121 of this appendix. Regardless of the method that it will use to measure ineffectiveness, an entity must document that method at inception of the hedging relationship and consistently apply it throughout the hedging relationship.

CHANGE IN VARIABLE CASH FLOWS METHOD

A6.60 The change in variable cash flows method provides an approach to measuring ineffectiveness that is most consistent with the objective of a cash flow hedge, that is, to offset the changes in the hedged cash flows related to the hedged risk. This is accomplished by comparing the floating leg of the swap with the hedged floating rate cash flows of the asset or liability. The theory behind this methodology is that the cash flow hedge is accomplished primarily through the variable leg of the interest rate swap. Thus, the hedge’s ineffectiveness should not be affected by the change in fair value that is attributable to the fixed leg portion of the swap. That is, only the floating-rate component of the swap provides the cash flow hedge and any change in the swap’s fair value that is attributable to the fixed-rate leg is not relevant to the variability of the hedged interest payments (receipts) on the floating-rate liability (asset).
A6.61 Under this method, the interest rate swap that is designated as the hedging instrument would be recorded at fair value on the statement of financial position. Calculating ineffectiveness involves comparing the present value of the cumulative change in the expected future cash flows on the variable leg of the swap and the present value of the cumulative change in the expected future interest cash flows on the floating-rate asset or liability. (Because the focus of a cash flow hedge is on whether the hedging relationship achieves offsetting changes in cash flows, if the variability of the hedged cash flows of the floating-rate asset or liability is based solely on changes in a floating-rate index, the present value of the cumulative changes in expected future cash flows on both the floating-rate leg of the swap and the floating-rate asset or liability should be calculated using the discount rates that would be used to determine the fair value of the swap.) If hedge ineffectiveness exists, AOCI would be adjusted to a balance that reflects the difference between the overall change in fair value of the swap since its inception and the amount of ineffectiveness that must be recorded in earnings.

A6.62 The footnote to paragraph 68(dd) of the Standard (ASC paragraph 815-20-25-104(f)) indicates that the shortcut method is not permitted for cash flow hedge situations in which the cash flows of the hedged item and the hedging instrument are based on the same index but that index is not the benchmark interest rate. However, the entity may obtain results that are similar to the results that would be obtained if the shortcut method were permitted. As a result of this footnote, we believe that the change in variable cash flows method for measuring ineffectiveness may result in no ineffectiveness being recognized in earnings even if the shortcut method is not used (such as in the case of a hedge that involves an interest rate index other than a benchmark rate and the risk being hedged is the total change in cash flows from an asset or liability rather than the benchmark interest rate) if the following conditions are met:

- The hedged forecasted transactions relate to interest payments (receipts) of an existing floating-rate liability (asset) and that existing floating-rate liability (asset) was specifically identified and documented at inception of the hedging relationship;
- The hedging relationship has been and is expected to be highly effective;
- The floating-rate leg of the swap and the hedged variable cash flows of the asset or liability are based on the same interest rate index (e.g., Prime rate);
- The interest rate reset dates that apply to the floating-rate leg of the swap and to the hedged variable cash flows of the asset or liability are the same;
- The hedging relationship does not contain any other basis differences (e.g., ineffectiveness could be created if the variable leg of the swap contains a cap and the floating-rate asset or liability does not); and
- The likelihood of the obligor not defaulting is assessed as being probable.

A6.63 As indicated, ineffectiveness would be expected to result if any basis differences existed. For example, ineffectiveness would be expected to result from a difference in the indices used to determine cash flows on the variable leg of the swap (e.g., the three-month Treasury rate) and the hedged variable cash flows of the asset or liability (e.g., three-month LIBOR) or a mismatch between the interest rate reset dates that apply to the variable leg of the swap and the hedged variable cash flows of the hedged asset or liability.
A6.64 To demonstrate the change in variable cash flows method in an example hedging relationship, assume an entity designates a receive-floating, pay-fixed interest rate swap with a zero fair value as a hedge of variable interest rate payments on an existing interest-bearing debt instrument. Also assume the variable leg of the swap is based on the three-month Treasury rate and the variable cash flows of the debt are based on three-month LIBOR. Assume that the overall changes in fair value of the swap from inception of the hedge is $16,300, the present value of the cumulative change in cash flows on the variable leg of the swap is a gain (increased cash inflow) of $16,596, and the present value of the cumulative change in the expected future interest cash flows on the floating-rate liability due to changes in the cash flows expected for the remainder of the hedge term is a loss (increased cash outflow) of $16,396. (The cumulative changes in expected future cash flows on both the variable leg of the swap and the floating-rate debt are discounted using the rates that would be used to determine the fair value of the derivative.) Assuming the hedging relationship was highly effective, the entity would report in earnings a gain of $200 as ineffectiveness, which represents the amount by which the present value of the cumulative change in the cash flows on the variable leg of the swap exceeds the present value of the cumulative change in the expected cash flows on the floating-rate debt. The swap would be recorded at fair value on the statement of financial position (asset of $16,300) and the balance in AOCI would be adjusted to a credit of $16,100. In accordance with the requirements of paragraph 30(b) of the Standard (ASC paragraph 815-30-25-3(b)), there is no reported ineffectiveness when the present value of the cumulative change in the future expected cash flows on the floating-rate debt exceeds the present value of the cumulative change in the future cash flows on the variable leg of the swap.

A6.65 The change in variable cash flows method may not be used if the fair value of the swap is not zero or somewhat near zero at inception of the hedge because this method does not require entities to recognize in earnings currently the ineffectiveness related to the interest element of the change in fair value of a hedging instrument that incorporates a financing element.

HYPOTHETICAL DERIVATIVE METHOD

A6.66 The hypothetical derivative method may provide the most operational approach of the three methods. In summary, the hypothetical derivative method involves calculating the change in fair value for a hypothetically perfect swap (e.g., terms that identically match the critical terms of the variable-rate asset or liability that is being hedged) and comparing it with the change in fair value of the swap. This method is likely to be the most operational as entities are likely to be able to value cash flows that are identical to the variable-rate asset or liability being hedged without difficulty.

A6.67 Under the hypothetical derivative method, the measurement of hedge ineffectiveness is based on a comparison of the changes in fair value of the swap that is designated as the hedging instrument and the change in fair value of a hypothetical swap. That hypothetical swap would have terms that identically match the critical terms of the floating-rate asset or liability (i.e., the same notional amount, same repricing dates, the index on which the hypothetical swap’s variable rate is based matching the index on which the asset or liability’s variable rate is based, mirror image caps and floors, and a zero fair value at the inception of the hedging relationship). Essentially, the hypothetical derivative would need to satisfy all of the applicable conditions in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102, 25-104 through 25-106, and 815-
20-55-71) to qualify for use of the shortcut method except the criterion in paragraph 68(dd) of the Standard (ASC paragraph 815-20-25-104(f)). Thus, the hypothetical swap would be expected to perfectly offset the hedged cash flows. The change in the fair value of the perfect hypothetical swap can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction for purposes of applying paragraph 30(b)(2) of the Standard (ASC paragraph 815-30-25-3(b)(2)).

Example A6.0: Hedge of Variable Rate Debt That Contains a Floor

Company R issued variable-rate debt that pays interest at a floating benchmark interest rate plus a fixed credit spread. The debt agreement provides that the benchmark interest rate can never be negative -- i.e., it has a floor of zero. The floor was included in the provisions of the debt agreement to ensure that the lender (1) receives a minimum amount of interest (i.e., the initial credit spread) and (2) never has to make an interest payment to R.

R enters into an interest rate swap to hedge its exposure to variability in interest cash flows caused by changes in the benchmark interest rate. However, the variable leg of the interest rate swap does not have a matching floor of zero.

R documents the interest rate swap as a hedge of its exposure to changes in the variable benchmark rate above the floor of zero. Because the interest rate swap has no matching floor, R is precluded from using the shortcut method. R documents that it will use the hypothetical derivative method to assess effectiveness.

The embedded floor in the variable-rate debt security is a source of ineffectiveness because the swap lacks a mirror-image floor. This should be considered when applying the long-haul method of testing effectiveness and measuring ineffectiveness. The hypothetical perfect swap would need to incorporate terms that identically match the critical terms of the debt instrument and have an initial fair value of zero. Therefore, the hypothetical perfect swap would incorporate a floor while the actual derivative hedging instrument would not, and the hypothetical perfect swap would also likely have a different fixed leg than the actual swap so that the hypothetical perfect swap would have an initial fair value of zero. These differences would need to be considered when testing whether the hedging relationship is highly effective and when measuring the amount of ineffectiveness to be recognized in the income statement.

It is not necessary for the benchmark interest rate to actually decline below zero for there to be ineffectiveness in this relationship. The mere potential for negative interest rates will be a source of ineffectiveness because the probability of a negative benchmark rate would be considered as part of determining the fair value of the hypothetical perfect swap that contains the floor.

See Example 6.13 for an example of a long-haul cash flow hedge of variable rate debt when the hedging instrument (i.e., an interest rate swap) has a cap and a floor but the hedged item (i.e., variable-rate debt) does not.

A6.68 Assuming the hedging relationship has been and is expected to be highly effective, an entity using the hypothetical derivative method is required to measure ineffectiveness. To do that, the swap is recorded at fair value on the statement of financial position, and AOCI would be
adjusted to a balance that reflects the lesser of either the cumulative change in the fair value of that swap or the cumulative change in the fair value of a perfect hypothetical swap. Determining the fair value of both the perfect hypothetical swap and the actual swap should use discount rates based on the relevant swap curves. In addition, the same credit risk adjustment that is used to determine the fair value of the actual derivative should be used to calculate the fair value of the perfect hypothetical swap as long as the likelihood that the counterparty to the swap or the entity will not default continues to be probable. The amount of ineffectiveness, if any, recorded in earnings would be equal to the excess of the cumulative change in the fair value of the swap over the cumulative change in the fair value of the perfect hypothetical swap. Paragraph 30(b) of the Standard (ASC paragraph 815-30-25-3(b)) indicates that hedge ineffectiveness in a cash flow hedge occurs only if the cumulative gain or loss on the derivative hedging instrument exceeds the cumulative change in the expected future cash flows on the hedged transaction.

A6.69 As indicated above, the hypothetical derivative essentially needs to satisfy all of the applicable conditions in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 through 25-106, and 815-20-55-71) to qualify for use of the shortcut method except the criterion in paragraph 68(dd) of the Standard (ASC paragraph 815-20-25-104(f)). In applying the hypothetical derivative method to a hedging strategy whereby an entity is hedging the variability in interest receipts or payments due to changes in the benchmark interest rate and the hedged forecasted transactions relate to the variability in interest payments of existing or forecasted variable-rate assets or liabilities, the terms of the hypothetical derivative also do not need to incorporate the provisions of paragraph 68(d) of the Standard (ASC paragraph 815-20-25-104(e)), which require the hypothetical derivative to contain a mirror-image call or put option if the liability or asset is prepayable. That requirement does not apply because the hedged cash flows would not be affected by a prepayment option in the asset or liability as long as it is probable that the asset or liability will be replaced with another asset or liability with the same repricing terms. An example of this situation would be one in which the hedged liability is a three-month LIBOR-based debt obligation that matures in five years and is prepayable at each quarterly interest reset date, the hedging instrument is a receive three-month LIBOR, pay fixed 2%, five-year interest rate swap, and it is probable that the debt will be replaced with similar debt if it is prepaid during the five-year period. (See DIG Issue G21 for further reference.) See Paragraph 29h.04 of this section for additional information about similar hedging strategies.

CHANGE IN FAIR VALUE METHOD

A6.70 The change in fair value method measures ineffectiveness by comparing the (i) present value of the cumulative change in expected, future variable cash flows related to the asset or liability being hedged with (ii) cumulative change in the fair value of the swap designated as the hedging instrument. Given the effect of fair valuing the fixed leg of the interest rate swap, this method appears to be the least desirable of the three methodologies. This is the case, even though under this method the discount rates applicable to determining the fair value of the swap that is designated as the hedging instrument also should be applied to the computation of present values of the cumulative changes in the hedged cash flows as long as the likelihood that the counterparty to the swap or the entity will not default continues to be probable.
SIMPLIFIED HEDGE ACCOUNTING APPROACH

A6.70a The Private Company Council (PCC) received feedback that it is often difficult for private companies to obtain fixed-rate borrowings. Entities may enter into receive-variable, pay-fixed interest rate swaps to economically convert the variable-rate borrowings into fixed-rate borrowings and the Standard permits an entity to apply hedge accounting if certain requirements are met. However, many private companies contend that they do not have the resources to understand or apply hedge accounting. In addition, some question the relevance and cost of determining and presenting the fair value of plain-vanilla interest rate swaps. In response to this feedback, the PCC introduced a simplified hedge accounting approach to make it easier for certain private companies to apply hedge accounting by alleviating certain aspects of the requirements relating to fair value, documentation, and measurement of hedge ineffectiveness. Financial institutions, not-for-profit entities and employee benefit plans, as well as, private businesses are not eligible to apply the simplified hedge accounting approach.

A6.70b ASU 2014-03, Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps – Simplified Hedge Accounting Approach (ASU 2014-03) introduced as a practical expedient a simplified hedge accounting approach that allows certain private companies to assume no ineffectiveness for qualifying cash flow hedging relationships of interest rate risk and provides an option to measure the swap at settlement or fair value. Alternatively, private companies may choose not to adopt the simplified hedge accounting approach. Under the simplified hedge accounting approach, there is no requirement to complete hedge documentation at the inception of the hedging relationship and private companies will be able to complete the documentation any time prior to the date on which the first annual financial statements are available to be issued after the hedge inception. Private companies that elect to apply the simplified hedge accounting approach should be cautious when completing hedge documentation after the inception of the hedging relationship. If a private company subsequently determines that it doesn’t qualify for the simplified hedge accounting approach, it will not be eligible to apply other forms of hedge accounting as of the original inception date because the documentation was not completed contemporaneously.

A6.70b1 The difference between settlement value and fair value is that nonperformance risk is not considered in determining settlement value. Although an entity may choose to measure the swap at either settlement or fair value under the simplified hedge accounting approach, the PCC noted that the guidance in the Standard requiring the consideration of counterparty credit risk would still apply. To initially and subsequently qualify for the simplified hedge accounting approach, a private company applying the simplified hedge accounting approach is required to satisfy the requirements of the Standard regarding the consideration of counterparty credit risk and the possibility of default by the counterparty to a hedging derivative. Refer to paragraph A6.23 for considerations on counterparty credit risk.

A6.70c To qualify for the simplified hedge accounting approach, the following conditions need to be met:

(a) Both the variable rate on the swap and the variable-rate borrowing are based on the same index and reset period. In complying with this condition, private companies are not limited to benchmark interest rates.
(b) The terms of the swap are typical and thus the swap is considered to be *plain-vanilla*, and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap.

(c) The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days.

(d) The swap’s fair value at inception (that is, at the time the swap was executed to hedge the interest rate risk of the borrowing) is at or near zero.

(e) The notional amount of the swap is equal to the principal amount of the borrowing that is being hedged. In complying with this condition, the amount of the borrowing being hedged may be less than the total principal amount of the borrowing.

(f) All interest payments on the borrowing during the term of the interest rate swap (or the effective term of the interest rate swap underlying a forward-starting swap) are designated as hedged whether in total or in proportion to the principal amount of the borrowing being hedged.

If any of these conditions subsequently cease to be met or the relationship otherwise ceases to quality for hedge accounting, the Standard in general applies at the date of change and on a prospective basis.

**A6.70d** Financial institutions, not-for-profit entities, employee benefit plans, and public businesses are not eligible to apply the simplified hedge accounting approach.
A6.70e Although the simplified hedge accounting approach is only permitted to be applied to plain-vanilla swaps, the PCC acknowledged that forward-starting interest rate swaps may qualify if the occurrence of the forecasted interest payments to be swapped is probable and the required conditions are met. The term *plain-vanilla* is not defined under U.S. GAAP and judgment will be required to determine what types of swaps would be considered to be plain-vanilla.

A6.70f The PCC observed that *a few days* in the condition that the repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days, is not intended to provide a blanket or extended period. Instead, it is provided only as a means to address administrative or other practicability concerns.

A6.70g The PCC decided that the fair value of the swap may be other than zero at the inception of the hedging relationship only if the swap was entered into at the relationship’s inception, the transaction price of the swap was zero in the entity’s principal market (or most advantageous market), and the difference between the transaction price and the fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction.
A6.70h Borrowings with interest rate caps or floors may qualify for the simplified hedge accounting approach if there is a comparable feature in the swap. Borrowings where the borrower has an option to select the interest rate index (You Pick 'Em Debt) may qualify as long as the interest rate of the swap and borrowing are based on the same index at the inception of the swap and thereafter (paragraph 29h.22).

A6.70i The simplified hedge accounting approach would not be limited to hedges of benchmark interest rates. Therefore, the simplified hedge accounting approach may be applied to borrowings that are not based on a benchmark interest rate (for example, the Prime Rate) as long as the borrowing and the swap are based on the same index and reset period. When making this determination, the PCC acknowledged that swaps are most commonly based on benchmark interest rates.

A6.70j The guidance is effective for annual periods beginning after December 15, 2014 and interim periods within annual periods beginning after December 15, 2015. Therefore, a calendar year-end company is required to make the elections included in this guidance beginning with its 2015 annual financial statements and for its 2016 interim financial statements. Early adoption is permitted for annual or interim periods for which financial statements have not yet been made available for issuance. For example, a company may choose to apply this guidance in its 2013 financial statements that have not yet been made available for issuance.

A6.70k Private companies can elect to apply the guidance on a swap-by-swap basis, provided that all of the conditions of applying the simplified hedge accounting approach are met. The election to apply the simplified hedge accounting approach to an existing swap should be made at the time of adoption of ASU 2014-03. The condition that the swap’s fair value is at or near zero at the time of adoption of the simplified hedge accounting approach does not need to be considered as long as the swap’s fair value was at or near zero at the time the swap was entered into (or acquired) by the entity.

A6.70l Private companies have an option to record the transition adjustments with either a modified retrospective approach or a full retrospective approach. Under the modified retrospective approach, the corresponding adjustments to reflect the application of hedge accounting from the date the swap was entered into (or acquired) will be recorded to the assets, liabilities, and opening balance of accumulated other comprehensive income and retained earnings in the period of adoption. Under the full retrospective transition approach, the financial statements for each individual period will be adjusted and the corresponding adjustments to the assets, liabilities, and opening balance of accumulated other comprehensive income and retained earnings will be recorded as of the beginning of the earliest period presented.

Forwards/Futures

A6.71 Forward contracts are negotiated between two parties to purchase a specific quantity of a commodity, a financial instrument, or a foreign currency at a specified price with delivery or settlement in the future. Those contracts can be physically settled by receipt of the underlying for a payment of cash or can be net cash settled by the parties, with one party receiving a payment for the difference between the price of the underlying on the date of the settlement (i.e., the spot price) and the forward price agreed to in the contract multiplied by the notional amount of the contract (i.e., number of units). Futures contracts and forward contracts have similarities but
futures contracts are standardized and traded on a regulated exchange. The other key differences between forward contracts and futures contracts are:

- Forward contracts are available for essentially any underlying if two parties agree to the contract; whereas, futures contracts are available only for certain underlyings (i.e., those underlyings with liquid markets) due to their standardized nature;

- Forward contract values are affected by the creditworthiness of the counterparty and the entity's own nonperformance risk; whereas, futures contract values are affected by the creditworthiness of the exchange on which the contract trades; and

- Forward contracts can either be gross (physically) settled or net cash settled; whereas, futures contracts generally provide for net cash settlement.

A6.72 A cash flow hedging relationship that involves a forward or futures contract as the hedging instrument may be assessed for hedge effectiveness and measured for hedge ineffectiveness in one of two ways:

- If the critical terms of the forward or futures contract and the hedged forecasted transaction match, an entity may be able to conclude that changes in cash flows of the forecasted transaction that are attributable to the risk being hedged are expected to be completely offset by the hedging derivative (i.e., there is no hedge ineffectiveness), except for amounts that are excluded from the assessment of effectiveness, if any. See discussion of this method in Paragraphs A6.73-A6.76 below.

- If the critical terms of the forward or futures contract and the hedged forecasted transaction do not match (e.g., underlying of contract and forecasted transaction is not the same or maturity of contract and timing of forecasted transaction are not the same), entities must determine the change in the cumulative cash flows of the hedging derivative instrument and the forecasted transaction using a variety of techniques that have developed in practice. See discussion of these techniques in Paragraphs A6.112-A6.121 of this appendix.

CRITICAL TERMS MATCH

A6.73 For cash flow hedging relationships in which critical terms are the same and involve a forward or futures contract, an entity may conclude that changes in the cash flows of the forecasted transaction that are attributable to the risk being hedged are expected to be completely offset by the hedging derivative and there is no hedge ineffectiveness. Thus if the entity believes the relationship would generate ineffectiveness if it were measured or if effectiveness were assessed, the critical-terms-match approach should not be used. An initial effectiveness assessment must be performed and documented. The extent of that assessment is based on judgment and would vary depending on the complexity of the derivative and forecasted transaction. That initial assessment might consist solely of a statement that the critical terms of the hedging instrument and the hedged forecasted transaction are the same and, accordingly, changes in cash flows attributable to the risk being hedged are expected to be completely offset by the hedging derivative and no ineffectiveness is expected (after consideration of the amounts, if any, excluded from the assessment of effectiveness and measurement of ineffectiveness). Subsequent assessments can be performed by verifying and documenting whether the critical
terms of the hedging instrument and the hedged forecasted transaction changed during the period under review and whether there have been any adverse developments concerning counterparty credit risk or the entity's own nonperformance risk related to the derivative hedging instrument that could affect the assessment of effectiveness and the conclusion of no ineffectiveness. If the conclusion is reached that there have been no changes in critical terms (which include the evaluation of creditworthiness of the counterparty to the derivative and the entity's own nonperformance risk), entities can document and conclude that the hedging relationship has been perfectly effective and there is no ineffectiveness to measure. An important component of this process is the assessment of whether there have been adverse developments in the creditworthiness of the counterparty to the forward or futures contract or the entity's own nonperformance risk. An adverse change may affect the cash flows of the derivative hedging instrument and preclude the use of the critical-terms-match approach.

A6.73a DIG Issue G9 "Assuming No Ineffectiveness When Critical Terms of the Hedging Instrument and the Hedged Transaction Match in a Cash Flow Hedge" states that in a cash flow hedge using critical terms match, an entity must assess whether there have been adverse developments regarding the risk of counterparty default. If there are no such developments and critical terms continue to match, the entity can conclude that there is no ineffectiveness. We believe that it is appropriate to apply this guidance to the entity's own nonperformance risk.

A6.73b We believe that the degree of change in the risk of default in DIG Issue G9 should be consistent with that of DIG Issue G10; therefore, assuming that the likelihood of the counterparty or the entity not defaulting is assessed as probable, changes in counterparty credit risk and the entity’s own nonperformance risk will not have an impact on the assessment of effectiveness or measurement of ineffectiveness, and the changes in the fair value of the derivative instrument due to changes in counterparty credit risk and an entity’s own nonperformance risk would be included in AOCI. However, if the likelihood of the counterparty or the entity not defaulting is assessed as no longer probable, the critical terms no longer match and the entity must measure the amount of ineffectiveness to be recorded currently in earnings and assess whether the hedging relationship has been and is expected to continue to be highly effective under the long haul method. DIG Issue G10 presumes that an entity would be unable to conclude that the hedging relationship in a cash flow hedge is expected to be highly effective in achieving offsetting cash flows when it is no longer probable that the derivative counterparty will not default. We expect that it would be rare for there to be sufficiently strong evidence to be able to overcome that presumption.

A6.73c It is important to note that even if the critical-terms-match approach is used, the creditworthiness of the counterparty to the hedged transaction must be assessed to determine whether the transaction is probable as required by paragraph 29(b) (ASC paragraph 815-20-25-15(b)) and further discussed in Paragraph A6.23 above.

A6.74 The critical terms of a forward or futures contract and a hedged forecasted transaction match if:

- The forward or futures contract is for the purchase or sale of the same quantity of the same underlying, at the same location as the hedged item (for nonfinancial underlyings), and at the same time. For example, an entity that is hedging the forecasted sale of West Texas natural gas can assume that a forward contract will be
fully effective only if the forward contract’s underlying is West Texas natural gas and is for the same quantity as the forecasted transaction and settles at the same time and in the same location as the forecasted transaction; and

- The fair value of the forward or futures contract at inception of the hedge is zero, and either:
  - The change in the spot-forward difference on the forward or futures contract is excluded from the assessment of effectiveness and included directly in earnings (see Paragraphs A6.09-A6.13 above); or
  - The change in cash flows of the hedged forecasted transaction is based on the forward price. (See DIG Issue G9 for further reference.)

**A6.74a** The Standard requires, among other things, that the fair value of the hedging instrument at the inception of the hedging relationship be zero to apply critical terms match. Therefore, questions arose surrounding whether a derivative instrument with a non-zero fair value meets this criterion and can be used as the hedging instrument in a hedging relationship accounted for under critical terms match. We believe that a derivative instrument that has a non-zero fair value at inception of the hedging relationship solely due to a bid-ask spread under Statement 157 (ASC Subtopic 820-10) would not preclude an entity from applying critical terms match, assuming that all other criteria noted above are met, as well as criteria similar to those discussed in Paragraph A6.41 for the shortcut method. This guidance is based on our current understanding and may be subject to modification depending on developments from standard setters.

**A6.75** As discussed in Paragraph A6.28, some forecasted transactions give rise to a receivable or payable (e.g., a forecasted sale of widgets expected to occur on September 30, 20X1 that will give rise to an accounts receivable that will settle on October 31, 20X1). In such a situation, the occurrence of the sale (the identified forecasted transaction) and its cash settlement are deemed to occur on September 30, 20X1 (i.e., on September 30, 20X1, there is, in effect, a cash inflow from the sale of the widgets and a simultaneous cash outflow for the financing of the sale). Thus, a forward contract that hedges the forecasted sale of the widgets and expires on September 30, 20X1 has the same cash settlement date as the forecasted sale transaction. Thus, we believe that the requirement that the forward contract and the forecasted transaction occur at the same time has been met.

**A6.76** When critical terms match, the change in the cash flows of the derivative hedging instrument can be viewed as a proxy for the change in the cash flows of the forecasted transaction and, as a result, there is no requirement to separately evaluate the change in the cash flows of the forecasted transaction.

**DYNAMIC HEDGING STRATEGIES WITH FUTURES CONTRACTS**

**A6.77** In assessing effectiveness of a cash flow hedge, an entity generally will need to consider the time value of money if it is significant in the circumstances. Considering the effect of the time value of money is especially important if the hedging instrument involves periodic cash settlements. An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense)
from reinvestment (or funding) of daily settlement gains (or losses) on the futures contracts do not distort the results of the hedge. To assess offset of cash flows when a tailing strategy has been used, an entity could include the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument. When using that strategy, the entity must document that it is undertaking a dynamic hedging strategy in which it commits itself to an ongoing repositioning strategy for the hedging relationship and believes that the forecasted transactions are probable of occurring. This documentation is required because normally it is inappropriate under the Standard to designate a derivative as a hedging instrument when it is expected that the derivative will not be highly effective in achieving offsetting cash flows attributable to the hedged risk during the period that the hedge is designated, unless the entity has committed itself to an ongoing dynamic hedging strategy. It is also important to note that, as discussed in Paragraphs 32.13-32.14 of this section, a rebalancing of the hedging derivatives in a hedging relationship requires a discontinuation of the existing relationship. Thus, in a dynamic hedging strategy, a new hedging relationship concurrently must be established and documented whenever a rebalancing is done.

Cross-Currency Interest Rate Swaps

A6.77a A cross-currency interest rate swap (CCIRS) is a contractual agreement between two parties to exchange:

- At inception, a fixed principal amount of one currency for a fixed principal amount of a different currency (usually based on the spot rate on the date of the transaction);
- Periodic interest cash flows in the two currencies of denomination based on the fixed principal amounts of the two currencies exchanged at inception at either a fixed rate of interest or a variable index-based rate of interest; and,
- At maturity, a final exchange of the fixed principal amounts exchanged at inception.

A6.77b CCIRS may be structured to accomplish different objectives. For example, some entities may hedge their exposure to both interest rate risk and foreign exchange risk (e.g., a foreign currency denominated variable rate debt hedged using a receive-variable, pay-fixed CCIRS), while other entities may hedge their exposure only to foreign exchange risk (e.g., a foreign currency denominated fixed rate debt hedged using a receive-fixed, pay-fixed CCIRS).

CRITICAL TERMS MATCH

A6.77c We believe that a receive-fixed, pay-fixed CCIRS designated to hedge the foreign exchange risk in a fixed rate foreign currency denominated financial asset or liability is eligible for the critical terms match method as explained in Paragraph A6.30 because:

- We believe that the Board intended that each general type of hedging instrument would be able to qualify for one less burdensome method for documenting and assessing effectiveness and measuring hedge ineffectiveness (most commonly either the shortcut method or the critical terms match method). Because the shortcut method can only be applied to interest rate swaps, it appears reasonable to conclude that receive-fixed, pay-fixed CCIRS would then be eligible for the critical terms match method (assuming all qualifying criteria are met);
• A CCIRS with two fixed legs has foreign exchange risk as the dominant risk exposure and is not considered a compound derivative instrument as explained in DIG Issues H9 and J6 (ASC subparagraph 815-20-25-67(b) and paragraph 815-20-25-68). We believe that a compound derivative instrument (i.e., a derivative with more than one underlying) is not eligible for the critical terms match method;

• The fair value of CCIRS reacts to changes in currency rates similar to a foreign currency forward contract as noted in Paragraph 42.19 in Chapter 7 of this book. In other words, economically, a CCIRS is similar to a foreign currency forward contract, which is eligible for the critical terms match method.

We believe the following terms should match between the hedged item and a receive-fixed, pay-fixed CCIRS for it to be eligible for the critical terms match method:

• The two currencies underlying the exchange rate of the CCIRS are the entity’s functional currency and the currency in which the hedged foreign currency financial asset or liability is denominated;

• The notional amount of the foreign currency leg of the CCIRS matches the designated portion of the principal amount of the hedged item throughout the term of the hedge;

• The interest payments on the foreign currency leg of the CCIRS match the designated portion of the hedged interest payments (both timing and amount);

• The maturity date of the CCIRS matches the final principal repayment date of the hedged item; and,

• The fair value of the CCIRS at inception of the hedge is zero (note that the principal amounts on the CCIRS will be exchanged at inception, but the net effect of this exchange should be based on current spot rates and therefore will be zero).

Options

A6.78 Unlike swaps, forwards, and futures contracts that require an entity to buy or sell an underlying instrument or to swap cash flows with another party, an option contract provides an option holder with the right, but not the obligation, to buy or sell an underlying instrument or to exchange cash flows with another party. The key features of options are:

• An option contract defines a price, referred to as the strike price, and establishes the term of the option, referred to as the exercise period.

• An option contract normally provides an option holder a call option or a put option. A call option enables the holder to benefit from an increase in the value of the underlying instrument above the exercise price; while a put option enables the holder to profit from a decrease in the value of the underlying instrument below the exercise price.

• Options generally are either American or European depending on their exercisability. The holder of an American option can exercise the option at any time during the exercise period whereas the holder of a European option can exercise an option only at maturity.
• An option holder (buyer) usually pays a premium for the right to exercise the option. Because of the nature of an option, the holder benefits from favorable movements (either up or down depending on whether it is a call or a put) in the price of the underlying instrument while risking only the loss of the option premium that it paid for the contract.

• An option writer (seller), on the other hand, is exposed to virtually unlimited loss in exchange for the option premium.

• An option comprises time value and intrinsic value. Time value represents the value of the time to the end of the exercise period, which is affected by volatility of the price of the underlying, the remaining option term, and other economic factors. Intrinsic value, commonly characterized by the term in the money is the amount by which the value of the underlying exceeds or is less than an option’s strike price depending on whether the option is a call or put, respectively. But in either case, it normally can only be a positive amount (meaning that an option cannot have an intrinsic value less than zero, even when (economically) the option is underwater).

• Options can be combined with other options (e.g., an interest rate collar that combines a cap and a floor) or with other types of derivatives (e.g., an option within a swap).

A6.79 It is important to note that before an entity can consider an option contract, a combination of option contracts, or a combination of an option contract with a nonoption derivative as a hedging instrument in a cash flow hedging relationship, it must determine whether the option or combination is a net purchased option or net written option. If the option or combination is a net written option, the hedging relationship must meet the Standard’s written option effectiveness test to be eligible for cash flow hedging. See discussion of these issues in Paragraphs 28c.01-28c.17 of this section.

PURCHASED OPTIONS

A6.80 A cash flow hedging relationship that involves a purchased option or combination of options resulting in a net purchased option or zero-cost collar as the hedging instrument may be assessed for hedge effectiveness in different ways:

• If hedge effectiveness is based on the option’s total changes in cash flows (i.e., the assessment will include the hedging instrument’s entire change in fair value – its gains and losses), the entity may focus on the hedging instrument’s terminal value (referred to herein as the terminal value approach). That approach focuses on the expected future pay-off amount of the option and the forecasted transaction. See discussion of this method in Paragraphs A6.81-A6.98 below.

• If hedge effectiveness is not based on total changes in cash flows, but rather on the value of the option excluding all time value and the critical terms of the option contract and the hedged forecasted transaction match, an entity may conclude that changes in cash flows of the forecasted transaction that are attributable to the risk being hedged are expected to be completely offset by the derivative hedging instrument. However, the excluded time value of the option contract will affect earnings each period. See discussion of this method in Paragraph A6.99 below.
• If hedge effectiveness is not based on total changes in cash flows and the critical terms of the option contract and the hedged forecasted transaction do not match (e.g., the underlying of the derivative hedging instrument is not the same as the hedged forecasted transaction), entities must measure the change in the cumulative cash flows of the forecasted transaction periodically using a variety of techniques that have developed in practice. See discussion of these techniques at Paragraphs A6.112-A6.121 of this appendix.

TERMINAL VALUE APPROACH

A6.81 Applying the cash flow hedge requirements to option-based hedging strategies often results in ineffectiveness because when an entity compares the total change in an option’s cash flows with the change in cash flows of the hedged forecasted transaction, ineffectiveness results from including the option premium, or time value, in the calculation of the total change in cash flows of the option with no offsetting element in the change in cash flows of the forecasted transaction. As a result, many entities choose to exclude the time value of the option from their calculation of effectiveness, thereby comparing only the changes in the intrinsic value of the option with the changes in expected future cash flows of the forecasted transaction. While excluding the option’s time value simplifies the assessment of effectiveness and measurement of ineffectiveness, it introduces volatility into an entity’s earnings because changes in the excluded component must be recognized in earnings.

A6.82 The terminal value approach provides a practical means of applying the provisions of the Standard when assessing effectiveness and measuring ineffectiveness in a cash flow hedging relationship with a purchased option that may allow an entity to include the time value component of the option in the assessment of effectiveness and measurement of ineffectiveness. The approach focuses on the hedging instrument’s terminal value (i.e., the expected pay-off at its maturity date) in determining whether the hedging relationship is expected to be highly effective at achieving offsetting cash flows that are attributable to the hedged risk during the term of the hedge. That is, effectiveness is assessed by comparing an option’s changes in the expected pay-off at its maturity with the changes in the expected cash flows of the forecasted transaction. As a result, the terminal value approach will result in higher effectiveness than an approach that compares the total changes in the option’s cash flows with the changes in the expected cash flows of the forecasted transaction.

A6.83 If the following conditions are met, an entity may focus on the hedging instrument’s terminal value in determining whether the hedging relationship is expected to be highly effective in achieving offsetting cash flows that are attributable to the hedged risk during the term of the cash flow hedge:

• The hedging instrument is a purchased option or a combination of only options that comprise either a net purchased option or a zero-cost collar;

• The exposure being hedged is the variability in expected future cash flows that are attributed to a particular rate or price beyond (or within) a specified level (or levels); and
• The assessment of effectiveness is documented as being based on total changes in the option’s cash flows (i.e., the assessment will include the hedging instrument’s entire change in fair value, not just changes in intrinsic value).

A6.84 At the onset of each cash flow hedging relationship in which the terminal value approach is used, an entity must document how it will assess effectiveness. That documented method must be applied consistently when assessing effectiveness throughout the hedging relationship. However, an entity’s focus on the hedging instrument’s terminal value is not an impediment to the entity’s subsequently deciding to de-designate that cash flow hedge before the occurrence of the hedged transaction.

A6.85 Certain purchased option contracts comprise a series of contracts, each with a potential cash flow, that are used to hedge a series of forecasted transactions. For example, a purchased cap comprises a series of purchased caplets that may be used to hedge a series of hedged transactions (such as caplets that hedge a series of interest payments at different quarterly dates). When that type of option is designated as the hedging instrument in a cash flow hedge, the entity may focus on the terminal value of each caplet (i.e., the expected future pay-off amount at the maturity date of each caplet) in determining whether each of those hedging relationships is expected to be highly effective in achieving offsetting cash flows.

A6.86 If the conditions in Paragraph A6.83 as well as the following additional conditions are met, the hedging relationship may be considered to be perfectly effective and, therefore, no ineffectiveness will be recognized in earnings:

- The critical terms of the hedging instrument (such as its notional amount, underlying, and maturity date) completely match the related terms of the hedged forecasted transaction (such as, the notional amount, the variable that determines the variability in cash flows, and the expected date of the hedged transaction). As with the earlier discussion of the critical-terms-match approach in this appendix, an entity must also conclude that it is probable that the counterparty to the derivative and the entity will not default;
- The strike price (or prices) of the hedging option (or combination of options) matches the specified level (or levels) beyond (or within) which the entity’s exposure is being hedged;
- The hedging instrument’s inflows (outflows) at its maturity date completely offset the outflows (inflows) from any increase or decrease in the hedged transaction’s cash flows, from the date of hedge designation, for the risk being hedged; and
- The hedging instrument can be exercised only on a single date, its contractual maturity date.

A6.87 As discussed in Paragraph A6.75, some forecasted transactions give rise to a receivable or payable (e.g., a forecasted sale of widgets expected to occur on September 30, 20X1 that will give rise to an accounts receivable that will settle on October 31, 20X1). In such a situation, the occurrence of the sale (the identified forecasted transaction) and its cash settlement are deemed to occur on September 30, 20X1 (i.e., on September 30, 20X1, there is, in effect, a cash inflow from the sale of the widgets and a simultaneous cash outflow for the financing of the sale). Thus, a purchased option that hedges the forecasted sale of the widgets and expires and is exercisable

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on September 30, 20X1 has the same cash settlement date as the forecasted sale transaction. Therefore, we believe that the requirement that the maturity date of the purchased option and the expected date of the forecasted transaction match has been met.

**A6.88** An initial effectiveness assessment must be performed and documented. If the option and forecasted transaction are not complex, that initial assessment may consist solely of a statement that the critical terms of the hedging instrument and the hedged forecasted transaction are the same and, accordingly, changes in cash flows that are attributable to the risk that is being hedged are expected to be completely offset by the option’s expected pay-off at its maturity as the entity is using the terminal value approach. Subsequent assessments can be performed by verifying and documenting whether the critical terms of the hedging instrument and the hedged forecasted transaction changed during the period under review and whether there have been any adverse developments related to the credit risk of the counterparty to the derivative hedging instrument or the entity's own nonperformance risk that could affect the assessment of effectiveness and the assumption of no ineffectiveness. If an entity concludes that there have been no changes in critical terms (which include the evaluation of creditworthiness of the counterparty to the derivative and the entity's own nonperformance risk), the entity can document and conclude that the hedging relationship has been perfectly effective and there is no ineffectiveness to measure under the terminal value approach. An important component of this process is the assessment of whether there have been adverse developments that involve the creditworthiness of the counterparty to the option contract or the entity's own nonperformance risk. An adverse change may affect the cash flows of the derivative hedging instrument and preclude the use of the terminal value approach. If the entity concludes that the hedging relationship may be considered to be perfectly effective, the entity would simply record all changes in the hedging option’s fair value (including changes in the option’s time value) in OCI. It is important to note that even if the terminal value approach is used, the creditworthiness of the counterparty to the hedged transaction must be assessed to determine whether the transaction is probable as required by paragraph 29(b) (ASC paragraph 815-20-25-15(b)) and further discussed in Paragraph A6.23 above.

**A6.89** If the four conditions in Paragraph A6.86 above are not met, the entity must determine whether the hedging relationship is expected to be highly effective throughout the term of the hedging relationship. That is, an entity must perform an initial assessment of effectiveness as well as subsequent assessments of effectiveness. If an entity determines, at each assessment date, that the hedging relationship is highly effective, the entity must determine whether ineffectiveness must be recognized in earnings by comparing the change in fair value of the actual hedging instrument and the change in fair value of a perfectly effective hypothetical hedging instrument. That hypothetical hedging instrument should have terms that meet the four conditions above. The change in fair value of that hypothetical hedging instrument can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction(s) as described in paragraph 30(b)(2) of the Standard (ASC paragraph 815-30-25-3(b)(2)).

**A6.90** When ineffectiveness is required to be recognized, AOCI would be adjusted to a balance that represents the lesser of either the cumulative change in the fair value of the actual hedging instrument or the cumulative change in the fair value of the hypothetical derivative. (Consistent with paragraph 30(b)(1) of the Standard (ASC paragraph 815-30-25-3(b)(1)), that comparison
excludes the effect of the hedging instrument’s gains or losses that were previously reclassified from AOCI into earnings pursuant to paragraph 31 (ASC paragraphs 815-30-35-38 through 35-41). The amount of ineffectiveness, if any, recorded in earnings would be equal to the excess of the cumulative change in the fair value of the actual hedging derivative over the cumulative change in the fair value of the hypothetical derivative.

A6.91 Regardless of whether the hedging relationship is considered to be perfectly effective, when the terminal value approach is used in a cash flow hedging relationship, the portion of the gain or loss that is reported in AOCI would be reclassified consistent with the provisions in paragraph 31 of the Standard (ASC paragraphs 815-30-35-38 through 35-41). For example, the fair value of a single cap at the inception of a hedging relationship of interest rate risk on variable-rate debt with quarterly interest payments over the next two years for which the entity determines that the relationship will not result in any ineffectiveness should be allocated to the respective caplets within the single cap on a fair value basis at the inception of the hedging relationship. That original allocated fair value amount should be reclassified out of AOCI into earnings when each of the respective hedged forecasted transactions (the eight interest payments) affects earnings. Because the amount in AOCI is a net amount that comprises both derivative gains and derivative losses, the original allocated fair value amount for an individual caplet that is reclassified out of AOCI into earnings may be greater than the net amount in AOCI.

A6.92 To illustrate the terminal value approach, assume an entity forecasts that in one year it will purchase 1,000 ounces of gold at the then current market prices for use in its operations. The entity wishes to protect itself against increases in the cost of gold above the current market price of $275 per ounce. The entity purchases a one-year cash-settled at-the-money gold call option on 1,000 ounces of gold, and pays a premium of $10,000. If the price of gold is above $275 at the maturity (settlement) date, the counterparty will pay the entity 1,000 times the difference in price. If the price of gold is $275 or below at the maturity date, the contract expires unexercised. The option cannot be exercised before its contractual maturity date. The entity designates the purchased call option contract as a hedge of the variability in the purchase price (cash outflow) of the 1,000 ounces of gold for prices above $275 per ounce.

A6.93 Because the conditions discussed in Paragraph A6.83 are met and (1) the critical terms of the hedging derivative completely match the hedged forecasted transaction, (2) the strike price of the hedging instrument matches the specified level ($275) beyond which the entity’s exposure is being hedged, (3) the hedging derivative’s inflows at expiration completely offset the hedged transaction’s outflows for any increase in the price of gold above $275 per ounce, and (4) the hedging option cannot be exercised before its contractual maturity date, the entity would conclude there is no ineffectiveness to be recognized in earnings.

A6.94 In this example, the company would reclassify the purchased option’s gain or loss that is reported in AOCI in earnings when the cost of the gold is reported in earnings (e.g., when it is included in cost of goods sold). See Example 6.18 in Paragraph 31.08 of this section for a comprehensive illustration of the terminal value approach. In addition, see Paragraphs A6.81-A6.98 for hedging strategies in which the terminal value approach may be applied.

**SWAPTIONS**

A6.95 An interest rate swaption is an option to enter into a specified interest rate swap at maturity of the option. In exchange for an option premium, the buyer has the right, but not the
obligation, to enter into a specified swap agreement or, in some cases, receive cash proceeds for the fair value of that swap agreement at the expiration of the option. In essence, if the buyer of the swaption is in a gain position at the option’s maturity, it will exercise the option; however, if the buyer is in a loss position at the option’s maturity, it will not exercise the option. We believe an interest rate swaption represents a purchased option from the perspective of the buyer and, accordingly, the terminal value approach may be used, and the hedging relationship may be considered perfectly effective, when the hedging instrument is an interest rate swaption in a cash flow hedging relationship as long as the requirements noted in Paragraphs A6.83 and A6.86 are met. However, entities should note that the terminal value approach focuses on the expected pay-off of the option at its maturity date, not the potential cash flows on the interest rate swap. As a result, the terminal value approach would require an entity to focus on the increase in cash flows to be received, in the form of cash or the fair value of the swap, on expiration of the option portion of the interest rate swaption versus the increase or decrease in cash flows to be exchanged during the term of the interest rate swap. That requirement may be inconsistent with an entity’s hedging strategy and may preclude the use of the terminal value approach.

A6.96 To illustrate when an entity cannot use the terminal value approach, assume in six months Company A expects to issue $100 million of 10-year-variable-rate debt. Company A will be exposed to variability in cash flows in the future quarterly interest payments on the debt due to changes in the benchmark interest rate. The entity enters into a swaption to hedge the variability in the 40 future quarterly interest payments, attributable to changes in the benchmark interest rate above 6% over the next 10 years related to its 10-year $100 million debt that begins in six months. The swaption provides the entity the right, but not the obligation, to enter into a 10-year, receive-three-month LIBOR, pay-fixed 6% interest rate swap with a notional amount of $100 million and payment and receipt dates that coincide with the payment dates on the debt instrument. When three-month LIBOR is above 6%, Company A will exercise its option. When three-month LIBOR is below 6%, it will allow its option to expire. The entity does not meet the conditions to apply the terminal value approach (as described in Paragraph A6.83) as follows:

- The hedging instrument for the first time period of the proposed hedging relationship is a purchased option; however for the second time period it is an interest rate swap; and,
- The exposure being hedged for the first time period of the proposed hedging relationship is variability in interest payments above 6%; however, in the second time period, it is increased or decreases in three-month LIBOR from 6%.

A6.97 [Not used].

A6.98 While the terminal value approach provides a practical solution for hedging with net purchased options in a cash flow hedge, that approach cannot be applied in cash flow hedging relationships that involve hedging instruments other than purchased options or combinations of only options that comprise a net purchased option or zero-cost collar. In other words, a nonoption derivative instrument that contains an option (e.g., a swap with an embedded option) or a net written option would not qualify. In addition, the terminal value approach cannot be used in a fair value hedging relationship, regardless of whether the hedging instrument is a net purchased option or a combination of only options that make up either a net purchased option or a zero-cost collar. (See DIG Issue G20 for further reference.)
CRITICAL TERMS MATCH

A6.99 If an entity does not use the terminal value approach, it may still conclude that a hedge of a forecasted transaction with a purchased option contract will be highly effective and that there will be no ineffectiveness to be recognized in earnings if all critical terms match (i.e., there is no hedge ineffectiveness). An initial effectiveness assessment must be performed and documented. The extent of that assessment is based on judgment and would vary depending on the complexity of the option and forecasted transaction. That initial assessment might consist solely of a statement that the critical terms of the hedging instrument and the hedged forecasted transaction are the same and, accordingly, changes in cash flows attributable to the risk being hedged are expected to be completely offset by the hedging derivative and no hedge ineffectiveness is expected (after considering the amounts that are excluded from the assessment of effectiveness and measurement of ineffectiveness). Subsequent assessments can be performed by verifying and documenting whether the critical terms of the hedging instrument and the hedged forecasted transaction changed during the period under review and whether there were any adverse developments surrounding the risk of counterparty credit risk related to the derivative hedging instrument or the entity's own nonperformance risk that could affect the assessment of effectiveness and the conclusion of no ineffectiveness. If the entity concludes that there have been no changes in critical terms (which includes the creditworthiness of the counterparty to the derivative and the entity's own nonperformance risk), entities can document and conclude that the hedging relationship has been perfectly effective and there is no ineffectiveness to measure. If the entity believes the relationship would generate ineffectiveness if it were measured or if effectiveness were assessed, the critical-terms-match approach should not be used. An important component of this process is the assessment of whether there have been adverse developments in the creditworthiness of the counterparty to the option or the entity's own nonperformance risk. An adverse change may affect the cash flows of the derivative hedging instrument and preclude the use of the critical-terms-match approach.

A6.99a DIG Issue G9 state that in a cash flow hedge using critical terms match, an entity must assess whether there have been adverse developments regarding the risk of counterparty default. If there are no such developments and critical terms continue to match, the entity can conclude that there is no ineffectiveness. We believe that it is appropriate to apply this guidance to the entity's own nonperformance risk.

A6.99b We believe that the degree of change in the risk of default in DIG Issue G9 should be consistent with that of DIG Issue G10; therefore, assuming that the likelihood of the counterparty or the entity not defaulting is assessed as probable, changes in counterparty credit risk and the entity’s own nonperformance risk will not have an impact on the assessment of effectiveness or measurement of ineffectiveness, and the changes in the fair value of the derivative instrument due to changes in counterparty credit risk and an entity’s own nonperformance risk would be included in AOCI. However, if the likelihood of the counterparty or the entity not defaulting is assessed as no longer probable, the critical terms no longer match and the entity must measure the amount of ineffectiveness to be recorded currently in earnings and assess whether the hedging relationship has been and is expected to continue to be highly effective under the long haul method. DIG Issue G10 presumes that an entity would be unable to conclude that the hedging relationship in a cash flow hedge is expected to be highly effective in achieving offsetting cash flows when it is no longer probable that the derivative counterparty will not
It is important to note that even if the critical-terms-match approach is used, the creditworthiness of the counterparty to the hedged transaction must be assessed to determine whether the transaction is probable as required by paragraph 29(b) (ASC paragraph 815-20-25-15(b)) and further discussed in Paragraph A6.23 above. The critical terms match if:

- The option is for the purchase or sale of the same quantity of the same underlying, at the same location (for nonfinancial underlyings) with the same maturity date as the hedged item; and
- The change in all of the elements of the time value of the option is excluded from the assessment of effectiveness and included each period in earnings. See Paragraphs A6.104-A6.105 for further discussion of this item.

Under the critical-terms-match approach, when there have been no changes in critical terms, amounts recognized in earnings each period are limited to the change in the fair value of the derivative hedging instrument that is attributable to changes in time value of the option.

OTHER ISSUES RELATED TO OPTIONS

If entities cannot use the terminal value approach, they may need to exclude the time value of the hedging option derivative from the assessment of effectiveness and measurement of ineffectiveness as discussed in Paragraphs A6.09-A6.13 above to meet the requirement of high effectiveness. When doing so, the following issues should be considered:

- The various measures of intrinsic value;
- The requirement that all changes in intrinsic value be included in the assessment of hedge effectiveness and measurement of ineffectiveness; and
- The ability to exclude certain portions of the change in time value from the assessment of hedge effectiveness and measurement of ineffectiveness.

VARIOUS MEASURES OF INTRINSIC VALUE

As indicated in Paragraph A6.78 above, the total value of an option contract, at a point in time, can be separated into time value and intrinsic value. Market convention considers all of the following to be measures of intrinsic value:

- The difference between the strike price and the spot price of the underlying asset,
- The present value of the difference between the strike price and the forward price of the underlying asset, and
- The difference between the strike price and the forward price of the underlying, undiscounted.

An entity may assess effectiveness and measure ineffectiveness based on any of these three methods when an option is used as the hedging instrument in a cash flow hedging relationship. In the area of cash flow hedge accounting, there is flexibility in the measurement of the change in value of the hedged cash flow. That is, the Standard requires that the measurement

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of cash flow hedge ineffectiveness be performed by comparing the changes in present value of
the expected future cash flows of the forecasted transaction with the change in fair value of the
derivative (aside from any excluded component), and each of the three methods would
accomplish that requirement. As part of the overall documentation for each hedging relationship,
entities must document the measure of intrinsic value that will be used in the assessment of
hedge effectiveness and measurement of ineffectiveness. That measure must be used consistently
for each period following designation of the hedging relationship. (See DIG Issue E19 for further
reference.)

REQUIREMENT TO INCLUDE ALL CHANGES IN INTRINSIC VALUE IN
EFFECTIVENESS ASSESSMENT AND INEFFECTIVENESS MEASUREMENT

A6.103 Regardless of how an entity measures the intrinsic value of an option in a cash flow
hedging relationship for effectiveness assessment testing, that assessment of effectiveness (and
related cash flow hedge accounting) must be performed for all changes in the intrinsic value, i.e.,
for all periods of time when the option has an intrinsic value, however calculated. As a result, an
entity cannot arbitrarily exclude some portion of the option’s intrinsic value from the hedge
effectiveness assessment and measurement of ineffectiveness simply through an articulation of
the risk exposure definition. For example, assume Company A is a U.S. dollar functional
currency entity and forecasts the purchase of goods in pounds sterling. Also assume Company A
purchases an at-the-money call option on pounds sterling under which the notional amount of the
option equals the forecasted value of goods to be purchased, the option exercise date is the date
on which the purchase will be consummated, the strike price and the forward market exchange
rate for 1 pound sterling are both $1.50, and the time value component of the option is $0.15 per
pound sterling. It would be inappropriate for Company A to assert that only limited risk
exposures are being hedged, such as exposures related only to currency exchange rate changes
above $1.65 per pound sterling. As described in Paragraphs A6.81-A6.98 of this appendix,
entities may be able to use the terminal value approach when assessing effectiveness. (See DIG
Issue G11 for further reference.)

ABILITY TO EXCLUDE CERTAIN PORTIONS OF THE CHANGE IN TIME VALUE
FROM EFFECTIVENESS ASSESSMENT AND INEFFECTIVENESS MEASUREMENT

A6.104 As described in Paragraphs A6.09-A6.13 of this appendix, entities commonly seek to
exclude the time value component of a derivative hedging instrument from the assessment of
effectiveness and measurement of ineffectiveness because that component is not relevant to the
entity’s risk management strategy. Instead of excluding all of the change in time value, entities
may exclude the portion of the change in time value of an option attributable to:

• The passage of time (theta);
• Volatility (vega); and
• Interest rates (rho).

However, entities may not exclude from the assessment of hedge effectiveness and measurement
of ineffectiveness the aspect of the change in time value due to changes in other market variables
(i.e., other than rho and vega). (See DIG Issue E19 for further reference.)
A6.105 To compute the changes in an option’s time value that would be excluded from the assessment of hedge effectiveness and measurement of ineffectiveness, entities must use a technique that appropriately isolates those aspects of the change in time value. Generally, to allocate the total change in an option’s time value to its different aspects (i.e., the passage of time and the market variables) the change in time value attributable to the first aspect to be isolated is determined by holding all other aspects constant as of the beginning of the period. Each remaining aspect of the change in time value is then determined in turn in a specified order based on the ending values of the previously isolated aspects. If one aspect of the change in time value is excluded from the assessment of hedge effectiveness and measurement of ineffectiveness (e.g., \( \theta \)), that aspect must be the first aspect for which the change in time value is computed and would be determined by holding all other parameters constant for the period used to assess hedge effectiveness. However, in cases in which more than one aspect of the change in time value is excluded from the assessment of hedge effectiveness and measurement of ineffectiveness (e.g., \( \theta \) and \( \nu \)), entities must determine the amount of that change in time value by isolating each of those two aspects in turn in a pre-specified order (one first, the other second). The second aspect to be isolated would be based on the ending value of the first isolated aspect and the beginning values of the remaining aspects. The portion of the change in time value that is included in the assessment of effectiveness and measurement of ineffectiveness is determined by deducting from the total change in time value the portion of the change in time value attributable to excluded components. While the ability to exclude the portion of the change in time value attributable to certain aspects from the assessment of hedge effectiveness and measurement of ineffectiveness in a cash flow hedge may result in more hedging relationships that involve option contracts meeting the Standard’s hedge criterion related to hedge effectiveness, the use of the terminal value approach may provide an entity with additional benefits, such as less earnings volatility, since more of the changes in the option’s fair value would be included in OCI. (See DIG Issue E19 for further reference.)

**COMBINATION OF OPTIONS**

**Different Notional Amounts**

A6.106 In DIG Issue E18, the FASB staff concluded that a hedging relationship in which a zero-cost collar that comprises a single purchased option and single written option that have different notional amounts is designated as the hedging instrument and the hedge’s effectiveness is assessed based on changes in the collar’s intrinsic value, the hedged item may be specified as two different proportions of the same asset referenced in the collar, based on the upper and lower price ranges specified in the two options that comprise the collar. That is, the quantities of the forecasted transaction that are designated as being hedged may be different based on the price ranges in which the collar’s intrinsic value is other than zero. This strategy is used by entities that seek full protection of downside risk while partially paying for this protection by selling some of the upside potential. This approach is permitted only for zero-cost collars that are a combination of a single written option and a single purchased option for which the underlying in both options is the same. The FASB staff stated that this approach cannot be analogized for other derivatives that are designated as hedging instruments. We believe the prohibition from analogizing to this approach is meant to preclude entities, such as those in the mortgage banking industry, from designating the hedged item at the inception of a hedging relationship by initially specifying a
series of possible percentages of the hedged item, such as a servicing right asset, that each corresponds to a specified independent variable, such as an interest rate, as discussed in Paragraph 21a.25 of Section 5. Therefore, we believe entities may be able to enter into hedging relationships in which effectiveness is based on the intrinsic value of a combination of options when that combination of options is not within the scope of the FASB staff’s guidance. For example, we believe a hedging relationship that involves a combination of options in which the notional amounts are the same, but the strike prices are different, is not equivalent to the hedging relationship covered by the staff’s guidance. (See Question 26 in the Questions and Answers section that follows Appendix A to Section 5.) In addition, we believe that, if the conditions for the use of the terminal value approach are met (see Paragraphs A6.81-A6.98), the approach can be applied to the hedging strategies discussed in this paragraph. (See DIG Issues E18, G15 and G20 for further reference.)

Effectiveness Assessment Only When Intrinsic Value Changes

A6.107 In a cash flow hedging relationship in which a combination of options (deemed to be a net purchased option) is designated as the hedging instrument and the effectiveness of the hedge is assessed based only on changes in intrinsic value of the hedging instrument(s), the assessment of effectiveness may be based only on changes in the underlying that cause a change in the intrinsic value of the hedging instrument(s). As a result, the assessment should exclude ranges of changes in the underlying for which there is no change in the hedging instrument’s intrinsic value. Accordingly, hedging relationships that offer protection only within various ranges of changes in the underlying, instead of in all ranges of change, may qualify for cash flow hedge accounting if the hedging instrument (a combination of options) is considered a purchased option or a net purchased option. Since the changes in the hedging instrument’s underlying that occur outside of the various ranges not covered in the hedging strategy are excluded from the assessment of hedge effectiveness, the related changes in the present value of the cumulative cash flows of the combination option for the excluded components would be currently recognized in earnings. (See DIG Issue G15 for further reference.) We believe that, if the conditions for the use of the terminal value approach are met (see Paragraphs A6.81-A6.98), the approach can be applied to these hedging strategies.

A6.108 To illustrate, assume Company A forecasts that it will purchase inventory that will cost 100 million foreign currency (FC) units. Company A’s functional currency is the U.S. dollar. To limit the variability in U.S. dollar-equivalent cash flows associated with changes in the U.S. dollar-FC exchange rate, Company A constructs a currency collar as follows:

- A purchased call option providing Company A the right to purchase FC100 million at an exchange rate of $0.885 per FC1; and
- A written put option obligating Company A to purchase FC50 million at an exchange rate of $0.80 per FC1.

The purchased call option provides Company A with protection when the U.S. dollar-FC exchange rate increases above $0.885 per FC1. The written put option partially offsets the cost of the purchased call option and obligates Company A to give up some of the foreign currency gain related to the forecasted inventory purchase as the U.S. dollar-FC exchange rate decreases below $0.80 per FC1. (For both options, the underlying is the same—the U.S. dollar-FC exchange rate.)
Assume that the combination of options represent a net purchased option for purposes of applying the Standard and that Company A specifies in the hedge effectiveness documentation that the collar’s time value will be excluded from the assessment of hedge effectiveness. The hedging relationship qualifies for cash flow hedge accounting. That is, the foreign currency collar could be documented as hedging the variability in U.S. dollar-equivalent cash flows for 100% of the forecasted FC100 million purchase price of inventory for U.S. dollar-FC exchange rate movements above $0.885 per FC1 and variability in U.S. dollar-equivalent cash flows for the first 50% of the forecasted FC100 million purchase price of inventory for U.S. dollar-FC exchange rate movements below $0.80 per FC1. Cash flow hedge accounting could be applied for those changes in the underlying (the U.S. dollar-FC exchange rate) that cause changes in the collar’s intrinsic value (i.e., changes below $0.80 per FC1 and above $0.885 per FC1). Since the hedge’s effectiveness is based on changes in the collar’s intrinsic value, hedge effectiveness must be assessed based on the exchange rate changes by comparing the change in intrinsic value of the collar with the change in the specified quantity of the forecasted transaction for those changes in the underlying.

A6.109 Similarly, assume Company B issues floating-rate debt (indexed to three-month LIBOR) and wishes to hedge its risk to variability in cash flows due to three-month LIBOR changes when three-month LIBOR is greater than 7%. Assume Company B purchases an interest rate cap with a notional amount equal to the principal of the debt and a strike price of 7% that includes a knock-out provision (a written call) that nullifies the cap when three-month LIBOR reaches 12%. If the derivative instrument represents a net purchased option under the Standard, the entity can designate the risk being hedged as the risk of variability in cash flows due to three-month LIBOR changes when three-month LIBOR exceeds 7% but is below 12%.

Different Underlyings

A6.110 The financial marketplace developed complex option contracts to simultaneously mitigate the effects of a variety of risks. Often, these complex options contain multiple underlyings and are structured to achieve certain economic results. When an entity uses complex option contracts in a cash flow hedging relationship, all of the requirements in the Standard must be met to apply hedge accounting. When reviewing those requirements, the following should be kept in mind:

- If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, the hedged forecasted transaction cannot be a group of inflows and outflows since the Standard was not structured to permit hedge accounting for strategies that involve hedges of a spread between revenues and expenses.
- The hedging relationship must be expected to be highly effective, both at inception and throughout the hedge period, in achieving offsetting cash flows attributable to the hedged risk. Paragraphs 29(g) and 29(h) of the Standard (ASC paragraphs 815-20-25-15(i), 25-15(j) and 25-43(d)) indicate the risks that an entity may designate as the hedged risk. When defining the risk to be hedged, an entity cannot indicate that it is hedging a specific risk but only when another specific risk is also present, even when the complex option contains two or more underlyings that are economically related to those risks.
A6.111 To illustrate the difficulties an entity would encounter if it wanted to use a complex option in a cash flow hedging relationship, assume an oil-producing entity enters into an oil-indexed interest rate cap, which would provide protection against an increase in interest rates on its outstanding variable-rate debt over a specified level when oil prices decline below a specified level. That type of option may be entered into when the oil-producing entity is concerned that the combination of a decrease in oil prices together with an increase in interest rates above a specified level would negatively affect its ability to make scheduled, variable interest payments on the debt. That is, the entity is concerned both with decreasing revenues (reduced cash inflows) and increasing expenses (increased cash outflows). While the option may mitigate risk from an economic standpoint, the following must be kept in mind from an accounting viewpoint:

- The oil-producing entity could not hedge the variability in the difference between interest payments and sales proceeds on oil because of the criterion in paragraph 29(a) of the Standard (ASC paragraph 815-20-25-15(a)) that requires that if the hedged transaction is a group of individual transactions, those individual transactions need to share the same risk exposure for which they are designated as being hedged. Accordingly, the hedged forecasted transaction cannot be a group of oil sales inflows and interest payment outflows, or the net of those cash flows.

- The complex option would likely not be highly effective in a hedge of the variability in interest cash flows attributable to changes in a benchmark interest rate above a certain percent. This is because there could be occasions when the option’s cash flows are affected by the oil-based underlying in place of (or in addition to) the cash flows affected by the change in the benchmark interest rate.

- The complex option would not be highly effective in a hedge of the risk of overall changes in the sales proceeds from the forecasted sale of oil below the contractually specified price per barrel in the interest rate cap. This is because the hedging relationship would fail to qualify under paragraph 28(b) of the Standard (ASC paragraphs 815-20-25-75, 25-76, and 25-80) because the cash inflows from the oil-linked interest rate cap are calculated based on the debt’s principal amount and the excess of the benchmark interest rate over a specified level. Because the cash inflows from the oil-linked interest rate cap are unrelated to the proceeds from oil sales, the oil-producing entity could not expect the proposed hedging relationship to be highly effective at achieving offsetting cash flows. (See DIG Issue G22 for further reference.)

Assessing Hedge Effectiveness and Measuring Hedge Ineffectiveness When Critical Terms Are Not the Same

A6.112 In many cases, the assessment of hedge effectiveness and the measurement of hedge ineffectiveness will not be specifically covered by what has been discussed above. These situations may arise when:

- A difference exists between the basis of the derivative hedging instrument and the hedged forecasted transaction (such as a pound sterling-based hedging instrument and euro-based hedged forecasted transaction) to the extent that those bases do not move in tandem; or
• A difference exists in critical terms of the derivative hedging instrument and the hedged forecasted transaction, such as differences in notional amounts, maturities, quantity, location, or delivery dates.

A6.113 In these situations, entities will need to determine the changes in the forecasted transaction’s cash flow attributable to the hedged risk and compare these changes to the changes in cash flows of the derivative hedging instrument. Determining the change in cash flows of the forecasted transaction that is attributable to the hedged risk can be difficult.

A6.114 The methodologies discussed in Paragraphs A6.115-A6.121 below may assist entities when determining the change in cash flows of the forecasted transaction that is attributable to the hedged risk.

HYPOTHETICAL DERIVATIVE INSTRUMENT

A6.115 If the critical terms of the derivative hedging instrument and the hedged forecasted transaction are not the same, the change in cash flows of the hedged forecasted transaction attributable to the hedged risk could be measured by using a hypothetical derivative instrument. In summary, this method involves calculating the change in fair value for a hypothetically perfect derivative (e.g., terms that identically match all the terms of the forecasted transaction) and comparing it with the change in fair value of the derivative hedging instrument.

A6.116 Under this method, the measurement of hedge ineffectiveness is based on a comparison of the changes in fair value of the derivative that is designated as the hedging instrument and the change in fair value of the hypothetical derivative. That hypothetical derivative would have terms that identically match all the terms of the forecasted transaction. Thus, the hypothetical derivative would be expected to perfectly offset the hedged cash flows. The change in the fair value of the perfect hypothetical derivative can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction for purposes of applying paragraph 30(b)(2) of the Standard (ASC paragraph 815-30-25-3(b)(2)).

A6.117 Assuming that the hedging relationship has been and is expected to be highly effective, an entity that uses this method is required to measure ineffectiveness. To do that, the derivative is recorded at fair value on the statement of financial position, and AOCI would be adjusted to a balance that represents the lesser of either the cumulative change in the fair value of the derivative or the cumulative change in the fair value of a perfect hypothetical derivative. The measurement of the fair value of both the perfect hypothetical derivative and the derivative should use discount rates based on information specific to each instrument (i.e., the relevant pricing curve). In addition, the same credit risk adjustment that is used to determine the fair value of the actual derivative should be used to calculate the fair value of the perfect hypothetical derivative as long as the likelihood that the counterparty to the derivative or the entity will not default continues to be probable. The amount of ineffectiveness, if any, that is recorded in earnings would be equal to the excess of the cumulative change in the fair value of the actual derivative over the cumulative change in the fair value of the perfect hypothetical derivative. Paragraph 30(b) of the Standard (ASC paragraph 815-30-25-3(b)) indicates that hedge ineffectiveness in a cash flow hedge occurs only if the cumulative gain or loss on the derivative hedging instrument exceeds the cumulative change in the expected future cash flows on the hedged transaction.
A6.118 If the original terms of the forecasted transaction change during the hedge period, but the original transaction still is probable of occurring, the terms of the hypothetical derivative must be changed to perfectly offset the new terms of the transaction. The amount of ineffectiveness, if any, that is recorded in earnings in that period would be equal to the excess of the cumulative change in the fair value of the actual derivative over the cumulative change in the fair value of the newly established perfect hypothetical derivative.

A6.119 If the hedging relationship (i) involves a purchased option or combination of options resulting in a net purchased option or zero-cost collar, (ii) is not within the scope of the terminal value approach discussed in Paragraphs A6.81-A6.98, and (iii) the hypothetical derivative instrument is used to measure hedge ineffectiveness, an entity cannot conclude that time value, or any element of time value, offsets any of the hedged changes in cash flows. Thus, all elements of the time value of the purchased option should be excluded from the assessment of effectiveness and measurement of ineffectiveness and reflected in earnings currently. In other words, the only situation in which time value may be included in the assessment of effectiveness and measurement of ineffectiveness for purchased options or zero-cost collars (without affecting hedge effectiveness) is when the terminal value approach is used. The terminal value approach is an exception to the Standard’s view that time value, or option premium, does not offset hedged changes in cash flows and thus generates ineffectiveness.

PROJECT FUTURE CASH FLOWS USING FORWARD PRICE CURVES

A6.120 Some entities may have the information available to use forward price curves to determine changes in the expected future cash flows of the hedged forecasted transaction. In these circumstances, entities may use forward price curves to estimate changes in expected future cash flows by performing the following steps:

1. At the end of each reporting period, use the appropriate current forward price curve to determine the expected future cash flows for the remaining term to maturity.

2. Discount those expected future cash flows if the effectiveness technique requires a discounted value. Due to the flexibility provided by the Standard in selecting a discount rate, the discount rate an entity selects must be documented at the inception of a hedge.

3. The difference between the amounts calculated in step 2 for the current reporting period and the amount calculated at inception of the hedging relationship can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction for purposes of applying paragraph 30(b)(2) of the Standard (ASC paragraph 815-30-25-3(b)(2)).

PROJECT FUTURE CASH FLOWS USING RECENT SALES OR PURCHASE ORDERS

A6.121 When hedging a forecasted sale or purchase of certain nonfinancial assets, entities may be required to estimate future sales or purchase prices because a market is not available to help make these estimates. An approach that would remove some of the inherent limitations in the entity’s estimate involves basing the estimates on recent sales orders or purchase orders with similar terms to the terms of the hedged forecasted sale or purchase. For example, assume on
January 1, 20X1, PYD Co. enters into a hedgeable forecasted transaction to sell 10,000 widgets at the then current market price one year into the future. To lock in the sales price of the widgets, the Company enters into a forward contract to sell 10,000 units for $95,000, the current selling price of widgets with terms that match the forecasted transaction ($100,000) less a discount that represents the time value of money for one year based on $100,000 notional (or $5,000). It is now March 31, 20X1, and the Company has been entering into purchase orders for widgets to be delivered in nine months for a similar number of units at a sales price of $9.90 per unit. Thus, the Company could base its estimate of the cumulative change in cash flows of the forecasted sale of 10,000 units using $1,000 ((original implied price of $10 less current price of $9.90) times 10,000 units).

**Impact of Master Netting Agreements on Derivative Instruments**

A6.122 As discussed in Section 4, when derivative instruments are subject to a master netting agreement, the determination of their fair value must incorporate the master netting agreement. Thus, when an entity has a portfolio of derivative instruments with a counterparty subject to a master netting agreement, the fair value measurement of the derivative instruments is often made at the portfolio level even though the portfolio is comprised of more than one unit of account. In determining the fair value of the derivative instruments subject to the master netting agreement at the portfolio level, counterparty credit risk and an entity’s own nonperformance risk generally would be calculated as a top level adjustment for credit risk on a portfolio basis. However, for applying hedge accounting, the Standard requires that the assessment of effectiveness and measurement of ineffectiveness be performed at the individual hedge relationship level. As the assessment of effectiveness and measurement of ineffectiveness require the comparison of the gain or loss, or the change in cash flows, of the derivative hedging instrument to the changes in the cash flows of the hedged transaction, a change in the cash flows of the derivative instrument will impact the assessment and measurement.

A6.123 Questions have arisen as to whether an entity with a portfolio of derivative instruments subject to a master netting agreement that includes derivatives that are designated as hedging instruments, must allocate the portfolio level credit adjustment to the individual derivative instruments that are part of the hedging relationships. The following guidance related to the impact of credit risk on derivative instruments subject to master netting agreements is based on discussions with the SEC and FASB staffs and affects hedging relationships differently based on the method used for assessing effectiveness and measuring ineffectiveness.

**ASSESSMENT OF EFFECTIVENESS ANALYSIS**

A6.124 For cash flow hedges accounted for using long-haul, critical-terms-match, or the shortcut method, Statement 133 (including the guidance in DIG Issues G10) allows an entity to conclude that, excluding other sources of ineffectiveness, the hedging relationship is highly effective if the likelihood that the counterparty to the derivative instrument or the entity itself will not default is deemed probable. Therefore, changes in the fair value of the derivative instrument due to changes in counterparty credit risk and the entity’s own nonperformance risk would be recorded in OCI. As such, if the derivative instrument was subject to a master netting agreement and the likelihood of either party to the contract not defaulting is probable, an entity would be able to conclude that the hedging relationship would be highly effective without performing an

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allocation of the portfolio level credit adjustment. However, an allocation may be necessary for measuring ineffectiveness (refer to the discussion of measurement of ineffectiveness below).

**A6.125** If an entity cannot conclude that the likelihood of the counterparty or the entity itself not defaulting is probable, an entity would need to consider the impact of any changes in credit risk on the effectiveness assessment. DIG Issue G10 presumes that an entity would be unable to conclude that the hedging relationship in a cash flow hedge is expected to be highly effective in achieving offsetting cash flows when it is no longer probable that the counterparty to the derivative or the entity itself will not default. At that point, the cash flow hedging relationship would need to be discontinued and it would no longer be necessary for an entity to consider the impact of an allocation of the portfolio level credit adjustment on the effectiveness assessment. In a situation where an entity concludes that the hedging relationship has been and will continue to be highly effective in achieving offsetting cash flows, even though the entity cannot conclude that the likelihood of the counterparty or the entity itself not defaulting is probable, the entity would need to allocate the portfolio level credit adjustment to individual derivatives and complete the assessment of effectiveness on an individual hedging relationship basis using fair values of the derivative(s) including the impact of the allocation. We expect that it would be rare for there to be sufficiently strong evidence to support this conclusion. However, shortcut method cash flow hedging relationships would need to be terminated as discussed in Paragraph A6.56b once an entity cannot conclude that the likelihood of the counterparty to the swap or the entity itself not defaulting is probable.

**A6.125a** If the entity determines that a quantitative analysis is necessary and that the portfolio level credit adjustment needs to be allocated to the derivative instruments within a portfolio, it should identify a systematic and rational allocation method and should apply that method consistently.

**A6.125b** The following are examples of methods for allocating portfolio level credit adjustments that would be considered systematic and rational. However, other methods may be appropriate for purposes of allocating a portfolio level credit adjustment to the individual derivatives within the portfolio. Because a derivative portfolio consists of assets and liabilities, the portfolio level credit adjustment allocations to the individual derivatives would include increases and decreases that should sum up to the overall credit adjustment for the portfolio.

- **Marginal contribution allocation** - Allocate a portion of the portfolio level credit adjustment to each derivative instrument within the portfolio by determining the incremental amount that each derivative instrument within the portfolio contributes to the overall portfolio level credit adjustment.

- **Relative fair value allocation** - Allocate a portion of the portfolio level credit adjustment to each derivative instrument within the portfolio in proportion to the relative fair values of each of the derivative instruments to the fair value of the portfolio.

- **In-exchange fair value allocation** - Allocate a portion of the portfolio level credit adjustment to each derivative instrument within the portfolio in proportion to the in-exchange fair value of each derivative instrument (that is, the standalone value of each derivative as if it were not within a portfolio).
• Relative credit adjustment allocation - Allocate a portion of the portfolio level credit adjustment to each derivative instrument within the portfolio in proportion to the relative credit adjustment that would be required for each of the derivative instruments on a standalone basis. Similar to the in-exchange fair value allocation approach, the use of an in-exchange measurement would be applied to each derivative instrument within the portfolio to apply this method.

A6.126c In May 2011, the FASB issued ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (ASU 2011-04 or the ASU) which, among other things, addresses the fair value measurement of financial instruments with offsetting market or counterparty credit risks. The ASU has an effective date for interim and annual periods beginning after December 15, 2011 for public entities and annual periods beginning after December 15, 2011 for nonpublic entities. Nonpublic entities may early-adopt the ASU for any interim period beginning after December 15, 2011. The examples above are systematic and rational methods for allocating portfolio level credit adjustments to the individual derivative instruments within that portfolio. This would often apply to derivative instruments subject to master netting agreements. The portfolio measurement guidance provided in the ASU however, would also apply to portfolios of derivative instruments that are not subject to a master netting agreement. Further, it also would apply to nonderivative financial instruments. Regardless of the method that an entity uses, the appropriate allocation method is affected by the fair value hierarchy of the financial instruments within the portfolio. We understand from conversations with the FASB staff that the FASB staff believes the fair value allocated to financial instruments within the portfolio classified in Level 1 of the fair value hierarchy should be determined using the instrument price times the quantity (PxQ) consistent with the guidance in paragraph 27 of Statement 157 (ASC 820-10-35-44). We would expect that this would not apply to portfolio level credit adjustments because the portfolio to which such adjustments would apply would likely not contain Level 1 derivative instruments. However, this may be applicable to adjustments related to other risks such as interest rate, foreign currency or price risks because the portfolio to which these adjustments would apply may contain Level 1 instruments. For example, assume an entity holds 10,000 exchange-traded equity securities and has an off-setting position of forward contracts to sell 6,000 of the same exchange traded equity securities. In addition, the entity concludes the portfolio measurement exception criteria have been met and the entity has elected to apply the net portfolio exception. The entity should allocate to the forward contracts the fair value measurement adjustment that resulted from the valuation of the net portfolio position with no adjustment being allocated to the Level 1 equity securities (i.e., equity securities are valued at PxQ). If allocating the net portfolio adjustment to the forward contracts results in an unexpected basis in the forward contracts, the entity should carefully reevaluate the appropriateness of using the net portfolio exception. See Paragraphs 17.03a and 17.07c1 of Section 4 for additional information.

MEASUREMENT OF INEFFECTIVENESS ANALYSIS

A6.126 If the master netting agreement contains derivatives that are hedging instruments in cash flow hedges accounted for using long-haul, critical-terms-match or the shortcut method, an entity also must determine if it is necessary to allocate the portfolio level credit adjustment to the individual derivative instruments for the purpose of measuring ineffectiveness for hedging relationships using long-haul and to ascertain that AOCI is properly stated for those using the
shortcut method or critical-terms-match. An entity may perform an analysis instead of performing the allocation to determine if it is necessary to allocate the portfolio level credit adjustment to the individual derivative instruments subject to the master netting agreement to ascertain if the amounts recorded on the income statement and balance sheet related to derivatives in hedging relationships subject to the master netting agreement are reasonably stated (AOCI versus earnings). A qualitative analysis may be used as long as it considers the analysis' objectives. These objectives relate to the reasonableness of the hedging relationship’s impact on AOCI and earnings. If an allocation of the portfolio level credit adjustment to the individual derivatives under the master netting agreement is not deemed necessary, amounts related to the portfolio level credit adjustment would be recorded in earnings rather than recorded in AOCI. The qualitative analysis should consider all relevant facts and circumstances, including: the size of the portfolio level credit adjustment; the hedging relationships’ degree of effectiveness without considering the portfolio level credit adjustment; the creditworthiness of the counterparty and the entity itself; the probability of default by either party; and other potential future sources of ineffectiveness.

**A6.127** If a reasonable conclusion that the amounts recorded on the income statement and balance sheet related to derivatives in hedging relationships subject to the master netting agreement are reasonably stated cannot be reached based on a solely qualitative analysis, a quantitative analysis would be necessary. Quantitative procedures may include the selection of an allocation approach (refer to discussion in Assessment of Effectiveness Analysis section), the completion of the allocation, the potential measurement of ineffectiveness on an individual hedging relationship basis using fair values of the derivative(s) including the impact of the allocation and the adjustment of the amounts recorded in AOCI (with respect to hedges applying shortcut or critical terms match).

**TIMING OF PROCEDURES AND ONGOING REQUIREMENTS**

**A6.128** This qualitative or quantitative analysis should be considered as an additional component of the assessment of effectiveness and measurement of ineffectiveness (or the monitoring of credit for cash flow hedges applying shortcut or critical terms match). Therefore, for an entity to continue to apply hedge accounting related to derivative instruments subject to a master netting agreement subsequent to the adoption of the guidance, we would expect either a qualitative or quantitative analysis to be performed as often as the hedge documentation for the hedging relationship requires an assessment of effectiveness and measurement of ineffectiveness (or monitoring of credit for cash flow hedges applying shortcut or critical terms match, whether on a daily, weekly, monthly, quarterly, or other basis.

**A6.128a** This guidance should not be analogized to other fact patterns.

**Additional Examples of Hedge Documentation**

**A6.129** As discussed throughout this appendix, the assessment of effectiveness and measurement of ineffectiveness is complex. Accordingly, comprehensive hedge documentation is essential to sufficiently describe the strategy. Below are two examples of hedge documentation for cash flow hedging strategies involving sales and purchases of financial and nonfinancial assets, respectively.
Example A6.1: Documentation of the Hedging Strategy – Forecasted Sales of Mortgage Loans

Risk management objective and strategy
We originate fixed rate mortgages to borrowers in conjunction with our mortgage banking operation. Originations cycle through our pipeline (typically 60 days) and remain in the warehouse after closing (typically 45 days) until they are ultimately sold to the investor. Beginning from the time we enter into interest rate lock commitments with borrowers through the date of sale, we are exposed to changes in market interest rates as these changes will affect the price paid by investors upon sale. For example, in a rising interest rate environment, the value of these fixed rate mortgage loans will decline and result in a reduction of the sales price. Our objective is to hedge the variability in the proceeds related to the expected sale of our mortgage loans. Our strategy for achieving this objective is to use futures and purchased options with notional amounts and underlying rates that we believe will be highly effective at hedging those changes.

Nature of the risk being hedged
The hedged risk is defined as the risk of changes in the expected proceeds upon sale of mortgage loans attributable to changes in the U.S. treasury rate. The specific benchmark rate designated as being hedged for individual hedging relationships associated with this strategy will be based on the tenor of the mortgage loans underlying the portfolio, or hedging bucket, of forecasted sales designated as the hedged item (i.e., 15-yr Treasury or 30-yr Treasury). The hedge period for individual relationships will typically be approximately 45 days, as relationships are generally established in conjunction with closing mortgage loans. The beginning of the hedge period may be after the inception of the derivative due to use of these derivatives as economic hedges of the pipeline (i.e., outstanding interest rate lock commitments) for which no hedge accounting will be applied.

Derivative hedging instrument
The individual hedging relationships associated with this overall strategy may link multiple derivative contracts in combination to either completely eliminate the variability in cash flows associated with the forecasted loan sale or eliminate the variability in cash flows when the benchmark rate exceeds a specified threshold. Derivatives will be linked to hedging buckets of forecasted sales based on the similarity of the tenor and coupon rate of the derivative and the tenor and coupon rate of the mortgage loans expected to be sold. A new hedging relationship will be designated each time a derivative is linked to a specified hedging bucket of forecasted sales. However, instruments with other underlying indices may be used if we are able to demonstrate that basis differences from the hedged risk do not invalidate the assumption of high effectiveness.
**Hedged forecasted transaction**

The hedged forecasted transaction is defined as the first sales of mortgage loans over the 30-day period beginning on the 1st day of the month in which the derivative contract matures/settles that (i) in aggregate represent sales of the amount of principal equal to the notional amount of the hedging instrument, and (ii) are not currently being hedged by another derivative instrument or were not previously identified in a relationship originally designated earlier in priority that has been terminated for which amounts remain in AOCI. Individual relationships will link hedging instruments to a specified hedging bucket of forecasted sales. Hedging buckets have been identified based upon the tenor and coupon rates of the mortgage loans expected to be sold.

Only those individual forecasted sales that are considered to be *similar* with respect to the risk being hedged are included within the same hedging bucket. Because there is no explicit index on which the cash flows of the forecasted sales are based, all individual forecasted sales of mortgage loans, regardless of coupon and tenor, share the same risk exposure to changes in any designated benchmark rate. However, we acknowledge that the extent of the change in the proceeds on a forecasted sale of a mortgage loan is significantly affected by both the mortgage loan’s tenor and its stated coupon. Accordingly, we will identify our hedging buckets first by tenor and then more specifically by range of coupon rates. For example, each forecasted sale within a particular hedging bucket will be related to a loan with the same tenor, such as 30 years. However, there may be multiple 30-yr hedging buckets based on the range of stated coupon rates. We have determined our hedging buckets to be:

- 30-yr fixed 4.8-5.6%
- 30-yr fixed 5.7-6.7%
- 15-yr fixed 4.3-5.2%
- 15-yr fixed 5.3-5.8%

In order to demonstrate similarity within each hedging bucket, we regressed the cumulative changes in the forecasted proceeds from the sale of a mortgage loan with the smallest coupon rate in the range assigned to the hedging bucket attributable to the possible changes in the benchmark rate with the cumulative changes in the forecasted proceeds from the sale of a mortgage loan with the largest coupon rate in the range assigned to the hedging bucket attributable to the possible changes in the benchmark over a series of 45-day periods (to match our anticipated hedge term) starting at the inception of the strategy going back for 32 distinct 45-day periods (resulting in 32 data points). We believe that using changes in the benchmark rates for the last 32 45-day periods is reasonable for purposes of identifying possible changes in rates over the next 45 days. The results of the regression analysis show that the changes in the expected proceeds for sales of mortgage loans at the outer points of the range for each hedging bucket are highly correlated with one another.

Similarity is to be assessed at the inception of a new hedging relationship as well as each period when the entity assesses effectiveness and measures ineffectiveness for existing relationships; however, we have prepared an analysis to show that the outer points of the above ranges will continue to be highly correlated unless the cumulative change in the
benchmark rate exceeds 8bp for more than 14 consecutive 45-day periods for the 15-yr buckets and 6bp for more than 16 45-day periods for the 30-yr buckets. We will monitor the cumulative changes in the benchmark rates for each 45-day period and continue to conclude for all new and existing relationships that the buckets remain similar unless the changes hit the aforementioned sensitivity parameters.

To support that the hedged forecasted transactions are probable of occurring, we prepare a daily pipeline/warehouse report, by individual hedging bucket. The pipeline/warehouse report forecasts the sales of all closed and committed mortgage loans, taking into account estimated fall-out from the pipeline. Treasury monitors and reviews this report on a daily basis to ensure that we continue to expect to have sales in each hedging bucket adequate to cover our hedge positions. We typically hedge approximately 40% of our total forecasted mortgage loan sales.

**Method for assessing prospective effectiveness**

At Inception

At the inception of each individual hedging relationship, we will assess prospective effectiveness using a regression analysis. Because the prospective assessment is intended to justify an expectation that the relationship will be highly effective over future periods in achieving offsetting changes in cash flows, our regression analysis will demonstrate high correlation between the cumulative changes in fair value of the hedging instrument and the cumulative changes in fair value of a perfectly effective hypothetical derivative (that is regarded as a proxy for the change in the present value of the expected future cash flows on the hedged forecasted sales). Because the term of the individual hedging relationships are expected to be 45 days, we will demonstrate an expectation of high effectiveness on a monthly basis based on historical changes in the benchmark rate over a series of 45-day periods.

Because the hedged forecasted transaction specified for each hedging relationship is a bucket of individual forecasted sales of mortgage loans with the same tenor but within a range of coupon rates, we will perform two regression analyses (using 32 sets of data points for each analysis) to demonstrate that the hedging instrument is expected to be highly effective at hedging the outer points of the range of each hedging bucket. We believe that if the hedging instrument is proven to be highly effective at both ends of the range, we can expect it to be highly effective with respect to all the individual sales within the hedging bucket and thus the relationship will be highly effective regardless of the ultimate composition of the hedging bucket.
Each set of data points to be used in the regressions will be determined as discussed below. Our regression will encompass 32 such data points, each based on a cumulative change in fair value over a 45-day period for the series of 45-day periods beginning at the inception of the hedge and going back a total of 32 45-day periods.

Hedging instrument: The cumulative change in the fair value of the derivative over a 45-day period. In cases where the historical prices for the hedging instrument do not exist, the fair value will be computed with inputs based on the current spot price of the treasury instrument underlying the derivative (e.g., the spot price of a 4.8%, 30-yr Treasury bond), the derivative’s maturity/settlement date, and the applicable Treasury yield curve for that particular date to ensure that the valuations reflect the historical benchmark yield curves actually in place for each of the 32 45-day periods. We believe that using changes in the benchmark rates for the last 32 45-day periods is reasonable for purposes of identifying possible changes in rates over the next 45 days.

Hedged forecasted transaction:

For regression #1: The cumulative change in the fair value of the perfectly effective hypothetical derivative (PEH1) over a 45-day period. For relationships involving futures contracts, PEH1 is a futures contract (with a zero fair value at inception of the hedging relationship) to sell a treasury note/bond with tenor equal to the tenor of the bucket being hedged with a coupon rate equal to the smallest coupon rate in the range associated with that individual bucket. For relationships involving option contracts, PEH1 is a European option contract to sell a treasury note/bond with tenor equal to the tenor of the bucket being hedged with a coupon rate equal to the smallest coupon rate in the range associated with that individual bucket (note we are assessing effectiveness for option relationships based on total changes in option’s cash flows). The strike price on the option is equal to the specified threshold over which the increase in the benchmark rate that is designated as the risk being hedged.

For regression #2: The cumulative change in the fair value of the perfectly effective hypothetical derivative (PEH2) over a 45-day period. For relationships involving futures contracts, PEH2 is a futures contract (with a zero fair value at inception of the hedging relationship) to sell a treasury note/bond with tenor equal to the tenor of the bucket being hedged with a coupon rate equal to the largest coupon rate in the range associated with that individual bucket. For relationships involving option contracts, PEH2 is a European option contract to sell a treasury note/bond with tenor equal to the tenor of the bucket being hedged with a coupon rate equal to the largest coupon rate in the range associated with that individual bucket. The strike price on the option is equal to the specified threshold over which the increase in the benchmark rate that is designated as the risk being hedged.

The settlement date of both PEH1 and PEH2 (the PEHs) will be determined at the inception of the hedge based on an analysis of sales history in the prior month for that particular bucket. For example, if the individual relationship was designated in April for the sale of the first $1MM of principal from the 30-yr (4.8-5.6%) hedging bucket in the month of June (and there were no other hedging relationships related to that hedging bucket previously designated for forecasted sales in the month of June), we will accumulate the sales data from the month of
March to determine how many days (from the beginning of March, because the hedged forecasted transaction is defined as the 1st sales) it took to sell $1MM in principal of that bucket’s loans. We will then compute a weighted average number of days into the month and use that weighted average to determine the settlement date of the PEHs. For example, if the first two sales in March were $500K each, one sale occurring on the 1st day of March, and the second sale occurring on the 10th day of March, the PEHs would have a settlement date of March 5. If, however, there was already a hedging relationship in place for the first $2MM of principal sold in June, then the settlement date for the PEHs for the next $1MM in principal sold would be based on the weighted average number of days that it took during March to sell dollars $2,000,001-$3,000,000 in principal. The previous month’s activity is used because we believe that recent historical information regarding the individual buckets is an appropriate basis on which to develop our best estimate of future settlements.

Because the underlying mortgage loans are sold after origination (typically within 45 days), the treasury note/bond underlying the PEHs must have remaining maturity at the settlement date less than the tenor. In order to determine the remaining maturity, we will accumulate the data on the sales from the month prior to the inception of the hedge to determine how many days the related mortgage loans underlying those sales for that particular hedging bucket remained in the warehouse prior to sale. We will then compute a weighted average number of days and use that weighted average to determine the remaining maturity of the PEHs (i.e., tenor less weighted average days in the warehouse = remaining maturity at sale). The previous month’s activity is used because we believe that recent historical information regarding the individual buckets is an appropriate basis on which to develop our best estimate of future conditions.

The fair value of the PEHs will be computed with inputs based on the current spot price of the treasury instrument underlying the PEH (e.g., the spot price of a 4.8%, 30-yr Treasury bond), the derivative’s maturity/settlement date, and the applicable Treasury yield curve for that particular date to ensure that the valuations reflect the historical benchmark yield curves actually in place for each of the 32 45-day periods. We believe that using changes in the benchmark rates for the last 32 45-day periods is reasonable for purposes of identifying possible changes in rates over the next 45 days.

During the hedging relationship

We will update the regression analyses discussed above every 45 days, continuously using the most current 32 data points.

**Method for assessing retrospective effectiveness**

Our prospective assessment is intended to justify an expectation that the relationship will be highly effective over future periods in achieving offsetting changes in cash flows. In contrast, our retrospective assessment is intended to determine whether the relationship has been highly effective cumulatively to date. Accordingly, we will assess retrospective effectiveness on a dollar-offset basis. In order to support hedge accounting for all relationships within the bucket for the previous period, the cumulative change in the fair value of the actual derivatives will need to offset at least 80%, and up to 125%, of the cumulative change in the fair value of the associated PEHs.
Manner in which ineffectiveness will be measured

Ineffectiveness will be measured using a perfectly effective hypothetical (PEH3). The terms of the PEH will be determined at the inception of the hedge based on an analysis of the sales made in the prior month for that particular bucket. For relationships involving futures contracts, PEH3 is a futures contract (with a zero fair value at inception of the hedging relationship) to sell a treasury note/bond with tenor equal to the tenor of the bucket being hedged with a coupon rate equal to the weighted average coupon rate of all the mortgage loans in the warehouse at the inception of the hedge that meet the parameters of the bucket being hedged. For relationships involving option contracts, PEH3 is a European option contract to sell a treasury note/bond with tenor equal to the tenor of the bucket being hedged with a coupon rate equal to the weighted average coupon rate of all the mortgage loans in the warehouse at the inception of the hedge that meet the parameters of the bucket being hedged.

The strike price on the option is equal to the specified threshold over which the increase in the benchmark rate that is designated as the risk being hedged. We use a weighted average coupon of the warehouse loans associated with entire hedging bucket because we believe that (i) each loan within that bucket has an equal chance of being within the 1st sales of the month (and therefore being identified as a hedged forecasted transaction), and (ii) we believe that it is more likely that the sale will be related to loans already closed at the inception of the hedging relationship as opposed to potential loans that exist in the pipeline.

The settlement date of PEH3 will be determined at the inception of the hedge based on an analysis of the sales history in the prior month for that particular hedging bucket, as discussed above in the context of the development of PEHs for assessing prospective effectiveness. We will accumulate the data on the sales from the previous month to determine how many days from the beginning of the month it took to sell the amount of principal subject to the hedge. We will then compute a weighted average number of days into the month and use that weighted average to determine the settlement date of PEH3.

Because the underlying mortgage loans are sold after origination (typically within 45 days), the treasury note/bond underlying PEH3 will be required to have remaining maturity at the settlement date less than the tenor. Consistent with the method discussed above in the context of the development of the PEHs for assessing prospective effectiveness, in order to determine the remaining maturity, we will accumulate the data on the sales from the previous month to determine how many days the mortgage loans underlying the sales in that particular bucket remained in the warehouse prior to sale. We will then compute a weighted average number of days and use that weighted average to determine the remaining maturity of the PEH3 (i.e., tenor less weighted average days in the warehouse = remaining maturity at sale).

As discussed above, the terms of PEH3 will be determined at the inception of the hedge. The process we follow to construct the PEH (i.e., using historical data) will be modified when/if we observe that the historical information regarding the behavior of the hedging buckets used in PEH3’s construction is no longer an appropriate basis on which to estimate future conditions.

The discount rates used to compute the fair value of PEH3 at the beginning of the hedging period will be equal to the weighted average coupon of PEH3 at the inception of the hedge (yielding a fair value of zero for futures contracts at the inception of the hedging relationship).
The discount rates at the end of the measurement period will be equal to weighted average coupon of PEH3 at the inception of the hedge adjusted (up or down) for changes in the designated benchmark rates (based on the most recent yield curve) from the inception of the hedge to the end of the measurement period.

If the cumulative change in fair value of the actual derivative exceeds the cumulative change in fair value of PEH3 on a dollar-offset basis, we will record that excess as ineffectiveness in p&l. Amounts recorded in AOCI are reclassified from earnings when the hedged forecasted sales occur (i.e., when they affect earnings). Ineffectiveness will only be measured for relationships involving options when the options are in the money.

A6.130 The following is an example of hedge documentation for cash flow hedging strategy involving the forecasted purchase of fuel.

Example A6.2: Documentation of the Hedging Strategy – Forecasted Purchases of Fuel

Risk management objective and strategy

In conjunction with our freight transport operation, we purchase fuel at various marketing points (e.g., New York Harbor, U.S. Gulf Coast, Los Angeles) on an ongoing basis. Because our transport operations involve both air and ground transport, we regularly purchase both jet and diesel fuel. Fuel costs make up a substantial part of our total operating expenses and thus our overall profitability and operating cash flows are exposed to the variability in the market price for fuel. Our objective is to hedge that variability. Variability is limited to changes in prices at various marketing points as we have negotiated fixed delivery cost from the marketing points. Our strategy for achieving this objective is to use futures and purchased options with notional amounts and underlying indices that we believe will be highly effective at hedging that variability.

Nature of the risk being hedged

The hedged risk is defined as the risk of overall changes in cash outflows for the purchase of fuel. Our exposure to changes in the overall price of fuel will be impacted by both the type of fuel expected to be purchased (e.g., jet fuel or diesel fuel) and the marketing point. As discussed above, the variability in the overall cash outflows for the purchase of fuel is limited to changes in spot prices at various marketing points as we have negotiated fixed delivery cost from those marketing points. The hedge period for individual relationships is typically three months.

Derivative hedging instrument

The individual hedging relationships associated with this overall strategy may link multiple derivative contracts in combination to either completely eliminate the variability in cash flows associated with the forecasted purchases of fuel or eliminate the variability in cash flows when the overall price exceeds a specified threshold. Derivatives will be linked to hedging buckets
of forecasted purchases based on their similarity to the overall price risk associated with the forecasted purchases. Similarity of overall price risk will be based upon both the type and location of fuel expected to be purchased. Typically, our hedging instruments will be futures or purchased options indexed to either the NYMEX Heating Oil, NY Harbor No. 2 index (generally used for relationships involving forecasted purchases of jet fuel) or the NYMEX West Texas Intermediate Crude Oil index (generally used for relationships involving forecasted purchases of diesel fuel) as these indices generally exhibit high correlation with the changes in market prices for the hedged forecasted purchases. However, instruments with other underlying indices may be used if we are able to demonstrate high effectiveness. A new hedging relationship will be designated each time a derivative is linked to a specified hedging bucket of forecasted purchases.

**Hedged forecasted transaction**

The hedged forecasted transaction is defined as the first purchases of gallons of fuel over the 30-day period beginning on the 1st day of the month in which the derivative contract matures/settles that (i) in aggregate represent the number of gallons (or equivalent barrels) equal to the notional amount of the hedging instrument, and (ii) are not currently being hedged by another derivative instrument or were not previously identified in a relationship originally designated earlier in priority that has been terminated for which amounts remain in AOCI. Individual relationships will link hedging instruments to a specified hedging bucket of forecasted purchases. Hedging buckets have been identified based upon the type and marketing point of the fuel expected to be purchased.

Only those individual forecasted purchases that are considered to be *similar* with respect to the risk being hedged are included within the same hedging bucket. Because the overall price of a gallon of fuel is significantly affected by both the type of fuel and the location of the purchase, we will identify our hedging buckets first by type and then more specifically by marketing point. For example, each forecasted purchase within a particular hedging bucket will be for the same type, either jet fuel or diesel fuel. However, there may be multiple jet fuel hedging buckets based on the marketing point at which the jet fuel is expected to be purchased. We have determined our hedging buckets to be:

- **Bucket 1:** Jet fuel, New York Harbor, U.S. Gulf Coast, Los Angeles
- **Bucket 2:** Jet fuel, Singapore, Rotterdam
- **Bucket 3:** Diesel fuel, New York Harbor, U.S. Gulf Coast
- **Bucket 4:** Diesel fuel, Los Angeles

In order to demonstrate similarity within each hedging bucket, we regressed the cumulative change in the forecasted price of a gallon of fuel at each marketing point with the cumulative change in the forecasted price of a gallon of fuel at each other marketing point within the hedging bucket over the series of three-month periods (to match our anticipated hedge term) starting at the inception of the strategy going back for 32 distinct three-month periods (resulting in 32 data points). We believe that using cumulative changes in prices for the previous 32 three-month periods is reasonable for purposes of identifying possible changes in prices over the next three months. The results of the regression analysis show that the changes in the expected prices for purchases of fuel at the each of the marketing points within the...
hedging bucket are highly correlated with one another. Because similarity is to be assessed at the inception of the hedging relationship as well as each period thereafter when the entity assesses effectiveness and measures ineffectiveness for existing relationships, we will update our regression analysis on a monthly basis (which will capture the results of actual changes during the previous month). We will monitor both jet and diesel fuel prices by marketing point on a weekly basis for changes in general price trends to ensure that performing our monthly regression analysis continues to be adequate to demonstrate expected similarity for all of our new and existing individual hedging relationships.

To support that the hedged forecasted transactions are probable of occurring, we prepare a weekly freight and usage report, by individual hedging bucket. The freight and usage report forecasts expected shipments (both those secured by contract and anticipated volume) by week over a six-month period. This report is monitored on a weekly basis to ensure that we continue to expect to have purchases of fuel related to each individual hedging bucket adequate to cover our hedge positions. We typically hedge approximately 40% of our total forecasted fuel purchases.

**Method for assessing prospective effectiveness**

At Inception

At the inception of each individual hedging relationship, we will assess prospective effectiveness using a regression analysis. Because the prospective assessment is intended to justify an expectation that the relationship will be highly effective over future periods in achieving offsetting changes in cash flows, our regression analysis will demonstrate high correlation between the cumulative changes in fair value of the hedging instrument and the cumulative changes in fair value of a perfectly effective hypothetical derivative (that is regarded as a proxy for the change in the present value of the expected future cash flows of the hedged forecasted purchases of fuel) over a series of 32 three-month periods.

Because the hedged forecasted transaction specified for each hedging relationship is a bucket of individual forecasted purchases of fuel of the same type but from differing marketing points, we will perform separate regression analyses (using 32 sets of data points for each analysis) to demonstrate that the hedging instrument is expected to be highly effective at hedging overall price risk for purchases at each of the individual marketing points identified within each hedging bucket. For example, for an individual hedging relationship associated with Bucket 1 above, three regression analyses would be prepared to demonstrate that the derivative would be highly effective at hedging forecasted purchases whose price varies upon (1) the New York Harbor index, (2) the U.S. Gulf Coast index, and (2) the Los Angeles index. This analysis demonstrates that the hedging relationship would be highly effective regardless of the ultimate composition of the hedging bucket (e.g., if 100% of the forecasted purchases were from any one of the identified marketing points).

Each set of data points to be used in the regression will be determined as discussed below. Our regression will encompass 32 such data points, each based on the cumulative change in fair value over a three-month period for the series of three-month periods beginning at the inception of the hedge and going back a total of 32 three-month periods.
Hedging instrument: The cumulative change in the fair value of the derivative over a three-month period. In cases where historical prices for the hedging instrument do not exist, the fair values will be computed with inputs based on the current spot price of the commodity underlying the derivative, the derivative’s maturity/settlement date, and the applicable forward price curve for that particular date to ensure that the valuations reflect the historical price curves actually in place during each of the 32 three-month periods. We believe that using changes in prices for the previous 32 three-month periods is reasonable for purposes of identifying possible changes in prices over the next three months.

Hedged forecasted transaction: The cumulative change in the fair value of the perfectly effective hypothetical derivative (PEH1) over a three-month period. For relationships involving futures contracts, PEH1 is a futures contract (with a zero fair value at inception of the hedging relationship) to purchase fuel of the type of the bucket being hedged at the marketing point within that individual bucket for which the regression is being prepared. For relationships involving option contracts, PEH1 is a European option contract to purchase fuel of the type of the bucket being hedged at the marketing point within that individual bucket for which the regression is being prepared (note we are assessing effectiveness for option relationships based on total changes in option’s cash flows). The strike price on the option is equal to the specified threshold over which the increase in the overall market price of fuel (either jet fuel or diesel fuel) is designated as the risk being hedged.

The settlement date of each of the PEHs will be determined at the inception of the hedge based on an analysis of the purchases made in the prior three-month period for that particular bucket. For example, if the individual relationship was designated in March for the purchase of the first one million gallons of jet fuel associated in hedging Bucket 1 in the month of June (and there were no other hedging relationships related to that hedging bucket previously designated for forecasted purchases in the month of June), we will accumulate the purchase data from the three-month period spanning December-February to determine how many days (from the beginning of December, because the hedged forecasted transaction is defined as the 1st purchases) it took to purchase one million gallons of that hedging bucket’s fuel. We will then compute a weighted average number of days into the three-month period and use that weighted average to determine the settlement date of the PEHs. For example, if the first two purchases during the three-month period were 500,000 gallons each, one purchase occurring on the 1st day of December, and the second purchase occurring on the 31st day of January, the PEHs would have a settlement date of January 1. If, however, there was already a hedging relationship in place for the first two million gallons of jet fuel purchased, then the settlement date for the PEHs for the next one million gallons purchased would be based on the weighted average number of days that it took during the three-month period spanning December-February to purchase gallons 2,000,001-3,000,000. The activity for the previous three-month period is used because we believe that recent historical information regarding the individual buckets is an appropriate basis on which to develop our best estimate of future settlements.

The fair value of each of the PEHs will be computed with inputs based on the current spot price of the type of fuel and applicable marketing point (e.g., NYMEX New York Harbor Jet Kerosene, NYMEX U.S. Gulf Coast Low-Sulfur No. 2 Diesel Fuel, etc.) for which the regression is being prepared and the applicable forward price curve for that particular date to ensure that the valuation reflects the historical price curves actually in place during each three-
month period. We believe that using changes in prices for the previous 32 three-month periods is reasonable for purposes of identifying possible changes in prices over the next three months.

During the hedging relationship

We will update the regression analyses discussed above on a monthly basis, continuously using the most current 32 data points.

Method for assessing retrospective effectiveness

Our prospective assessment is intended to justify an expectation that the relationship will be highly effective over future periods in achieving offsetting changes in cash flows. In contrast, our retrospective assessment is intended to determine whether the relationship has been highly effective cumulatively to date. Accordingly, we will assess retrospective effectiveness on a dollar-offset basis. In order to support hedge accounting for all relationships within the bucket for the previous period, the cumulative change in the fair value of the actual derivatives will need to offset at least 80%, and up to 125%, of the cumulative change in the fair value of the associated PEHs.

Manner in which ineffectiveness will be measured

Ineffectiveness will be measured using a perfectly effective hypothetical derivative (PEH2). The terms of the PEH2 will be determined at the inception of the hedge based on an analysis of the purchases made in the prior three-month period for that particular bucket.

PEH2 may consist of a series of perfectly effective hypothetical derivatives (peh1, peh2, peh3, etc.), in cases where the hedging bucket consists of forecasted purchases from more than one marketing point. For example, for an individual hedging relationship for the forecasted purchase of one million gallons of fuel within Bucket 1, PEH2 may consist of peh1 (indexed to NYMEX New York Harbor Jet Kerosene), peh2 (indexed to NYMEX U.S. Gulf Coast Jet Kerosene), and peh3 (indexed to NYMEX Los Angeles Jet Kerosene), the aggregate notional of which will equal one million gallons. The notional amount of each individual peh will be based on the relative proportion of all purchases made at each marketing point within the hedging bucket during the prior three-month period. For relationships involving futures contracts, each peh is a futures contract (with a zero fair value at inception of the hedging relationship) to purchase fuel of the type associated with the bucket being hedged at the relevant marketing point. For relationships involving option contracts, each peh is a European option contract to purchase fuel of the type associated with the bucket being hedged at the relevant marketing point. The strike price on the option is equal to the specified threshold over which the increase in the overall market price of fuel (either jet fuel or diesel fuel) is designated as the risk being hedged. We use the relative proportion of all purchases made at each marketing point within the hedging bucket during the prior three-month period because (i) the relative distribution of our demand at each marketing point over quarterly periods (driven by shipping volumes) has historically remained stable and (ii) our fuel purchases are evenly distributed at each of the marketing points throughout the quarter and therefore each gallon of fuel, regardless of the marketing point, has an equal chance of being within the 1st purchases of the month (and therefore being identified as a hedged forecasted transaction).
The settlement date of PEH2 will be determined based on an analysis of the purchases made over the prior three-month period for that particular hedging bucket, as discussed above in the context of the development of PEHs for assessing prospective effectiveness. We will accumulate the data on the purchases from the previous three-month period to determine how many days from the beginning of the period it took to purchase the number of gallons subject to the hedge. We will then compute a weighted average number of days into the period and use that weighted average to determine the settlement date of PEH2.

As discussed above, the terms of PEH2 will be determined at the inception of the hedge. The process we follow to construct the PEH (i.e., using historical data) will be modified when/if we observe that the historical information regarding the behavior of the hedging buckets used in PEH2’s construction is no longer an appropriate basis on which to estimate future conditions.

If the cumulative change in fair value of the actual derivative exceeds the cumulative change in fair value of PEH2 on a dollar-offset basis, we will record that excess as ineffectiveness in p&l. Amounts recorded in AOCI are reclassified from earnings when the hedged forecasted purchases occur (i.e., when they affect earnings as operating expense). Ineffectiveness will only be measured for relationships involving options when the options are in the money.

QUESTIONS & ANSWERS


1. Goldco does not know how many units of gold watches and gold pens it will sell in the coming months. The sales prices of these products are affected directly by changes in the market price of gold. Assume Goldco could demonstrate that a gold forward contract would be effective in achieving offsetting changes in cash flows related to all changes in sales price of the products.

Q. Would Goldco qualify for hedge accounting for the forecasted sale of the products with a gold forward contract?

A. No. Paragraph 28(a) (ASC paragraphs 815-20-25-3 and 25-13) requires the formal documentation of the hedging relationship to be sufficiently specific so that it can determine whether the forecasted transaction has occurred. Goldco does not know how many units of gold watches and pens will be sold and cannot determine whether the forecasted transaction has occurred. For the forecasted sale to qualify for hedge accounting, Goldco must be able to estimate the number of units of each product that will be sold and the estimated timing of the sales.

2. Knight Co. expects to issue a fixed-rate debt obligation three months from today. Until the date of issuance, Knight is exposed to variability in cash flows that are attributable to interest rate risk. This interest rate risk arises to the extent the fixed rate available to Knight changes from the rate it would currently pay to the rate it will be required to pay once the terms of the debt issuance are determined. To hedge this exposure to cash flows, Knight enters into a
forward starting interest rate swap that will require it to pay interest at a fixed rate and receive interest at a variable rate. It plans to terminate the swap when it issues the debt obligation.

Q. How should Knight account for the forward starting interest rate swap?

A. Until the fixed-rate debt obligation is issued (i.e., the date on which the interest rate on the debt obligation is determined), the forward starting interest rate swap is hedging a cash flow exposure (i.e., the variability of the interest payments on the debt due to a change in the benchmark interest rate). Thus, Knight should report all changes in the fair value of the forward starting swap that are attributable to the hedged risk that are considered effective in OCI. The amount in AOCI should be reclassified into earnings as the forecasted transaction is reported in earnings (in this case, amortized over the life of the debt obligation).

3. Q. Can an instrument that contains an embedded written option (e.g., a written swaption) qualify as a hedging instrument in a cash flow hedge?

A. Yes, in certain circumstances. The Standard provides that a derivative instrument that results from combining a net written option and any other nonoption derivative instrument should be considered a net written option. As a written swaption fits this description, the entity would need to consider the net written option criteria of paragraph 28(c) of the Standard (ASC paragraphs 815-20-25-94 and 25-95) to determine whether hedge accounting is appropriate. A swaption qualifies for cash flow hedge accounting only if the combination of the hedged item and the swaption (or net written option) provides at least as much potential for favorable cash flows as exposure to unfavorable cash flows. The test is met if a percentage favorable change in the underlying would provide at least as much favorable cash flows as the unfavorable cash flows that would be incurred from an unfavorable change in the underlying of the same percentage.

In addition, when a derivative instrument is embedded in another derivative instrument, the entire instrument must qualify for hedge accounting for the derivative instrument to qualify for hedge accounting. For example, an entity may not separate a compound derivative instrument into two derivative instruments so that one would qualify for hedge accounting, while the other would not.

4. SWM owns 100 shares of Company B common stock. SWM is restricted from selling the common stock for one month, and expects to sell the common stock at that time. SWM is concerned that Company B’s share price will decline in the next month and decides to hedge this exposure by entering into a short position in Company B’s stock. To do so, SWM borrows 100 shares of Company B from Bank X for a one-month period. SWM immediately sells these shares in the open market at fair market value. At the end of the month, SWM satisfies its obligation to Bank X using the 100 shares of Company B that it owns.

Q. Would SWM be permitted to designate the short position as a cash flow hedge of its investment in Company B?

instrument in a cash flow hedge. Short positions generally do not meet the definition of a derivative instrument under paragraphs 6(b) and 8 of the Standard (ASC paragraphs 815-10-15-83(b) and 815-10-15-92, 15-94 through 15-96), because they require an initial investment equal to the notional amount. In this instance, SWM was required to obtain (when it borrowed the shares) and deliver (when it sold the shares) 100 shares of Company B, which is the notional amount. As a consequence, this transaction would not qualify as a cash flow hedge.

In paragraph 290 of the Standard, the Board intentionally did not address whether short sales arrangements would always (or never) meet the definition of a derivative instrument under paragraph 6 of the Standard (ASC paragraphs 815-10-15-83 and 15-85), because the terms and customs of the contracts vary. Instead, the specific terms of the contract must be evaluated to determine whether it meets the Standard’s definition of a derivative instrument.

5. Mark Co. purchased an option three months ago. Mark intends to use the option to hedge a qualifying forecasted purchase that it expects to occur nine months from today.

Q. Can Mark Co. document and designate the hedging relationship today so that the hedge accounting would be applied retroactively from the date the option was purchased?

A. No. Paragraph 28 of the Standard (ASC paragraph 815-20-25-3) requires that the hedging relationship be formally documented at the inception of the hedge. Mark Co., therefore, may not designate and document the hedge today and retroactively qualify for hedge accounting. Mark Co., however, may formally document the existence of a qualifying hedge today and apply hedge accounting prospectively.

Eligibility Requirements of the Forecasted Transaction (paragraph 29 of the Standard (ASC paragraphs 815-20-25-15 and 25-43))

6. International Bank has a pool of variable-rate commercial mortgages. The interest rates on these mortgages are based on U.S. Treasury, Canadian Treasury, or LIBOR. A historical analysis of the movement in these rates indicates that they are highly correlated.

Q. Can International Bank designate the pool of variable-rate commercial mortgages as the hedged item in a cash flow hedge of the benchmark interest rate risk even though the mortgages are not all based on the same index?

A. No. Paragraph 29(a) of the Standard (ASC paragraph 815-20-25-15(a)) states that if the hedged transaction is a group of individual transactions, those transactions must share the same risk exposure for which they are designated as being hedged. Further, paragraph 462 of the Standard (ASC paragraphs 815-20-55-22 and 55-23) includes an example in which the Board concluded that forecasted interest payments on several variable-rate debt instruments must vary with the same index to qualify for hedge accounting with a single derivative instrument. Thus, International Bank cannot designate the pool of commercial mortgages with interest rates based on multiple indices as the hedged item in a cash flow hedge.

7. Widget Inc. produces consumer goods called Widgets. Although the CEO recently decided to expand its operations to include the manufacturing of equipment used to produce widgets,
the Board must approve this change in business strategy. This change will require Widget Inc. to purchase, among other things, steel to manufacture the equipment. It has never purchased steel in the past. Although Widget Inc. has not entered into a firm commitment to purchase steel from Steelco, it expects to complete a purchase transaction within six months. Steelco is one of several possible suppliers. Widget Inc. wants to lock in the purchase price of steel.

Q. Can Widget Inc. designate the transaction with Steelco as a hedged item in a cash flow hedge?

A. The answer to this question depends on specific facts and circumstances. In these circumstances, we believe Widget Inc. cannot designate the transaction as hedged item in a cash flow hedge. Paragraph 29(b) (ASC paragraph 815-20-25-15(b)) requires that forecasted transactions be probable. Paragraphs 463 - 465 of the Standard (ASC paragraphs 815-20-25-16, 815-20-55-24 and 55-25) provide guidance on determining whether a forecasted transaction is probable. Paragraph 464 (ASC paragraph 815-20-25-16) states that probable is the area within a range in which the future event is likely to occur. Paragraph 463 of the Standard (ASC paragraph 815-20-55-24) states that the likelihood of a transaction occurring can be supported by information or evidence such as the frequency of similar past transactions (none, in the case of Widget Inc.); the financial ability and operational ability of the entity to carry out the transaction (uncertain until the Board approves the change in business strategy); the extent of loss or disruption of operations that could result if the transaction does not occur (unknown); and the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (moderate, given that Steelco is one of several suppliers). Given the facts as described above, we believe that the transaction does not meet the probable criterion. Thus, Widget Inc. may not designate the expected steel purchase as the hedged item in a cash flow hedge.

8. M Co. is a cereal producer. The primary ingredient in the Company’s hottest selling product is wheat.

Q. Can M Co. designate a wheat futures contract as a hedge of the forecasted sale of its wheat-based cereal?

A. Yes. In a hedge of a forecasted sale or purchase of a nonfinancial asset, paragraph 29(g) (ASC paragraph 815-20-25-15(i)) requires the designated risk to be the risk of changes in the cash flows related to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset). Thus, M Co. could qualify for hedge accounting if it uses a wheat futures contract to hedge the risk of changes in cash flows related to all changes in the sales price of the wheat-based cereal. The cereal manufacturer must establish that this futures contract is highly effective at achieving offsetting changes in the cash flows of the wheat-based cereal sales related to all changes in the sales price of the cereal. The cereal manufacturer would be required to recognize hedge ineffectiveness to the extent that the cumulative gain or loss on the wheat futures contract does not move in tandem with the cumulative change in the expected future cash flows that is attributable to the forecasted sale of wheat-based cereal inventory. M Co., however, is precluded from designating the wheat futures contract as a cash flow hedging instrument of the wheat ingredient of its cereal.
8a. Q. In a cash flow hedge of an operating lease with variable lease payments, can an entity designate a specific risk (e.g., risk of changes in the benchmark interest rate) as the hedged risk?

A. Under an operating lease, the lessor performs when, and only when, the leased asset(s) is made available to the lessee within the agreed upon time period (However, a lessee’s accounting for an operating lease will change under ASU 2016-02, Leases, and the lessee will generally recognize a nonfinancial right of use asset). Consequently, an operating lease is a nonfinancial executory contract, not a recognized financial asset or liability.

In a hedge of a forecasted sale or purchase of a nonfinancial asset, paragraph 29(g) (ASC paragraph 815-20-25-15(i)) requires the designated risk to be either (1) the risk of changes in the functional currency equivalent cash flows attributable to changes in the related foreign currency exchange rate or (2) the risk of changes in the cash flows related to all changes in the purchase price or sales price of the asset. Consequently, an entity would be permitted to designate the total changes in cash flows as the hedged risk or, if the lease rentals are denominated in a foreign currency, to designate the variability in those cash flows arising from foreign currency risk as the hedged risk.

8b Q. In a capital lease, can an entity designate a specific risk (e.g., risk of changes in the benchmark interest rate) as the hedged risk in a cash flow hedge?

A. Yes. Under capital leases, financial assets and financial liabilities are recognized by the lessors and lessees, respectively. Paragraph 29(h) of the Standard (ASC paragraph 815-20-25-15(j)) permits specific types of risk to be hedged in a cash flow hedge of the variable cash flows of an existing financial asset or liability. Therefore, an entity would be permitted to hedge risks such as interest rate risk, foreign exchange risk, and credit risk.

9. GCF expects to purchase an equity security three months from today. To reduce the variability in cash flows associated with price movements in that security, GCF simultaneously enters into a forward contract to purchase the same security. GCF wishes to designate the forward contract as a hedge of its forecasted purchase.

Q. What methodology should GCF use to determine whether the cash flow hedging relationship is highly effective?

A. The Standard does not specify a methodology that must be used to determine whether a hedging relationship is highly effective. Rather, at inception of a hedge, an entity is required to define how it will assess a hedge’s effectiveness in achieving offsetting changes in cash flows that are attributable to the risk that is being hedged. Paragraph 386 of the Standard (ASC paragraph 815-20-25-81) outlines the Board’s requirement that the methodology used be reasonable and used consistently throughout the hedging relationship. Paragraph 386 of the Standard (ASC paragraph 815-20-25-81) also requires an entity to assess effectiveness for similar hedges in a similar manner. Thus, the use of different methods for similar hedges should be justified. In addition, if an entity identifies an improved method for assessing effectiveness, it must discontinue the existing hedging relationship and designate a new relationship that uses the improved method.
10. Dee would like to acquire shares of Cee, a publicly traded company, three months from now. The Company would account for its investment in Cee as a trading security under Statement 115 (ASC Subtopic 320-10). Alternatively, Dee is considering entering into a derivative instrument three months from today with a value indexed to the market price of Cee’s common stock (assume the derivative instrument meets the definition of a derivative instrument under the Standard).

Q. Can either the forecasted acquisition of the Statement 115 (ASC Subtopic 320-10) trading security or the forecasted acquisition of the derivative instrument be designated as a hedged item?

A. No. Neither item would qualify as a hedged item in a cash flow hedge. Paragraph 29(d) of the Standard (ASC paragraphs 815-20-25-15(d) and 25-15(e)) prohibits designating as a hedged item a forecasted acquisition of assets or liabilities that will be reported in the statement of financial position at fair value with subsequent changes in fair value reported currently in earnings. As trading securities and derivative instruments are reported in the statement of financial position at fair value with subsequent changes in fair value being reported currently in earnings, neither item would qualify as a hedged item in a cash flow hedge.

If, however, the security were classified as an available-for-sale security under Statement 115 (ASC Subtopic 320-10), it could be designated as the hedged item in a cash flow hedge.

11. On January 1, 20X1, Doe Inc. issued a 15-year, variable-rate debt obligation (based on LIBOR). Simultaneously, Doe entered into a ten-year interest rate swap (with a variable leg based on LIBOR) to receive interest at a variable rate and to pay interest at a fixed rate.

Q. Can the 10-year interest rate swap be used to hedge the variability in cash flows during the first 10 years of the 15-year variable-rate debt obligation?


12. On January 1, 20X1, Doe Inc. issued a 10-year variable-rate debt obligation (based on LIBOR). Simultaneously, Doe entered into a 15-year interest rate swap (with a variable leg based on LIBOR) to receive interest at a variable rate and to pay interest at a fixed rate.

Q. Can the first 10 years of the 15-year interest rate swap be used to hedge the variability in cash flows associated with the 10-year variable-rate debt obligation?

A. No. Paragraph 18 of the Standard (ASC paragraphs 815-10-35-2 and 815-20-25-45) permits entities to designate either all or a proportion of a derivative instrument as a hedging instrument, but prohibits separating a derivative instrument into components that represent different risks and designating one of those components as the hedging instrument. We believe
separating a derivative instrument into different segments based on the timing of interest payments or receipts would result in one portion of the contract having different risks from those attributable to the entire derivative contract. Thus, we believe Doe would be precluded from hedging the variability in cash flows of the 10-year variable-rate debt obligation using the first 10 years of the 15-year interest rate swap because the first 10 years of the swap represents a portion of the entire derivative instrument.

13. On January 1, 20X0, Doe issued a 15-year variable-rate debt obligation (LIBOR). On January 1, 20X5, Doe entered into a 10-year interest rate swap (LIBOR) to receive interest at a variable rate and to pay interest at a fixed rate.

Q. Can the 10-year interest rate swap be used to hedge the variability in cash flows during the last 10 years of the 15-year, variable-rate debt obligation (i.e., the swap is entered into at the beginning of the sixth year of the variable-rate debt obligation)?


14. Jas Co. owns 50% of a joint venture, JV, and uses the equity method of accounting to account for that investment. JV has a $10,000,000 LIBOR-rate debt obligation. Jas Co. is concerned that fluctuations in LIBOR may adversely affect the earnings of JV and thereby affect its share of the earnings. To mitigate this risk, Jas Co. enters into a pay-fixed, receive-LIBOR interest rate swap to lock in the cost of JV’s debt obligation.

Q. Is Jas Co. permitted to use cash flow hedge accounting for the interest rate swap that it used to hedge the variability in cash flows due to changes in LIBOR associated with JV’s debt obligation?

A. No. Paragraph 29(c) of the Standard (ASC paragraph 815-20-25-15(c)) requires the forecasted transaction in a cash flow hedge to be (1) a transaction and 2) to present an exposure to cash flows for the hedged risk that could affect reported earnings. The effect of changes in LIBOR on Jas Co.’s income statement is not a transaction from Jas Co.’s perspective. In addition, neither Jas Co. nor any of its consolidated subsidiaries have any direct exposure to variability in cash flows that is attributable to its interest in the JV. Thus, we believe Jas Co. may not use cash flow hedge accounting in this instance.

15. LAP Co. wishes to hedge a forecasted sale of a product to a third party. The terms of the forecasted sale include a fixed sales price because the buyer agreed to purchase 100 units of the product for $100 on March 31, 20X1. The sales agreement does not include a disincentive for nonperformance.

Q. Can LAP Co. hedge the future sale in a cash flow hedge?
A. No. Paragraph 29(c) of the Standard (ASC paragraph 815-20-25-15(c)) requires that, in addition to being with a party external to the reporting entity, the hedged forecasted transaction in a cash flow hedge must present an exposure to variations in cash flows that could affect reported earnings. LAP Co.’s future sale of the product does not expose the entity to variations in cash flows because the sales price of the units to be sold is fixed at $100. In addition, the future sale is not a firm commitment and cannot be hedged under the fair value hedge model. If the sales price were the market price on March 31, 20X1, the forecasted transaction would qualify for designation as a cash flow hedged item.

Accounting for a Cash Flow Hedge (paragraphs 30 and 31 of the Standard (ASC paragraphs 815-30-35-3, 35-4, 35-7, and 35-38 through 35-41))

16. Company SGP enters into a hedge of the forecasted purchase of 1,000 shares of available-for-sale equity securities. Shortly thereafter, the hedged available-for-sale securities appreciate in value and Company SGP reports a $1,000,000 net gain in AOCI related to the derivative hedging instrument.

Q. When should the $1,000,000 net gain be reclassified into earnings?

A. Paragraph 31 of the Standard (ASC paragraphs 815-30-25-38 through 35-41) states that the net gain in AOCI related to a forecasted transaction should be reclassified into earnings when the hedged forecasted transaction is reported in earnings (i.e., when the available-for-sale equity securities are sold). In addition, the amount in AOCI should be reclassified into earnings if:

- It becomes probable that the forecasted purchase of the available-for-sale equity securities will not occur by the end of the originally specified time period or within two months thereafter (paragraph 33 (ASC paragraphs 815-30-40-4 and 40-5)); or

- There is an other-than-temporary impairment of the available-for-sale equity securities that is included in earnings (paragraph 35 (ASC paragraph 815-30-35-43)). In this circumstance, any offsetting net gain related to the transaction should be reclassified into earnings immediately. For example, if Company SGP recorded an other-than-temporary impairment of $750,000 because of a decline in the fair value of these available-for-sale equity securities, $750,000 of the $1,000,000 gain in AOCI would be reclassified into earnings to offset the impairment loss recognized on the available-for-sale securities.

If the other-than-temporary impairment was $750,000 and Company SGP had reported in AOCI a net loss of $1,000,000 on account of the derivative hedging instrument, in addition to recording the $750,000 impairment loss on the available-for-sale securities, Company SGP would reclassify the $1,000,000 net loss into earnings immediately as the amount is not expected to be recovered when the forecasted transaction is reported in earnings.
17. Company X reported a net gain of $5,000,000 in AOCI that resulted from the hedge of a forecasted purchase of 10,000 units of inventory. In the subsequent year, Company X expects to sell 20,000 units of inventory.

Q. Does Company X have latitude in determining when to recognize the $5,000,000 net gain?

A. No. Similar to the accounting for the sales of inventory, we believe that Company X, as part of its formal documentation of this hedging relationship, would have to establish a cost flow assumption (e.g., LIFO, FIFO, or Average Cost) for reclassifying from AOCI into earnings the net gains or losses on derivative hedging instruments.

18. Q. If the hedging instrument is a forward starting interest rate swap, can an entity measure ineffectiveness under paragraph 30(b) of the Standard (ASC paragraph 815-30-25-3(b)) by comparing the floating leg of the swap and the hedged floating rate cash flows of the asset or liability (change in variable cash flows method discussed in DIG Issue G7)?

A. No. When applying paragraph 30(b) (ASC paragraph 815-30-25-3(b)) an entity will be unable to apply the change in variable cash flows method since that method pertains to interest rate swaps and not forward starting swaps or swaptions.

19. Q. Is a swaption an option or is it a swap with a cap?

A. A swaption is an option to enter into a swap at a future date. A swap with a cap represents a swap transaction that has a cap on the variable leg of the transaction.

Discontinuance of Cash Flow Hedge Accounting (paragraphs 34 and 35 of the Standard (ASC paragraphs 815-30-25-42 and 25-43))

20. On January 1, 20X1, Henry Co. purchased a call option to hedge the forecasted purchase of 10,000 units of inventory, which is expected to occur in twelve months. At June 30, 20X1, a $5,000,000 gain on the call option remains in AOCI. On July 1, 20X1, Henry Co. enters into a firm commitment to acquire the 10,000 units of inventory in six months, thereby transforming the forecasted transaction into a firm commitment.

Q. How should Henry Co. account for $5,000,000 gain in AOCI?

A. When the hedged forecasted transaction becomes a firm commitment, it no longer qualifies as a cash flow hedge because there is no variability in expected future cash flows. Thus, under paragraph 32 of the Standard (ASC paragraphs 815-30-40-1 through 40-3), Henry Co. would discontinue prospectively applying cash flow hedge accounting to the forecasted transaction/call option hedging relationship. Paragraph 29 of the Standard (ASC paragraphs 815-20-25-15 and 25-43) requires an entity to continue to report in AOCI until the date the hedged forecasted transaction is reported in earnings any gains or losses on the hedging instrument that are reported in AOCI to the date that the hedge is discontinued. Thus, in this circumstance, the $5,000,000 gain in AOCI would be reclassified into earnings when the hedged inventory is sold.
Accounting for Impairment of a Hedged Item paragraphs 34 and 35 of the Standard (ASC paragraphs 815-30-25-42 and 25-43)

21. During this past year, Company A hedged the forecasted purchase of 10,000 units of its inventory. Before today, Company A expected to be able to sell these units for $16,000,000. Due to a recent influx of imported units that resulted in an oversupply of units in the market, Company A now expects the sales price for the units to erode. As of today, the following is true:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales value of units</td>
<td>$11,000,000</td>
</tr>
<tr>
<td>Cost of units</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Loss in AOCI</td>
<td>$3,000,000</td>
</tr>
</tbody>
</table>

Company A expects the sales price to remain at $11,000,000 for the next six months.

Q. Is Company A required to recognize an impairment loss at December 31, 20X1?

A. Yes. Paragraph 31 of the Standard (ASC paragraphs 815-30-35-38 through 35-41) requires that if an entity expects at any time that continued reporting of a loss in AOCI would lead to recognizing a net loss on the combined hedging instrument and hedged transaction in one or more periods, the loss currently reported in AOCI should be reclassified immediately into earnings for the amount that is not expected to be recovered. Thus, Company A would reclassify $2,000,000 of the $3,000,000 loss in AOCI because this amount is not expected to be recovered when the forecasted transaction affects earnings (the remaining $1,000,000 loss will be recovered through futures sales).
Section Seven: Hedging Foreign Currency Exposures (updated June 2016)

INTRODUCTION

The global marketplace continues to develop and today, more than ever, entities are conducting business globally. As a result, it is common for entities to have fair value and cash flow exposures that involve foreign currencies as well as exposures due to net investments in foreign operations. For example, a U.S. entity may expect to receive euros from the future sale of inventory. The provisions of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended (Statement 133 or Standard) relating to hedges of foreign currency exposures specifically address the accounting for hedges of net investments in foreign operations and expand on the fair value and cash flow hedge accounting models of the Standard.

This section discusses the application of the Standard to hedges of foreign currency risk. The relevant guidance in this area is set forth primarily in paragraphs 36 - 42 of the Standard (ASC paragraphs 815-20-25-28 through 25-71, 815-35-35-1 and 35-2, 815-25-35-15 through 35-17, and 815-20-35-1). The section builds on the fair value and cash flow sections of the Handbook (Sections 5 and 6, respectively), and should not be read without understanding the concepts discussed in those sections. It also builds on the foreign currency concepts set forth in FASB Statement No. 52, Foreign Currency Matters (Statement 52) (ASC Topic 830, Foreign Currency Matters).

For additional discussion of foreign currency issues, readers should refer to the KPMG Guide to Accounting for Foreign Currency.

FUNCTIONAL CURRENCY CONCEPT

Fundamental to the accounting for hedges of foreign currency exposures is the need to understand when a foreign currency exposure exists for accounting purposes. In this regard, the Standard is consistent with Statement 52 (ASC Topic 830) and indicates that a foreign currency exposure exists when a transaction, asset or liability, or net investment in a foreign operation is denominated in a currency other than an entity’s functional currency. Thus, an entity whose functional currency is the U.S. dollar would have a foreign currency exposure only in instances where it has transactions, assets or liabilities, or a net investment in a foreign operation denominated in a currency other than the U.S. dollar. (ASC Topic 830) states that an entity’s functional currency “is the currency of the primary economic environment in which the entity operates.” Appendix A of Statement 52 (ASC paragraph 830-10-55-5) lists the following six indicators that should be considered in the determination of an entity’s functional currency: cash flow, sales price, sales market, expenses, financing, and intercompany transactions and arrangements. The examples below illustrate when an entity has foreign currency risk:
Example 7.1: Identifying Foreign Currency Risk

Eagle Inc.’s functional currency is the U.S. dollar. Wallaby Ltd. is an operating subsidiary of Eagle. Its functional currency is the Australian dollar.

Eagle wishes to hedge the foreign currency exposure inherent in Eagle’s intercompany sales to Wallaby (these sales are denominated in Australian dollars). It also wishes to hedge the foreign currency exposure relating to the third-party sales revenue generated by Wallaby in Australian dollars.

From Eagle’s perspective, Eagle’s sales to Wallaby create foreign currency exposure because they are denominated in a currency other than Eagle’s functional currency. With respect to the third-party sales revenue generated by Wallaby, Wallaby’s sales transactions do not directly expose Eagle to foreign currency risk because Eagle is not a party to the transaction. Therefore, Eagle cannot receive hedge accounting for hedges of Wallaby’s sales. In addition, because Wallaby’s sales transactions are in Wallaby’s functional currency, Wallaby does not have a foreign currency exposure.

Example 7.2: Identifying Foreign Currency Risk

Parent Co. has German and British subsidiaries. The functional currency of each subsidiary is its local currency. Each of the subsidiaries has entered into separate agreements to purchase a ship from a British shipbuilder. The contract requires payment for the ship in pounds sterling.

From the British subsidiary’s perspective, the pound sterling commitment does not create a foreign currency exposure because the transaction is denominated in its functional currency. However, from the German subsidiary’s perspective, the commitment to purchase a ship does create foreign currency exposure because its price is not denominated in euros.

Functional Currency Exposures

Although the potential effect of a foreign currency movement is similar for forecasted transactions that have not yet been recorded, the effect a foreign currency movement has on an entity’s financial statements is best illustrated by discussing existing assets and liabilities. From an accounting standpoint, a receivable that is denominated in a foreign currency (a long position) decreases in value when the functional currency of the entity gets stronger (the same base amount of foreign currency purchases less functional currency) and increases in value when the functional currency of the entity gets weaker (the same base amount of foreign currency purchases more functional currency). Likewise, a payable that is denominated in a foreign currency (or a short position) decreases in value when the functional currency of the entity gets stronger (the same base amount of foreign currency can be repaid with less functional currency) and increases in value when the functional currency of the entity gets weaker (the same base amount of foreign currency can be repaid with more functional currency). For accounting
purposes, such changes in value result in income statement volatility during the life of the exposure because Statement 52 (ASC Topic 830) requires that such balances be remeasured at spot rates at each balance sheet date through earnings. The examples below illustrate this concept:

Example 7.3: Foreign Currency Changes in a Recognized Asset

ABC Inc.’s functional currency is the U.S. dollar. On January 1, 20X1 ABC sells its product to a third party. The sale is denominated in yen with payment due from the third party on March 1, 20X1. As a result of the sale, ABC records a 120,000,000 yen receivable on its books. At the time the receivable is recorded, the exchange rate is $1 = 120 yen. On January 1, 20X1, ABC has a functional currency equivalent receivable of $1,000,000 (120,000,000 yen / 120). Assume the dollar strengthens versus the yen over the next month such that the exchange rate at January 31, 20X1 is $1 = 125 yen. On January 31, 20X1, ABC has a functional currency equivalent receivable of $960,000 (120,000,000 yen / 125). Although ABC still expects to receive 120,000,000 yen on March 1, 20X1, it has a functional currency loss of $40,000 for the month due to changes in foreign exchange rates. Assume the dollar weakens versus the yen over the next month such that the exchange rate at February 28, 20X1 is $1 = 100 yen. On February 28, 20X1, ABC has a functional currency receivable of $1,200,000 (120,000,000 yen / 100). Although ABC still expects to receive 120,000,000 yen on March 1, 20X1, it has a functional currency gain of $240,000 for the month and a cumulative functional currency gain of $200,000 due to changes in foreign exchange rates.

Example 7.4: Foreign Currency Changes in a Recognized Liability

ABC Inc.’s functional currency is the U.S. dollar. On January 1, 20X1 ABC purchases a product from a third party. The purchase is denominated in yen with payment due to the third party on March 1, 20X1. As a result of the purchase, ABC records a 120,000,000 yen payable on its books. At the time the payable is recorded, the exchange rate is $1 = 120 yen. On January 1, 20X1, ABC has a functional currency equivalent payable of $1,000,000 (120,000,000 yen / 120). Assume the dollar strengthens versus the yen over the next month such that the exchange rate at January 31, 20X1 is $1 = 125 yen. On January 31, 20X1, ABC has a functional currency equivalent payable of $960,000 (120,000,000 yen / 125). Although ABC still expects to pay 120,000,000 yen on March 1, 20X1, it has a functional currency gain of $40,000 for the month due to changes in foreign exchange rates. Assume the dollar weakens versus the yen over the next month such that the exchange rate at February 28, 20X1 is $1 = 100 yen. On February 28, 20X1, ABC has a functional currency payable of $1,200,000 (120,000,000 yen / 100). Although ABC still expects to pay 120,000,000 yen on March 1, 20X1, it has a functional currency loss of $240,000 for the month and a cumulative functional currency loss of $200,000 due to changes in foreign exchange rates.
As a result of these and similar functional currency exposures, entities may wish to hedge the resulting variability in functional currency using the fair value or cash flow hedging models.

**HEDGEABLE FOREIGN CURRENCY EXPOSURES**

**36.01** Paragraph 36 of the Standard (ASC paragraphs 815-20-25-28, 25-29, and 25-52) specifically state(s) the types of foreign currency exposures that can be hedged for accounting purposes:

36. If the hedged item is denominated in a foreign currency, an entity may designate the following types of hedges of foreign currency exposure, as specified in paragraphs 37–42:

   (a) A fair value hedge of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale security)

   (b) A cash flow hedge of a forecasted transaction, an unrecognized firm commitment, the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability, or a forecasted intercompany transaction

   (c) A hedge of a net investment in a foreign operation.

The recognition in earnings of the foreign currency transaction gain or loss on a foreign-currency-denominated asset or liability based on changes in the foreign currency spot rate is not considered to be the remeasurement of that asset or liability with changes in fair value attributable to foreign exchange risk recognized in earnings, which is discussed in the criteria in paragraphs 21(c)(1) and 29(d). Thus, those criteria are not impediments to either a foreign currency fair value or cash flow hedge of such a foreign-currency-denominated asset or liability or a foreign currency cash flow hedge of the forecasted acquisition or incurrence of a foreign-currency-denominated asset or liability whose carrying amount will be remeasured at spot exchange rates under paragraph 15 of Statement 52. A foreign currency derivative instrument that has been entered into with another member of a consolidated group can be a hedging instrument in a fair value hedge or in a cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment hedge in the consolidated financial statements only if that other member has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge.

Derivatives Implementation Group (DIG) Issues related to this paragraph are E3, H5, H12 and J2. See [DIG Issues Index](#).

**36.02** In general terms, a fundamental principle of the Financial Accounting Standards Board (FASB or Board) relating to foreign currency hedging was to make the accounting for hedges of foreign currency exposures consistent with those of other fair value and cash flow exposures. This principle resulted in the Board permitting hedge accounting for forecasted foreign-currency-
denominated transactions hedged with foreign currency forward contracts as well as any other foreign currency derivative contract. In addition, tandem or cross-currency hedging is also permitted as discussed in Paragraph 36.22 of this section. A conceptual application of this fundamental principle would have resulted in prohibiting hedge accounting for hedges of net investments in foreign operations. Designating such an investment as a hedged item would be considered the same as designating a group of dissimilar assets and liabilities as the hedged item, which is not permitted for a fair value or cash flow hedge. However, Statement 52 (ASC Topic 830) previously permitted hedge accounting for such hedges and practice in this area was well established. Because the Board did not comprehensively reconsider the accounting provisions of (ASC Topic 830), the Board decided to continue to permit hedge accounting for hedges of net investments in foreign operations. Thus, although the Board was seeking consistency, it decided to accept this difference between the hedge accounting models applied to foreign currency exposures and the models applied to other exposures.

36.03 Another inconsistency between the foreign currency hedging models and other hedging models is the use of a nonderivative instrument as the hedging instrument. The cash flow and fair value hedging models do not permit use of a nonderivative instrument as the hedging instrument. As discussed in Paragraphs 37.08 and 42.04 of this section, a nonderivative instrument can be the hedging instrument in a foreign currency fair value hedge of an unrecognized firm commitment or a foreign currency hedge of a net investment in a foreign operation. The Board accepted this inconsistency for the same reasons noted above (i.e., a well established practice of using nonderivative instruments for these hedges under Statement 52 ASC Topic 830)). However, the use of a nonderivative instrument in conjunction with a foreign currency cash flow hedge is not permitted, even if the entity is hedging the forecasted foreign currency cash flows related to an unrecognized firm commitment.

36.04 Paragraph 36 of the Standard (ASC paragraphs 815-20-25-28, 25-29, and 25-52) permit(s) hedge accounting for the following foreign currency hedging relationships:

- A fair value hedge of an unrecognized firm commitment (unrecognized firm commitment and firm commitment are used interchangeably in this section) or a recognized asset or liability (including an available-for-sale security) (see Paragraph 37.01 of this section);
- A cash flow hedge of a forecasted transaction, an unrecognized firm commitment, the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability or a forecasted intercompany transaction (see Paragraph 40.01 of this section); and
- A hedge of a net investment in a foreign operation (see Paragraph 42.01 of this section).

36.05 Consistent with fair value and cash flow hedges, all foreign currency hedges, including net investment hedges, require formal documentation at the inception of the hedging relationship, including documentation of the entity’s risk management objective and strategy for undertaking the hedge. The documentation must include:

- The hedging instrument;
- The hedged item or transaction;

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The nature of the risk being hedged;
The method that will be used to retrospectively and prospectively assess the hedging instrument’s effectiveness; and
The method that will be used to measure hedge ineffectiveness.

CERTAIN MATTERS RELEVANT TO FOREIGN CURRENCY HEDGING

36.06 The types of transactions that may be hedged give rise to certain issues that have particular relevance to foreign currency hedging; these include:

- hedging recognized foreign-currency-denominated assets or liabilities;
- hedging intercompany transactions;
- Intercompany foreign currency derivative instruments (internal derivatives);
- Hedge effectiveness and ineffectiveness,
- Tandem, or cross-currency hedging; and
- When is the hedged item denominated in a foreign currency.

Hedging Recognized Foreign-Currency-Denominated Assets or Liabilities

36.07 The Standard permits hedging recognized (as well as forecasted transactions that will become recognized) foreign-currency-denominated assets or liabilities. The interaction of Statement 52 (ASC Topic 830) and the Standard challenged the Board with respect to recognized foreign-currency-denominated assets and liabilities, since the Board elected not to comprehensively reconsider the provisions of Statement 52 (ASC Topic 830). Under Statement 52 (ASC Topic 830), these assets and liabilities are remeasured to the reporting entity’s functional currency at the spot rate through earnings. Under the Standard, assets or liabilities that are remeasured with changes in fair value attributable to the hedged risk reported currently in earnings, or forecasted transactions that become recognized and subsequently remeasured for changes in fair value attributable to the hedged risk through earnings, cannot be hedged. Thus, the issue became whether these items could be hedged under the Standard. The Board originally concluded that they could not. Then it reversed its position and concluded that the Statement 52 (ASC Topic 830) remeasurement was not a remeasurement at fair value. Accordingly, the Standard permits hedging recognized foreign-currency-denominated assets or liabilities in either the fair value or cash flow foreign currency hedging model and forecasted transactions that will become recognized in the cash flow foreign currency hedging model.

Hedging Intercompany Transactions

36.08 Paragraph 36(b) of the Standard (ASC paragraphs 815-20-25-28, 25-29, and 25-52) specifically permit(s) hedging forecasted intercompany foreign currency transactions (further discussed in Paragraph 40.11 of this section). Paragraphs 36(a) and 36(b) (ASC paragraphs 815-20-25-28(a) and 25-28(b)) also permit hedging recognized foreign-currency-denominated assets or liabilities, which include intercompany assets or liabilities. Hedging intercompany foreign exchange risk is permitted since an intercompany transaction denominated in a foreign currency
gives rise to a gain or loss when it is remeasured to the entity’s functional currency under Statement 52 (ASC Topic 830) (at spot rates), which is not eliminated in consolidation; and, therefore, the risk affects consolidated earnings. On the other hand, intercompany foreign-currency-denominated transactions cannot be hedged for overall changes in fair value or cash flows, interest rate or credit risk because these risks do not affect consolidated earnings. The exposure to these risks of one party to the contract will be offset by the opposite exposure of the other party to the contract within a consolidated group; thus, any potential earnings exposure will be eliminated in consolidation. However, from the perspective of a subsidiary’s separate financial statements, any of the previously mentioned risks, including foreign exchange risk, presents exposure to that subsidiary’s earnings and are thus eligible for hedge accounting solely for purposes of the subsidiary’s stand-alone financial statements.

36.09 The definition of a firm commitment pursuant to the Standard states that it must be with an unrelated party. Thus, an intercompany commitment cannot be considered a firm commitment and cannot be hedged in the fair value model. However, a foreign-currency-denominated intercompany commitment or a commitment with a related party external to the reporting entity, is eligible to be hedged in the foreign currency cash flow model as a forecasted transaction (see Paragraph 40.15 of this section for further discussion).

Intercompany Foreign Currency Derivative Instruments (Internal Derivatives)

36.10 Paragraph 36 of the Standard (ASC paragraphs 815-20-25-28, 25-29, and 25-52) includes guidance when a foreign currency derivative contract between entities within the same consolidated group (internal derivative) can be accounted for as a hedging instrument in the consolidated financial statements. Specifically, paragraph 36 (ASC paragraph 815-20-25-52) states that an internal derivative entered into with another member of the consolidated group cannot be considered a derivative hedging instrument in the consolidated financial statements unless the risk acquired through the internal derivative has been offset with an unrelated third party derivative contract. We believe the Board reached this conclusion because of the functional currency concept of Statement 52 (ASC Topic 830). Under the functional currency concept, foreign currency exposure exists when a transaction is denominated in a currency different from the entity’s functional currency. Internal derivatives do not offset foreign currency exposure on a consolidated basis. Instead, they merely transfer the exposure from one party to another and may alter the form of the exposure if the functional currencies of the two entities are different. Unless an internal derivative is offset by a contract that transfers the exposure to an unrelated third party, the consolidated exposure has not been offset.

36.11 For example, a subsidiary with the euro as its functional currency would be exposed to U.S. dollar/euro currency fluctuations for a U.S. dollar receivable. If the euro subsidiary entered into a foreign currency forward contract with its parent to sell the U.S. dollars it expects to receive for euros and the terms of the forward perfectly offset the terms of the U.S. dollar receivable, the foreign currency risk at the subsidiary level would be eliminated. However, the internal derivative would not offset the exposure to variable cash flows on a consolidated basis. It would merely transfer the exposure so that the parent now would have a euro exposure (i.e., a commitment to sell euros to its subsidiary). In consolidation, the internal derivative could not be accounted for as a hedging instrument because it does not reduce the variability of cash flows on
a consolidated basis. In consolidation, the forward contract at the parent and subsidiary levels would be eliminated and the original U.S. dollar/euro exposure of the subsidiary would continue to exist.

36.12 As noted above, the contract between the subsidiary and its parent effectively eliminates the U.S. dollar/euro exposure at the subsidiary level. Thus, for purposes of the separate financial statements of the subsidiary, this contract could qualify as a cash flow derivative hedging instrument. If the subsidiary accounts for the internal derivative using hedge accounting and the parent does not enter into an offsetting contract with a third party, the parent would have to eliminate the hedge accounting entries made at the subsidiary level for purposes of the consolidated financial statements.

36.13 Consider the same facts. However, assume that the parent enters into a foreign currency forward contract with an unrelated third party to offset the exposure it acquired from entering into the internal derivative with its subsidiary. That is, the parent enters into a foreign currency forward contract to buy euros and sell U.S. dollars with an unrelated third party and documents that the unrelated third party contract has been entered into in order to offset the specific contract entered into with the subsidiary. In this specific circumstance, the parent has offset the exposure acquired from the subsidiary and, on a consolidated basis, eliminated its exposure to the variability in foreign currency cash flows. Thus, the cash flow hedge accounting used at the subsidiary level carries forward for purposes of the consolidated financial statements as long as the hedge documentation at the subsidiary level plus the documentation at the parent level linking the hedged exposure with the unrelated third party derivative contract are maintained. In the parent’s separate financial statements, prior to consolidation, the internal derivative and the unrelated third party derivative contract would be accounted for as speculative derivative instruments because hedge accounting is not permitted when a derivative instrument is used to offset the risks arising from another derivative instrument.

OFFSETTING INTERNAL DERIVATIVES

36.14 While paragraph 36 of the Standard (ASC paragraphs 815-20-25-28, 25-29, and 25-52) permit(s) the designation of internal derivatives entered into with another member of a consolidated group (such as a treasury center) as a hedging instrument in the consolidated financial statements, the requirement to individually offset each internal derivative with a third party contract can negate the efficiency and cost savings provided by a treasury center that manages risk on a centralized basis. The risk exposures centralized by a treasury center by issuing internal derivatives to affiliates are usually offset on a net basis, rather than individually, by contracts with unrelated third parties. However, a fundamental justification for the application of hedge accounting to internal derivatives in consolidated financial statements under paragraph 36 (ASC paragraphs 815-20-25-28, 25-29, and 25-52) is the existence of an individual offsetting third party derivative contract that supports each internal derivative. The practice of offsetting multiple internal derivatives with a net third party contract portrays hedged items in various affiliates functioning as hedges of one another.

36.15 The Board also observed that applying hedge accounting in the consolidated financial statements under the Standard to internal derivatives that are offset on a net basis by third party contracts would conflict with basic consolidation procedures required by paragraph 6 of Accounting Research Bulletin No. 51, Consolidated Financial Statements (ASC paragraph 810-
Such a conflict exists because certain effects related to intercompany balances arising from the application of hedge accounting to internal derivatives would not be eliminated in consolidation. For example, for fair value hedges, the adjustment to the carrying amount of the hedged item, as determined by the change in fair value of the hedged item attributable to the hedged risk resulting from applying hedge accounting would not be eliminated in consolidation. For cash flow hedges, amounts recorded in other comprehensive income, and the timing of reclassification of those amounts into earnings, similarly result from applying hedge accounting to internal derivatives and would not be eliminated in consolidation. For those reasons, as a general rule, internal derivatives do not qualify as hedging instruments in the consolidated financial statements if those internal derivatives are not offset by unrelated third party contracts on an individual basis.

36.16 Notwithstanding this general rule, the Standard permits a limited exception to offset the net foreign currency exposure of internal derivatives issued by a treasury center with an unrelated third party for certain internal derivatives that are used to hedge the foreign currency cash flow risk associated with a forecasted borrowing, purchase, sale or an unrecognized firm commitment. (See Paragraph 40A.01 of this section for further discussion.)

HEDGING OTHER RISKS WITH INTERNAL DERIVATIVES

36.17 Foreign currency risk exists in relation to an entity’s (e.g., a subsidiary) functional currency. Thus, the foreign currency hedging models require that the operating unit with the foreign currency exposure be party to the hedging instrument. However, for interest rate and credit risk or the risk of changes in overall fair value or cash flows (as long as the changes do not include foreign currency fluctuations), there is no concept similar to the functional currency concept. Therefore, the Standard does not require that the operating unit with these risks be party to the hedging derivative. For example, a treasury center can enter into a derivative contract with a third party and document and designate it as the hedging instrument in a hedge of the interest rate risk of another member of the consolidated group solely for purposes of the consolidated financial statements. For purposes of the stand-alone financial statements of the entity that incorporates the treasury center, the derivative contract would not be a hedging instrument. However, upon consolidation of the other member of the consolidated group, the derivative contract entered by the treasury center would qualify as the hedging instrument. If the other member of the consolidated group (i.e., the subsidiary with the interest rate risk) wishes to qualify for hedge accounting of the interest rate exposure in its separate financial statements, it, as the reporting unit, must be a party to the hedging instrument, which can be an internal derivative from a consolidated perspective obtained from the treasury center. The internal derivative for interest rate risk can qualify for designation as the hedging instrument only for the subsidiary’s separate company financial statements. For purposes of the consolidated financial statements the internal derivative between the treasury center and the consolidated entity would be eliminated and the third party derivative entered by the treasury center would be the hedging instrument.

Hedge Effectiveness and Ineffectiveness

36.18 In defining how hedge effectiveness will be assessed, an entity must specify whether all or just a portion of the gain or loss on a derivative hedging instrument will be included in the
assessment of hedge effectiveness. That is, the Standard permits, but does not require, gains or losses pertaining to the time value element of a derivative hedging instrument’s change in fair value to be excluded from the assessment of hedge effectiveness (see Paragraph 20A.12 of Section 5 and 28B.12 of Section 6 for a detailed discussion). Commonly used foreign exchange derivative hedging instruments that incorporate time value are foreign currency forward contracts and currency options. Specifically, paragraph 63 of the Standard (ASC paragraph 815-20-25-82) indicates:

- If the effectiveness of a hedge using an option contract is assessed based on changes in the option’s intrinsic value, changes in the time value of the option are excluded from the assessment of hedge effectiveness and are included currently in earnings.

- If the effectiveness of a hedge using 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 option is excluded from the assessment of hedge effectiveness and is included currently in earnings.

- If the effectiveness of a hedge using a forward contract is assessed based on changes in spot rates, the change in fair value of the forward contract related to the forward premium/discount is excluded from the assessment of hedge effectiveness and is included currently in earnings.

36.19 If an entity excludes gains and losses associated with the time value element of a derivative instrument’s change in fair value from the assessment of hedge effectiveness, the forward premium or discount (for foreign currency forward contracts) and time or volatility value (for currency options) will be included in earnings each reporting period. This may result in earnings volatility when hedging foreign currency exposure because the Board did not amend Statement 52’s (ASC Topic 830) requirement that foreign-currency-denominated assets and liabilities be remeasured to the functional currency based on spot exchange rates through earnings. This issue is discussed further in Paragraphs 39.04 and 41.05 of this section.

36.20 For a cash flow hedging relationship that involves a (net) purchased option contract, an entity may consider DIG Issue No. G20, “Cash Flow Hedges: Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge” (DIG Issue G20). This issue would reduce the need to exclude the time value of the option from the effectiveness assessment if certain conditions are met; thus, reducing volatility in earnings. DIG Issue G20 is discussed starting with Paragraph A6.98 of Appendix A to Section 6. Examples of foreign currency cash flow hedges using the approach in DIG Issue G20 are included in this section as Examples 7.15 and 7.18.

36.21 In general, we would expect entities to assess effectiveness and measure ineffectiveness for foreign currency fair value hedges of recognized foreign-currency-denominated assets and liabilities using spot rates in order to minimize ineffectiveness, even though the time value component of the derivative hedging instrument would be recognized in earnings. Alternatively, to minimize ineffectiveness and earnings volatility, entities may select to use, whenever possible, the foreign currency cash flow hedge model or hedge a combination of foreign exchange and benchmark interest rate risks in the foreign currency fair value hedge model (see Paragraphs 39.04 - 39.05 for a further discussion of this issue). In addition, we would expect entities to assess effectiveness and measure ineffectiveness for all foreign currency cash flow hedges as
well as foreign currency fair value hedges of unrecognized firm commitments using forward rates, if permitted, in order to minimize ineffectiveness as well as the volatility in earnings that otherwise results.

**Tandem, or Cross-Currency, Hedging**

36.22 Other than the overall test that the hedging relationship be highly effective, the Standard has no specific guidance detailing which currencies or derivative instruments should be used when hedging a given currency exposure. Thus, for example, if it can be shown that movements in the fair value of an Australian-dollar-denominated foreign currency forward contract are highly effective (at inception and on an ongoing basis) at offsetting the fair value changes in the foreign currency exposures in firmly committed Canadian-dollar sales transactions, hedge accounting may be used. When is the Hedged Item *Denominated* in a Foreign Currency

36.23 The Standard notes that a hedged item is required to be denominated in a currency other than the hedging unit’s functional currency. Foreign currency exposure exists in relation to an entity’s functional currency. For example, euro-denominated transactions of a euro functional currency subsidiary are not eligible for foreign currency hedging since they do not present a foreign currency exposure in relation to the subsidiary’s functional currency. Such transactions do not affect consolidated earnings. However, we believe that a transaction that is settled in an entity's functional currency, but whose settlement amount is determined by converting a specified amount of a foreign currency into the entity's functional currency at the spot or average exchange rate is, in effect, denominated in a currency other than the entity's functional currency.

For example, assume that Company A (which has the U.S. dollar as its functional currency) enters into an agreement with a third party that entitles the third party to produce and distribute one of Company A's products in exchange for quarterly royalty payments based on a percentage of euro-denominated sales. If the calculation of the royalty payment is based on euro-denominated sales, but the royalty payment received by Company A is in the form of U.S. dollars (being the euro-denominated sales converted to U.S. dollars using the average exchange rate for the period), we believe that, in effect, the transaction is denominated in a currency other than Company A's functional currency (i.e., the euro).

**SINGLE DERIVATIVE CASH FLOW HEDGE**

36A.01 Paragraph 36A of the Standard (ASC paragraphs 815-20-25-34 through 25-36) address hedges of foreign-currency-denominated forecasted transactions and the resulting recognized foreign-currency-denominated receivables or payables, as follows:

36A. The provisions in paragraph 36 that permit a recognized foreign-currency-denominated asset or liability to be the hedged item in a fair value or cash flow hedge of foreign currency exposure also pertain to a recognized foreign-currency-denominated receivable or payable that results from a hedged forecasted foreign-currency-denominated sale or purchase on credit. An entity may choose to designate a single cash flow hedge that encompasses the variability of functional currency cash flows attributable to foreign exchange risk related to the settlement of the foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit. Alternatively, an entity may choose to designate a cash flow hedge of the variability of...
functional currency cash flows attributable to foreign exchange risk related to a forecasted foreign-currency-denominated sale or purchase on credit and then separately designate a foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable. In that case, the cash flow hedge would terminate (be dedesignated) when the hedged sale or purchase occurs and the foreign-currency-denominated receivable or payable is recognized. The use of the same foreign currency derivative instrument for both the cash flow hedge and the fair value hedge is not prohibited though some ineffectiveness may result.

DIG Issue related to this paragraph is H15. See DIG Issues Index.

36A.02 Paragraph 36A (ASC paragraphs 815-20-25-34 through 25-36) indicates that an entity may choose to designate a cash flow hedge of the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to a forecasted foreign-currency-denominated sale or purchase on credit and then separately designate a foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable all with the same derivative hedging instrument. With this choice, the cash flow hedge would terminate and the derivative instrument would be dedesignated when the hedged sale or purchase occurs and the foreign-currency-denominated receivable or payable is recognized. The entity could then redesignate the derivative instrument as the hedging instrument in a foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable. If an entity applied this alternative, ineffectiveness would result from the mismatch of the hedging instrument’s fair value being based on a time period to settlement date, whereas the change in forecasted cash flows is calculated based on a shorter time period (through the sale or purchase date).

36A.03 Alternatively, an entity could designate a derivative instrument as the hedging instrument in a single cash flow hedge of the foreign currency exposure of variability in the functional-currency-equivalent cash flows associated with the forecasted transaction (i.e., sale or purchase on credit) and related settlement of the resultant foreign-currency-denominated receivable or payable. We expect most entities will elect to designate a single hedging relationship with a single derivative instrument to hedge foreign currency risk through the date of settlement, since this will result in less ineffectiveness than the alternative in paragraph 36A (ASC paragraphs 815-20-25-34 through 25-36). It also results in cash flow hedge accounting being elected for the entire relationship which, as discussed in Paragraph 36.21, may often result in less volatility in earnings. See Paragraph 41.15 of this section for a further discussion of this matter.

FOREIGN CURRENCY FAIR VALUE HEDGES

37.01 In order to qualify as a fair value hedge of the foreign currency exposure inherent in an unrecognized firm commitment (discussed in paragraph 37 of the Standard (ASC paragraph 815-20-25-58)), a recognized asset or liability (discussed in paragraph 37A of the Standard (ASC paragraphs 815-20-25-37(a) and 25-71(b)(1))) or an available-for-sale security (discussed in paragraph 38 of the Standard (ASC paragraphs 815-20-25-37(b) and 25-71(b)(2))), the Standard requires that all the hedge criteria for a fair value hedge be met (these criteria are specified in paragraphs 20 and 21 of the Standard (ASC paragraphs 815-20-25-3, 25-12, 25-43, 25-75, 25-76,
25-94, and 25-95), except that a nonderivative instrument can be designated as a hedging instrument in the hedge of the foreign currency exposure inherent in an unrecognized firm commitment. The following is a list of all of the fair value hedge criteria, which are discussed in detail in Section 5:

- Formal documentation (see Paragraphs 20A.01 and 36.05);
- Effectiveness of hedging relationships (see Paragraph 20B.01);
- Special rules for written options (see Paragraph 20C.01);
- Nondervative hedging instruments (prohibition not applicable for foreign-currency-denominated unrecognized firm commitments) (see Paragraph 20.07);
- The nature of the hedged item (that is all, or a specific portion, of an individual asset, liability, or firm commitment or a portfolio of similar assets or liabilities) (see Paragraphs 21.02 - 21A.15);
- Hedged item must present an exposure that could affect earnings (see Paragraphs 21B.01 - 21b.02);
- Items prohibited from being designated as the hedged item (see Paragraphs 21C.01 - 21D.03); as previously discussed in Paragraph 36.07 of this section, the Board clarified that the Statement 52 (ASC Topic 830) remeasurement at spot rate to the functional currency was not a remeasurement at fair value as contemplated in paragraph 21(c)(1) of the Standard (ASC paragraph 815-20-25-43(c)(3)); and
- Risks that can be hedged (see Paragraphs 21E.01 - 21F.17).

Additionally, the Standard requires that the conditions in paragraphs 40(a) and 40(b) (ASC paragraph 815-20-25-30) be met in order for the hedging relationship to qualify as a fair value hedge of a foreign currency exposure. (See DIG Issue H1 for further reference) Those additional conditions are discussed in detail beginning at Paragraph 40.04 of this section and generally require that:

- The operating unit that has the foreign currency exposure be a party to the hedging instrument; and
- The hedged transaction is denominated in a currency other than that unit’s functional currency.

**Foreign-Currency-Denominated Firm Commitments**

Paragraph 37 of the Standard (ASC paragraph 815-20-25-58) addresses hedging an unrecognized firm commitment in a foreign currency fair value model as follows:

37. **Unrecognized firm commitment.** A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in...
In order to qualify as a fair value hedge of the foreign currency exposure inherent in an unrecognized firm commitment, the hedge criteria discussed in Paragraphs 37.01 and 37.02 of this section must be met.

The term *unrecognized firm commitment* is used in paragraph 37 (ASC paragraph 815-20-25-58) in the same manner as it is used in the fair value hedging model (see Paragraphs 21a.03 - 21A.11 of Section 5). The definition of a firm commitment requires that the price in the agreement be fixed. From that, one could conclude that a commitment denominated in a currency other than the entity’s functional currency could not be considered a firm commitment because the price is not fixed in terms of the entity’s functional currency. Those holding this view would conclude that because a commitment denominated in a foreign currency always exposes an entity to variability in its functional currency cash flows, it cannot qualify as a hedged item in a fair value hedge.

The Board acknowledged this view but ultimately concluded that a commitment could be considered a firm commitment if its price was expressed in a specified amount of currency, regardless of whether that currency was the entity’s functional currency or a foreign currency. The definition of a firm commitment set forth in Appendix F to the Standard (ASC Section 815-10-20) reflects this conclusion. The Board reached this conclusion principally because Statement 52 (ASC Topic 830) previously prescribed an accounting method similar to the fair value hedge accounting method for foreign-currency-denominated firm commitments. The Board did not want to change existing practice significantly in this area because it had not undertaken a complete reconsideration of Statement 52 (ASC Topic 830). Thus, the Board concluded that hedges of firm commitments denominated in a currency other than the entity’s functional currency may be accounted for using the fair value hedge accounting model. Since a firm commitment in a currency other than the entity’s functional currency also exposes the entity to variability in cash flows due to changes in currency rates, it also may be a hedged transaction in a cash flow hedge of foreign currency risk. (See DIG Issue H5 for further reference)

The definition of a firm commitment also requires that the commitment be with an unrelated party. Thus, the definition prohibits the designation of an intercompany commitment as the hedged item in a fair value hedge. In addition, a foreign-currency-denominated commitment with a related party outside the reporting entity would not meet the definition of a firm commitment and, thus, cannot qualify as a hedged item in a fair value hedge. However, a foreign-currency-denominated commitment with related parties (e.g., subsidiary to subsidiary in a consolidated group, operating entity to related party outside the consolidated group) may qualify as a forecasted transaction in a cash flow hedge pursuant to paragraph 36(b) of the Standard (ASC paragraph 815-20-25-28(b)) because the criteria for forecasted transactions do not include a criterion that the contract be with an unrelated party and the intercompany or related party commitment does expose an entity to variability in functional-currency-equivalent cash flows that could affect reported earnings. (See Paragraph 40.11 of this section.)
NONDERIVATIVE HEDGING INSTRUMENTS

37.08 Consistent with the provisions of Statement 52 (ASC Topic 830), paragraph 37 of the Standard (ASC paragraph 815-20-25-58) allows a nonderivative foreign-currency-denominated financial instrument to be designated as a fair value hedging instrument of the foreign currency exposure associated with unrecognized firm commitments (or a specific portion of a firm commitment), as long as the nonderivative financial instrument gives rise to a foreign currency transaction gain or loss under Statement 52 (ASC Topic 830). This is one of only two instances where a nonderivative foreign-currency-denominated financial instrument can be used as a hedging instrument (see Paragraph 42.04 of this section for a discussion of hedges of net investments in foreign operations for the other instance). The nonderivative foreign-currency-denominated instrument can be an intercompany instrument (e.g., an intercompany foreign-currency-denominated borrowing). A nonderivative financial instrument that is reported at fair value, such as an instrument to which an entity has chosen to apply the fair value option under FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (ASC Topic 825, Financial Instruments), cannot be the hedging instrument since it does not give rise to a foreign currency transaction gain or loss under Statement 52 (ASC Topic 830).

37.09 An entity may designate a nonderivative intercompany foreign-currency-denominated financial instrument (e.g., intercompany borrowing or receivable) as the hedging instrument in a foreign currency fair value hedge of an unrecognized firm commitment and qualify for hedge accounting in the consolidated financial statements. However, hedge accounting in the consolidated financial statements may only be applied if the counterparty to the intercompany nonderivative financial instrument has entered into an unrelated third party nonderivative financial instrument that offsets the foreign currency exposure acquired from the entity that has the firm commitment. (See DIG Issue H12 for further reference)

37.10 In contrast to a derivative hedging instrument whose gain or loss is measured by reference to changes in total fair value, the gain or loss of a nonderivative hedging instrument is measured by reference to changes in spot exchange rates as required by paragraph 15 of Statement 52 (ASC paragraph 830-20-35-1). Consequently, an entity should understand the potential accounting results and differences in choosing the hedging instrument when hedging the foreign currency exposure of a firm commitment. (Refer to Paragraph 39.03 of this section for additional information.)

Recognized Asset or Liability

37A.01 Paragraph 37A (ASC paragraphs 815-20-25-37(a) and 25-71(b)(1)) addresses a fair value hedge of the foreign currency exposure inherent in a recognized asset or liability as follows:

37A. Recognized asset or liability. A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of a recognized asset or liability. A derivative instrument can be designated as hedging the changes in the fair value of a recognized asset or liability (or a specific portion thereof) for which a foreign currency transaction gain or loss is recognized in
37A.02 In order to qualify as a fair value hedge of a recognized foreign-currency-denominated asset or liability, the hedge criteria discussed in Paragraphs 37.01 and 37.02 of this section must be met.

37A.03 In addition, the Standard permits a recognized foreign-currency-denominated asset or liability to be eligible as a hedged item in a fair value hedge of foreign currency exposure, as long as the asset or liability is subject to recognition of foreign currency transaction gains or losses in earnings under the provisions of paragraph 15 of Statement 52 (ASC paragraph 830-20-35-1).

37A.04 Even though each classification of securities accounted for under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (ASC Topic 320, Investments -- Debt and Equity Securities), are recognized assets, they each have different considerations with respect to whether the change in fair value attributable to foreign exchange is a hedgeable risk under the Standard. Trading securities are not hedgeable under the foreign currency fair value model since they are recorded at fair with all fair value changes (including those resulting from foreign currency changes) reported currently in earnings. Held-to-maturity debt securities are hedgeable under paragraph 37A of the Standard (ASC paragraphs 815-20-25-37(a) and 25-71(b)(1)) because foreign currency transaction gains or losses are recognized directly in earnings under the provisions of paragraph 15 of Statement 52 (ASC paragraph 830-20-35-1). Although foreign currency transaction gains or losses on available-for-sale securities are not recognized directly in earnings under the provisions of paragraph 15 of Statement 52 (ASC paragraph 830-20-35-1), they are hedgeable pursuant to paragraph 38 of the Standard (ASC paragraphs 815-20-25-37(b) and 25-71(b)(2)) and the criteria set forth therein.

AVAILABLE-FOR-SALE SECURITIES

38.01 Paragraph 38 of the Standard (ASC paragraphs 815-20-25-37(b) and 25-71(b)(2)) addresses the accounting for fair value hedges of available-for-sale securities and states:

38. Available-for-sale security. A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of an available-for-sale security. A derivative instrument can be designated as hedging the changes in the fair value of an available-for-sale debt security (or a specific portion thereof) attributable to changes in foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in paragraphs 22-27 if all the fair value hedge criteria in paragraphs 20 and 21 and the conditions in paragraph 40(a) and 40(b) are met. An available-for-sale equity security can be hedged for changes in the fair value attributable to changes in foreign currency exchange rates and qualify for the accounting specified in paragraphs 22-27 only if the fair value hedge criteria in paragraphs 20 and 21 are met and the following two conditions are satisfied:
The change in fair value of the hedged available-for-sale equity security attributable to foreign exchange risk is reported in earnings pursuant to paragraph 23 and not in other comprehensive income.

38.02 The Standard permits an enterprise to designate a derivative instrument as a hedge of the foreign currency exposure inherent in an available-for-sale debt or equity security. A nonderivative financial instrument cannot be designated as the hedging instrument. In order to qualify for hedge accounting, it is necessary that the hedging relationship satisfy the hedge criteria discussed in Paragraphs 37.01 and 37.02 of this section if the hedged item is an available-for-sale debt or equity security. We believe this is the case even though the Standard is not explicit in its requirement that the conditions in paragraphs 40(a) and 40(b) of the Standard (ASC paragraph 815-20-25-30) be met if the hedged item is an available-for-sale equity security.

38.03 In addition to meeting the hedge criteria noted in Paragraphs 37.01 and 37.02 of this section, additional criteria are required to be met in order to qualify for hedge accounting of foreign currency exposures inherent in available-for-sale equity securities. These additional criteria are discussed below.

Additional Criteria for Available-For-Sale Equity Securities

38.04 The Board concluded that foreign-currency-denominated available-for-sale debt securities give rise to hedgeable foreign exchange risk because they embody cash flows denominated in a foreign currency. The cash flows embodied in investments in marketable equity securities, on the other hand, are not inherently denominated in a particular currency.

38.05 Because available-for-sale equity securities are not inherently denominated in any particular currency, the Standard specifies that additional criteria must be met in order for foreign currency risk to be a hedgeable exposure. In this context, the Board concluded that foreign currency risk is a hedgeable exposure in an available-for-sale equity security if both of the following criteria are met:

- The security is not traded on an exchange (or other established marketplace) on which trades are denominated in the investor’s functional currency; and
- Dividends or other cash flows to the holder of the equity security are all denominated in the same foreign currency as the currency expected to be received on the sale of the security.

38.06 The reason for these additional criteria is that the Board concluded that regardless of the country in which the issuer of an equity security is domiciled, that security presents no discernible foreign exchange risk to a holder who may trade the security for a price denominated in its functional currency. For example, if an entity is based in the UK with operations primarily in Europe, its equity securities may trade on the London, New York, and Tokyo stock exchanges.
Therefore, although the UK company itself may be exposed to European currency risk, if a Japanese investor acquires the UK company’s equity securities on the Tokyo exchange (denominated in Japanese yen), the Japanese entity has no direct currency exposure. Similarly, an investor with a U.S. dollar functional currency could trade in the New York market and not be exposed to any direct currency risk on its investment in the securities of the UK company. On the other hand, if the UK company’s securities were traded only in London and only in pounds sterling, then a U.S. dollar or Japanese yen functional currency entity investing in those securities would be directly exposed to currency risk and that risk would be considered a hedgeable foreign currency exposure.

Combination of Options as the Hedging Instrument

38.07 In a foreign currency fair value hedging relationship in which a combination of options (deemed to be a net purchased option) is designated as the hedging instrument and the effectiveness of the hedge is assessed based only on changes in intrinsic value of the hedging instrument, the assessment of effectiveness may be based only on changes in the underlying that cause a change in intrinsic value of the hedging instrument. Thus, the assessment can exclude ranges of changes in the underlying for which there is no change in the hedging instrument’s intrinsic value. This allows hedging relationships that offer protection only within ranges of changes in the underlying instead of in all ranges of change. However, all changes in the hedging instrument’s fair value other than the intrinsic value (i.e., the time value) would be recognized in earnings immediately. (See DIG Issue G15 for further reference)

Hedging Foreign Currency Fair Value Changes In Interim Periods

38.08 When hedging the risk of changes in fair value attributable to changes in the related foreign currency exchange rates, an entity does not need to hedge all of the foreign currency exposures throughout the life of the hedged item if the effectiveness of the hedge is assessed based only on changes in the spot rate of the hedging instrument. For example, if a U.S. dollar functional currency entity has a 1,000,000 yen receivable recorded on its books with a maturity of sixty days, it may enter into a forward contract to pay yen and receive U.S. dollars to hedge the risk of changes in fair value of that receivable due to changes in the yen/U.S. dollar exchange rate. If the effectiveness of the hedge is assessed based only on changes in the spot rate of the hedging instrument, the maturity of the forward contract can be at the end or at any point during those sixty days. However, any changes in the forward contract’s value due to changes in the forward premium/discount would be recognized in earnings immediately.

ACCOUNTING FOR FOREIGN CURRENCY FAIR VALUE HEDGES

39.01 Paragraph 39 (ASC paragraphs 815-25-35-15 and 35-16) provides specific guidance with respect to accounting for foreign currency fair value hedges:

39. Gains and losses on a qualifying foreign currency fair value hedge shall be accounted for as specified in paragraphs 22-27. The gain or loss on a nonderivative hedging instrument attributable to foreign currency risk is the foreign currency transaction gain or loss as determined under Statement 52. That foreign currency transaction gain or loss
shall be recognized currently in earnings along with the change in the carrying amount of the hedged firm commitment.

12 The foreign currency transaction gain or loss on a hedging instrument is determined, consistent with paragraph 15 of Statement 52, as the increase or decrease in functional currency cash flows attributable to the change in spot exchange rates between the functional currency and the currency in which the hedging instrument is denominated.

39.02 The accounting for a foreign currency fair value hedge is the same as all other fair value hedges (see Paragraph 22.01 of Section 5 for a detailed discussion). Thus, the derivative hedging instrument is recorded in the statement of financial position at fair value with changes in fair value reported in earnings each reporting period. Also reflected in earnings are the changes in the hedged item’s fair value for the risk being hedged.

39.03 When the hedged item is the foreign currency exchange risk of an unrecognized firm commitment and the hedging instrument is a derivative forward contract, we would expect entities to calculate the changes in fair value of the hedged item based on forward foreign exchange rates to minimize hedge ineffectiveness. That is, if the spot exchange rate were used to calculate the change in fair value of the firm commitment due to changes in the foreign exchange rates, the resultant amount would not fully offset the change in fair value of the derivative hedging instrument (which is calculated based on forward rates) in earnings. However, when a foreign-currency-denominated nonderivative financial instrument is the hedging instrument, we would expect entities to calculate the change in the fair value of the hedged item based on spot rates to minimize hedge ineffectiveness. That is, if the forward exchange rate were used to calculate the change in fair value of the firm commitment due to changes in foreign exchange rates, the resultant amount would not be fully offset by the change in the nonderivative hedging instrument (calculated based on spot rates) in earnings.

39.04 If an entity is hedging a recognized foreign-currency-denominated asset or liability, the effectiveness of the fair value hedging relationship due to changes in foreign currency rates is affected by the interaction of the Standard and Statement 52 (ASC Topic 830). Statement 52 (ASC Topic 830) requires recognized foreign-currency-denominated assets and liabilities to be remeasured to functional currency based on spot exchange rates through earnings. Therefore, the adjustment of these assets and liabilities for changes in the fair value due to changes in foreign exchange rates is limited to the changes based on spot rates while the change in fair value of the derivative hedging instrument is based on forward rates. A result of this is earnings volatility for the spot/forward rate difference. Thus, we would expect an entity to use the foreign currency cash flow hedging model when possible when hedging only the foreign currency exposure of a recognized financial asset or liability. This may be as simple as changing the documented hedging strategy. For example, if an entity has a non-interest earning foreign currency denominated receivable due in sixty days, it is exposed to changes in fair value due to changes in foreign currency rates over the next sixty dates. It could enter into a forward contract to deliver the foreign currency in sixty days and receive its functional currency and designate the contract in a fair value hedging relationship. However, it could also view its exposure as the change in functional currency cash flows due to changes in foreign currency rates through collection of the receivable. It could enter into the same forward contract to deliver the foreign currency in sixty days and receive its functional currency and designate the contract in a cash flow hedging relationship.
39.05 To mitigate the earnings volatility caused by entering into a foreign currency fair value hedging relationship for recognized interest-bearing financial assets or liabilities, entities may wish to hedge the combination of foreign exchange risk and the benchmark interest rate risk. Hedging the change in fair value attributable to changes in both the benchmark interest rate and foreign exchange rate of a recognized foreign-currency-denominated financial asset or liability requires a two-step approach to adjust the basis of the hedged item. First, the hedged item is adjusted through earnings for the change in fair value attributable to a change in the foreign benchmark interest rate. Second, the basis-adjusted (for changes in foreign benchmark interest rates) foreign-currency-denominated asset or liability is remeasured to the functional currency at the spot rate through earnings. The Board believes that following this approach effectively eliminates any difference that will be reflected in earnings related to the use of different measurement criteria for the hedged item and the hedging instrument. This approach is illustrated in Example 7.8 of this section. See Paragraph 40.20 for an exhibit that shows various types of hedging approaches with respect to interest and/or foreign exchange risk for recognized foreign-currency-denominated financial assets or liabilities.

Examples of Foreign Currency Fair Value Hedges

39.06 Set forth below are examples that illustrate the application of these provisions for the following hedging relationships:

- Fair value hedge of a firm foreign-currency-denominated purchase commitment with a forward contract;
- Fair value hedge of a foreign-currency-denominated firm commitment with a tandem currency forward;
- Fair value hedge of a foreign-currency-denominated available-for-sale equity security with a put option; and
- Fair value hedge of fixed-rate foreign-currency-denominated debt obligation with a variable cross-currency interest rate swap.

Each of the examples assumes that all criteria for hedge accounting, including all required documentation, have been met at the onset of the hedging relationship and at each period end.

**Example 7.5: Fair Value Hedge of a Firm Foreign-Currency-Denominated Purchase Commitment with a Forward Contract**

Balmoral Co.’s functional currency is the U.S. dollar. On October 1, 20X0, Balmoral enters into a firm commitment to purchase equipment for delivery on March 31, 20X1 in pounds sterling (£). The price of the equipment is fixed at £10,000 with payment due on delivery.

Also on October 1, 20X0, Balmoral enters into a foreign currency forward contract to buy £10,000 on March 31, 20X1. Balmoral will pay $1.10 per £, which is the current forward rate for an exchange on March 31, 20X1. Balmoral designates the foreign currency forward contract as a hedge of its risk of changes in the fair value of the firm commitment resulting from changes in the $/£ exchange rate. This hedging strategy
should enable the equipment to be recorded at $11,000 (the forward price inherent in the foreign currency forward contract) at the time of purchase regardless of the then prevailing spot exchange rate.

**Assumptions**

Spot rates, forward rates, and fair value of the foreign currency forward contract are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot Currency</th>
<th>Forward Currency</th>
<th>Fair Value</th>
<th>Change in Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>October 1, 20X0</td>
<td>£1 = $1.00</td>
<td>£1 = $1.10</td>
<td>$ —</td>
<td>$ —</td>
</tr>
<tr>
<td>December 31, 20X0</td>
<td>£1 = $1.50</td>
<td>£1 = $1.40</td>
<td>$2,970</td>
<td>$2,970</td>
</tr>
<tr>
<td>March 31, 20X1</td>
<td>£1 = $1.15</td>
<td>—</td>
<td>$500</td>
<td>$(2,470)</td>
</tr>
</tbody>
</table>

1 Determined using the change in forward rates discounted at the risk free rate.

Balmoral will assess hedge effectiveness and measure any ineffectiveness by comparing the overall changes in fair value of the forward contract to the changes in fair value of the firm commitment measured by reference to changes in the $/£ forward exchange rates. Changes in the fair value of the foreign currency forward contract related to changes in the £ forward price are expected to be 100% effective in offsetting the changes in fair value of the firm commitment due to changes in the $/£ forward exchange rate because both are denominated in the same currency and have the same terms.

(a) There would be a memorandum entry made on October 1, 20X0 documenting the existence of the hedging relationship. The financial records of Balmoral would not otherwise be impacted as of this date because the foreign currency forward contract was at market rates (i.e., fair value was zero).

(b) The journal entries as of December 31, 20X0 would be as follows:

1. **Change in fair value of firm commitment (P&L)** $2,970
   **Firm commitment (B/S)** $2,970
   (To record the change in fair value of the foreign currency exposure of the firm commitment)

2. **Forward contract (B/S)** 2,970
   **Unrealized gain on forward contract (P&L)** 2,970
   (To record the change in fair value of the foreign currency forward contract)

(c) The journal entries as of March 31, 20X1 would be as follows:

1. **Firm commitment (B/S)** 2,470
   **Change in fair value of firm commitment (P&L)** 2,470
   (To record the change in fair value of the foreign currency exposure of the firm commitment)
2. Unrealized loss on forward contract (P&L)  2,470
   Forward contract (B/S)   2,470
   (To record the change in fair value of the foreign currency forward contract)

3. Cash (B/S)  500
   Forward contract (B/S)  500
   (To record settlement of the foreign currency forward contract)

4. Plant and equipment (B/S)  11,500
   Cash (B/S)  11,500
   (To record the purchase of the equipment from the UK supplier at the March 31, 20X1 spot rate)

5. Firm commitment (B/S)  500
   Plant and equipment (B/S)  500
   (To adjust plant and equipment to reflect the hedge of the firm commitment)

Observations

Balmoral’s hedging objective was to lock in the purchase price of the equipment at the U.S. dollar price based on the £ forward rate on October 1, 20X0. During the period the hedge was in place, the U.S. dollar weakened against the pound sterling. Without any hedge, the equipment would have cost $11,500 (£10,000 at the spot exchange rate of £1:$1.15). However, with the hedge, Balmoral limited its net cash outflow to $11,000.

Because Balmoral chose to assess hedge effectiveness based on changes in the fair value of the firm commitment using forward rates and the terms of the hedged item and foreign currency forward contract were the same, no hedge ineffectiveness was reflected in earnings.

Example 7.6: Fair Value Hedge of a Foreign-Currency-Denominated Firm Commitment With a Tandem Currency Forward

CBB Corp.’s functional currency is the U.S. dollar. On January 1, 20X0, CBB enters into a firm commitment to purchase a machine for delivery on May 31, 20X0. The price of the machine will be 270,000 Australian dollars (AUD). CBB wishes to hedge its exposure to changes in the fair value of the firm commitment resulting from changes in the $/AUD exchange rate i.e., it wishes to lock in its U.S. dollar amount payable (and, therefore, the U.S. dollar cost of the machine) at the forward rate available on January 1, 20X0. For risk management purposes, management of CBB does not permit any department to enter into $/AUD derivative contracts; consequently, CBB plans to hedge the $/AUD exposure.
inherent in the firm commitment with a $/Canadian dollar (CAD) derivative hedging instrument. On January 1, 20X0, CBB enters into a foreign currency forward contract to buy on May 31, 20X0, CAD 240,000 for U.S. dollars. CBB will pay $0.6125 for CAD1 (a total of $147,000). CBB designates the foreign currency forward contract as a hedge of its risk of changes in the fair value of the firm commitment resulting from changes in the $/AUD forward exchange rate. Such a hedging strategy is not prohibited by the Standard provided changes in the fair value of the $/CAD derivative instrument are highly effective at offsetting changes in the fair value of the $/AUD firm commitment due to changes in the foreign currency risk.

CBB expects the forward contract to be highly effective as a hedge because (a) CAD240,000 is approximately equal to AUD240,000 at the May 31, 20X0 forward exchange rate in effect on January 1, 20X0, (b) settlement of the forward contract and the firm commitment will occur on the same date, and (c) in recent years, changes in the value in $ of CAD over five-month periods have been highly correlated with changes in the value in $ of AUD over those same periods. CBB will assess effectiveness by comparing overall changes in the fair value of the forward contract to the changes in fair value in $ of the firm commitment due to changes in $/AUD forward exchange rates.

**Assumptions**

Relevant exchange rates are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>$/CAD Forward Rate for settlement on 5/31/X0</th>
<th>$/AUD Forward Rate for settlement on 5/31/X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1</td>
<td>$0.6125/CAD1</td>
<td>$0.5454/AUD1</td>
</tr>
<tr>
<td>March 31</td>
<td>$0.5983/CAD1</td>
<td>$0.5317/AUD1</td>
</tr>
<tr>
<td>May 31</td>
<td>$0.5777/CAD1</td>
<td>$0.5137/AUD1</td>
</tr>
</tbody>
</table>

The following table summarizes at inception, quarter-end, and May 31, 20X0, (a) fair values and total changes in fair values of the foreign currency forward contract, (b) the change in fair value of CBB’s firm commitment, and (c) the ineffectiveness of the hedge.

<table>
<thead>
<tr>
<th>Foreign currency forward contract</th>
<th>Hedge Inception 1/1/X0</th>
<th>Quarter End 3/31/X0</th>
<th>Delivery Date 5/31/X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>$/CAD forward rate with maturity on 5/31/X0</td>
<td>$0.6125</td>
<td>$0.5983</td>
<td>$0.5777</td>
</tr>
<tr>
<td>Units of currency (CAD)</td>
<td>240,000</td>
<td>240,000</td>
<td>240,000</td>
</tr>
<tr>
<td>Fwd price of CAD240,000 in dollars</td>
<td>147,000</td>
<td>143,592</td>
<td>138,648</td>
</tr>
<tr>
<td>Contract price in dollars</td>
<td>(147,000)</td>
<td>(147,000)</td>
<td>(147,000)</td>
</tr>
<tr>
<td>Difference</td>
<td>0</td>
<td>(3,408)</td>
<td>(8,352)</td>
</tr>
<tr>
<td>Fair value (present value of difference)</td>
<td>(3,391)</td>
<td>(8,352)</td>
<td></td>
</tr>
<tr>
<td>Change in fair value during period</td>
<td>$ (3,391)</td>
<td>$ (4,961)</td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td></td>
</tr>
<tr>
<td><strong>Firm commitment</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>$/AUD forward rate with</strong></td>
<td>$ 0.5454</td>
<td>$ 0.5317</td>
<td>$ 0.5137</td>
</tr>
<tr>
<td><strong>maturity on 5/31/X0</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Units of currency (AUD)</td>
<td>270,000</td>
<td>270,000</td>
<td>270,000</td>
</tr>
<tr>
<td>Fwd price of AUD270,000 in</td>
<td>(147,258)</td>
<td>(143,559)</td>
<td>(138,699)</td>
</tr>
<tr>
<td>dollars</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initial forward price in dollars</td>
<td>147,258</td>
<td>147,258</td>
<td>147,258</td>
</tr>
<tr>
<td>Difference</td>
<td>0</td>
<td>3,699</td>
<td>8,559</td>
</tr>
<tr>
<td>Fair value (present value of difference)</td>
<td>3,681</td>
<td>8,559</td>
<td></td>
</tr>
<tr>
<td>Change in fair value during period</td>
<td>$ 3,681</td>
<td>$ 4,878</td>
<td></td>
</tr>
<tr>
<td>Hedge ineffectiveness for the period (difference between changes in fair values of forward contract denominated in CAD and the firm commitment denominated in AUD)</td>
<td>$ 290</td>
<td>$ (83)</td>
<td></td>
</tr>
</tbody>
</table>

(a) There would be a memorandum entry made on January 1, 20X0, documenting the existence of the hedging relationship. The financial records of CBB would not otherwise be impacted as of this date because the foreign currency forward contract was at market rates.

(b) The journal entries as of March 31, 20X0 would be as follows:

1. Firm commitment (B/S) $ 3,681
   Gain on firm commitment (P&L) $ 3,681
   (To record the change in fair value of the foreign currency exposure of the firm commitment)

2. Loss on forward contract (P&L) 3,391
   Forward contract (B/S) 3,391
   (To record changes in fair value of the derivative hedging instrument)

(c) The journal entries as of May 31, 20X0 would be as follows:

1. Firm commitment (B/S) 4,878
   Gain on firm commitment (P&L) 4,878
   (To record the change in fair value of the foreign currency exposure of the firm commitment)
2. Loss on forward contract (P&L) 4,961
   Forward contract (B/S) 4,961
   (To record changes in fair value of the derivative hedging instrument)

3. Forward contract (B/S) 8,352
   Cash (B/S) 8,352
   (To record settlement of the foreign currency forward contract)

   Cash (B/S) 138,699
   (To record the purchase of the machine at the May 31, 20X0 spot rate)

5. Machine (B/S) 8,559
   Firm commitment (B/S) 8,559
   (To adjust machine to reflect the hedge of the firm commitment)

**Observations**

CBB has recognized the machine at its price in AUD (AUD270,000) at the forward rate in effect at the inception of the hedge ($0.5454 per AUD1). The change in fair value of the $/CAD foreign currency forward contract was highly effective in offsetting the changes in fair value of the $/AUD firm commitment such that the ineffective portion of the hedge was a net $207 gain. This gain was recognized in earnings (as the difference between recognizing changes in the fair value of the hedging foreign currency forward contract and changes in the fair value of the hedged firm commitment).

**Example 7.7: Fair Value Hedge of a Foreign-Currency-Denominated Available-For-Sale Equity Security With a Put Option**

Ridgeway Inc.’s functional currency is the U.S. dollar. Ridgeway owns 10,000 shares of London PLC’s publicly traded stock and classifies the equity securities as available-for-sale securities. London PLC is listed only on the London exchange and its share price and dividends are denominated in pounds sterling (£).

As of April 1, 20X0, the London PLC shares are trading at £100 per share (Ridgeway Inc.’s investment is valued at £1,000,000) and Ridgeway has an unrealized gain of $250,000 in other comprehensive income (OCI) associated with those shares. Ridgeway wishes to hedge the fair value of its investment in London PLC against adverse changes in the $/£ exchange rate. On April 1, 20X0, Ridgeway purchased a foreign currency put option from Bank A for $30,000. The purchased put option allows Ridgeway to put £1,000,000 to Bank A in exchange for $1,000,000 on September 30, 20X0. Ridgeway
designates the purchased put option as a hedge of its risk of changes in fair value of its available-for-sale (AFS) equity portfolio (for £1,000,000) resulting from changes in the $/£ exchange rate.

**Assumptions**

Share prices, foreign exchange rates, and fair value of Ridgeway’s investment portfolio are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Number of Shares</th>
<th>Share price £</th>
<th>Portfolio Value in £</th>
<th>Spot $/£</th>
<th>Portfolio Value in £</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1</td>
<td>10,000</td>
<td>100</td>
<td>1,000,000</td>
<td>£1 = $1.00</td>
<td>1,000,000</td>
</tr>
<tr>
<td>June 30</td>
<td>10,000</td>
<td>105</td>
<td>1,050,000</td>
<td>£1 = $0.90</td>
<td>945,000</td>
</tr>
<tr>
<td>September 30</td>
<td>10,000</td>
<td>105</td>
<td>1,050,000</td>
<td>£1 = $0.85</td>
<td>892,500</td>
</tr>
</tbody>
</table>

The change in fair value of the portfolio is attributable to both changes in the exchange rates and market prices. Set out below are the changes attributable to each:

<table>
<thead>
<tr>
<th>Three Month Period to:</th>
<th>Total Change in Portfolio Fair Value</th>
<th>Change due to Changes in Exchange Rates</th>
<th>Change due to Changes in Stock Market Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30</td>
<td>($55,000)</td>
<td>($100,000) 1</td>
<td>$ 45,000 2</td>
</tr>
<tr>
<td>September 30</td>
<td>(52,500)</td>
<td>(52,500) 3</td>
<td>—</td>
</tr>
</tbody>
</table>

1 Effect of movements in spot exchange rates on hedged equity value of £1,000,000.
2 Increase in the US$ value of the equity security resulting from an increase in the share price. The £50,000 increase in value was converted at the spot rate at June 30.
3 Exchange loss on the original hedged equity value of £1,000,000, plus the exchange loss on the £50,000 increase in equity value arising subsequent to entering into the hedge.

At June 30 and September 30, the value of the portfolio was £1,050,000. Note, however, that the notional amount of Ridgeway’s hedging instrument was only £1,000,000. Therefore, subsequent to the decrease in the value of the pound sterling (which is assumed to have occurred on June 30), a portion of Ridgeway’s foreign currency exchange risk was not hedged.

For the three-month period ending September 30, exchange rates caused the value of the portfolio to decline by $52,500. Of that amount, only $50,000 was offset by changes in the value of the currency put option. The difference between those amounts ($2,500) represents the exchange rate loss on the unhedged portion of the portfolio (i.e., the additional £50,000 of fair value that arose through increased share prices after entering into the currency hedge). At June 30, the additional £50,000 of stock value had a U.S. dollar fair value of $45,000. At September 30, using the spot rate of £1=$0.85, the fair value of this additional portion of the portfolio declined to $42,500 due to currency movements.

Ridgeway will exclude from its assessment of hedge effectiveness the portion of the fair value of the put option attributable to time value. That is, Ridgeway will recognize changes in that portion of the put option’s fair value in earnings but will not consider those changes to represent ineffectiveness.
The fair value, time value, and intrinsic value of the currency put option is as follows:

<table>
<thead>
<tr>
<th></th>
<th>(A) Assumed Fair Value</th>
<th>(B) Intrinsic Value</th>
<th>(A) - (B) Time Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1</td>
<td>$ 30,000</td>
<td>$ —</td>
<td>$ 30,000</td>
</tr>
<tr>
<td>June 30</td>
<td>125,000</td>
<td>100,000</td>
<td>25,000</td>
</tr>
<tr>
<td>September 30</td>
<td>150,000</td>
<td>150,000</td>
<td>—</td>
</tr>
</tbody>
</table>

4 Based on an option pricing model.
5 Based on the difference between the spot exchange rate at April 1 and the date the fair value of the put option is being determined (e.g., at June 30: ($1 - $0.90) * 1,000,000).

(a) The journal entry as of April 1, 20X0 would be as follows:

1. Purchased put option (B/S) $ 30,000
   Cash (B/S) $ 30,000
   (To record the purchase of the put option in the statement of financial position at fair value)

(b) The journal entries as of June 30, 20X0 would be as follows:

1. Change in time value of put option (P&L) 5,000
   Purchased put option (B/S) 5,000
   (To reflect the change in the time value of the put option)

2. Purchased put option (B/S) 100,000
   Unrealized gain on intrinsic value of option (P&L) 100,000
   (To record the change in the intrinsic value of the put option)

3. Unrealized loss on AFS portfolio due to exchange rates (P&L) 100,000
   OCI 45,000
   AFS equity securities (B/S) 55,000
   (To reflect the change in fair value of the AFS equity security. The change in fair value attributable to the change in exchange rates is recorded through earnings, the remainder through OCI)

(c) The journal entries as of September 30, 20X0 would be as follows:

1. Change in time value of put option (P&L) 25,000
### Observations

Ridgeway’s hedging objective was to lock in the U.S. dollar value of the foreign-currency-denominated investment at the spot exchange rate that existed at April 1, 20X0. At April 1, 20X0, Ridgeway’s investment in London PLC had an asset carrying value of $1,000,000 and an unrealized gain of $250,000 in OCI related to that investment. If Ridgeway had not entered into a foreign currency fair value hedge of its investment in London PLC, at September 30, 20X0, its investment would have had an asset carrying value of $892,500 and an unrealized gain of $142,500 in OCI related to that investment. The decrease in the unrealized gain in OCI related to the investment during the period of $107,500 would have reflected the strengthening of the U.S. dollar against the pound sterling ($152,500 unrealized loss), offset in part by an increase in London PLC’s stock price over the period between April 1, 20X0 and September 30, 20X0 ($45,000 unrealized gain).

However, Ridgeway hedged against the risk of the U.S. dollar strengthening against the pound sterling to the extent of a £1,000,000 notional amount. As a result, the loss in value of the investment in London PLC attributable to foreign exchange movements to the

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchased put option (B/S)</td>
<td>25,000</td>
</tr>
<tr>
<td>(To record the change in the time value of the put option; since the option has reached its exercise date the time value is zero)</td>
<td></td>
</tr>
<tr>
<td>2.   Purchased put option (B/S)</td>
<td>50,000</td>
</tr>
<tr>
<td>Gain on intrinsic value of option (P&amp;L)</td>
<td>50,000</td>
</tr>
<tr>
<td>(To record the change in the intrinsic value of the put option)</td>
<td></td>
</tr>
<tr>
<td>3.   Cash (B/S)</td>
<td>150,000</td>
</tr>
<tr>
<td>purchased put option (B/S)</td>
<td>150,000</td>
</tr>
<tr>
<td>(To record the net cash settlement of the purchased currency put option)</td>
<td></td>
</tr>
<tr>
<td>4.   Unrealized loss on AFS portfolio due to exchange rates (P&amp;L)</td>
<td>50,000</td>
</tr>
<tr>
<td>AFS equity securities (B/S)</td>
<td>50,000</td>
</tr>
<tr>
<td>(To reflect the change in fair value of the hedged portion of the AFS equity portfolio attributable to the hedged risk)</td>
<td></td>
</tr>
<tr>
<td>5.   OCI</td>
<td>2,500</td>
</tr>
<tr>
<td>AFS equity securities (B/S)</td>
<td>2,500</td>
</tr>
<tr>
<td>(To reflect the change in fair value of the unhedged portion of the AFS equity portfolio)</td>
<td></td>
</tr>
</tbody>
</table>
extent of the £1,000,000 notional amount is reflected in the income statement ($150,000) and was offset by gains on the derivative hedging instrument. Consequently, at September 30, 20X0, its investment has an asset carrying value of $892,500 and an unrealized gain of $292,500 in OCI related to that investment.

Example 7.8: Fair Value Hedge of Fixed-Rate Foreign-Currency-Denominated Debt with a Variable Cross-Currency Interest Rate Swap (Fixed to Variable Scenario)

ABC Company’s functional currency is the U.S. dollar. On January 1, 20X0, ABC borrowed 100,000 euros (EUR) for five years with a fixed coupon rate of 5.68%. Also on January 1, 20X0, ABC enters into a 5-year fixed-to-variable cross-currency interest rate swap (cross-currency swap) in which it will receive fixed EUR at 5.68% on EUR 100,000 and pay floating $ at London Interbank Offered Rate (LIBOR) plus 0.536% on $102,000. There will be a final exchange of principal on maturity of the contract (ABC will receive EUR 100,000 and pay $102,000). Both the debt and the cross-currency swap will pay interest annually on December 31.

ABC designates the cross-currency swap as a fair value hedge for changes in the fair value of the debt due to changes in both the benchmark interest rate (LIBOR) and foreign exchange rates ($/EUR). ABC will assess hedge effectiveness and measure ineffectiveness by comparing the change in fair value of the cross-currency interest rate swap with changes in the fair value of the EUR debt attributable to changes in the benchmark interest rate and the $/EUR spot exchange rate during the period.

Assumptions

The spot exchange rates for $/EUR, LIBOR flat EUR swap rate, and 1 year $ LIBOR rate over the life of the hedge are as follows:

<table>
<thead>
<tr>
<th></th>
<th>1/1/X0</th>
<th>12/31/X0</th>
<th>12/31/X1</th>
<th>12/31/X2</th>
<th>12/31/X3</th>
<th>12/31/X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spot Rate</td>
<td>1.0200</td>
<td>1.0723</td>
<td>1.0723</td>
<td>1.1273</td>
<td>1.1851</td>
<td>1.2458</td>
</tr>
<tr>
<td>EUR swap rate</td>
<td>5.160%</td>
<td>5.151%</td>
<td>5.040%</td>
<td>4.854%</td>
<td>4.480%</td>
<td>N/A</td>
</tr>
<tr>
<td>1 yr $LIBOR</td>
<td>6.00%</td>
<td>5.50%</td>
<td>6.00%</td>
<td>6.50%</td>
<td>7.00%</td>
<td>N/A</td>
</tr>
</tbody>
</table>

The fair values of the debt attributable to changes in both euro interest rates and spot exchange rates and the changes in those fair values, and the fair values of the cross currency swap and the changes in those fair values, are shown in the following table:

<table>
<thead>
<tr>
<th></th>
<th>1/1/X0</th>
<th>12/31/X0</th>
<th>12/31/X1</th>
<th>12/31/X2</th>
<th>12/31/X3</th>
<th>12/31/X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Spot Rate</td>
<td>1.0200</td>
<td>1.0723</td>
<td>1.0723</td>
<td>1.1273</td>
<td>1.1851</td>
<td>1.2458</td>
</tr>
<tr>
<td>(100,000)</td>
<td>(100,032)</td>
<td>(100,322)</td>
<td>(100,567)</td>
<td>(100,647)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B Fair Value of</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt (in EUR)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
As a fair value hedge, changes in the fair value of the debt for the risks being hedged (benchmark interest rate and foreign exchange) are recognized in earnings along with changes in the fair value of the cross-currency swap. The income statement effect, including interest expense, is set out below for each year ended.

<table>
<thead>
<tr>
<th></th>
<th>12/31/X0</th>
<th>12/31/X1</th>
<th>12/31/X2</th>
<th>12/31/X3</th>
<th>12/31/X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense*</td>
<td>(6,667)</td>
<td>(6,157)</td>
<td>(6,667)</td>
<td>(7,177)</td>
<td>(7,687)</td>
</tr>
<tr>
<td>Change in Value of Debt (D)</td>
<td>(5,265)</td>
<td>(310)</td>
<td>(5,791)</td>
<td>(5,908)</td>
<td>17,274</td>
</tr>
<tr>
<td>Change in Value of Swap (F)</td>
<td>5,332</td>
<td>310</td>
<td>5,830</td>
<td>5,885</td>
<td>(17,357)</td>
</tr>
<tr>
<td>Net Income Stmt Impact</td>
<td>(6,599)</td>
<td>(6,157)</td>
<td>(6,628)</td>
<td>(7,200)</td>
<td>(7,770)</td>
</tr>
<tr>
<td>Ineffectiveness (D-F)</td>
<td>67</td>
<td>—</td>
<td>39</td>
<td>(23)</td>
<td>(83)</td>
</tr>
</tbody>
</table>

* The interest expense is calculated based on $ LIBOR plus .536% on $102,000. The fixed euro interest expense remeasured into the functional currency ($) is adjusted by the net cash payment on the cross-currency swap to reflect the variable $ interest rate (LIBOR + .536%) inherent in the cross-currency swap.

Journal entries are provided for only the first two years of the hedging relationship. The example is based on annual periods; normally the assessment of effectiveness, measurement of ineffectiveness and fair value adjustments of the hedged item and derivative would be done at least quarterly.

(a) The journal entries as of January 1, 20X0 would be as follows:

1. There would be a memorandum entry made on January 1, 20X0, documenting the existence of the hedging relationship. The financial records are not impacted as of this date by the cross-currency swap since it was at market.

2. Cash (B/S) $ 102,000
   Debt (B/S) $ 102,000

   (To record EUR 100,000 debt at spot rate)
(b) The journal entries as of December 31, 20X0 would be as follows:

1. Unrealized loss on fixed-rate debt (P&L) 34
   Loss on foreign exchange remeasurement (P&L) 5,231
   Debt (B/S) 5,265

   (To record the change in fair value of the debt due to changes in the benchmark interest rate [(EUR 100,032 - EUR 100,000) * 1.0723 = $34] and remeasurement at spot rate)

2. Cross-currency swap (B/S) 5,332
   Unrealized gain on Swap (P&L) 5,332

   (To record the change in fair value of the derivative hedging instrument)

3. Interest expense-debt (P&L) 6,091
   Interest expense-net swap payments (P&L) 576
   Cash (B/S) 6,667

   (To record interest expense on the debt and the net interest cash payment on the swap. For illustrative purposes EUR debt interest for the year is translated at 12/31/X0 spot rate)

(c) The journal entries as of December 31, 20X1 would be as follows:

1. Unrealized loss on fixed-rate debt (P&L) 310
   Debt (B/S) 310

   (To record change in the fair value of debt due to changes in the benchmark interest rates. Note, there is no remeasurement to functional currency adjustment since the spot rate is unchanged)

2. Cross-currency swap (B/S) 310
   Unrealized gain on swap (P&L) 310

   (To record the change in fair value of the derivative hedging instrument)

3. Interest expense (P&L) 6,091
   Interest expense-net swap payments (P&L) 66
   Cash (B/S) 6,157

   (To record interest expense on the debt and the net interest cash payment on the swap. For illustrative purposes EUR loan interest for the year translated at 12/31/X1 spot rate)

Observations
By using a cross-currency swap ABC eliminated its foreign exchange risk by locking in a forward call on EUR 100,000 at EUR 1: $1.02 enabling ABC to settle its EUR debt for a fixed $ amount ($102,000). ABC also converted the fixed EUR interest payments into variable $ LIBOR based interest payments thus hedging its exposure to changes in interest rates. The cross-currency swap was highly effective in offsetting changes in the fair value of the debt attributable to changes in the benchmark interest rate (LIBOR) and remeasurement at spot of the debt into its functional currency ($).

In contrast, ABC could have hedged the change in fair value of the debt attributable to foreign currency exchange risk only with either a foreign currency forward contract or cross-currency swap to receive fixed interest EUR and pay fixed $. In either of these instances, since ABC would not be hedging the risk of change in fair value of the debt for changes in the benchmark interest rate, the hedged item would not be adjusted for changes in the interest rates and would only be adjusted (remeasured) to the functional currency at the spot rate pursuant to Statement 52 (ASC Topic 830). The income statement would be impacted due to the difference between the spot and forward rates.

FOREIGN CURRENCY CASH FLOW HEDGES

40.01 Paragraph 40 of the Standard (ASC paragraphs 815-20-25-30, 25-38 through 25-40, 25-71, and 815-20-55-130) addresses foreign currency cash flow hedges as follows:

40. A nonderivative financial instrument shall not be designated as a hedging instrument in a foreign currency cash flow hedge. A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with a forecasted transaction (for example, a forecasted export sale to an unaffiliated entity with the price to be denominated in a foreign currency), a recognized asset or liability, an unrecognized firm commitment, or a forecasted intercompany transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary) qualifies for hedge accounting if all the following criteria are met:

(a) For consolidated financial statements, either (1) the operating unit that has the foreign currency exposure is a party to the hedging instrument or (2) another member of the consolidated group that has the same functional currency as that operating unit (subject to the restrictions in this subparagraph and related footnote) is a party to the hedging instrument. To qualify for applying the guidance in (2) above, there may be no intervening subsidiary with a different functional currency.* (Refer to paragraphs 36, 40A, and 40B for conditions for which an intercompany foreign currency derivative can be the hedging instrument in a cash flow hedge of foreign exchange risk.)

(b) The hedged transaction is denominated in a currency other than the hedging unit’s functional currency.
(c) All of the criteria in paragraphs 28 and 29 are met, except for the criterion in paragraph 29(c) that requires that the forecasted transaction be with a party external to the reporting entity.

(d) If the hedged transaction is a group of individual forecasted foreign-currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.

(e) If the hedged item is a recognized foreign-currency-denominated asset or liability, all the variability in the hedged item’s functional-currency-equivalent cash flows must be eliminated by the effect of the hedge. (For example, a cash flow hedge cannot be used with a variable-rate foreign-currency-denominated asset or liability and a derivative based solely on changes in exchange rates because the derivative does not eliminate all the variability in the functional currency cash flows.)

* For example, if a dollar-functional, second-tier subsidiary has a euro exposure, the dollar-functional consolidated parent company could designate its U.S. dollar–euro derivative as a hedge of the second-tier subsidiary’s exposure provided that the functional currency of the intervening first-tier subsidiary (that is, the parent of the second-tier subsidiary) is also the U.S. dollar. In contrast, if the functional currency of the intervening first-tier subsidiary was the Japanese yen (thus requiring the financial statements of the second-tier subsidiary to be translated into yen before the yen-denominated financial statements of the first-tier subsidiary are translated into U.S. dollars for consolidation), the consolidated parent company could not designate its U.S. dollar–euro derivative as a hedge of the second-tier subsidiary’s exposure.

DIG Issues related to this paragraph are E3, G23, H1, H4, H5, H13, and H16. See DIG Issues Index.

40.02 In order to qualify as a hedge of the foreign currency exposure to variability in functional-currency-equivalent cash flows associated with a forecasted transaction, including forecasted intercompany transactions (discussed in Paragraph 40.11 of this section), a recognized asset or liability (discussed in Paragraph 40.16 of this section), or an unrecognized firm commitment (discussed in Paragraph 40.14 of this section), the Standard requires that all the general cash flow hedge criteria specified in paragraphs 28 and 29 (ASC paragraphs 815-20-25-3, 25-13, 25-14, 25-50, 25-51, 25-94, 25-95, and 815-20-25-15 and 25-43) be satisfied except for the criterion in paragraph 29(c) (ASC paragraph 815-20-25-15(c)), which requires that the transaction be with a party external to the reporting entity. The following is a list of all the criteria, which are discussed in detail in Section 6:

- Formal documentation (see Paragraphs 28A.01 and 36.05);
- Effectiveness of hedging relationships (see Paragraph 28B.01);
- Special rules for written options (see Paragraph 28C.01);
• Special rules for basis swaps (see Paragraph 28D.01);
• A group of forecasted transactions must share the same risk exposure (see Paragraph 29A.01);
• Forecasted transaction must be probable (see Paragraph 29B.01);
• Forecasted transaction must be with a party external to the reporting entity (not applicable for hedges of foreign currency forecasted transactions);
• Forecasted transaction must present an exposure that could affect earnings (see Paragraph 29C.07);
• Items prohibited from being designated as the hedged item, excluding the criterion of paragraph 29 (d) of the Standard (ASC paragraphs 815-20-25-15(d) and 25-15(e)) (see Paragraphs 29D.01 - 29F.05) (as previously discussed in Paragraph 36.07 of this section, the Board clarified that the Statement 52 (ASC Topic 830) remeasurement at spot rate to the functional currency was not a remeasurement at fair value as contemplated in paragraph 29(d) of the Standard (ASC paragraphs 815-20-25-15(d) and 25-15(e))); and
• Risks that may be hedged (see Paragraphs 29G.01 - 29H.15).

40.03 Additionally, the Standard requires that the conditions in paragraphs 40(a) and 40(b) (ASC paragraph 815-20-25-30) be met in order for the hedging relationship to qualify as a cash flow hedge of a foreign currency exposure. (See DIG Issue H1 for further reference) Those conditions are discussed in detail in the following paragraph and generally require that:

- The operating unit that has the foreign currency exposure be a party to the derivative hedging instrument; and
- The hedged transaction be denominated in a currency other than that unit’s functional currency.

Hedging at the Operating Unit Level

40.04 In order to qualify for hedge accounting, paragraph 40(a) of the Standard (ASC paragraph 815-20-25-30(a)) requires that the operating unit that has the foreign currency exposure be a party to the hedging instrument. This requirement is necessary because, under Statement 52’s (ASC Topic 830) functional currency approach, all foreign currency exposures exist only in relation to an entity’s functional currency. Therefore, exposure to foreign currency risk must be assessed at the operating unit level.

40.05 A parent company whose functional currency differs from its subsidiary’s functional currency is not directly exposed to the risk of exchange rate changes for a subsidiary’s transactions that are denominated in a currency other than its functional currency. The parent cannot hedge that risk. Accordingly, a parent company that has a different functional currency may not directly hedge a subsidiary’s foreign currency transactions.

40.06 For purposes of applying paragraph 40(a) (ASC paragraph 815-20-25-30(a)) for the consolidated financial statements, the operating unit should be defined by using a functional currency approach rather than a legal entity approach. Accordingly, if the subsidiary has the
same functional currency as the parent company, the parent company may enter into a hedging instrument that is designated as the hedge of the subsidiary’s foreign currency exchange risk in the consolidated financial statements. There cannot be an intervening subsidiary with a different functional currency from the parent company between the parent company and the subsidiary that has the foreign currency exchange risk being hedged. This is based on the fact that when a subsidiary and its parent company have the same functional currency, they also have the same foreign currency exposure. The same analysis would apply if another member of the consolidated group, instead of the parent, entered into the hedging instrument.

40.07 For example, a U.S. dollar functional currency parent company cannot directly hedge the foreign currency risk in its euro functional currency subsidiary’s forecasted yen-denominated export sales because the parent has no direct exposure to exchange risk for the yen-denominated sales. However, if both the parent and subsidiary had the U.S. dollar as their functional currency, the parent company could enter into a derivative instrument to hedge the yen-denominated forecasted sales of the subsidiary, provided there was no intervening subsidiary with a different functional currency. In contrast, if there was an intervening UK subsidiary with a pound sterling functional currency then the U.S. dollar functional currency parent company could not enter into a hedging instrument on behalf of its second tier U.S. dollar functional currency subsidiary.

40.08 In order to recognize the effects of hedge accounting in a subsidiary’s separate financial statements, the subsidiary must enter into the hedging instrument. This instrument can be with a third party or another member of the consolidated group.

Currency Other Than the Functional Currency

40.09 Paragraph 40(b) of the Standard (ASC paragraph 815-20-25-30(b)) requires that the hedged transaction be denominated in a currency other than the hedging unit’s functional currency. Foreign currency exposure exists in relation to an entity’s functional currency. For example, euro-denominated transactions of a euro functional currency subsidiary are not eligible for foreign currency hedging since they do not present a foreign currency exposure in relation to the subsidiary’s functional currency. Such transactions do not affect consolidated earnings.

40.10 Paragraph 40 of the Standard (ASC paragraphs 815-20-25-30, 25-38 through 25-40, 25-71, and 815-20-55-130) addresses the types of transactions (hedged items) that are eligible to be hedged in a foreign currency cash flow model. These include:

- Forecasted transactions, including forecasted intercompany transactions;
- Unrecognized firm commitments; and
- Recognized foreign-currency-denominated assets and liabilities.

Forecasted Transactions

40.11 Paragraph 40 of the Standard (ASC paragraphs 815-20-25-30, 25-38 through 25-40, 25-71, and 815-20-55-130) permits an entity to designate the foreign currency exposure to variability in the functional-currency-equivalent cash flows of forecasted foreign-currency-denominated transactions as a hedged transaction in a cash flow hedge, whether the transaction is with a third party or an intercompany transaction. The Standard requires that the hedge criteria discussed in Paragraphs 40.02 - 40.03 of this section be met, except the criterion that requires the forecasted
transaction be with a party external to the reporting entity. This is because a forecasted intercompany transaction that will be denominated in a currency other than the entity’s functional currency gives rise to variability in functional currency cash flows due to exchange rate changes that affect consolidated earnings. Therefore, a forecasted intercompany transaction presents an exposure to foreign currency risk and is eligible for designation as a hedged transaction if the other criteria for a foreign currency cash flow hedge are met.

NETTING FORECASTED INFLOWS AND OUTFLOWS

40.12 Paragraph 40(d) (ASC paragraph 815-20-25-39(c)) is consistent with paragraph 29(a) of the Standard (ASC paragraph 815-20-25-15(a)). It states that for a group of individual forecasted transactions to be considered similar for purposes of being hedged as one, the group cannot include both forecasted foreign currency inflows and outflows. As an example, an entity that forecasts sales and purchases in the same foreign currency cannot net the forecasted sales and purchases and simply hedge the net foreign currency exposure. The entity would have to separately hedge either the forecasted sales or the forecasted purchases. While an entity is not permitted to hedge the net foreign currency exposure in this example, it can hedge a gross exposure (that equals the net exposure) and qualify for hedge accounting. As an example, assume that a U.S. dollar functional currency entity forecasts that it will receive 1,000,000CAD (related to sales of its product) on May 15, 20X0 and also forecasts that it will pay 700,000CAD (related to purchases of inventory) on May 15, 20X0. The entity would have a net receive position of 300,000CAD but it is not permitted to designate that net position as the hedged transaction. However, provided the requirements in Paragraph 40.02 and 40.03 of this section are met, the entity may hedge the foreign currency risk related to the forecasted receipt of 300,000CAD (related to sales of its products) on May 15, 20X0.

FORECASTED INTERCOMPANY DIVIDENDS

40.13 A forecasted intercompany dividend either in foreign or functional currency, cannot qualify as a hedgeable forecasted transaction, because an intercompany dividend does not affect earnings. In essence, a hedge of a forecasted intercompany dividend expected to be paid from future earnings is a hedge of those future earnings. The Standard prohibits hedge accounting for hedges of future earnings. However, once foreign-currency-denominated dividends are declared by the subsidiary and recognized as dividends receivable/payable by the parent/subsidiary, they can be hedged as recognized foreign-currency-denominated assets/liabilities for changes in foreign currency rates (refer to Paragraph 36.07 of this section).

Unrecognized Firm Commitments

40.14 Paragraphs 37.05 and 37.06 of this section address the issue that a commitment could be considered a firm commitment if its price were expressed in a specified amount of currency, regardless of whether that currency was the entity’s functional currency or a foreign currency. Thus, such a commitment is eligible to be hedged in a fair value hedge. In addition, a firm commitment in a currency other that the entity’s functional currency also exposes the entity to variability in its functional-currency-equivalent cash flows due to changes in currency rates. Accordingly, an unrecognized foreign currency firm commitment may be the hedged item in a cash flow hedge of foreign currency risk.
40.15 The definition of a firm commitment also requires that the commitment be with an *unrelated party*. Thus, the definition prohibits the designation of an intercompany commitment or a commitment with a related party outside the reporting entity as the hedged item in a fair value hedge. However, foreign-currency-denominated commitments with related parties (e.g., subsidiary to subsidiary within a consolidated group, reporting entity to related party outside the consolidated financial statements) may qualify as forecasted transactions in a cash flow hedge because the criteria for forecasted transactions do not include a criterion that the contract be with an *unrelated party* and the intercompany or related party commitment does expose an entity to variability in functional-currency-equivalent cash flows that could affect reported earnings.

**Recognized Foreign-Currency-Denominated Assets And Liabilities**

40.16 Paragraph 40(e) (ASC paragraphs 815-20-25-39(d) and 25-40) permit(s) an entity to designate a derivative instrument as a hedge of the foreign currency exposure of the foreign-currency-equivalent cash flows associated with a recognized foreign-currency-denominated asset or liability provided *all* the variability in the hedged item’s functional-currency-equivalent cash flows is eliminated by the effect of the hedge. A simple application of this requirement is when a non-interest bearing foreign-currency-denominated asset (e.g., an account receivable) or liability (e.g., an account payable) is hedged with a forward currency contract. Since the variability in functional-currency-equivalent cash flows of the non-interest bearing asset or liability is only attributable to foreign exchange rate changes, all variability is eliminated by the forward currency contract. If all of the variability is not eliminated, an entity could designate the recognized foreign-currency-denominated asset or liability as the hedged item in a foreign currency fair value hedge if all of the fair value hedge criteria are met. The following examples expand on this concept for an interest bearing foreign-currency-denominated asset or liability. A fixed-rate yen-denominated loan could be hedged for variability in functional-currency-equivalent cash flow with a forward currency contract since the yen interest payments are fixed and the forward currency contract eliminates the remaining variability due to foreign exchange rates. In contrast, a variable-rate yen-denominated loan could not be hedged for variability in functional-currency-equivalent cash flow with a forward currency contract since the forward currency contract only eliminates the variability due to foreign exchange rates and variability still exists due to the variable interest rate. As further discussed below an entity could hedge this loan with a cross-currency interest rate swap in the cash flow hedging model. Additionally, as discussed in Paragraph 40.18, an entity may designate only selected portions of a recognized asset or liability in a cash flow hedge of the associated variability arising from the foreign currency denominated cash flows as long as all of the variability for the selected cash flows is eliminated.

40.17 The reference in paragraph 40(e) (ASC paragraphs 815-20-25-39(d) and 25-40) to the elimination of *all* variability in cash flows is not intended to require that the hedging instrument be perfectly effective. The requirement in paragraph 40(e) (ASC paragraphs 815-20-25-39(d) and 25-40) to eliminate all variability is intended to ensure that the hedging relationship is highly effective at offsetting *all risks* that impact the variability of cash flows. Thus, paragraph 40(e) (ASC paragraphs 815-20-25-39(d) and 25-40) precludes only the specific exclusion of a risk from the hedge that will affect the variability in cash flows. As long as no element of risk impacting the variability in cash flows has been specifically excluded from a foreign currency cash flow hedge, and the hedging instrument is highly effective at providing the necessary offset
in the variability of all cash flows, a less-than-perfect hedge would meet the requirement in paragraph 40(e) (ASC paragraphs 815-20-25-39(d) and 25-40). In other words, if the recognized foreign-currency-denominated asset or liability has a variable interest rate and an entity wishes to hedge the foreign exchange risk for both the principal and interest, the hedging relationship must offset the variability in cash flows for both foreign exchange risk and interest rate risk. The hedging relationship would have to fix the cash flows in terms of the entity’s functional currency. (See DIG Issue H16 for further reference) Consider the following example:

Example 7.9: Application of Paragraph 40(e)ASC paragraphs 815-20-25-39(d) and 25-40)

Situation 1
TMF Corporation has issued a fixed-rate foreign-currency-denominated debt obligation that is callable by TMF. TMF would like to hedge its variability in functional-currency-equivalent cash flows due to changes in foreign currency rates. TMF entered into a fixed-to-fixed cross-currency interest rate swap. Assume that the swap will be highly effective in hedging the foreign currency exposure of the debt instrument and it is probable that the call option will not be exercised by TMF.

A fixed-to-fixed currency interest rate swap could be used to hedge the cash flow exposure due to foreign currency exchange rate changes on the fixed-rate foreign-currency-denominated debt instrument that is callable even though the swap does not contain a mirror image call option. This would be true as long as the terms of the swap and the debt instrument are such that they would be highly effective at providing offsetting cash flows and as long as it was probable that the debt instrument would not be called and would remain outstanding.

Situation 2
DMA Company has issued a variable-rate foreign-currency-denominated debt obligation and desires to hedge its variability in functional-currency-equivalent cash flows due to changes in foreign currency rates and interest rates. DMA uses a floating-to-fixed cross-currency interest rate swap in which it receives the same foreign currency based on the variable-rate index contained in the debt obligation and pays a fixed amount in its functional currency. There is a ten-day difference between the reset dates in the debt obligation and the swap (i.e., the ten-day difference in reset dates results in the hedge being highly effective, but not perfectly effective).

A floating-to-fixed cross-currency interest rate swap could be used to hedge the cash flow exposure due to foreign currency exchange and interest rate changes on the variable-rate foreign-currency-denominated debt instrument even though there is a ten-day difference between the reset dates in the debt instrument and the swap. This would be true as long as the difference in reset dates is not significant enough to cause the hedge to fail to be highly effective at providing offsetting cash flows.

40.18 It is important to note that the carrying amount of a financial asset or liability, such as a loan, is comprised of the present value of the interest payments and the present value of the principal payment(s). (See DIG Issue H4 for further reference) An entity can specify as the hedged item specific cash flows (paragraph 29(a) (ASC paragraph 815-20-25-15(a))) associated
with all or a portion of the recognized foreign-currency-denominated principal and/or interest of a financial asset or liability. For either fixed or variable-rate foreign-currency-denominated assets or liabilities an entity is permitted to hedge the variability in functional-currency-equivalent cash flows for the following:

- All payments of both principal and interest;
- All payments of principal only;
- All or a fixed portion of selected payments of either principal or interest; and
- Selected payments of both principal and interest.

For each of the above situations, an entity can utilize cash flow hedge accounting to hedge the variability in the specific principal repayments, interest cash flows, or both. (See DIG Issue G23 for further reference)

40.19 In the variable-rate yen loan example described in Paragraph 40.16, an entity could designate as the hedged item only the present value of the principal amount of the variable-rate yen-denominated loan. In this case, using a forward currency contract, the entity would designate a hedging relationship for the variability in functional-currency-equivalent cash flows due to foreign exchange rates since the forward contract eliminates the variability of the designated hedged item. This is because the interest payment component of the loan, whose variability is not eliminated, is not part of the designated hedged item.

40.20 The following exhibit summarizes various approaches to hedging foreign exchange risk and/or interest rate risk in either a fair value or cash flow model for recognized foreign-currency-denominated financial assets or liabilities.

### Exhibit 7.1: Hedging Approaches for Foreign Exchange and/or Interest Rate Risk

<table>
<thead>
<tr>
<th>Hedged Item</th>
<th>Hedge Objective (1)</th>
<th>Hedge Result</th>
<th>Hedge Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fixed-rate, foreign-currency denominated (FCD) instrument</strong></td>
<td>Reduce foreign exchange (FX) and interest rate risk</td>
<td>US$ variable-rate interest and US$ principal</td>
<td>Fair value hedge of FX and interest risk</td>
</tr>
<tr>
<td>Fixed-rate, FCD instrument</td>
<td>Fix variability due to FX risk</td>
<td>US$ fixed-rate interest and US$ principal</td>
<td>Cash flow or fair value hedge (2) of FX risk</td>
</tr>
<tr>
<td>Fixed-rate, FCD instrument</td>
<td>Eliminate change in FCD fair value of instrument due to FCD interest rate risk</td>
<td>FCD variable-rate interest and FCD principal</td>
<td>Fair value hedge of FCD interest rate risk</td>
</tr>
<tr>
<td>FCD trade payable or receivable</td>
<td>Fix variability due to FX risk</td>
<td>US$ fixed payment amount</td>
<td>Cash flow or fair value hedge (2) of FX risk</td>
</tr>
<tr>
<td>Variable-rate, FCD instrument</td>
<td>Fix variability of principal and interest payments due to FX and interest risk (3)</td>
<td>US$ fixed interest rate and US$ principal</td>
<td>Cash flow hedge of variability of FX and interest risk</td>
</tr>
<tr>
<td>-------------------------------</td>
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<td>------------------------------------------</td>
<td>--------------------------------------------------</td>
</tr>
<tr>
<td>Variable-rate, FCD instrument</td>
<td>Reduce variability of FX risk (3)</td>
<td>US$ variable-rate interest and US$ principal</td>
<td>Fair value hedge (2) of FX risk (4)</td>
</tr>
<tr>
<td>Variable-rate, FCD instrument</td>
<td>Reduce variability of FX risk (3)</td>
<td>US$ variable-rate interest and US$ principal</td>
<td>Fair value hedge (2) of FX risk (4)</td>
</tr>
<tr>
<td>Variable-rate, FCD instrument</td>
<td>Reduce variability due to interest risk</td>
<td>FCD fixed-rate interest and FCD principal</td>
<td>Cash flow hedge of variability of FCD interest</td>
</tr>
<tr>
<td>Variable-rate, FCD instrument</td>
<td>Fix variability of principal payment due to FX risk</td>
<td>Fixed US$ principal</td>
<td>Cash flow or fair value hedge (2) of FX risk for principal</td>
</tr>
</tbody>
</table>

(1) Assumptions are that the US$ is the functional currency and that the interest rate is the benchmark rate.
(2) Fair value hedging model usually results in spot/forward differences and earnings volatility. See Paragraphs 39.04 and 41.05 of this section for further discussion.
(3) Alternatively, as discussed in Paragraph 40.18 of this section, the hedged item could be designated as the functional-currency-equivalent cash flows of a specified amount of a variable-based foreign currency interest payment(s). As an example, if an entity had a EUR 100,000 variable loan, it could designate as the hedged item the first EUR 3,000 of a specified variable-rate interest payment(s) if it is probable that the hedged variable interest payment(s) will exceed EUR 3,000. Then entity could enter into a cash flow hedge with a foreign currency forward contract since all of the variability associated with the first EUR 3,000 of the variable interest payment(s) would be eliminated.
(4) Alternatively, as discussed in Paragraph 40.18 of this section and as demonstrated in the last approach in the exhibit, if the hedged item was designated to be the principal payment component only, the cash flow hedging model could be used.

### Treasury Center – Internal Derivatives

#### 40A.01
Paragraph 40A of the Standard (ASC paragraph 815-20-25-61) addresses the use of internal derivatives as derivative hedging instruments in foreign currency cash flow hedges. Paragraph 40A (ASC paragraph 815-20-25-61) reads as follows:

40A. *Internal derivative.* A foreign currency derivative contract that has been entered into with another member of a consolidated group (such as a treasury center) can be a hedging instrument in a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment in the consolidated financial statements only if the following two conditions are satisfied. (That foreign currency derivative instrument is hereafter in this section referred to as an internal derivative.)

(a) From the perspective of the member of the consolidated group using the derivative as a hedging instrument (hereafter in this section referred to as the hedging
affiliates), the criteria for foreign currency cash flow hedge accounting in paragraph 40 must be satisfied.

(b) The member of the consolidated group not using the derivative as a hedging instrument (hereafter in this section referred to as the issuing affiliate) must either (1) enter into a derivative contract with an unrelated third party to offset the exposure that results from that internal derivative or (2) if the conditions in paragraph 40B are met, enter into derivative contracts with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts.

DIG Issues related to this paragraph are E3 and H14. See DIG Issues Index.

40A.02 The member of the consolidated group that has the foreign currency exposure and is using the internal derivative as a hedging instrument (hereafter referred to as the hedging affiliate) in the consolidated financial statements, must meet the criteria for foreign currency cash flow hedge accounting, which is addressed in paragraph 40 of the Standard (ASC paragraphs 815-20-25-30, 25-38 through 25-40, 25-71, and 815-20-55-130) and Paragraphs 40.02 - 40.10 of this section. In addition, the requirements that must be met by the counterparty to the internal derivative (i.e., the member of the consolidated group that does not use the derivative as a hedging instrument, such as a treasury center) are addressed in paragraphs 36 and 40A of the Standard (ASC paragraphs 815-20-25-28, 25-29, and 25-52, and 815-20-25-61).

40A.03 Paragraph 36 (ASC paragraphs 815-20-25-28, 25-29, and 25-52) provides that an internal derivative can be used in a fair value or cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment hedge only if the treasury center has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the internal derivative. Paragraph 40A (ASC paragraph 815-20-25-61) permits more flexibility when using internal derivatives to hedge the foreign currency cash flow risk associated with a forecasted borrowing, purchase, or sale or an unrecognized firm commitment. In this instance, the treasury center can either enter into an offsetting contract with an unrelated third party or if the criteria of paragraph 40B of the Standard (ASC paragraphs 815-20-25-62 and 25-63) are met, enter into derivative contracts with unrelated third parties that would offset, on an aggregate or net basis, the foreign exchange risk arising from multiple internal derivatives. In offsetting the various foreign currency exposures pursuant to paragraph 40A(b)(2) of the Standard (ASC paragraph 815-20-25-61(b)(2)), a treasury center is permitted to enter into third party derivatives with neither leg being in the treasury center’s functional currency. For example, if a U.S. dollar functional currency treasury center was long yen and short euros, it could enter into a yen/euro currency swap. Any residual yen or euro exposure not offset by the currency swap would need to be separately offset.

TREASURY CENTER – OFFSETTING NET EXPOSURES

40B.01 Paragraph 40B (ASC paragraphs 815-20-25-62 and 25-63) (aggregating or netting foreign currency exposures) is only applicable to cash flow hedges of forecasted transactions or unrecognized firm commitments. Paragraph 40B (ASC paragraphs 815-20-25-62 and 25-63) reads as follows:
40B. **Offsetting net exposures.** If an issuing affiliate chooses to offset exposure arising from multiple internal derivative contracts on an aggregate or net basis, the derivatives issued to hedging affiliates may qualify as cash flow hedges in the consolidated financial statements only if all of the following conditions are satisfied:

(a) The issuing affiliate enters into a derivative contract with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts, and the derivative contract with the unrelated third party generates equal or closely approximating gains and losses when compared with the aggregate or net losses and gains generated by the derivative contracts issued to affiliates.

(b) Internal derivatives that are not designated as hedging instruments are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative. In addition, nonderivative contracts may not be used as hedging instruments to offset exposures arising from internal derivative contracts.

(c) Foreign currency exposure that is offset by a single net third-party contract arises from internal derivative contracts that mature within the same 31-day period and that involve the same currency exposure as the net third-party derivative. The offsetting net third-party derivative related to that group of contracts must offset the aggregate or net exposure to that currency, must mature within the same 31-day period, and must be entered into within 3 business days after the designation of the internal derivatives as hedging instruments.

(d) The issuing affiliate tracks the exposure that it acquires from each hedging affiliate and maintains documentation supporting linkage of each internal derivative contract and the offsetting aggregate or net derivative contract with an unrelated third party.

(e) The issuing affiliate does not alter or terminate the offsetting derivative with an unrelated third party unless the hedging affiliate initiates that action. If the issuing affiliate does alter or terminate the offsetting third-party derivative (which should be rare), the hedging affiliate must prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative.

DIG Issue related to this paragraph is H14. See [DIG Issues Index](#).

40B.02 Treasury centers that issue internal derivatives will need to segregate those internal derivatives issued for foreign currency fair value, net investment and recognized asset or liability cash flow hedges, which are not permitted to be aggregated or netted (can only be offset on an individual basis), from internal derivatives issued for cash flow hedges of forecasted transactions or unrecognized firm commitments, which can be aggregated or netted. This will result in system and tracking issues for a treasury center that issues internal derivatives for various hedging purposes. It will require that the treasury center know the hedging relationship that the hedging affiliate is establishing with the internal derivative.
40B.03 If a treasury center chooses to offset exposures from multiple internal derivatives on an aggregate or net basis, the internal derivatives issued to hedging affiliates may qualify as cash flow hedges in the consolidated financial statements only if all of the following conditions are met:

- The treasury center enters into offsetting third-party contracts, on an aggregate or net basis for each foreign currency, and the third party derivatives generate equal or closely approximating gains and losses when compared with the aggregate or net losses and gains generated by the internal derivatives issued to the hedging affiliates. We believe this requirement is much more stringent than the 80% – 125% rule used to test hedge effectiveness discussed beginning at Paragraph 20b.05 of Section 5 and Paragraph 28b.06 of Section 6.
- Internal derivatives that are not designated as hedging instruments are excluded from the determination of the foreign currency exposure to be offset on a net basis. We believe this requirement would permit entities to decide the level or amount of the offsetting contract they enter into with an unrelated third party. This is further discussed in Paragraph 40B.05.
- Nondervivative contracts may not be used as hedging instruments to offset exposures arising from internal derivatives.
- In aggregating foreign currency risk, the internal derivatives must mature within the same 31-day period as the offsetting third party derivative.
- The offsetting third party derivative must be entered into within three business days after the designation of internal derivatives as hedging instruments.
- The treasury center tracks the exposure it acquires from each hedging affiliate and maintains documentation supporting linkage of each internal derivative and the offsetting aggregate or net derivative contract with a third party. We believe this should be documented contemporaneously upon entering the offsetting third party derivative. The Board observed that applying hedge accounting to internal derivatives that are offset on a net basis by a third party derivative contract could be viewed as macro hedging—using a single derivative to hedge a dissimilar portfolio of assets and liabilities—which is not permitted under the Standard. However, the Board acknowledged that this practice differs from macro hedging because internal derivatives establish individual hedging relationships that can be linked to the net third party contract.
- The treasury center does not alter or terminate the offsetting third party derivative unless the hedging affiliate initiates the action. If the third party derivative is altered or terminated without the hedging affiliate’s initiation (which should be rare), then the hedging affiliate must cease hedge accounting for the internal derivative in the consolidated financial statements on a prospective basis.

40B.04 As discussed in Paragraph 40A.03 of this section, in instances in which a qualifying foreign currency cash flow hedging relationship exists in accordance with paragraph 40A(b)(2) of the Standard (ASC paragraph 815-20-25-61(b)(2)) and the exposures arising from multiple internal derivative contracts are aggregated or netted for each foreign currency, the treasury
center could enter into a third party derivative with neither leg being the treasury center’s functional currency provided the amount of the respective currencies of each leg are equivalent with respect to each other based on forward exchange rates. (See DIG Issue H14 for further reference) The following example illustrates this concept:

Example 7.10: Treasury Center Offsetting Contract

The treasury center of KAG, Inc. has a functional currency of the U.S. dollar. It enters into internal derivatives with hedging affiliates that treat these derivatives as cash flow hedging instruments in the consolidated financial statements. It aggregates and nets the exposures from all these internal derivative contracts as per the requirements of paragraphs 40A, 40B and 40C of the Standard (ASC paragraphs 815-20-25-61 through 25-64).

Situation 1

After netting the aggregated exposures from these internal derivative contracts, the treasury center is short 390 euros and long 46,800 yen. Assume that the corresponding forward exchange rate was 1 euro = 120 yen. Also assume the treasury center enters into a third party receive 390 euros and pay 46,800 yen contract to offset the short and long exposures. Since the amount of the respective currencies of each leg are equivalent with respect to each other based on the corresponding forward exchange rates, the third party position with neither leg being the treasury center’s functional currency would meet the offsetting requirements. That is, the third party contract is to receive 390 euros and pay 46,800 yen (at the forward rate of 1 euro = 120 yen) and the actual exposures are a short position of 390 euros and a long position of 46,800 yen (at the exact same forward rate of 1 euro = 120 yen).

Situation 2

After netting the aggregated exposures from these internal derivative contracts, the treasury center is short 390 euros and long 51,000 yen. Assume that the corresponding forward exchange rate was 1 euro = 120 yen. Since a third party receive 390 euros and pay 46,800 yen contract would not offset the short and long exposures, the treasury center would need to enter into another third party contract with the receive leg of the second third party position being the treasury center’s functional currency and the pay leg of the second third party position equal to 4,200 yen (the difference between the actual long exposure and the first third party contract’s pay leg) in order to meet the offsetting requirements.

40B.05 Pursuant to paragraph 40B(b) of the Standard (ASC paragraph 815-20-25-62(c)), we believe an entity, through the treasury center, is permitted to decide the level or amount of the offsetting contract it enters into with an unrelated third party. For example, an entity can decide the level of foreign currency exposure it wants to hedge, and not hedge, by identifying which internal derivatives are to be offset with a third party derivative and designated as hedging instruments for purposes of the consolidated financial statements. Even if certain internal derivatives are not designated as hedging instruments for the consolidated financial statements, a hedging affiliate may qualify for hedge accounting in its separate financial statements if it meets all of the applicable criteria for hedge accounting. The approach of deciding the level or amount of the offsetting contract appears simple, but if a large number of internal derivatives exist,
application of this approach could become very complex. Further decisions affecting the designated hedging relationship should be made by the hedging affiliate as noted in paragraph 40B(e) of the Standard (ASC paragraphs 815-20-25-62(f) and 25-63).

40B.06 If the hedging affiliate modifies the internal derivative (resulting in a dedesignation) or dedesignates the hedging relationship, the treasury center will have to reassess compliance with the above requirements. The treasury center would have to update the hedging documentation that links the third party derivative to the aggregate or net internal derivatives being hedged. If the conditions in paragraph 40B of the Standard (ASC paragraphs 815-20-25-62 and 25-63) were initially met, the remaining internal derivatives from this linked hedging relationship can continue to receive hedge accounting in the consolidated financial statements. The treasury center can enter into a third party derivative to offset the impact for the changed internal derivative and essentially rebalance the offsetting hedging relationship to 100%. Alternatively, it could redesignate the excess portion of the third party derivative to another hedging relationship or leave the existing third party derivative alone and have a speculative position on that portion of the third party derivative.

40B.07 The following example illustrates the application of paragraphs 40A and 40B (ASC paragraphs 815-20-25-61 through 25-63). Specifically, the example illustrates the mechanism for offsetting risks assumed by a treasury center using internal derivatives on a net basis with third party contracts. This example does not demonstrate the computation of fair values and makes certain simplifying assumptions:

Example 7.11: Hedge Accounting in the Consolidated Financial Statements Applied to Internal Derivatives That are Offset on a Net Basis by Third-Party Contracts

Company XYZ is a U.S. company with the U.S. dollar as both its functional currency and its reporting currency. Company XYZ has three subsidiaries: Subsidiaries G, J and B. Their country location and functional currency are noted in the table below. Company XYZ utilizes a treasury center to manage foreign exchange risk on a centralized basis. Forecasted foreign exchange risk of Subsidiaries G, J, and B is transferred to the treasury center via internal derivatives. The treasury center then offsets that exposure to foreign currency risk with third party contracts. To the extent possible, the treasury center offsets exposure to each individual currency on a net basis with third party contracts.

On January 1, Subsidiaries G, J, and B conclude that various foreign-currency-denominated forecasted transactions with external third parties for purchases and sales of various goods are probable. Also on January 1, Subsidiaries G, J, and B enter into internal foreign currency forward contracts with the treasury center to hedge the foreign exchange risk of those transactions with respect to their individual functional currencies. The treasury center has the same functional currency as the parent company ($).

Subsidiaries G, J, and B have the following foreign currency exposures and enter into the following internal derivatives with the treasury center (TC):

<table>
<thead>
<tr>
<th>Subsidiary</th>
<th>Internal Derivatives with TC</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## Functional Currency Forecasted Exposures

<table>
<thead>
<tr>
<th></th>
<th>Functional Currency</th>
<th>Forecasted Exposures</th>
<th>Expected Transaction Date</th>
<th>Currency Received</th>
<th>Currency Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>G</td>
<td>EUR</td>
<td>JPY pay 12,000</td>
<td>June 1</td>
<td>JPY 12,000</td>
<td>EUR 115 *</td>
</tr>
<tr>
<td></td>
<td></td>
<td>GBP rec 50</td>
<td>June 1</td>
<td>EUR 80 *</td>
<td>GBP 50</td>
</tr>
<tr>
<td>J</td>
<td>JPY</td>
<td>USD pay 100</td>
<td>June 15</td>
<td>JPY 10,432 *</td>
<td>EUR 100</td>
</tr>
<tr>
<td></td>
<td></td>
<td>EUR rec 100</td>
<td>June 15</td>
<td>JPY 10,160</td>
<td>GBP 201 *</td>
</tr>
<tr>
<td></td>
<td></td>
<td>USD rec 330</td>
<td>June 30</td>
<td>GBP 201 *</td>
<td>USD 330</td>
</tr>
</tbody>
</table>

* Computed based on forward exchange rates as of January 1.

Subsidiaries G, J, and B designate the internal derivatives with the treasury center as cash flow hedges of their foreign currency forecasted purchases and sales. Those internal derivatives may be designated as hedging instruments in the consolidated financial statements if the requirements of the Standard are met. From the Subsidiaries’ perspectives, the requirements of paragraph 40A (ASC paragraph 815-20-25-61) for foreign currency cash flow hedge accounting are satisfied as follows:

(a) From the perspective of the hedging affiliate, the hedging relationship must meet the requirements of paragraph 40 of the Standard (ASC paragraphs 815-20-25-30, 25-38 through 25-40, 25-71, and 815-20-55-130) for cash flow hedge accounting. Subsidiaries G, J, and B meet those requirements. In each hedging relationship, the forecasted transaction being hedged is denominated in a currency other than the subsidiary’s functional currency, and the individual subsidiary that has the foreign currency exposure relative to its functional currency is a party to the hedging instrument. In addition, the criteria in paragraphs 28 and 29 of the Standard (ASC paragraphs 815-20-25-3, 25-13 through 25-15, 25-43, 25-50, 25-51, 25-94, and 25-95) are met. Specifically, each subsidiary prepares formal documentation of the hedging relationships, including the date on which the forecasted transactions are expected to occur and the amount of foreign currency being hedged. The forecasted transactions being hedged are specifically identified, are probable of occurring, and are transactions with external third parties that create cash flow exposure that would affect reported earnings. Each subsidiary also documents its expectation of high effectiveness and how it will measure ineffectiveness based on the internal contracts designated as hedging instruments.

(b) The treasury center must offset the internal derivatives either individually or on a net basis. The treasury center determines that it will offset the exposure arising from the internal derivatives with Subsidiaries G, J, and B on a net basis with third-party contracts. Each currency for which a net exposure exists at the treasury center is offset by a third party contract based on that currency.
In order to determine the net currency exposure arising from the internal derivatives with Subsidiaries G, J, and B, the treasury center performs the following analysis:

### Subsidiary Perspective—Internal Derivatives with the Treasury Center

#### Currency Received / (Currency Paid)

<table>
<thead>
<tr>
<th>Subsidiary</th>
<th>Derivative with TC</th>
<th>EUR</th>
<th>JPY</th>
<th>GBP</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>G (German)</td>
<td>Internal Derivative 1</td>
<td>(115)</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>Internal Derivative 2</td>
<td>80</td>
<td>12,000</td>
<td>(50)</td>
<td>—</td>
</tr>
<tr>
<td>J (Japanese)</td>
<td>Internal Derivative 3</td>
<td>—</td>
<td>(10,160)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>Internal Derivative 4</td>
<td>(100)</td>
<td>10,432</td>
<td>—</td>
<td>100</td>
</tr>
<tr>
<td>B (U.K.)</td>
<td>Internal Derivative 5</td>
<td>—</td>
<td>—</td>
<td>201</td>
<td>(330)</td>
</tr>
<tr>
<td>Net Exposure</td>
<td></td>
<td>(135)</td>
<td>12,272</td>
<td>151</td>
<td>(230)</td>
</tr>
</tbody>
</table>

### Treasury Center Perspective—Internal Derivatives with the Subsidiaries

#### Currency Received / (Currency Paid)

<table>
<thead>
<tr>
<th>Subsidiary</th>
<th>Derivative with TC</th>
<th>EUR</th>
<th>JPY</th>
<th>GBP</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>G (German)</td>
<td>Internal Derivative 1</td>
<td>115</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>Internal Derivative 2</td>
<td>(80)</td>
<td>(12,000)</td>
<td>(50)</td>
<td>—</td>
</tr>
<tr>
<td>J (Japanese)</td>
<td>Internal Derivative 3</td>
<td>—</td>
<td>10,160</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>Internal Derivative 4</td>
<td>100</td>
<td>(10,432)</td>
<td>—</td>
<td>(100)</td>
</tr>
<tr>
<td>B (U.K.)</td>
<td>Internal Derivative 5</td>
<td>—</td>
<td>—</td>
<td>201</td>
<td>330</td>
</tr>
<tr>
<td>Net Exposure</td>
<td></td>
<td>135</td>
<td>(2,272)</td>
<td>151</td>
<td>230</td>
</tr>
</tbody>
</table>

In order for Subsidiaries G, J, and B to designate the internal derivatives as hedging instruments in the consolidated financial statements, the treasury center must meet certain required criteria outlined in paragraph 40B (ASC paragraphs 815-20-25-62 and 25-63) in determining how it will offset exposure arising from multiple internal derivatives that it has issued. Based on a determination that the requirements of paragraph 40B (ASC paragraphs 815-20-25-62 and 25-63) are satisfied, the treasury center determines the net exposure in each currency with respect to the U.S. dollar (its functional currency). The treasury center determines that it will enter into the following three third party foreign currency forward contracts. The treasury center enters into the contracts on January 1. The contracts mature on June 30.

### Treasury Center's Contracts with Unrelated Third parties

#### Currency Bought / (Currency Sold)

<table>
<thead>
<tr>
<th>Third party</th>
<th>EUR</th>
<th>JPY</th>
<th>GBP</th>
<th>$</th>
</tr>
</thead>
</table>

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### Net Exposure

<table>
<thead>
<tr>
<th>Contract</th>
<th>Beginning of Period</th>
<th>End of Period</th>
<th>FC Gain / (Loss)</th>
<th>$ Gain / (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract 1</td>
<td>(135)</td>
<td>—</td>
<td>—</td>
<td>138 *</td>
</tr>
<tr>
<td>Contract 2</td>
<td>—</td>
<td>12,272</td>
<td>—</td>
<td>(121) *</td>
</tr>
<tr>
<td>Contract 3</td>
<td>—</td>
<td>—</td>
<td>151</td>
<td>(247) *</td>
</tr>
<tr>
<td>Net Exposure</td>
<td>(135)</td>
<td>(12,272)</td>
<td>151</td>
<td>(230)</td>
</tr>
</tbody>
</table>

* Computed based on forward exchange rates as of January 1.

### At the end of the quarter, each subsidiary determines the functional currency (FC) gains and losses for each contract with the treasury center:

<table>
<thead>
<tr>
<th>Subsidiary</th>
<th>Derivative with TC</th>
<th>Beginning of Period FC Receive / (Pay) *</th>
<th>End of Period FC Receive / (Pay) *</th>
<th>FC Gain / (Loss) **</th>
<th>$ Gain / (Loss) ***</th>
</tr>
</thead>
<tbody>
<tr>
<td>G (German)</td>
<td>Derivative 1</td>
<td>(115)</td>
<td>(115)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>Derivative 2</td>
<td>80</td>
<td>83</td>
<td>(3)</td>
<td>(3)</td>
</tr>
<tr>
<td>J (Japanese)</td>
<td>Derivative 3</td>
<td>(10,160)</td>
<td>(10,738)</td>
<td>578</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>Derivative 4</td>
<td>10,432</td>
<td>10,421</td>
<td>11</td>
<td>—</td>
</tr>
<tr>
<td>B (U.K.)</td>
<td>Derivative 5</td>
<td>201</td>
<td>204</td>
<td>(3)</td>
<td>(5)</td>
</tr>
<tr>
<td>Net $ Gain / (Loss)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(3)</td>
</tr>
</tbody>
</table>

* Computed based on forward exchange rates as of January 1 and March 31.
** For simplicity, functional currency gains or losses are not affected by discounting in this example.
*** Functional currency gains and losses converted to U.S. dollars based on current spot rates.

### At the end of the quarter, the treasury center determines its gains or losses on third party contracts:

<table>
<thead>
<tr>
<th>Contracts with Third Parties</th>
<th>Beginning of Period $ Receive / (Pay) *</th>
<th>End of Period $ Receive / (Pay) *</th>
<th>$ Gain / (Loss) **</th>
</tr>
</thead>
<tbody>
<tr>
<td>Third Party Contract 1</td>
<td>138</td>
<td>131</td>
<td>7</td>
</tr>
<tr>
<td>Third Party Contract 2</td>
<td>(121)</td>
<td>(114)</td>
<td>(7)</td>
</tr>
<tr>
<td>Third Party Contract 3</td>
<td>(247)</td>
<td>(244)</td>
<td>(3)</td>
</tr>
<tr>
<td>Net $ Gain/(Loss)</td>
<td></td>
<td></td>
<td>(3)</td>
</tr>
</tbody>
</table>

* Computed based on forward exchange rates as of January 1 and March 31.
** For simplicity, gains or losses are not affected by discounting in this example.

In this example the treasury center’s net gain on the internal derivatives with Subsidiaries G, J and B exactly offset the net loss on its third party derivatives. This will not always be the case since paragraph 40B(c) (ASC paragraph 815-20-25-62(d)) permits aggregating or netting internal derivatives within a 31-day period against a single offsetting third party derivative.
Below is a summary of the journal entries in $ by the various entities to record the change in fair value of the derivative contracts.

<table>
<thead>
<tr>
<th>March 31 Entries</th>
<th>Derivative Asset</th>
<th>Derivative Liability</th>
<th>Accumulated Other Comprehensive Income (AOCI)</th>
<th>Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Subsidiary Entries:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sub G derivative 1 *</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Sub G derivative 2</td>
<td>—</td>
<td>(3)</td>
<td>3</td>
<td>—</td>
</tr>
<tr>
<td>Sub J derivative 3</td>
<td>5</td>
<td>—</td>
<td>(5)</td>
<td>—</td>
</tr>
<tr>
<td>Sub J derivative 4 *</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Sub B derivative 5</td>
<td>—</td>
<td>(5)</td>
<td>5</td>
<td>—</td>
</tr>
<tr>
<td><strong>Treasury Center Entries for Internal Derivatives:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sub G derivative 1 *</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Sub G derivative 2</td>
<td>3</td>
<td>—</td>
<td>—</td>
<td>(3)</td>
</tr>
<tr>
<td>Sub J derivative 3</td>
<td>—</td>
<td>(5)</td>
<td>—</td>
<td>5</td>
</tr>
<tr>
<td>Sub J derivative 4 *</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Sub B derivative 5</td>
<td>5</td>
<td>—</td>
<td>—</td>
<td>(5)</td>
</tr>
<tr>
<td><strong>Treasury Center Entries for Third Party Derivatives:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Third party contract 1</td>
<td>7</td>
<td>—</td>
<td>—</td>
<td>(7)</td>
</tr>
<tr>
<td>Third party contract 2</td>
<td>—</td>
<td>(7)</td>
<td>—</td>
<td>7</td>
</tr>
<tr>
<td>Third party contract 3</td>
<td>—</td>
<td>(3)</td>
<td>—</td>
<td>3</td>
</tr>
<tr>
<td><strong>Net consolidated result</strong></td>
<td>7</td>
<td>(10)</td>
<td>3</td>
<td>—</td>
</tr>
</tbody>
</table>

* No entry was made since there was no change in the derivative’s fair value.

**Observations**

In consolidation, the amounts in Subsidiaries G, J, and B’s balance sheets reflecting derivative assets and derivative liabilities arising from internal derivatives acquired from the treasury center eliminate against the treasury center’s derivative liabilities and derivative assets arising from internal derivatives issued to the subsidiaries. The amount reported in consolidated AOCI reflects the net entries to AOCI of Subsidiaries G, J, and B. The treasury center’s gross derivative asset and gross derivative liability arising from third party contracts are also reported in the consolidated balance sheet. Based on the assumptions in this illustration, the treasury center’s net loss on third party contracts used to offset the exposure, on a net basis, of internal derivatives with Subsidiaries G, J, and B equals the net loss on those internal derivatives.
Therefore, within the treasury center, the gains on internal derivatives issued to Subsidiaries G, J, and B, and the losses on third party contracts are equal and offsetting. However, if the treasury center’s net gain or loss on third party contracts does not equal the net gain or loss on internal derivatives designated as hedging instruments by affiliates, the difference must be recognized as ineffectiveness in consolidated earnings. In that case, it would not be unusual for the hedging subsidiaries to experience little or no ineffectiveness in their stand-alone financial statements (as the critical terms of the internal derivatives closely or exactly match the terms of the hedged forecasted transactions), while a greater amount of ineffectiveness would be recognized in the consolidated financial statements.

TREASURY CENTER – EXCLUSIONS

40C.01 Paragraph 40C (ASC paragraph 815-20-25-64) addresses hedging relationships with internal derivatives that are not permitted to be netted or aggregated. Paragraph 40C (ASC paragraph 815-20-25-64) reads as follows:

40C. A member of a consolidated group is not permitted to offset exposures arising from multiple internal derivative contracts on a net basis for foreign currency cash flow exposures related to recognized foreign-currency-denominated assets or liabilities. That prohibition includes situations in which a recognized foreign-currency-denominated asset or liability in a fair value hedge or cash flow hedge results from the occurrence of a specifically identified forecasted transaction initially designated as a cash flow hedge.

40C.02 The provisions of paragraphs 40A and 40B (ASC paragraphs 815-20-25-61 through 25-63) for aggregating or netting foreign currency risk cannot be used to offset exposures arising from internal derivatives related to recognized foreign-currency-denominated assets or liabilities or net investment hedges. This creates an issue for a treasury center that is aggregating or netting internal derivatives pursuant to paragraphs 40A and 40B of the Standard (ASC paragraphs 815-20-25-61 through 25-63) for cash flow hedges of forecasted transactions or unrecognized firm commitments once these transactions occur and become recognized assets or liabilities if the internal derivative has not yet matured. At the point a forecasted transaction or firm commitment occurs, an internal derivative that the treasury center aggregated or netted, for purposes of entering into third party derivative contracts, would no longer qualify for hedge accounting in the consolidated financial statements.

40C.03 Additionally, the treasury center would have to update the hedging documentation that links the third party derivative to the aggregate or net internal derivatives remaining. If the conditions in paragraph 40B of the Standard (ASC paragraphs 815-20-25-62 and 25-63) were initially met, the remaining internal derivatives from this linked hedging relationship can continue to receive hedge accounting in the consolidated financial statements. The treasury center can enter into a third party derivative to offset the impact for the internal derivative that no longer qualifies for aggregation or netting and essentially rebalance the offsetting hedging relationship to 100%. Alternatively, it could redesignate the excess proportion of the third party derivative related to the internal derivative that no longer qualifies for aggregation or netting to another hedging relationship or leave the existing third party derivative alone and have a speculative position on that proportion of the third party derivative.
ACCOUNTING FOR FOREIGN CURRENCY CASH FLOW HEDGES

41.01 Paragraph 41 of the Standard (ASC paragraph 815-20-25-65) addresses the accounting for foreign currency cash flow hedges:

41. A qualifying foreign currency cash flow hedge shall be accounted for as specified in paragraphs 30-35 (ASC Subtopic 815-30).

41.02 The accounting for foreign currency cash flow hedges is the same as the accounting for the cash flow hedging model as specified in paragraphs 30 - 35 of the Standard (ASC paragraphs 815-30-35-3, 35-4, 35-7, 35-38 through 35-43, and 815-30-40-1 through 40-5). (see Paragraph 30.01 of Section 6). In summary, a derivative instrument designated and effective as a cash flow hedge is recorded in the statement of financial position at fair value. The portion of the derivative instrument’s change in fair value that is effective as a hedge of the foreign currency risk inherent in a hedged item is reported in AOCI and the ineffective portion and any amount excluded from the assessment of hedge effectiveness are reported currently in earnings. The amount in AOCI is reclassified to earnings in the same periods during which the hedged item affects earnings.

Hedging a Forecasted Transaction or Unrecognized Firm Commitment

41.03 If the hedged item is all of the variability in functional-currency-equivalent cash flows of a forecasted transaction or an unrecognized firm commitment and the hedging instrument is a forward-based derivative, we would expect entities to assess hedge effectiveness and measure ineffectiveness based on forward foreign exchange rates to minimize hedge ineffectiveness. That is, if the spot exchange rate was used to assess hedge effectiveness and measure ineffectiveness, changes in the excluded component, the difference between the spot rate and the forward rate (which is used to calculate the fair value of the derivative hedging instrument), would be reflected currently in earnings. If the hedged item is the variability in functional-currency-equivalent cash flows attributable to a particular foreign exchange rate beyond (or within) a specified level (or levels) and the hedging instrument is an option-based derivative and all the characteristics of DIG Issue G20 are met, we would expect entities to assess hedge effectiveness and measure ineffectiveness based on the total changes in cash flows of the derivative to minimize hedge ineffectiveness. That is, if the intrinsic value was used to assess hedge effectiveness and measure ineffectiveness, changes in the excluded component (the time value) would be reflected currently in earnings.

Reclassification from Accumulated Other Comprehensive Income When Hedging Forecasted Intercompany Transactions

41.04 Since an entity is permitted to designate the foreign currency exposure to variability in the functional-currency-equivalent cash flows of forecasted foreign-currency-denominated intercompany transactions, an issue arises relating to the reclassification of amounts in AOCI that is unique to foreign currency cash flow hedging. The general cash flow hedging model requires amounts in AOCI to be reclassified into earnings in the same period or periods during which the forecasted transaction affects earnings. Specifically, the amounts in AOCI representing the effective portion of the gain or loss on a derivative designated as a cash flow hedge of a forecasted foreign-currency-denominated intercompany transaction should be reclassified into consolidated earnings in the period that the forecasted transaction affects earnings.
consolidated earnings. Consequently, if a subsidiary is hedging the functional-currency-equivalent cash flows of a forecasted foreign-currency-denominated intercompany transaction, the subsidiary would reclassify any amounts in AOCI into earnings in the same period or periods during which its forecasted transaction affects earnings for its stand-alone financial statements. However, when the subsidiary is consolidated with other entities, any amounts in AOCI would not be reclassified into earnings unless and until the forecasted transaction affects the consolidated earnings. Entities will need to develop systems to track these differences. (See DIG Issue H13 for further reference) Consider the following example:

**Example 7.12: Reclassifying into Earnings Amounts in AOCI Related to a Cash Flow Hedge of a Forecasted Foreign-Currency-Denominated Intercompany Sale**

Parent A is a multinational corporation that has the U.S. dollar as its functional currency. Parent A has two subsidiaries: Subsidiary E, which has the euro as its functional currency, and Subsidiary J, which has the Japanese yen as its functional currency. Subsidiary E manufactures a product and has a forecasted sale of the product to Subsidiary J that will be transacted in yen. Eventually, Subsidiary J will sell the product to an unrelated third party in yen. Subsidiary E enters into a forward contract with an unrelated third party to hedge the cash flow exposure of its forecasted intercompany sale in yen to changes in the euro-yen exchange rate.

The transaction meets the hedge criteria of paragraph 40 (ASC paragraphs 815-20-25-30, 25-38 through 25-40, 25-71, and 815-20-55-130). Specifically, the operating unit having the foreign currency exposure (Subsidiary E) is a party to the hedging instrument; the hedged transaction is denominated in yen, which is a currency other than Subsidiary E’s functional currency; and all other applicable criteria in paragraphs 28 and 29 of the Standard (ASC paragraphs 815-20-25-3, 25-13 through 25-15, 25-43, 25-50, 25-51, and 25-94) are satisfied. Subsidiary E measures the derivative instrument at fair value and records the effective portion of the gain or loss on the derivative instrument in OCI, with the ineffective portion, if any, recorded in current earnings.

In Subsidiary E’s separate financial statements, the reclassification of the amount of derivative gain or loss from AOCI into earnings should occur in the period the forecasted intercompany sale is recorded since Subsidiary E’s earnings are affected by the change in the euro-yen exchange rate when the sale to Subsidiary J occurs.

However, because that intercompany sale is eliminated in consolidation, the reclassification into earnings from AOCI in the consolidated financial statements should occur when the forecasted sale affects the earnings of Parent A (i.e., sale of the product by Subsidiary J to the unrelated third party).

**Hedging a Recognized Foreign-Currency-Denominated Asset or Liability**

41.05 Hedging the cash flow variability of functional-currency-equivalent cash flows involving a recognized foreign-currency-denominated asset or liability is affected by the interaction of Standard and Statement 52 (ASC Topic 830). Statement 52 (ASC Topic 830) requires recognized foreign-currency-denominated assets and liabilities to be remeasured to the functional currency based on spot exchange rates through earnings. Therefore, the adjustment of these recognized assets and liabilities is affected by the interaction of the hedge of cash flows and the remeasurement of the recognized asset or liability.
assets and liabilities for changes in foreign exchange rates is limited to the changes based on spot rates. The Standard requires all derivatives to be recognized on the balance sheet at fair value. The fair value of all derivative instruments incorporates forward rates. In other words, the cash flow hedging model would not provide any benefit to a hedging relationship involving the variability of functional-currency-equivalent cash flows of a recognized foreign-currency-denominated asset or liability since the income statement effect would be similar to not using hedge accounting, i.e., earnings volatility due to changes in fair value of the derivative’s forward premium/discount component would be recognized currently in earnings.

41.06 As discussed in Paragraph 30.14 of Section 6, paragraph 30(d) of the Standard (ASC paragraphs 815-30-35-3(d) through 35-3(f)) addresses this by providing an exception to the general hedging guidance for certain foreign currency cash flow hedging relationships when an entity assesses effectiveness and calculates ineffectiveness based on total changes in the hedging instrument’s cash flows. The Board decided to permit this special application of cash flow hedge accounting for recognized foreign-currency-denominated assets and liabilities because it believes permitting this exception to the general hedging guidance in the Standard is consistent with its general principle of providing special hedge accounting to mitigate the effects on earnings of different existing measurement criteria for foreign-currency-denominated transactions.

41.07 In summary, paragraph 30(d) of the Standard (ASC paragraphs 815-30-35-3(d) through 35-3(f)) indicates that when applying the cash flow hedging model to the variability of the functional-currency-equivalent cash flows related to changes in foreign exchange rates involving recognized foreign-currency-denominated assets or liabilities, two reclassifications from AOCI are required each period when the assessment of effectiveness and the measurement of ineffectiveness are based on total changes in cash flows of the derivative hedging instrument. One reclassification relates to the remeasurement of the hedged item at spot rates and the other reclassification relates to the recognition of the cost element of the hedging derivative instrument. When the provisions of paragraph 30(d) (ASC paragraphs 815-30-35-3(d) through 35-3(f)) are applicable, we would expect entities to assess effectiveness and measure ineffectiveness based on total changes of the derivative hedging instrument to minimize hedge ineffectiveness. It is important to note that the special approaches in paragraph 30(d) (ASC paragraphs 815-30-35-3(d) through 35-3(f)) including those for recognizing the cost element of a foreign currency derivative, should not be analogized to other hedging relationships. They are an accommodation in the Standard due to the unique attributes of foreign currency cash flow hedging.

41.08 Paragraph 30(d) of the Standard (ASC paragraphs 815-30-35-3(d) through 35-3(f)) makes a distinction between a non-option-based derivative and an option-based derivative such as a foreign currency option. In the following paragraphs we will refer to non-option-based foreign currency derivatives as forward contracts. Although the concept in paragraph 30(d) (ASC paragraphs 815-30-35-3(d) through 35-3(f)) is the same whether a forward contract or an option contract is used as the hedging instrument, we will discuss these separately as there are minor differences in application. The application of paragraph 30(d) (ASC paragraphs 815-30-35-3(d) through 35-3(f)) discussed below assumes that any ineffectiveness within the hedging relationship is recognized immediately in earnings and the amounts in AOCI relate only to the effective portion of the hedging relationship.
APPLICATION OF PARAGRAPH 30(D) (ASC PARAGRAPHS 815-30-35-3(D) THROUGH 35-3(F)) WHEN THE ASSESSMENT OF EFFECTIVENESS AND THE MEASUREMENT OF INEFFECTIVENESS ARE BASED ON TOTAL CHANGES IN CASH FLOWS OF A FORWARD CONTRACT

41.09 For forward contracts, an amount should be reclassified from AOCI each period to offset the transaction gain or loss arising from the Statement 52 (ASC Topic 830) remeasurement of the foreign-currency-denominated asset or liability at the spot exchange rate. Additionally, an amount should be reclassified from AOCI each period representing the cost attributable to the spot/forward difference of the hedging derivative.

41.10 The cash flow hedging model for recognized foreign-currency-denominated assets and liabilities requires use of the interest method at the inception of the hedging relationship to determine the amount of cost or income to be ascribed to each period of the hedging relationship when the hedging instrument is a forward-based contract. However, for simplicity, the amount of cost or income to be ascribed each period may be determined using a pro-rata method based on the number of days in the hedging relationship if not materially different. One such method would be based on the daily interest implicit in the forward contract. This is done by dividing the forward/spot premium or discount by the number of days in the forward contract. The amount of daily interest would be recognized for the number of days in the period.

APPLICATION OF PARAGRAPH 30(D) (ASC PARAGRAPHS 815-30-35-3(D) THROUGH 35-3(F)) WHEN THE ASSESSMENT OF EFFECTIVENESS AND THE MEASUREMENT OF INEFFECTIVENESS ARE BASED ON TOTAL CHANGES IN CASH FLOWS OF AN OPTION CONTRACT

41.11 If the hedging instrument is a currency option-based derivative and all the requirements of DIG Issue G20 are met, an amount should be reclassified each period to or from AOCI with respect to the changes in the underlying that result in a change in the hedging option’s intrinsic value. Intrinsic value is based on the spot rate of the underlying. When the option is in-the-money this change would parallel the Statement 52 (ASC Topic 830) remeasurement to spot of the recognized asset or liability. If the option’s exercise price is in-the-money at the beginning and end of the period, and the notional amount of the option and the balance of the hedged asset or liability match, this reclassification would fully offset the Statement 52 (ASC Topic 830) transaction gain or loss. If the option’s exercise price is out-of-the-money at the end of the period, any amounts previously reclassified from AOCI when the option was in-the-money during the periods of the recognized foreign-currency-denominated receivable or payable must be reclassified to AOCI. Additionally, the cost of the currency option should be amortized to earnings on a rational basis. This is illustrated in Example 7.18 of this section.

41.12 The methodology described in paragraph 30(d) (ASC paragraphs 815-30-35-3(d) through 35-3(f)) requires use of an amortization method at the inception of the hedging relationship to determine the amount of cost or income to be ascribed to each period of the hedging relationship when the hedging instrument is a currency option-based contract. For simplicity, we believe most entities will use a straight-line amortization method. The amount of daily cost would be recognized for the number of days in the period.
41.13 If the assessment of effectiveness and the measurement of ineffectiveness is not based on the total changes in cash flows of an option contract, paragraph 30(d) (ASC paragraphs 815-30-35-3(d) through 35-3(f)) requires that an amount be reclassified each period to or from AOCI with respect to the changes in the underlying that result in a change in the hedging option’s intrinsic value as discussed in Paragraph 41.11 above. However, the changes in the option’s time value would be recognized in earnings once they occur. This would create earnings volatility.

HEDGING FOREIGN EXCHANGE AND INTEREST RATE RISKS

41.14 A derivative instrument that hedges the exposure of foreign-currency-equivalent cash flows associated with a recognized foreign-currency-denominated interest-bearing asset or liability (i.e., the exposure related to both principal and interest) and eliminates all the variability in the hedged item’s functional-currency-equivalent cash flows hedges both foreign exchange and interest rate risks. To mitigate volatility in earnings for hedging relationships involving all of a recognized foreign-currency-denominated interest-bearing financial asset or liability, entities may wish to hedge the combination of foreign exchange and interest rate risks.

HEDGING INTERCOMPANY FOREIGN-CURRENCY DENOMINATED DEBT USING THE HYPOTHETICAL DERIVATIVE METHOD

41.14a There are unique considerations when applying the hypothetical derivative method for assessing and measuring ineffectiveness when a fixed-for-fixed cross-currency interest rate swap is used to hedge intercompany fixed-rate debt. This is because the hedging relationship relates to both interest rate risk (which would be eliminated in consolidation) and foreign currency risk (which would not). In a cash flow hedge of the foreign-currency risk associated with foreign-currency denominated debt issued by a third party where the hedging instrument is a fixed-for-fixed cross-currency interest rate swap, the hypothetical derivative would have a zero fair value at inception of the hedging relationship and the terms would match the terms of the hedged forecasted transactions. However, judgment must be applied in defining the hypothetical derivative when the foreign-currency denominated debt is intercompany. In the absence of further clarification by the standard-setter, we believe there are two approaches an entity may consider when determining the terms of the perfectly effective hypothetical derivative.

- Approach 1: Defining the hedged risk as solely the foreign currency risk associated with the principal amount of the intercompany debt. Under this approach, the hypothetical derivative would be defined as a forward contract that exactly matches the principal amount of the intercompany debt. In this instance the foreign currency risk inherent in that principal amount is a risk that affects consolidated earnings during the life of the hedging relationship under ASC Topic 830, even though the debt and the interest payments on that debt would be eliminated in consolidation. This approach would not include the foreign currency risk related to the interest payments on the intercompany debt as they are eliminated in consolidation. Accordingly, under ASC Topic 830, foreign currency risk affects consolidated earnings only when interest payments are accrued but unpaid. If this approach is followed, the relationship may have significant ineffectiveness and may not qualify as a highly...
effective hedging relationship due to the changes in fair value of the net coupon payments included in the hedging instrument (in this example, the fixed-for-fixed cross-currency interest rate swap) that would not be included in the hypothetical derivative.

- **Approach 2:** Defining the hedged risk as the foreign currency risk associated with both (a) the principal amount of the intercompany debt and (b) the forecasted interest payments on the intercompany debt. Under this approach, the hypothetical derivative would be defined as a fixed-for-fixed cross-currency interest rate swap that exactly matches the principal amount of the intercompany debt and the forecasted interest payments of the intercompany debt. In this instance, the foreign currency risk inherent in the principal amount is a risk that under ASC Topic 830 affects consolidated earnings during the life of the hedging relationship and the foreign currency risk inherent in the forecasted interest payments will eventually affect earnings as each interest payment is accrued. While the foreign currency risk related to each interest payment does not affect earnings until it is accrued, we believe that this approach is acceptable by analogy to ASC subparagraph 815-20-25-38(d), which permits an entity to hedge the foreign currency risk related to the forecasted sale to a foreign subsidiary or the forecasted royalty from a foreign subsidiary. In these two examples, the foreign currency risk does not affect consolidated earnings until either the sale is recorded as a payable/receivable or the royalty is earned and recorded as a payable/receivable. When an entity uses this approach, we believe that amounts should be reclassified from AOCI to earnings in a pattern that is identical to the one that would be used if the debt were issued to a third party (and interest payments were not eliminated in consolidation). Reclassifying in this manner is necessary so that the AOCI balance at the end of the hedged period for the hedging relationship is zero. However, these reclassifications will introduce volatility in consolidated earnings because the interest payments will only affect consolidated earnings for the risk being hedged (foreign currency risk) from the time they are accrued until the time they are paid.

**HEDGING FROM FORECASTED DATE TO SETTLEMENT DATE**

41.15 As discussed in Paragraph 36A.03 of this section, an entity can designate a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to settlement of the foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit. The interaction of (a) the single derivative cash flow hedge method when using a forward-based contract or a purchased option-based contract whereby the assessment of effectiveness and measurement of ineffectiveness is based on total changes in the hedging instrument’s cash flows and (b) paragraph 30(d) (ASC paragraphs 815-30-35-3(d) through 35-3(f)) can be summarized as follows: (See DIG Issue H15 for further reference)

1. The effective portion of the gain or loss on the hedging instrument including the change in time value, if applicable, is reported in AOCI during the period prior to the purchase or sale date of a forecasted foreign currency transaction.
(2) The spot/forward premium or discount, or option premium is used to determine the amount of cost or income to be ascribed to each period of the hedging relationship. The amount of cost or income to be ascribed each period can be determined by using a pro-rata method based on the number of days in the hedging relationship.

(3) For forecasted sales on credit, the amount of cost or income ascribed to the forecasted period to the date of sale is reclassified from AOCI to earnings on the date of the sale. For forecasted purchases on credit, the amount of cost or income ascribed to the forecasted period is reclassified from AOCI to earnings in the same period or periods during which the asset acquired affects earnings.

(4) The income or cost ascribed to each period encompassed during the periods of the recognized foreign-currency-denominated receivable or payable that results from the forecasted sale or purchase is reclassified from AOCI to earnings at the end of each reporting period pursuant to paragraph 30(d) of the Standard (ASC paragraphs 815-30-35-3(d) through 35-3(f)).

(5) During the period in which the foreign-currency denominated receivable or payable is recognized, an amount that will offset the related transaction gain or loss arising from remeasurement of the receivable or payable under Statement 52 (ASC Topic 830) must be reclassified from AOCI each period if the hedging instrument is a forward-based contract. If the hedging instrument is an option-based contract, an amount with respect to the changes in the underlying that result in a change in the option’s intrinsic value must be reclassified to or from AOCI each period (see Paragraph 41.11 for a further discussion of this issue).

Combination of Options as the Hedging Instrument

41.16 In a foreign currency cash flow hedging relationship in which a combination of options (deemed to be a net purchased option) is designated as the hedging instrument and the effectiveness of the hedge is assessed based only on changes in intrinsic value of the hedging instrument, the assessment of effectiveness may be based only on changes in the underlying that cause a change in intrinsic value of the hedging instrument. Thus, the assessment can exclude ranges of changes in the underlying for which there is no change in the hedging instrument’s intrinsic value. This allows hedging relationships that offer protection only within selected ranges of changes in the underlying instead of in all ranges of change. However, all changes in the hedging instrument’s fair value other than the intrinsic value (i.e., the time value) would be recognized in earnings immediately. (See DIG Issue G15, for further reference)

41.17 In a foreign currency cash flow hedging relationship in which a combination of options (deemed to be a net purchased option) is designated as the hedging instrument and all of the characteristics of DIG Issue G20 are met such that the effectiveness of the hedge can be assessed based on total changes in cash flows of the hedging instrument, the assessment of effectiveness may be based only on changes in the underlying that cause a change in intrinsic value of the hedging instrument. Thus, the assessment can exclude ranges of changes in the underlying for which there is no change in the hedging instrument’s intrinsic value. This allows hedging relationships that offer protection only within selected ranges of changes in the underlying instead of in all ranges of change.
Hedging Foreign Currency Cash Flow Changes in Interim Periods

41.18 When hedging the risk of changes in cash flows attributable to changes in the related foreign currency exchange rates, an entity does not need to hedge all of the foreign currency exposures throughout the life of the hedged item if the effectiveness of the hedge is assessed based only on changes in the spot value of the hedging instrument. For example, if a U.S. dollar functional currency entity expects to sell a product in sixty days for 1,000,000 yen, it may enter into a forward contract to pay yen and receive U.S. dollars to hedge the risk of changes in cash flows of that sale due to changes in the yen/U.S. dollar exchange rate. If the effectiveness of the hedge is assessed based only on changes in the spot value of the hedging instrument, the maturity of the forward contract can be at the end or at any point during those sixty days. However, any changes in the forward contract’s time value would be recognized in earnings immediately.

41.19 When hedging the risk of changes in cash flows attributable to changes in the related foreign currency exchange rates, an entity may not need to hedge all of the foreign currency exposures throughout the life of the hedged item if the effectiveness of the hedge is assessed based on changes in total cash flows of the hedging instrument. For example, if a U.S. dollar functional currency entity expects to sell a product in sixty days for 1,000,000 yen, it may enter into a forward contract to pay yen and receive U.S. dollars to hedge the risk of changes in cash flows of that sale due to changes in the yen/U.S. dollar exchange rate. If the effectiveness of the hedge is assessed based on changes in total cash flows of the hedging instrument, the maturity of the forward contract can be at the end or at any point during those sixty days. However, ineffectiveness would occur due to the timing of the expected cash flows on the forecasted transaction versus the timing of the cash flows for the forward contract. Before such a relationship is entered, entities must meet all the criteria for hedge accounting, including an expectation that the hedging relationship will be highly effective.

Examples of Foreign Currency Cash Flow Hedges

41.20 Set forth below are examples that illustrate the application of these provisions for the following hedging relationships:

- Cash flow hedge of fixed-rate foreign-currency-denominated debt with a forward contract (fixed to fixed scenario);
- Cash flow hedge of variable-rate foreign-currency-denominated debt with a variable to fixed cross-currency interest rate swap (variable to fixed scenario);
- Cash flow hedge of a forecasted foreign-currency-denominated sale with a purchased option;
- Cash flow hedge of a forecasted foreign-currency-denominated purchase with a forward contract;
- Cash flow hedge of a recognized foreign-currency-denominated payable with a forward contract;
- Single cash flow hedge with a foreign currency purchased option; and
- Single cash flow hedge with a foreign currency forward contract.
Each of the examples assumes that all criteria for hedge accounting have been met at the onset of the hedging relationship and at each period end.

Example 7.13: Cash Flow Hedge of Fixed-Rate Foreign-Currency-Denominated Debt with a Forward Contract (Fixed to Fixed Scenario)

On January 1, 20X0, Company DEF, a U.S. dollar functional currency entity, issues a zero-coupon debt instrument with a notional amount of pounds sterling (£) £154,767 for £96,098. The interest rate implicit in the debt is 10%. The debt will mature on December 31, 20X4. DEF enters into a forward contract to buy £154,767 in 5 years at the forward rate of 1.09 (cost $168,719) and designates the forward contract as a hedge of the variability of the functional-currency-equivalent cash flows on the debt. Because the currency, notional amount, and maturity of the debt and the forward contract match, the entity concludes that no ineffectiveness will result. The U.S. dollar interest rate implicit in the forward contract is 11.028%.

Assumptions

<table>
<thead>
<tr>
<th>As of</th>
<th>Spot</th>
<th>$/£ Forward</th>
<th>Forward Rate Change</th>
<th>£ Present Value</th>
<th>$ Spot Amounts (@ 11.028%)</th>
<th>$ Fair Value* Forward</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X0</td>
<td>1.0406</td>
<td>1.090</td>
<td>0</td>
<td>96,098</td>
<td>100,000</td>
<td>0</td>
</tr>
<tr>
<td>12/31/X0</td>
<td>1.1</td>
<td>1.185</td>
<td>0.095</td>
<td>105,708</td>
<td>116,279</td>
<td>111,028</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>1.1</td>
<td>1.163</td>
<td>0.073</td>
<td>116,279</td>
<td>127,907</td>
<td>123,272</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>1.1</td>
<td>1.142</td>
<td>0.052</td>
<td>127,906</td>
<td>140,697</td>
<td>136,867</td>
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<tr>
<td>12/31/X3</td>
<td>1.1</td>
<td>1.121</td>
<td>0.031</td>
<td>140,697</td>
<td>154,767</td>
<td>151,960</td>
</tr>
<tr>
<td>12/31/X4</td>
<td>1.1</td>
<td>1.100</td>
<td>0.010</td>
<td>154,767</td>
<td>170,244</td>
<td>168,719</td>
</tr>
</tbody>
</table>

* Fair value of the forward contract is computed based on discounting the notional amount at the current forward rate for the remaining period to maturity less the notional amount at the forward contract’s rate. As an example, at December 31, 20X0, £154,767*(1.185-1.09)= $14,703, discounted four years to $9,328.

Note, for simplicity journal entries are only shown for the first two years and are presented annually. Normally, such entries would be made quarterly.

(a) The journal entries as of January 1, 20X0 would be as follows:

1. There would be a memorandum entry on January 1, 20X0, documenting the existence of the hedging relationship. The financial records of DEF would not be impacted as of this date because the foreign currency forward was at market rates.

2. Cash (B/S) $ 100,000
   Debt obligation (B/S) 100,000

   (To record £96,098 debt at spot rate)

(b) The journal entries as of December 31, 20X0 would be as follows:
1. Interest expense (P&L)  
   Debt obligation (B/S)  
   10,571  
   (To accrue interest on the £ debt at the implicit interest rate of 10%. Remeasured at the period end spot rate for simplicity. ((£96,098*10%)*1.1))

2. Other income/expense (P&L)  
   Debt obligation (B/S)  
   5,708  
   (To record the spot remeasurement of the debt to the functional currency. (£105,708*1.1=$116,279 less recorded amount of $110,571))

3. Forward contract (B/S)  
   Unrealized gain on forward (OCI)  
   9,328  
   (To record the change in fair value of the forward contract)

4. Unrealized loss on forward (AOCI)  
   Interest expense (P&L)  
   Other income/expense (P&L)  
   5,251  
   457  
   5,708  
   (To reclassify a net amount out of AOCI to increase interest expense to the $ implicit interest rate in the forward contract of 11.028% and to offset the spot remeasurement loss. ($100,000*11.028%=$11,028 less recorded interest of $10,571=$457))

(c) The journal entries as of December 31, 20X1 would be as follows:

1. Interest expense (P&L)  
   Debt obligation (B/S)  
   11,628  
   (To accrue interest on the £ debt at the implicit interest rate of 10%. Remeasured at the period end spot rate for simplicity. ((£105,708*10%)*1.1))

2. Unrealized loss on forward (AOCI)  
   Forward contract (B/S)  
   1,287  
   (To record the change in fair value of the forward contract)

3. Interest expense (P&L)  
   Unrealized gain on forward (AOCI)  
   616  
   616  
   (To reclassify an amount out of AOCI to increase interest expense to the $ implicit interest rate in the forward contract of 11.028% ($111,028*11.028%=$12,244 less record interest of $11,628=$616))
4. There is no entry as of December 31, 20X1 to record the spot remeasurement of the debt to the functional currency since the spot exchange rate in the example did not change during the year.

Observations
By using a forward contract, DEF eliminated its foreign exchange risk by locking in a forward call on £154,767 at £1: $1.09, enabling DEF to settle its £ debt obligation for a fixed U.S. dollar amount ($168,719). The hedging relationship also resulted in the net period interest charges being converted to the US$ rate of 11.028% rather than the 10% UK rate.

Example 7.14: Cash Flow Hedge of Variable-Rate Foreign-Currency-Denominated Debt with a Variable to Fixed Cross-Currency Interest Rate Swap (Variable to Fixed Scenario)

XYZ Company’s functional currency is the U.S. dollar ($). On January 1, 20X0, XYZ borrowed EUR 100,000 for one year at a variable rate of Euribor plus 50 basis points (bps). Also on January 1, 20X0, XYZ enters into a one-year variable-to-fixed cross-currency interest rate swap (cross-currency swap) in which it will receive Euribor plus 50 bps on EUR 100,000 and pay fixed $ at 6.373% on $102,000. There will be a final exchange of principal at maturity of the cross-currency swap (XYZ will receive EUR 100,000 and pay $102,000). The debt and the cross-currency swap will pay interest quarterly at March 31, June 30, September 30 and December 31.

XYZ designates the cross-currency swap as a cash flow hedge of the euro debt for changes in the functional-currency-equivalent cash flows due to the variable interest payments and changes in foreign exchange rates ($/EUR). XYZ will assess hedge effectiveness and measure ineffectiveness using the hypothetical method. Since the critical terms of the hedged item and cross-currency swap match (notional amount of debt, interest indices, settlement date, rate reset and maturity dates), the terms of the hypothetical cross-currency swap match the actual cross-currency swap. Therefore, XYZ has concluded that there will be no hedge ineffectiveness.

Assumptions
The spot exchange rate for $/EUR, flat Euribor swap rate, and U.S. LIBOR rate over the life of the hedge are as follows:

<table>
<thead>
<tr>
<th></th>
<th>1/1/X0</th>
<th>3/31/X0</th>
<th>6/30/X0</th>
<th>9/30/X0</th>
<th>12/31/X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spot Rate</td>
<td>1.0200</td>
<td>1.0723</td>
<td>1.0723</td>
<td>1.1273</td>
<td>1.1851</td>
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<tr>
<td>Euribor swap rate</td>
<td>5.160%</td>
<td>5.151%</td>
<td>5.040%</td>
<td>4.854%</td>
<td>4.480%</td>
</tr>
<tr>
<td>U.S. LIBOR</td>
<td>6.00%</td>
<td>5.50%</td>
<td>6.00%</td>
<td>6.50%</td>
<td>7.00%</td>
</tr>
</tbody>
</table>

The remeasurement at spot of the debt and the fair value and changes in fair value of the cross-currency swap, are shown in the following table:
<table>
<thead>
<tr>
<th>Spot Rate</th>
<th>1/1/X0</th>
<th>3/31/X0</th>
<th>6/30/X0</th>
<th>9/30/X0</th>
<th>12/31/X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt at Spot (in $)</td>
<td>(102,000)</td>
<td>(107,230)</td>
<td>(107,230)</td>
<td>(112,730)</td>
<td>(118,510)</td>
</tr>
<tr>
<td>Change in Period</td>
<td>—</td>
<td>(5,230)</td>
<td>—</td>
<td>(5,500)</td>
<td>(5,780)</td>
</tr>
<tr>
<td>Fair Value of Swap</td>
<td>—</td>
<td>4,911</td>
<td>5,287</td>
<td>10,905</td>
<td>16,510</td>
</tr>
<tr>
<td>Change in Period</td>
<td>—</td>
<td>4,911</td>
<td>376</td>
<td>5,618</td>
<td>5,605</td>
</tr>
</tbody>
</table>

The income statement effect of the debt and the derivative are set forth below for each quarter ended period.

<table>
<thead>
<tr>
<th>3/31/X0</th>
<th>6/30/X0</th>
<th>9/30/X0</th>
<th>12/31/X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense * (EUR)</td>
<td>(1,415)</td>
<td>(1,413)</td>
<td>(1,385)</td>
</tr>
<tr>
<td>Interest expense ** ($)</td>
<td>(1,517)</td>
<td>(1,515)</td>
<td>(1,561)</td>
</tr>
<tr>
<td>Swap interest settlement</td>
<td>(108)</td>
<td>(110)</td>
<td>(64)</td>
</tr>
<tr>
<td>Net interest expense</td>
<td>(1,625)</td>
<td>(1,625)</td>
<td>(1,625)</td>
</tr>
</tbody>
</table>

* The interest expense is calculated based on Euribor plus 50bps on EUR 100,000.
** The variable euro interest expense for simplicity is remeasured into the functional currency ($) at the spot exchange rate at the end of the quarter.

(a) The journal entries as of January 1, 20X0 would be as follows:

1. Interest expense (P&L) 1,517
   Cash (B/S) 1,517
   (To pay interest on the euro debt at Euribor plus 50 bps. Remeasured at the period end spot rate for simplicity)

(b) The journal entries as of March 31, 20X0 would be as follows:

1. Interest expense (P&L) 1,517
   Cash (B/S) 1,517
   (To pay interest on the euro debt at Euribor plus 50 bps. Remeasured at the period end spot rate for simplicity)

2. Other income/expense (P&L) 5,230
   Debt obligation (B/S) 5,230
   (To record the spot remeasurement of the debt to the functional currency)
3. Interest expense (P&L)  108  
   Cash (B/S)  108  
   (To record the net interest cash payment on the cross-currency swap)

4. Cross-currency swap (B/S)  4,911  
   AOCI (B/S)  4,911  
   (To record the change in fair value of the cross-currency swap)

5. AOCI (B/S)  5,230  
   Other income/expense (P&L)  5,230  
   (To reclassify an amount out of AOCI to offset the spot remeasurement loss)

(c) The journal entries as of June 30, 20X0 would be as follows:

1. Interest expense (P&L)  1,515  
   Cash (B/S)  1,515  
   (To pay interest on the euro debt at Euribor plus 50 bps. Remeasured at the period end spot rate for simplicity)

2. Interest expense (P&L)  110  
   Cash (B/S)  110  
   (To record the net interest cash payment on the cross-currency swap)

3. Cross-currency swap (B/S)  376  
   AOCI (B/S)  376  
   (To record the change in fair value of the cross-currency swap)

(d) The journal entries as of September 30, 20X0 would be as follows:

1. Interest expense (P&L)  1,561  
   Cash (B/S)  1,561  
   (To pay interest on the euro debt at Euribor plus 50 bps. Remeasured at the period end spot rate for simplicity)

2. Other income/expense (P&L)  5,500  
   Debt obligation (B/S)  5,500
3. Interest expense (P&L) 64
   Cash (B/S) 64

(To record the net interest cash payment on the cross-currency swap)

4. Cross-currency swap (B/S) 5,618
   AOCI (B/S) 5,618

(To record the change in fair value of the cross-currency swap)

5. AOCI (B/S) 5,500
   Other income/expense (P&L) 5,500

(To reclassify an amount out of AOCI to offset the spot remeasurement loss)

(e) The journal entries as of December 31, 20X0 would be as follows:

1. Interest expense (P&L) 1,587
   Cash (B/S) 1,587

(To pay interest on the euro debt at Euribor plus 50 bps. Remeasured at the period end spot rate for simplicity)

2. Other income/expense (P&L) 5,780
   Debt obligation (B/S) 5,780

(To record the spot remeasurement of the debt to the functional currency)

3. Interest expense (P&L) 38
   Cash (B/S) 38

(To record the net interest cash payment on the cross-currency swap)

4. Cross-currency swap (B/S) 5,605
   AOCI (B/S) 5,605

(To record the change in fair value of the cross-currency swap)

5. AOCI (B/S) 5,780
   Other income/expense (P&L) 5,780

(To reclassify an amount out of AOCI to offset the spot remeasurement loss)
### Observations

By using a cross-currency swap, XYZ eliminated its foreign exchange and interest rate risk by locking in a forward call on EUR 100,000 at EUR 1:$1.02 enabling XYZ to settle its EUR debt for a fixed $ amount ($102,000). XYZ’s net cash payment at maturity of the debt was $102,000, which was $118,510 less the gain on the swap of $16,510. XYZ also converted the variable Euribor interest payments into a fixed $ amount based on 6.373% of $102,000, thus hedging its exposure to changes in interest rates. As a result, the interest expense on the EUR 100,000 debt, adjusted for the period swap interest settlement, totals $1,625 each quarter. The cross-currency swap was highly effective in offsetting changes in functional-currency-equivalent cash flows of the debt attributable to changes in the benchmark interest rate and remeasurement at spot of the debt into the functional currency ($).

### Example 7.15: Cash Flow Hedge of a Forecasted Foreign-Currency-Denominated Sale with a Purchased Option (DIG Issue G20 Approach)

CJ Company’s functional currency is the U.S. dollar. On January 1, 20X0 CJ forecasts a sale on credit for EUR 10,000,000. The sale is expected to occur December 31, 20X0. CJ purchases a European style put option for $442,000 for EUR 10,000,000 notional amount with an exercise rate of EUR 1 = $.90. CJ designates a cash flow hedge of the functional-currency-equivalent cash flows from the date the sale is forecasted to be probable of occurring through the expected sale date. CJ expects this hedging relationship to be perfectly effective in hedging against a depreciation of the euro below $.90 since the critical terms of the forecasted transaction match the critical terms of the put option (notional amount, underlying, maturity and strike price of the specified exposure level being hedged). CJ will assess effectiveness and measure ineffectiveness based on the terminal value approach in DIG Issue G20. CJ designates this as a cash flow hedge of the functional-currency-equivalent cash flows due to a depreciation of the euro below $.90. The put option is also expected to generate cash flows at maturity that offset the change in cash flows of the hedged sale for the risk being hedged. Based on these factors and the option’s single exercise date at maturity, CJ will not record any ineffectiveness or any portion of the option’s cost in earnings until the forecasted sale impacts earnings.

### Assumptions
<table>
<thead>
<tr>
<th>Date</th>
<th>EUR/$ Spot</th>
<th>Fair value of put option</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X0</td>
<td>0.90</td>
<td>$42,000</td>
</tr>
<tr>
<td>3/31/X0</td>
<td>0.88</td>
<td>491,000</td>
</tr>
<tr>
<td>6/30/X0</td>
<td>0.92</td>
<td>211,000</td>
</tr>
<tr>
<td>9/30/X0</td>
<td>0.89</td>
<td>261,000</td>
</tr>
<tr>
<td>12/31/X0</td>
<td>0.84</td>
<td>600,000</td>
</tr>
</tbody>
</table>

The fair value of the put option is based on an option pricing model.

(a) The journal entries as of January 1, 20X0 would be as follows:

1. Put Option (B/S) $442,000  
   Cash (B/S) $442,000  

   (To record the purchase of the put option)

(b) The journal entries as of March 31, 20X0 would be as follows:

1. Put Option (B/S) 49,000  
   AOCI (B/S) 49,000  

   (To record the change in fair value of the put option)

(c) The journal entries as of June 30, 20X0 would be as follows:

1. AOCI (B/S) 280,000  
   Put Option (B/S) 280,000  

   (To record the change in fair value of the put option)

(d) The journal entries as of September 30, 20X0 would be as follows:

1. Put Option (B/S) 50,000  
   AOCI (B/S) 50,000  

   (To record the change in fair value of the put option)

(e) The journal entries as of December 31, 20X0 would be as follows:

1. Accounts Receivable (B/S) 8,400,000  
   Sale (P&L) 8,400,000  

   (To record the EUR 10,000,000 sale at spot rate)
2. Put Option (B/S) 339,000
   AOCI (B/S) 339,000
   (To record the change in fair value of the put option)

3. Cash (B/S) 600,000
   Put Option (B/S) 600,000
   (To record the payment received by CJ to settle the put option)

4. AOCI (B/S) 158,000
   Sales (P&L) 158,000
   (To reclassify the amount in AOCI to sales since the hedged item is affecting earnings)

**Observations**

CJ recorded a sale of $8,400,000 (based on the December 31, 20X0 spot rate). The put option was effective at hedging functional-currency-equivalent cash flows for a depreciation of the euro below $.90. As a result of the hedge CJ’s net impact on earnings attributable to changes in the foreign currency exchange rate during the forecasted period was only the cost of the put option. At December 31, 20X0, CJ recorded a sale of $8,400,000 along with a gain on the put option of $158,000 for a total of $8,558,000 for the hedged EUR 10,000,000 sale. The difference between the functional-currency-equivalent value of $9,000,000 at the forecast date and the net recorded amount of $8,558,000 is the cost of the put option ($442,000). Absent this hedge CJ would have recorded only the sale of $8,400,000 and would have had an economic loss of $600,000 due to unhedged changes in the foreign exchange rate from the forecasted date.

**Example 7.16: Cash Flow Hedge of a Forecasted Foreign-Currency-Denominated Purchase with a Forward Contract**

MLD Company’s functional currency is the U.S. dollar. On January 14, 20X0 MLD forecasts the purchase of inventory on credit for 100,000 Swiss francs (SF). The purchase is expected to occur July 15, 20X0. MLD enters into forward contract to purchase SF100,000 at $.6614 USD = 1 SF. MLD designates a cash flow hedge of the functional-currency-equivalent cash flows from the date the purchase is forecasted to be probable of occurring through the purchase date. MLD expects this hedging relationship to be perfectly effective since the critical terms of the forecasted transaction match the foreign currency forward contract. MLD will assess effectiveness and measure ineffectiveness by verifying and documenting that the critical terms have not changed during the review period. As long as the critical terms continue to match, MLD will not record any ineffectiveness or any portion of the forward to spot premium in earnings until the forecasted purchase impacts earnings, i.e., when the inventory is sold.

**Assumptions**
Exchange rates are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot</th>
<th>7/15 Forward</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/14</td>
<td>0.6575</td>
<td>0.6614</td>
</tr>
<tr>
<td>3/31</td>
<td>0.6757</td>
<td>0.6793</td>
</tr>
<tr>
<td>6/30</td>
<td>0.6689</td>
<td>0.6734</td>
</tr>
<tr>
<td>7/15</td>
<td>0.6761</td>
<td>0.6761</td>
</tr>
</tbody>
</table>

The change in fair value of the foreign currency forward contract is based on the difference between the contract’s forward rate of 0.6614 and the forward rate at the balance sheet date for the remaining period to maturity of the forward contract. For example at March 31, 20X0 it would be SF100,000 *(0.6793-0.6614)= $1,790 discounted to July 15 at the risk free rate.

(a) There would be a memorandum entry on January 14, 20X0, documenting the existence of the hedging relationship. The financial records of MLD would not otherwise be impacted as of this date because the foreign currency forward was at market rates.

(b) The journal entries as of March 31, 20X0 would be as follows:

1. Forward Contract (B/S)  $ 1,703
   AOCI (B/S)                      $ 1,703

   (To record the change in fair value of the foreign currency forward contract)

(c) The journal entries as of June 30, 20X0 would be as follows:

1. AOCI (B/S) 526
   Forward Contract (B/S) 526

   (To record the change in fair value of the foreign currency forward contract.)

(d) The journal entries as of July 15, 20X0 would be as follows:

1. Inventory(B/S) 67,610
   Accounts Payable (B/S) 67,610

   (To record the purchase of inventory at spot rate)

2. Forward Contract (B/S) 293
   AOCI (B/S) 293

   (To record the change in fair value of the foreign currency forward contract)
3. Cash (B/S) Forward Contract (B/S) 1,470 1,470

(To record the payment received by MLD to settle the gain on the foreign currency forward contract)

**Observations**

MLD recorded inventory of $67,610 (based on the July 15, 20X0 spot rate). The amount at July 15, 20X0 in AOCI of $1,470 represents the effective portion of the hedging forward, which will remain in AOCI until the inventory is sold. At that time it will be reclassified to cost of sales resulting in a net cost of $66,140, which is equivalent to the forward contract’s rate of $.6614 = 1 SF that MLD locked in at January 14, 20X0.

**Example 7.17: Cash Flow Hedge of a Recognized Foreign-Currency-Denominated Payable with a Forward Contract**

QST Company’s functional currency is the U.S. dollar. On January 14, 20X0 QST purchases inventory on credit for 100,000 Swiss francs (SF). The payment is due April 15, 20X0. QST enters into a forward contract to purchase SF100,000 at $.6614 = 1 SF. QST designates a cash flow hedge of the functional-currency-equivalent cash flows through the payment date of April 14, 20X0. QST expects this hedging relationship to be perfectly effective since the critical terms of the foreign-currency-denominated payable match the foreign currency forward contract. QST will assess effectiveness and measure ineffectiveness by verifying and documenting that the critical terms have not changed during the review period. As long as the critical terms continue to match, QST will not record any ineffectiveness. QST will recognize the forward to spot premium (cost) on the forward contract based on the implicit interest rate of the forward contract recognized on a pro rata basis over the hedging relationship.

**Assumptions**

Exchange rates are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Spot</th>
<th>4/15 Forward</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/14</td>
<td>0.6575</td>
<td>0.6614</td>
</tr>
<tr>
<td>3/31</td>
<td>0.6757</td>
<td>0.6793</td>
</tr>
<tr>
<td>4/15</td>
<td>0.6761</td>
<td>0.6761</td>
</tr>
</tbody>
</table>

The change in fair value of the foreign currency forward contract is based on the difference between the contract’s forward rate of .6614 and the forward rate at the balance sheet date for the remaining period to maturity of the forward contract. For example at March 31, 20X0 it would be SF100,000 *(.6793-.6614)= $1,790 discounted to April 15 at the risk free rate.

(a) The journal entries as of January 14, 20X0 would be as follows:
1. There would be a memorandum entry on January 14, 20X0, documenting the existence of the hedging relationship. The financial records of QST would not otherwise be impacted as of this date because the foreign currency forward was at market rates.

2. Inventory (B/S) $65,750
    Accounts Payable (B/S) $65,750
    (To record the inventory purchase at spot rate)

(b) The journal entries as of March 31, 20X0 would be as follows:

1. Other Income/expense (P&L) 1,820
    Accounts Payable (B/S) 1,820
    (To record the spot remeasurement adjustment to the functional currency)

2. Forward Contract (B/S) 1,780
    AOCI (B/S) 1,780
    (To record the change in fair value of the foreign currency forward contract.)

3. AOCI (B/S) 1,820
    Other Income/expense (P&L) 1,820
    (To reclassify the effective portion of the change in fair value of the foreign currency forward contract from AOCI to offset the Statement 52 (ASC Topic 830) spot remeasurement adjustment)

4. Other Income/expense (P&L) 326
    AOCI (B/S) 326
    (To reclassify the portion of the forward premium on the foreign currency forward contract attributable to the hedging period (premium $390*/(76/91 days)))

(c) The journal entries as of April 15, 20X0 would be as follows:

1. Other Income/expense (P&L) 40
    Accounts Payable (B/S) 40
    (To record the spot remeasurement adjustment to the functional currency)

2. AOCI (B/S) 310
    Forward Contract (B/S) 310
    (To record the change in fair value of the foreign currency forward contract)
3. AOCI (B/S) 40
   Other Income/expense (P&L) 40

   (To reclassify the effective portion of the change in fair value of the foreign currency forward contract from AOCI to offset the Statement 52 (ASC Topic 830) spot remeasurement adjustment)

4. Accounts Payable (B/S) 67,610
   Cash (B/S) 67,610

   (To record the payment of the foreign-currency-denominated payable at spot rate)

5. Other Income/expense (P&L) 64
   AOCI (B/S) 64

   (To reclassify the portion of the forward premium on the foreign currency forward contract attributable to the hedging period (premium $390*/(15/91 days)))

4. Cash (B/S) 1,470
   Forward Contract (B/S) 1,470

   (To record the payment received by MLD to settle the gain on the foreign currency forward contract)

Observations

QST was able to lock in its functional currency payable at the January 14, 20X0 forward rate of $.6614 = 1 SF. QST initially recorded the SF100,000 payable at $65,750 and settled it on April 15, 20X0 at the spot rate of $67,610. This amount was offset by a $1,470 gain on the forward contract. Absent the forward contract QST would have realized a foreign exchange loss of $1,860 on the SF 100,000 payable. The difference of $390 (1,860-1,470) represents the forward to spot premium incurred by QST.

Example 7.18: Single Cash Flow Hedge With a Foreign Currency Purchased Option

On December 31, 20X1, Outback Corporation, a U.S. dollar functional currency entity, forecasts the sale of inventory on credit for AUD 10,000,000 on February 15, 20X2 with settlement of the receivable on April 15, 20X2. Outback purchases a foreign currency European style put option that gives it the right to sell AUD 10,000,000 on April 15, 20X2, for $5,000,000. The terms of the purchased put option are as follows:

Assumptions

Contract amount: AUD 10,000,000
Expiration date: April 15, 20X2
Put option strike price: AUD 2/ $1
Spot rate: AUD 2/ $1
Premium: $20,000

The option is purchased at the money; therefore, the premium on December 31, 20X1 reflects the option’s time value only. The option can be exercised only on its expiration date. The option is designated as a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the forecasted sale on credit on February 15, 20X2, and the settlement of the resulting foreign-currency-denominated receivable on April 15, 20X2. Outback defines its foreign currency risk as being in one direction since it wishes to preserve its functional-currency-equivalent cash flows when the exchange rate increases above AUD 2/$1 – the option will be exercised if the AUD/$ rate increases above the strike price of AUD 2/$1. That is, as the functional-currency-equivalent cash flows of $5,000,000 decrease, the pay-off amount of the option will compensate Outback for the difference.

Outback ascertains that (1) the critical terms of the hedging instrument completely match the related terms of the hedged forecasted transaction, (2) the strike price of the purchased option matches the specified level beyond which the entity’s exposure is being hedged, (3) the hedging instrument’s net functional-currency-equivalent inflows at its maturity date completely offset the change in the hedged transaction’s cash flows for the risk being hedged, and (4) the hedging instrument can be exercised only at its contractual maturity date. Based on this, Outback concludes that the hedging relationship is considered perfectly effective pursuant to DIG Issue G20.

The assumed spot exchange rates and fair value of the option are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot Exchange Rate</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20X1</td>
<td>$ 2.00</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>January 31, 20X1</td>
<td>2.10</td>
<td>253,095</td>
</tr>
<tr>
<td>February 15, 20X2</td>
<td>2.05</td>
<td>133,951</td>
</tr>
<tr>
<td>March 31, 20X2</td>
<td>1.90</td>
<td>3,000</td>
</tr>
<tr>
<td>April 15, 20X2</td>
<td>2.30</td>
<td>652,174</td>
</tr>
</tbody>
</table>

(a) The journal entries as of December 31, 20X1 would be as follows:

1. Purchased put option (B/S) $ 20,000
   Cash (B/S) $ 20,000

   (To record the purchase of the put option at fair value)

(b) The journal entries as of January 31, 20X1 would be as follows:

1. Purchased put option (B/S) 233,095

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(c) The journal entries as of February 15, 20X1 would be as follows:

1. AOCI (B/S) 119,144
   Purchased put option (B/S) 119,144

   (To record the change in fair value of the put option)

2. Accounts Receivable (B/S) 4,878,049
   Revenue (P&L) 4,878,049

   (To record the sale of inventory at spot rate)

3. AOCI (B/S) 121,951
   Revenue (P&L) 121,951

   (To transfer from AOCI the portion of the change in fair value of the put option that was considered effective [(AUD 10,000,000/2.00) – (AUD 10,000,000/2.05) = $121,951] during the forecasted period)

4. Other Income/expense (P&L) 8,762
   AOCI (B/S) 8,762

   (To reclassify the portion of the option premium attributable to the forecasted period (46 days). The amount recognized is based on an allocation of the option premium over the forecasted period [$20,000* (46 days/105 days (term of option)) = $8,762])

(d) The journal entries as of March 31, 20X1 would be as follows:

1. AOCI (B/S) 130,951
   Purchased put option (B/S) 130,951

   (To record the change in fair value of the put option)

2. Accounts Receivable (B/S) 385,109
   Other Income/expense (P&L) 385,109

   (To record the spot remeasurement adjustment to the functional currency)

3. Other Income/expense (P&L) 121,951
   AOCI (B/S) 121,951

   (To reclassify the effective portion of the change in fair value of the put option from AOCI to offset the Statement 52 (ASC Topic 830) spot remeasurement adjustment. This
amount is limited to the defined hedged exchange rate of AUD 2/$1 ($5,000,000) since Outback is only hedging against an increase in the rate, i.e., if the rate was to exceed AUD 2.00. Since the exchange rate changed from AUD 2.05 to AUD 1.90 per $1 this adjustment only offsets the movement from AUD 2.05 to AUD 2.00)

4. Other Income/expense (P&L)
   AOCI (B/S) 8,381
   (To reclassify the portion of the option premium attributable to the period of the recognized receivable hedge (44 days). The amount recognized is based on an allocation of the option premium over that period [$20,000* (44 days/105 days (term of option)) = $8,381])

(e) The journal entries as of April 15, 20X1 would be as follows:
1. Purchased put option (B/S) 649,174
   AOCI (B/S) 649,174
   (To record the change in fair value of the put option)

2. Other Income/expense (P&L) 915,332
   Accounts Receivable (B/S) 915,332
   (To record the spot remeasurement adjustment to the functional currency)

3. AOCI (B/S) 652,174
   Other Income/expense (P&L) 652,174
   (To transfer from AOCI the effective portion of the change in fair value of the put option from AOCI to offset the Statement 52 (ASC Topic 830) spot remeasurement adjustment. This amount is limited to the increase above the defined hedged exchange rate of AUD 2/$1 since Outback is only hedging against an increase in the rate. The change in fair value of the put option that was considered effective was $652,174, which was the change from AUD 2.00 to AUD 2.30 per $1)

4. Other Income/expense (P&L) 2,857
   AOCI (B/S) 2,857
   (To reclassify the portion of the option premium attributable to the period of the recognized receivable hedge (15 days). The amount recognized is based on an allocation of the option premium over that period [$20,000* (15 days/105 days (term of option)) = $2,857])

5. Cash (B/S) 4,347,826
   Accounts Receivable (B/S) 4,347,826
(To record the settlement of the foreign-currency-denominated receivable at spot rate)

6. Cash (B/S) 652,174
   Purchased put option (B/S) 652,174

(To record the cash receipt upon exercise of the put option by Outback)

Observations

Upon sale of the inventory, Outback recorded revenue of $4,878,049 (based on the February 15, 20X1 spot rate) and reclassified $121,951 from AOCI to revenue resulting in net revenue on this sale of $5,000,000. Part of the option premium of $20,000 attributable to the forecasted period was also recognized in earnings at this time. The net impact in Outback’s income statement for this AUD sale, collection of the AUD receivable and related hedging option was $4,980,000. This amount is based on the put option’s exchange rate of AUD 2/$1, which fixed the functional currency amount of the AUD 10,000,000 sale and collection at $5,000,000 less the option’s premium of $20,000. Outback was not exposed to the increase in the AUD/$ exchange rate since it effectively hedged its exposure.

Example 7.19: Single Cash Flow Hedge With a Foreign Currency Forward Contract

CAB Company’s functional currency is the U.S. dollar. On January 14, 20X0 CAB forecasts the purchase of inventory on credit for 100,000 Swiss francs (SF). The purchase is expected to occur July 15, 20X0 on credit and the payable will settle on August 29, 20X0. CAB enters into forward contract to buy SF100,000 at $.6614 = 1 SF. CAB designates a single cash flow hedge of the functional-currency-equivalent cash flows from the date the purchase is forecasted to be probable of occurring through the date of the expected payment of the related payable. CAB expects this hedging relationship to be perfectly effective since the critical terms of the forecasted transaction match the foreign currency forward contract. During the forecasted period CAB will assess effectiveness based on forward rates by verifying and documenting that there were no changes to the critical terms. As long as the critical terms continue to match, CAB will not record any ineffectiveness or any portion of the forward to spot premium in earnings until the forecasted purchase occurs and affects earnings. After the purchase occurs and the foreign-currency-denominated payable is recognized, CAB will assess effectiveness based on forward rates and review of the critical terms. The forward to spot premium will be recognized in earnings over this hedging period.

Assumptions

Exchange rates are as follows:

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<tr>
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<th>8/29 Forward</th>
<th>7/15 Forward</th>
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<tr>
<td>Spot</td>
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© 2019 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
The difference between the spot rate of .6575 and the forward rate to August 29 (.6614) represents the forward premium that will be recognized over the hedging relationship and amounts to $390. The change in fair value of the foreign currency forward contract is based on the difference between the contract’s forward rate of .6614 and the forward rate at the balance sheet date for the remaining period to maturity of the forward contract. For example at March 31, 20X0 it would be \[\text{SF100,000} \times (.6793 - .6614) = \$1,790\] discounted to August 29 at the risk free rate.

(a) There would be a memorandum entry on January 14, 20X0, documenting the existence of the hedging relationship. The financial records of CAB would not otherwise be impacted as of this date because the foreign currency forward was at market rates.

(b) The journal entry as of March 31, 20X0 would be as follows:

1. Forward Contract (B/S) \hspace{1cm} $1,703
   AOCI (B/S) \hspace{1cm} $1,703

(To record the change in fair value of the foreign currency forward contract)

(c) The journal entry as of June 30, 20X0 would be as follows:

1. AOCI (B/S) \hspace{1cm} 526
   Forward Contract (B/S) \hspace{1cm} 526

(To record the change in fair value of the foreign currency forward contract)

(d) The journal entry as of July 15, 20X0 would be as follows:

1. Inventory (B/S) \hspace{1cm} 67,610
   Accounts Payable (B/S) \hspace{1cm} 67,610

(To record the purchase of inventory at spot rate)

(e) The journal entry as of August 29, 20X0 would be as follows:

1. Forward Contract (B/S) \hspace{1cm} 663
   AOCI (B/S) \hspace{1cm} 663

(To record the change in fair value of the foreign currency forward contract)

2. Other Income/expense (P&L) \hspace{1cm} 370
### Accounts Payable (B/S) 370
(To record the spot remeasurement adjustment to the functional currency)

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<tr>
<td>3. AOCI (B/S)</td>
<td>370</td>
<td></td>
</tr>
<tr>
<td>Other Income/expense (P&amp;L)</td>
<td>370</td>
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(To reclassify the effective portion of the change in fair value of the foreign currency forward contract from AOCI to offset the Statement 52 (ASC Topic 830) spot remeasurement adjustment)

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<tr>
<td>4. Other Income/expense (P&amp;L)</td>
<td>77</td>
<td></td>
</tr>
<tr>
<td>AOCI (B/S)</td>
<td>77</td>
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(To reclassify the portion of the forward premium on the foreign currency forward contract attributable to the hedging period ($390* (45 days/227 days) = $77))

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<tr>
<td>5. Accounts Payable (B/S)</td>
<td>67,980</td>
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<tr>
<td>Cash (B/S)</td>
<td>67,980</td>
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(To record the settlement of the foreign-currency-denominated payable at spot rate)

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<tr>
<td>6. Cash (B/S)</td>
<td>1,840</td>
<td></td>
</tr>
<tr>
<td>Forward Contract (B/S)</td>
<td>1,840</td>
<td></td>
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(To record the cash receipt by CAB for the gain settling the foreign currency forward contract)

### Observations

Upon sale of the inventory purchased on July 15, 20X0, CAB would record cost of goods sold of $67,610 (based on the July 15, 20X0 spot rate) and reclassify the remaining $1,547 from AOCI to earnings to achieve a net cost of goods sold of $66,063. This amount coupled with the recognized cost of the forward previously recognized of $77 results in a net income statement cost of $66,140, which equates to the forward contract rate of $.6614 = 1 SF, as would be expected. Included in the $1,547 reclassified from AOCI to earnings is the cost of the forward not recognized in earnings until the sale of the inventory ($313).

### HEDGES OF THE FOREIGN CURRENCY EXPOSURE OF A NET INVESTMENT IN A FOREIGN OPERATION

42.01 Hedges of foreign currency exposures of net investments in foreign operations are discussed in paragraph 42 of the Standard (ASC paragraphs 815-20-25-66 and 815-35-35-1 and 35-2):
42. A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging the foreign currency exposure of a net investment in a foreign operation provided the conditions in paragraph 40(a) and 40(b) are met. (A nonderivative financial instrument that is reported at fair value does not give rise to a foreign currency transaction gain or loss under Statement 52 and, thus, cannot be designated as hedging the foreign currency exposure of a net investment in a foreign operation.) The gain or loss on a hedging derivative instrument (or the foreign currency transaction gain or loss on the nonderivative hedging instrument) that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation shall be reported in the same manner as a translation adjustment to the extent it is effective as a hedge. The hedged net investment shall be accounted for consistent with Statement 52; the provisions of this Statement for recognizing the gain or loss on assets designated as being hedged in a fair value hedge do not apply to the hedge of a net investment in a foreign operation.

DIG Issues related to this paragraph are H6, H7, H8, H9, H10, H11 and J11. See DIG Issues Index.

42.02 Consistent with Statement 52 (ASC Topic 830), the Standard permits an entity to designate a derivative instrument or a nonderivative foreign-currency-denominated financial instrument as a hedge of the foreign currency exposure inherent in a net investment in a foreign operation provided the conditions in paragraph 40(a) and 40(b) (ASC paragraph 815-20-25-30) are met (discussed further in Paragraphs 42.04, 42.33, and 42.34 of this section). (See DIG for further reference) A net investment in a foreign operation includes incorporated and unincorporated business structures such as subsidiaries, divisions, branches, joint ventures, consolidated variable interest entities, and investments accounted for by the equity method.

42.03 Designation of a net investment in a foreign operation as a hedged item would be considered the same as designating a group of dissimilar assets and liabilities as the hedged item, which is not permitted for a fair value or cash flow hedge. However, Statement 52 (ASC Topic 830) previously permitted hedge accounting for net investments and practice in this area was well established. Since the Board did not comprehensively reconsider the accounting provisions of Statement 52 (ASC Topic 830), the Board decided to continue to permit hedge accounting for net investment hedges. The Board also noted that, unlike other hedges of portfolios of dissimilar items, hedge accounting for the net investment in a foreign operation has been explicitly permitted by the literature.

**Hedging Instruments**

42.04 The Standard permits using derivative instruments as well as nonderivative financial instruments that give rise to a foreign currency transaction gain or loss under Statement 52 (ASC Topic 830) as hedging instruments. For example, a U.S. dollar functional currency entity with a euro-denominated debt obligation could designate the debt obligation as the hedging instrument to hedge a euro net investment in a subsidiary. A nonderivative financial instrument that is reported at fair value, such as an instrument to which an entity has chosen to apply the fair value option under FASB Statement No. 159 (ASC Topic 825), cannot be the hedging instrument since it does not give rise to a foreign currency transaction gain or loss under Statement 52 (ASC Topic 830). In addition, paragraph 42 of the Standard (ASC paragraphs 815-20-25-66 and 815-
35-35-1 and 35-2) requires the hedging instrument’s gain or loss to be reported in the cumulative translation adjustment (CTA) to the extent it is effective as an economic hedge, consistent with the accounting for the net investment. The accounting for a net investment hedge using a nonderivative financial instrument is further discussed in Paragraphs 42.33 and 42.34 of this section.

**42.05** The derivative hedging instrument can be with either a third party or a related party. If a parent company uses an internal derivative as the hedging derivative in a net investment hedge, the internal derivative must be offset with a third party on an individual basis to obtain hedge accounting in the consolidated financial statements. That is, the counterparty to the internal derivative, usually a treasury center as discussed in Paragraph 40A.03 of this section, must enter into an offsetting contract with a third party. We believe, consistent with prior practice, a parent company may designate a nonderivative foreign-currency-denominated intercompany financial instrument as the hedging instrument in a net investment hedge. However, we believe hedge accounting in the consolidated financial statements may only be applied if the affiliated counterparty to the intercompany nonderivative instrument has entered, on an individual basis, into a third party nonderivative financial instrument that offsets the foreign currency exposure. This requirement is consistent with the same requirement when using a nonderivative to hedge the foreign currency fair value exposure associated with an unrecognized firm commitment discussed in Paragraph 37.09 of this section.

**Hedging Criteria**

**42.06** Net investment hedges are subject to the criteria of paragraph 20 of Statement 52 (ASC paragraph 830-20-35-3), which are not changed by the Standard. Those criteria are that the hedging instrument must be designated and effective as an economic hedge of the net investment. In addition to the hedge criteria specified in paragraphs 40(a) and 40(b) of the Standard (ASC paragraph 815-20-25-30), the documentation requirements specified in Paragraph 36.05 of this section are applicable, and an entity must assess effectiveness and measure ineffectiveness at least quarterly and whenever financial statements or earnings are reported.

**Consideration of Counterparty Credit Risk and the Entity's Own Nonperformance Risk**

**42.06a** If a derivative instrument is designated as the hedging instrument in a net investment hedge, an entity needs to consider how the assessment of effectiveness and measurement of ineffectiveness may be impacted by the revised definition of fair value under 157, Fair Value Measurements (Statement 157) (ASC Topic 820), which requires that both counterparty credit risk and an entity's own nonperformance risk be included in determining fair value of the derivative instrument. Refer to Section 4 for further discussion of the impact of Statement 157 (ASC Topic 820) on the valuation of derivative instruments. Assuming the likelihood of the counterparty or the entity itself not defaulting on their obligations under the derivative instrument is assessed as probable, the changes in counterparty credit risk and an entity’s own nonperformance risk would not have an impact on the assessment of whether the hedging instrument is effective as an economic hedge of the net investment and the related measurement of ineffectiveness. Assuming there are no other sources of ineffectiveness and that the entity has elected to measure ineffectiveness based on forward rates as discussed starting in Paragraph
the total changes in the fair value of the derivative instrument (including changes in counterparty credit risk and an entity’s own nonperformance risk) would be included in cumulative translation adjustment (CTA). However, if the likelihood of the counterparty or the entity not defaulting is assessed as no longer probable, the entity must measure the amount of ineffectiveness to be recorded currently in earnings and assess whether the hedging relationship has been and is expected to continue to be effective as an economic hedge. The entity would be expected to have strong evidence supporting why the hedging relationship has been and is expected to continue to be effective as an economic hedge. Strong evidence would be needed to overcome the impact of the credit/nonperformance issues of the derivative on the effectiveness of the hedging relationship. We expect that it would be rare to conclude that a hedging relationship is expected to continue to be highly effective as an economic hedge of the net investment in a foreign operation when the likelihood that the counterparty will not default is no longer probable.

Impact of Master Netting Agreements on Derivative Instruments

If the derivative instrument designated as the hedging instrument in a net investment hedge is subject to a master netting agreement as discussed in Section 4, additional analysis is required with respect to the assessment of effectiveness and measurement of ineffectiveness. The fair value measurements of derivative instruments subject to a master netting agreement are often made at the portfolio level even though the portfolio is comprised of more than one unit of account. In determining the fair value of the derivative instruments subject to the master netting agreement at the portfolio level, counterparty credit risk and an entity’s own nonperformance risk generally would be calculated as a top level adjustment for credit risk on a portfolio basis. However, for applying hedge accounting, the Standard requires that the assessment of effectiveness and measurement of ineffectiveness be performed at the individual hedge relationship level. Therefore, additional analysis is required to determine if it is necessary to allocate the portfolio level credit adjustment for purposes of assessing effectiveness and measuring ineffectiveness.

ASSESSMENT OF EFFECTIVENESS ANALYSIS

For hedges of net investments in foreign operations, we believe that the guidance in the Standard allows an entity to conclude that, excluding other sources of ineffectiveness, the hedging relationship is effective as an economic hedge if the likelihood that the counterparty or the entity itself will not default is deemed probable. As such, if the derivative instrument was subject to a master netting agreement and the likelihood of either party to the contract not defaulting is probable, an entity could conclude that the hedging relationship would be highly effective without performing an allocation of the portfolio level credit adjustment.

If an entity cannot conclude that the likelihood of the counterparty or the entity itself not defaulting is probable, an entity would need to consider the impact of any changes in credit risk on the effectiveness assessment. There is a presumption that an entity would be unable to conclude that the hedging relationship is expected to continue to be highly effective as an economic hedge of the net investment in a foreign operation when the likelihood that the counterparty will not default is no longer probable. At that point, the hedging relationship would need to be discontinued and it would no longer be necessary for an entity to consider the impact
of an allocation of the portfolio level credit adjustment on the effectiveness assessment. Where an entity concludes that the hedging relationship has been and will continue to be highly effective as an economic hedge of the net investment in a foreign operation, even though the entity cannot conclude that the likelihood of the counterparty or the entity itself not defaulting is probable, the entity would need to allocate the portfolio level credit adjustment to individual derivatives and complete the assessment of effectiveness on an individual hedging relationship basis using fair values of the derivative(s) including the effect of the allocation. We expect that it would be rare for there to be sufficiently strong evidence to support this conclusion. If the entity determines that a quantitative analysis is necessary and that the portfolio level credit adjustment needs to be allocated to the derivative instruments within a portfolio, it should identify a systematic and rational allocation method and should apply that method consistently.

The following are examples of methods for allocating portfolio level credit adjustments that would be considered systematic and rational. However, other methods may also be appropriate for purposes of allocating a portfolio level credit adjustment to the individual derivatives within the portfolio. Because a derivative portfolio consists of assets and liabilities, the portfolio level credit adjustment allocations to the individual derivatives would include increases and decreases that should sum up to the overall credit adjustment for the portfolio.

- **Marginal contribution allocation** - Allocate a portion of the portfolio level credit adjustment to each derivative instrument within the portfolio by determining the incremental amount that each derivative instrument within the portfolio contributes to the overall portfolio level credit adjustment.

- **Relative fair value allocation** - Allocate a portion of the portfolio level credit adjustment to each derivative instrument within the portfolio in proportion to the relative fair values of each of the derivative instruments to the fair value of the portfolio.

- **In-exchange fair value allocation** - Allocate a portion of the portfolio level credit adjustment to each derivative instrument within the portfolio in proportion to the in-exchange fair value of each derivative instrument (that is, the standalone value of each derivative as if it were not within a portfolio).

- **Relative credit adjustment allocation** - Allocate a portion of the portfolio level credit adjustment to each derivative instrument within the portfolio in proportion to the relative credit adjustment that would be required for each of the derivative instruments on a standalone basis. Similar to the in-exchange fair value allocation approach, the use of an in-exchange measurement would be applied to each derivative instrument within the portfolio to apply this method.

**42.06d1** In May 2011, the FASB issued ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (ASU 2011-04 or the ASU) which, among other things, addresses the fair value measurement of financial instruments with offsetting market or counterparty credit risks. The ASU has an effective date for interim and annual periods beginning after December 15, 2011 for public entities and annual periods beginning after December 15, 2011 for nonpublic entities. Nonpublic entities may early-adopt the ASU for any interim period beginning after December 15, 2011. The examples above are systematic and rational methods for allocating portfolio level credit adjustments to the
individual derivative instruments within that portfolio. This would often apply to derivative instruments subject to master netting agreements. The portfolio measurement guidance provided in the ASU however, would also apply to portfolios of derivative instruments that are not subject to a master netting agreement. Further, it also would apply to nonderivative financial instruments. Regardless of the method that an entity uses, the appropriate allocation method is affected by the fair value hierarchy of the financial instruments within the portfolio. We understand from conversations with the FASB staff that the FASB staff believes the fair value allocated to financial instruments within the portfolio classified in Level 1 of the fair value hierarchy should be determined using the instrument price times the quantity (P\times Q) consistent with the guidance in paragraph 27 of Statement 157 (ASC 820-10-35-44). We would expect that this would not apply to portfolio level credit adjustments because the portfolio to which such adjustments would apply would likely not contain Level 1 derivative instruments. However, this may be applicable to adjustments related to other risks such as interest rate, foreign currency or price risks because the portfolio to which these adjustments would apply may contain Level 1 instruments. For example, assume an entity holds 10,000 exchange-traded equity securities and has an off-setting position of forward contracts to sell 6,000 of the same exchange traded equity securities. In addition, the entity concludes the portfolio measurement exception criteria have been met and the entity has elected to apply the net portfolio exception. The entity should allocate to the forward contracts the fair value measurement adjustment that resulted from the valuation of the net portfolio position with no adjustment being allocated to the Level 1 equity securities (i.e., equity securities are valued at P\times Q). If allocating the net portfolio adjustment to the forward contracts results in an unexpected basis in the forward contracts, the entity should carefully reevaluate the appropriateness of using the net portfolio exception. See Paragraphs 17.03a and 17.07c1 of Section 4 for additional information.

MEASUREMENT OF INEFFECTIVENESS ANALYSIS

42.06e If the master netting agreement contains derivatives that are hedging instruments in net investment hedges, an entity also must determine if it is necessary to allocate the portfolio level credit adjustment to the individual derivative instruments for the purpose of measuring ineffectiveness. An entity may perform an analysis instead of performing the allocation to determine if it is necessary to allocate the portfolio level credit adjustment to the individual derivative instruments subject to the master netting agreement to ascertain if the amounts recorded on the income statement and balance sheet related to derivatives in hedging relationships subject to the master netting agreement are reasonably stated (CTA versus earnings). A qualitative analysis may be used for measurement of ineffectiveness purposes as long as it considers the objectives of measuring ineffectiveness. These objectives relate to the reasonableness of the hedging relationship's impact on CTA and earnings. If an allocation of the portfolio level credit adjustment to the individual derivatives under the master netting agreement is not deemed necessary, amounts related to the portfolio level credit adjustment would be recorded in earnings rather than recorded in CTA. The qualitative analysis should consider all relevant facts and circumstances, including: the size of the portfolio level credit adjustment, the hedging relationships’ degree of effectiveness without considering the portfolio level credit adjustment, the creditworthiness of the counterparty and the entity itself, the probability of default by either party, and other potential future sources of ineffectiveness.
**42.06f** If a reasonable conclusion that the amounts recorded on the income statement and balance sheet related to derivatives in hedging relationships subject to the master netting agreement are reasonably stated cannot be reached based on a solely qualitative analysis, a quantitative analysis would be necessary. Quantitative procedures may include the selection of an allocation approach (refer to discussion in Assessment of Effectiveness Analysis section), the completion of the allocation, and the potential measurement of ineffectiveness on an individual hedging relationship basis using fair values of the derivative(s) including the impact of the allocation.

**TIMING OF PROCEDURES AND ONGOING REQUIREMENTS**

**42.06g** This qualitative or quantitative analysis should be considered as an additional component of the assessment of effectiveness and measurement of ineffectiveness for hedging relationships. Therefore, in order for an entity to continue to apply hedge accounting related to derivative instruments subject to a master netting agreement subsequent to the adoption of the guidance, we would expect either a qualitative or quantitative analysis to be performed as often as the hedge documentation for the hedging relationship requires an assessment of effectiveness and measurement of ineffectiveness (whether on a daily, weekly, monthly, quarterly, or other basis).

This guidance should not be analogized to other fact patterns.

**42.07** Even though the discussion of hedging net investment is limited in the Standard, the FASB has provided guidance on various issues through the DIG process. The following section of the section discusses:

- Forward premium or discount;
- Designation of hedged net investment;
- Unit with the exposure must be a party to the hedge;
- Combination of hedging instruments;
- Hedging with tandem currencies;
- Use of a compound derivative with multiple underlyings; and
- Foreign-currency-denominated debt as the hedging instrument and hedged item.

**Forward Premium or Discount**

**42.08** The Standard does not permit amortizing ratably to income the premium or discount (spot/forward difference) associated with a forward contract used as the hedging instrument. Guidance is set forth starting with Paragraph 42.22 of this section on how to measure ineffectiveness of the hedging relationship and how to record the hedging instrument on the balance sheet. (See DIG Issue H6 for further reference).

**Designation of Hedged Net Investment**

**42.09** Determining the amount of the net investment to hedge presents a challenge because the net investment balance is constantly changing as a subsidiary generates profits and losses. Entities may want to assess effectiveness and measure ineffectiveness of the hedging relationship based on the beginning, ending or average balance of the net investment. We believe that using
the ending or average balance would be tantamount to hedging the foreign currency exposure associated with the future net income (loss) of a foreign operation. This is not acceptable under the Standard since hedging forecasted foreign-currency-denominated inflows and outflows in one hedged portfolio is not permitted (paragraph 40(d) (ASC paragraph 815-20-25-39(c))). We believe entities should assess effectiveness and measure ineffectiveness of the hedging relationship at the beginning of the hedging period based on the beginning balance of the net investment.

42.10 An entity is required to consider the need to redesignate prospectively the hedging relationship whenever financial statements or earnings are reported, and at least every three months. An entity is not required to redesignate the hedging relationship more frequently even when a significant transaction (e.g., a dividend or additional investment) occurs during the interim period. However, entities may wish to do so to avoid volatility in the net investment hedge. An entity that expects its net investment in a foreign operation to decrease during the quarter may want to consider redesignating the hedged amount at the beginning of each month to mitigate the amount of volatility that would otherwise be included in the CTA. We believe this may be preferable in situations where the entity expects significant decreases during a quarter. (See DIG Issue H7 for further reference.)

42.11 The combination of assessing effectiveness and measuring ineffectiveness based on the beginning balance of the net investment with the requirement that subsequent period’s designation be performed prospectively creates the possibility that the offsetting amounts to be included in the CTA for the hedging instrument and the translation of the net investment may not equal. For example, on January 1, 20X0, an entity enters into a six-month foreign currency forward contract to sell SF1,000. This contract is designated as a hedge of the foreign currency exposure in its net investment of Subsidiary X. The Subsidiary X net investment balance at January 1, 20X0 is SF1,000. At March 31, 20X0, the net investment balance has declined to SF800. However, for the quarter ended March 31, 20X0, the entire change in fair value of the foreign currency forward contract is reflected in the CTA as the entire contract was designated and deemed effective as a hedge of the beginning balance of the net investment. On April 1, 20X0, Company A would need to prospectively redesignate up to 80% of the forward contract as a hedge of the net investment. The remaining 20% prospectively would be speculative or could be designated to hedge another risk.

42.12 The following example illustrates assessing effectiveness and measuring ineffectiveness of a hedge of the foreign currency exposure of a net investment based on the beginning balance of the net investment:

**Example 7.20: Assessing Effectiveness and Measuring Ineffectiveness of a Hedge of the Foreign Currency Exposure of a Net Investment**

KMD Company enters into a foreign currency forward contract that has a Canadian dollar (CAD) notional amount of CAD100,000 that is equal to the beginning balance of its net investment in a foreign operation in Canada. This foreign currency forward contract is immediately designated as a hedge of the entire beginning balance of the net investment at the inception of the hedge. As the net investment changes, KMD will assess the original hedging relationship at the end of every quarter and decide whether it needs to remove (i.e.,
dedesignate) part of the original relationship or designate a new hedging relationship for the following quarter. The following presents one method of such redesignation in those circumstances in which KMD chooses not to obtain a new derivative:

If the net investment had increased (e.g., to CAD 120,000), the original forward contract would be redesignated prospectively as hedging only a portion of the beginning balance of the net investment in that foreign operation. KMD could enter into an additional forward contract to hedge the net investment balance exceeding the original forward contract’s notional amount.

If the net investment had decreased (e.g., to CAD 90,000), only a proportion of the forward contract could be designated prospectively as hedging the entire beginning balance of the net investment in that foreign operation. The proportion of the forward contract not designated prospectively as the hedging instrument in the net investment hedge could be designated as a hedging instrument in a different hedging relationship or simply reported at fair value with its gain or loss subsequent to the dedesignation date recognized currently in earnings.

The full change in the fair value of the CAD 100,000 foreign currency forward contract would be recorded in the CTA for the quarter then ended for both scenarios above.

Unit with the Exposure Must Be a Party to the Hedge

42.13 Paragraphs 40(a) and 40(b) of the Standard (ASC paragraph 815-20-25-30) requires that the operating unit that has the foreign currency exposure be a party to the derivative hedging instrument and that the hedged transaction be denominated in a currency other than that unit’s functional currency. Another member of the consolidated group that has the same functional currency as the operating unit could also be party to the hedging instrument if there is no intervening subsidiary with a different functional currency. The application of paragraphs 40(a) and 40(b) (ASC paragraph 815-20-25-30) to hedges of the foreign currency exposure of a net investment changes certain practices followed before adoption of the Standard. For instance, before the adoption of the Standard, a parent company could designate in the consolidated financial statements, a nonderivative foreign-currency-denominated financial instrument entered into by Subsidiary A as the hedge of the parent’s net investment in Subsidiary B regardless of the functional currency of the Subsidiary A.

42.14 The following example illustrates this change in practice:

Example 7.21: Hedging a Foreign Net Investment with a Foreign-Currency-Denominated Liability of Another Subsidiary

Parent Co’s functional currency is the U.S. dollar. Parent Co. has two subsidiaries, Sub N in New Zealand and Sub J in Japan. The functional currency of each subsidiary is its local currency.

Under previous accounting, Sub N could issue yen-denominated notes and Parent could designate the notes payable as the hedging instrument in its hedge of its net investment in Sub J in the consolidated financial statements. However, this strategy is not permissible under the
Standard because Sub N is not part of the operating unit that has the foreign currency exposure.

Assume the same facts as above except that Sub N’s functional currency is the U.S. dollar. Under the Standard, Sub N could issue yen-denominated notes and Parent could designate the notes payable as the hedging instrument in its hedge of its net investment in Sub J since Sub N has the same functional currency as Parent and there are no intervening subsidiaries with a different functional currency.

On a consolidated basis, Parent will translate Sub J’s financial statements from its functional currency into U.S. dollars. Any foreign currency translation gains or losses are recorded in CTA. In the example where Sub N has a functional currency of the US dollar, to the extent that Sub N’s yen-denominated note is effective at hedging the exchange gains or losses arising on translation of Sub J’s financial statements from yen to U.S. dollars, the gain or loss in Sub N’s separate financial statements related to remeasuring the yen-denominated note to U.S. dollars will be reclassified in consolidation to the CTA. To the extent that the hedge has been ineffective, only the effective portion of the gain or loss recognized in Sub N’s separate financial statements will be reclassified to CTA. As a result, the ineffective portion of the hedge would be recognized currently in consolidated earnings.

In its separate financial statements, Sub N’s yen-denominated note would be remeasured at spot through earnings to its functional currency, the U.S. dollar, at period-end. The hedging relationship and special hedge accounting only exists in the context of the consolidated financial statements.

Combination of Hedging Instruments

42.15 The Standard prohibits considering a separate derivative and a nonderivative financial instrument as a combined hedging instrument (i.e., *single synthetic instrument*) for hedge accounting purposes. For example, a parent company that has the U.S. dollar as both its functional currency and its reporting currency has a net investment in a Japanese yen-functional-currency subsidiary. The parent issues fixed-rate, euro-denominated debt and simultaneously enters into a receive-euros, pay-yen currency swap (for all interest and principal payments) to synthetically convert the borrowing into a fixed-rate, yen-denominated borrowing. The parent company in this example cannot designate the euro-denominated borrowing and the currency swap in combination as a hedging instrument for its net investment in the Japanese yen-functional-currency subsidiary. This approach would result in measuring a derivative and a financial instrument as a single unit at the current spot rate (synthetic accounting), which violates the requirements of Statement 52 (ASC Topic 830) for remeasurement of foreign-currency-denominated debt at the spot rate relevant to the currency of the borrowing. It also violates the requirements of the Standard for measurement of all derivatives at fair value. (See DIG Issue H10 for further reference.)

42.16 In contrast, an entity could designate a foreign currency derivative and a foreign-currency-denominated nonderivative financial instrument individually as hedging different portions of its net investment in a foreign operation provided the derivative and the nonderivative financial instrument each individually qualified as a hedging instrument. For example, a Japanese yen-
U.S. dollar forward contract and a Japanese yen-denominated nonderivative financial instrument could each be designated as the hedging instrument in a hedge of different portions of the net investment in a Japanese yen-functional-currency subsidiary (i.e., two separate hedging relationships would be designated).

**Hedging with Tandem Currencies**

42.17 Under the Standard, the use of a tandem currency hedge is permitted. Entities may hedge the foreign currency risk inherent in a net investment in a foreign operation denominated in one currency using a derivative or nonderivative financial instrument denominated in a different currency (tandem currency), as long as the hedging relationship is expected to be, and is effective, as an economic hedge. Example 7.6 of this section provides an example of a tandem currency hedge. Measuring the amount of ineffectiveness in a net investment hedge for a derivative, including a derivative with multiple underlyings (currencies), is discussed starting with Paragraph 42.22 of this section.

**Use of a Compound Derivative with Multiple Underlyings**

42.18 An entity cannot use a compound derivative that has multiple underlyings—one based on foreign exchange risk and one or more not based on foreign exchange risk (e.g., interest rate index, Standard & Poor’s (S&P) 500)—as the hedging instrument in a net investment hedge. A receive-variable, pay-variable cross-currency interest rate swap can be designated as the hedging instrument in a net investment hedge if: (1) the interest rates are based on the same currencies contained in the swap, and (2) both legs of the swap have the same repricing intervals and dates. The ability to use this cross-currency interest rate swap as the hedging instrument is based on the fact that its fair value is primarily driven by changes in foreign exchange rates rather than changes in interest rates. Therefore, foreign exchange risk, rather than interest rate risk, is the dominant risk exposure in such a swap. In contrast, a cross-currency interest rate swap with one fixed-rate leg and one variable leg may not be designated as the hedging instrument in a net investment hedge. Measuring the amount of ineffectiveness in a net investment hedge for a qualifying derivative that has multiple underlyings is discussed starting with Paragraph 42.22 of this section.

42.19 A receive-fixed, pay-fixed cross-currency interest rate swap also qualifies to be designated as the hedging instrument in a net investment hedge. A cross-currency interest-rate swap that has two fixed interest legs is not a compound derivative because foreign currency rate changes primarily affect changes in its fair value. This type of derivative reacts very similarly to a foreign currency forward contract. Therefore, the general prohibition discussed above does not affect such a derivative. (See DIG Issue H9 for further reference.)

**Foreign-Currency-Denominated Debt as the Hedging Instrument and Hedged Item**

42.20 A foreign-currency-denominated fixed-rate debt instrument designated as the hedging instrument in a net investment hedge may also be designated as the hedged item in a fair value hedge of interest rate risk. The two hedging relationships address separate types of risk, which can be hedged individually under the Standard. As a result of applying fair value hedge accounting, the debt’s carrying amount will be adjusted to reflect changes in its foreign-
currency-denominated fair value attributable to interest rate risk. The notional amount of the debt
designated to hedge the net investment amount will change over time. When an entity performs
its quarterly redesignation of its net investment hedge, (see Paragraph 42.09 of this section) it
may have to adjust the amount of the hedged net investment due to changes in the debt’s notional
amount. Guidance for measuring ineffectiveness when the notional amount of the debt does not
equal the designated hedged amount is provided in Paragraph 42.34 of this section. (See DIG
Issue H11 for further reference.)

42.21 We believe a foreign-currency-denominated variable-rate debt instrument could be
designated as the hedging instrument in a net investment hedge and be the hedged item in a cash
flow hedge of interest rate risk. The cash flow accounting model does not result in adjusting
the notional amount of the debt so the quarterly redesignation (a concept discussed in Paragraph
42.09 of this section) would focus on changes of the net investment balance in assessing the
prospective hedged amount.

MEASURING THE AMOUNT OF INEFFECTIVENESS

42.22 Paragraph 42 of the Standard (ASC paragraphs 815-20-25-66 and 815-35-35-1 and 35-2)
requires that “the gain or loss on a hedging derivative instrument (or the foreign currency
transaction gain or loss on the nonderivative hedging instrument) that is designated as, and is
effective as, an economic hedge of the net investment in a foreign operation shall be reported in
the same manner as a translation adjustment “to the extent it is effective as a hedge.” The phrase
“to the extent it is effective as a hedge” determines the amount of ineffectiveness that is
recognized in earnings. However, the Standard does not provide detailed guidance regarding the
application of that phrase or how to determine the amount of any hedge ineffectiveness in a net
investment hedge. DIG Issue No. H8, "Measuring the Amount of Ineffectiveness in a Net
Investment Hedge," addresses how an entity should measure the amount of ineffectiveness that
must be recognized in earnings for a qualifying derivative or nonderivative instrument
designated as a hedge of a net investment in a foreign operation.

MEASURING INEFFECTIVENESS WITH A DERIVATIVE HEDGING INSTRUMENT

42.23 If a derivative instrument, including a purchased option, is used as the hedging instrument,
an entity is permitted to measure the amount of ineffectiveness in a net investment hedge using
either a method based on changes in spot exchange rates (intrinsic value for purchased options)
or on changes in forward exchange rates (total value for purchased options). However, an entity
must consistently use the same method for all its net investment hedges in which the hedging
instrument is a derivative; for example, the use of the spot method for some net investment
hedges and the forward method for other net investment hedges is not permitted. Also see
Paragraphs 42.06a-42.06g for a discussion of the impact of credit risk and master netting
agreements on derivative instruments and hedging relationships.

Method Based On Changes In Forward Rates

42.24 An entity may elect to measure ineffectiveness based on forward rates. If (a) the notional
amount of the derivative designated as a hedge of a net investment in a foreign operation
matches (i.e., equals) the portion of the net investment designated as being hedged, (b) the
derivative’s underlying relates solely to the foreign exchange rate between the functional
currency of the hedged net investment and the investor’s functional currency, and (c) the derivative has a fair value of zero at the date of hedge designation (see additional discussion in Paragraph 42.26a), all changes in fair value of the derivative should be reported in the same manner as a translation adjustment (i.e., reported in CTA). In that instance, no hedge ineffectiveness would be recognized in earnings. The time value component of purchased options or forwards, or the interest accrual/periodic cash settlement components of qualifying cross-currency interest rate swaps would remain in CTA. A qualifying cross-currency interest rate swap as discussed in Paragraphs 42.18 and 42.19 is a receive-variable, pay-variable cross-currency interest rate swap that has interest rates based on the same currencies contained in the swap where both legs of the swap have the same repricing intervals and dates or is a receive-fixed, pay-fixed cross-currency interest rate swap.

However, regardless of the hedging instrument, recognition of hedge ineffectiveness in earnings is required if:

(a) The notional amount of the derivative does not match the portion of the net investment designated as being hedged,

(b) The derivative’s underlying exchange rate is not the exchange rate between the functional currency of the hedged net investment and the investor’s functional currency, or

(c) The hedging derivative is a qualifying receive-variable, pay-variable cross-currency interest rate swap in which both legs are not based on comparable interest rate curves (e.g., pay foreign currency based on three-month LIBOR, receive functional currency based on three-month commercial paper rates). We interpret comparable interest rate curves to be comparable credit quality curves. In other words, a U.S. dollar LIBOR and euro LIBOR index would be comparable, whereas the commercial paper rate and a LIBOR index rate reflect different credit quality.

42.25 We believe most entities would prefer measuring ineffectiveness based on changes in the forward rate, as no ineffectiveness would be recognized in earnings if the notional amount and underlying currency in the hedging relationship match (see also the discussion in Paragraph 42.26a about hedging with derivatives that have a fair value other than zero at hedge designation). Additionally, for a hedging cross-currency swap, the interest rate indices would need to match the currency of the swap and be of comparable credit quality. If this were true, this method would enable an entity to recognize the cost (periodic cash settlement) of the hedging instrument in CTA and not earnings.

42.26 The measurement of hedge ineffectiveness due to the differences described above between the hedging derivative and the hedged net investment considers:

- **Different Notional Amounts.** If the notional amount of the hedging derivative does not match the portion of the net investment being hedged, the amount of hedge ineffectiveness required to be recognized in earnings must be measured by comparing the change in fair value of the actual hedging derivative and the change in fair value of a hypothetical derivative contract that has a notional amount that matches the portion of the net investment being hedged. The hypothetical derivative must also have a maturity that matches the maturity of the actual derivative designated as the
net investment hedge. Paragraph 42.26b presents a discussion of determining whether notional amounts match when a derivative’s coupons have been leveraged.

- **Different Currencies.** If the hedging derivative has an underlying foreign exchange rate that is not the exchange rate between the functional currency of the hedged net investment and the investor’s functional currency (a *tandem currency* hedge), the amount of hedge ineffectiveness required to be recognized in earnings must be measured by comparing the change in fair value of the actual hedging derivative with the change in fair value of a *hypothetical* derivative contract that has as its underlying the foreign exchange rate between the functional currency of the hedged net investment and the investor’s functional currency. The *hypothetical* derivative must also have a maturity date, repricing dates and payment frequencies for any interim payments that match the actual derivative designated as the net investment hedge.

- **Multiple Underlyings.** The only derivatives with multiple underlyings permitted to be designated as a hedge of a net investment are qualifying cross-currency interest rate swaps as discussed in Paragraphs 42.18 and 42.19. If a qualifying receive-variable, pay-variable cross-currency interest rate swap is the hedging instrument, but, for example, the interest rate curves are not comparable, the amount of hedge ineffectiveness to be recognized in earnings must be measured by comparing the change in fair value of the actual cross-currency interest rate swap with the change in fair value of a *hypothetical* receive-variable, pay-variable cross-currency interest rate swap. The *hypothetical* swap would be based on the functional currencies of the hedged net investment and the investor, with the interest rates based on the same currencies and comparable interest rate curves, and both legs of the *hypothetical* swap having the same repricing intervals and dates.

- If a receive-fixed, pay-fixed cross-currency interest rate swap is designated as the hedging derivative in a net investment hedge, but, for example, the hedge uses a tandem currency, the amount of hedge ineffectiveness required to be recognized in earnings must be measured by comparing the change in fair value of the actual cross-currency interest rate swap with the change in fair value of a *hypothetical* receive-fixed, pay-fixed cross-currency interest rate swap. The *hypothetical* swap would be based on the functional currencies of the hedged net investment and the investor, with the interest rates based on the same currencies contained in the *hypothetical* swap. The *hypothetical* derivative must also have a maturity that matches the maturity of the actual cross-currency interest rate swap designated as the net investment hedge.

42.26a In the absence of further clarification by the standard-setter, if the hedging instrument in a qualifying net investment hedging relationship meets the first two criteria in Paragraph 42.24 (i.e., (a) the notional amount of the derivative designated as a hedge of a net investment in a foreign operation matches (i.e., equals) the portion of the net investment designated as being hedged and (b) the derivative’s underlying relates solely to the foreign exchange rate between the functional currency of the hedged net investment and the investor’s functional currency) but the fair value of the hedging instrument on the date of designation is other than zero, we believe there are two different approaches an entity may take to recognize and measure ineffectiveness.
• **Approach 1:** Assumes the hypothetical derivative would be constructed with similar notional amounts, currencies, and underlyings as the hedging derivative; however the underlying rates would be the current market rates at the date of designation such that the hypothetical derivative would have a fair value of zero at the date of designation. This approach would isolate any ineffectiveness resulting from the embedded financing element and an entity would record those amounts in the income statement as ineffectiveness. This approach would be consistent with the required approaches when the fair value of a hedging instrument in a cash flow or fair value hedging relationship is other than zero on the date of hedge designation.

• **Approach 2:** Assumes that there would be no ineffectiveness to measure or recognize during the hedging relationship. This approach would be consistent with the wording in ASC Topic 815 (as summarized in Paragraph 42.24) that described three potential sources of ineffectiveness in a net investment hedging relationship – none of which relate to a requirement that the fair value of the hedging instrument must be zero at the date of designation.

We believe both approaches are acceptable for a hedge of a net investment in a foreign operation, however we believe most entities apply the second approach in practice as it is consistent with the general theory that an entity is required to have an expectation that the derivative will be effective as an economic hedge of foreign exchange risk associated with the hedged net investment. Entities should adopt a policy and apply it on a consistent basis for all hedges of net investments in foreign operations.

42.26b When a qualifying pay-variable, receive-variable cross currency swap or a pay-fixed, receive-fixed cross currency swap is designated as the hedging derivative in a net investment hedge, sometimes the terms of the swap are such that the coupons in the two currencies may be at levels higher than normal market rates yet the fair value of the swap at inception is still zero. For example, a USD functional currency entity has a Euro denominated foreign operation and wants to hedge its Euro net investment using a Euro/USD pay-fixed, receive-fixed cross currency interest rate swap for a notional amount of Euro 100 million/USD 113 million. The normal market terms of the swap may have fixed coupons of 1.5% for Euro and 2% for USD. If the entity decides to increase the coupon on the receive USD leg to 2.5%, the pay Euro leg of the swap can be adjusted to an amount higher than 1.5% so that the fair value of the swap at inception is still zero. It may appear that this swap will meet all the criteria outlined in ASC paragraph 815-35-35-18; however if leverage has been added to the coupon rates of the swap, it would effectively increase the notional amount of the swap. If the notional amounts have effectively been increased, then one criterion in ASC paragraph 815-35-35-18 would not be met (the notional amount of the derivative instrument does not match the portion of the net investment designated as being hedged) resulting in recognition of some ineffectiveness in net earnings. We would generally not consider leverage to have been added to the coupon rates of the swap if the rates were market rates at the swap’s inception, even if the swap was later designated as a hedging derivative when market rates changed.

42.27 If ineffectiveness must be recognized in earnings because the hedging instrument involves multiple differences (i.e., different notional amounts, currencies, and underlyings), the amount of ineffectiveness can be determined by a single comparison to the appropriate hypothetical derivative contract that does not incorporate those differences.

© 2019 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
42.28 It should be noted that, in order to designate a derivative as a hedge of a net investment, an entity is required to have an expectation that the derivative will be effective as an economic hedge of foreign exchange risk associated with the hedged net investment. Accordingly, if any difference in notional amount, currencies, or underlyings is present, the entity must establish an expectation that the actual derivative designated as the hedging instrument will be effective as an economic hedge. For example, if an entity designates a derivative that has an underlying exchange rate involving a currency other than the functional currency of the net investment, that exchange rate must be expected to move in tandem with the exchange rate between the functional currency of the hedged net investment and the investor’s functional currency. The determination of whether the derivative qualifies for net investment hedge accounting should be consistent with the approach used in the prior application of Statement 52 (ASC Topic 830) to determine whether a hedging instrument would be economically effective as a net investment hedge.

42.29 If any difference exists between the hedging derivative and the hedged net investment, changes in value of the hypothetical derivative must be recorded in the CTA. Any difference between the change in fair value of the hypothetical derivative and the actual hedging derivative must be recognized in earnings. Because the provisions of paragraph 42 of the Standard (ASC paragraphs 815-20-25-66 and 815-35-35-1 and 35-2), which in large part were carried forward from Statement 52 (ASC Topic 830), clearly imply that hedge ineffectiveness must be recognized currently in earnings, ineffectiveness in a net investment hedge must be recognized in earnings for both overhedges and underhedges. As a result, if the change in the fair value of the actual hedging derivative exceeds the change in fair value of the hypothetical derivative contract, the difference represents an overhedge that must be recognized in earnings. Similarly, if the change in fair value of the actual hedging derivative is smaller than the change in fair value of the hypothetical derivative contract, the difference represents an underhedge that must be recognized in earnings. The recognition of hedge ineffectiveness for an underhedge of an entity’s net investment in a foreign operation differs from the accounting for cash flow hedges.

42.30 Paragraph 71 of the Standard (ASC paragraph 815-30-35-5) permits hedging foreign currency risk on an after-tax basis, provided that the documentation of the hedge at its inception indicated that the assessment of effectiveness, including the calculation of ineffectiveness, will be on an after-tax basis (rather than on a pre-tax basis). If an entity has elected to hedge foreign currency risk on an after-tax basis, it must adjust the notional amount of its derivative appropriately to reflect the effect of tax rates. In that case, the hypothetical derivative contract used to measure ineffectiveness should have a notional amount that has been appropriately adjusted (pursuant to the documentation at inception) to reflect the effect of the after-tax approach.

Method Based On Changes In Spot Rates

42.31 An entity may elect to measure ineffectiveness based on spot rates. If the notional amount of the derivative designated as a hedge of a net investment in a foreign operation matches (i.e., equals) the portion of the net investment designated as being hedged, the derivative’s underlying exchange rate is the exchange rate between the functional currency of the hedged net investment and the investor’s functional currency, and the hedging derivative is, for example, a qualifying cross-currency interest rate swap or a forward contract, the change in the fair value of the...
derivative attributable to changes in the difference between the forward rate and spot rate would be excluded from the measure of hedge ineffectiveness and that change would be reported directly in earnings. The interest accrual/periodic cash settlement components of, for example, a qualifying cross-currency interest rate swap would also be reported directly in earnings. The effective portion of the change in fair value should be reported in the same manner as a translation adjustment (i.e., reported in the CTA). The effective portion that would be reported in the CTA should be determined based on changes in spot exchange rates. The spot-to-spot changes in value reported in the CTA should not be discounted.

42.32 If the notional amount of the derivative does not match the portion of the net investment designated as being hedged, or the derivative’s underlying exchange rate is not the exchange rate between the functional currency of the hedged net investment and the investor’s functional currency, or the hedging derivative is a qualifying cross-currency interest rate swap in which both legs are not based on comparable interest rate curves (i.e., comparable credit quality), the effective portion that would be reported in the CTA is based on a hypothetical derivative that does not incorporate those differences. Any difference between the hypothetical derivative and actual derivative must be recognized in earnings. That is, ineffectiveness must be recognized in earnings for both overhedges and underhedges. The hypothetical derivative must also have a maturity date, repricing dates and payment frequencies for any interim payments that match the actual derivative designated as the hedging instrument in the net investment hedge.

MEASURING INEFFECTIVENESS WITH A NONDERIVATIVE HEDGING INSTRUMENT

42.33 If the notional amount of the nonderivative foreign-currency-denominated financial instrument matches the portion of the net investment designated as being hedged and is denominated in the functional currency of the hedged net investment, the foreign currency transaction gain or loss upon remeasurement at the spot rate (after tax effects, if appropriate) should be reported in the same manner as the translation adjustment associated with the hedged net investment (i.e., reported in the CTA). In that case, no hedge ineffectiveness would be recognized in earnings.

42.34 Recognition of hedge ineffectiveness in earnings is required if the notional amount of the nonderivative instrument does not match the portion of the net investment designated as being hedged or the nonderivative instrument is denominated in a currency other than the functional currency of the hedged net investment. In that case, ineffectiveness must be recognized in earnings by comparing the foreign currency transaction gain or loss based on the spot rate change (after tax effects, if appropriate) of the nonderivative instrument to a transaction gain or loss based on the spot rate change (after tax effects, if appropriate) that would result from the appropriate hypothetical nonderivative instrument that does not incorporate those differences. Any difference between the spot rate change of the hypothetical nonderivative instrument and the actual hedging nonderivative instrument must be recognized in earnings. That is, ineffectiveness must be recognized in earnings for both overhedges and underhedges. The hypothetical nonderivative must also have a maturity that matches the maturity of the actual nonderivative designated as the net investment hedge.

42.35 Set forth below are examples that illustrate hedging a net investment in a foreign operation:
Both examples assume that all criteria for hedge accounting have been met at the onset of the hedging relationship and at each period-end.

### Example 7.22: Hedging a Net Investment in a Foreign Operation with a Foreign Currency Forward Contract

Owner Inc.’s functional currency is the U.S. dollar. Owner has a wholly-owned subsidiary, York Co. The functional currency of York is the pound sterling (£). As of January 1, 20X1, Owner has a net investment of £10,000,000. To hedge this net investment, Owner enters into a six-month pound sterling foreign currency forward contract that settles net cash. The foreign currency forward contract allows Owner to sell £10,000,000 on June 30, 20X1 at a fixed contract price of £1 = $1.50. The contract is at market, thus, no cash is exchanged at inception. Owner elects to measure ineffectiveness based on changes in the forward rates and on the beginning balance of the net investment at the beginning of the hedging period. Accordingly, all changes in the fair value of the forward contract will be reported in CTA since the hedged amount matches the notional amount of the forward contract and the underlying currency of the forward matches York’s functional currency. For the same reasons Owner believes the foreign currency forward contract will provide an economically effective hedge of its net investment in York.

#### Assumptions

The spot exchange rates, forward exchange rates, fair value of the foreign currency forward contract and changes in fair value are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Spot</th>
<th>Forward</th>
<th>Fair Value</th>
<th>Changes in Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X1</td>
<td>£1 = $1.475</td>
<td>£1 = $1.50</td>
<td>$ —</td>
<td>$ —</td>
</tr>
<tr>
<td>March 31, 20X1</td>
<td>£1 = $1.48</td>
<td>£1 = $1.55</td>
<td>(493,000) 1</td>
<td>(493,000)</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>£1 = $1.45</td>
<td>—</td>
<td>500,000</td>
<td>993,000</td>
</tr>
</tbody>
</table>

1 Determined using the change in forward rates discounted at the risk-free rate.

Also assume Owner’s net investment in York did not change during the hedging relationship (i.e., York’s operations were break-even during the period). Owner on April 1, 20X1 redesignated this hedging relationship to be for the balance of the net investment at April 1, 20X1 of £10,000,000. The foreign currency forward contract settles on June 30, 20X1 with Owner receiving $500,000 [£10,000,000*(£1.50-$1.45)].
(a) There would be a memorandum entry on January 1, 20X1, documenting the existence of this hedging relationship. The financial records of Owner would not otherwise be impacted as of this date because the foreign currency forward contract was at market rates.

(b) The journal entry as of March 31, 20X1 would be as follows:

1. Investment in York (B/S) $ 50,000
   Cumulative translation adjustment (AOCI) $ 50,000
   (To record the change in the carrying value of the net investment in York due to movement in spot exchange rates from January 1 to March 31)

2. Cumulative translation adjustment (AOCI) 493,000
   Forward Contract (B/S) 493,000
   (To record the change in the fair value of the foreign currency forward contract. The amount recorded in CTA is the entire change in fair value of the foreign currency forward contract since Owner elected to measure ineffectiveness based on the forward method and to use the beginning balance of the net investment at the beginning of the hedged period)

(c) The journal entry as of June 30, 20X1 would be as follows:

1. Cumulative translation adjustment (AOCI) 300,000
   Investment in York (B/S) 300,000
   (To record the change in the carrying value of the net investment in York due to movements in spot exchange rates from April 1 to June 30)

2. Forward Contract (B/S) 993,000
   Cumulative translation adjustment (AOCI) 993,000
   (To record the change in the fair value of the foreign currency forward contract)

3. Cash (B/S) 500,000
   Forward Contract (B/S) 500,000
   (To record the settlement of the foreign currency forward contract at 6/30/X1)

Observations

Owner was concerned that the dollar would strengthen relative to the sterling and entered into a foreign currency forward contract to hedge its net sterling investment. As a result of entering into this hedge, Owner locked in an exchange rate of £1=$1.50. Because the
spot exchange rate at the end of the hedge period was £1=$1.45, the counterparty paid Owner $500,000 (($1.50-1.45)*£10,000,000).

During the six months ended June 30, 20X1, Owner recorded a change in its net investment in York of $250,000 and an offsetting change in the fair value of the forward contract of $500,000 in CTA. The change in fair value of the forward contract exceeded the translation loss by $250,000. This amount is the forward to spot premium that Owner received from entering into the forward contract (($1.50 forward rate -1.475 spot rate at 1/1/X1)*£10,000,000). If Owner elected to measure ineffectiveness based on changes in the spot rate the $250,000 would have been recognized in earnings.

Example 7.23: Hedging a Net Investment in a Foreign Operation with a Foreign-Currency-Denominated Loan

Owner Inc.’s functional currency is the U.S. dollar. Owner has a wholly-owned subsidiary, Euroland Corp. The functional currency of Euroland is the EUR. As of January 1, 20X1, Owner has a net investment in Euroland of EUR 10,000,000. Owner also has a EUR 12,000,000 loan that matures on June 30, 20X1. Owner designates EUR 10,000,000 of this loan to hedge its EUR 10,000,000 net investment. Owner believes that since the hedged amount matches and the loan is denominated in euros the hedging relationship will provide an economically effective hedge of its net investment in Euroland.

Assumptions

The spot exchange rates and changes for remeasurement at the spot rate are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Spot</th>
<th>EUR 10,000,000</th>
<th>EUR 12,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 20X1</td>
<td>EUR 1 = $.90</td>
<td>$—</td>
<td>$—</td>
</tr>
<tr>
<td>March 31, 20X1</td>
<td>EUR 1 = $.95</td>
<td>$500,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>June 30, 20X1</td>
<td>EUR 1 = $.85</td>
<td>$1,000,000</td>
<td>$1,200,000</td>
</tr>
</tbody>
</table>

Also assume Owner’s net investment in Euroland did not change during the hedging relationship (i.e., Euroland’s operations were break-even during the period). Owner on April 1, 20X1 redesignated this hedging relationship to be for the balance of the net investment at April 1, 20X1 of EUR 10,000,000.

(a) There would be a memorandum entry made on January 1, 20X1 documenting the existence of this hedging relationship.

(b) The journal entry as of March 31, 20X1 are as follows:

1. Investment in Euroland (B/S) $500,000
   Cumulative translation adjustment (AOCI) $500,000

   (To record the change in the carrying value of the net investment in Euroland due to movement in spot exchange rates from January 1 to March 31)
2. Cumulative translation adjustment (AOCI) 500,000
   Other Income/expense (P&L) 100,000
   Loan (B/S) 600,000

(To record the remeasurement of the loan to the functional currency at the March 31 spot rate. The remeasurement of EUR 10,000,000 of the loan is recorded in CTA since it was designated as hedging the corresponding EUR net investment amount. The remeasurement of the undesignated portion of EUR 2,000,000 is recorded in earnings)

(b) The journal entries as of June 30, 20X1 are as follows:

1. Cumulative translation adjustment (AOCI) 1,000,000
   Investment in Euroland (B/S) 1,000,000

(To record the change in the carrying value of the net investment in Euroland due to movement in spot exchange rates from April 1 to June 30)

2. Loan (B/S) 1,200,000
   Cumulative translation adjustment (AOCI) 1,000,000
   Other Income/expense (P&L) 200,000

(To record the remeasurement of the loan to the functional currency at the June 30 spot rate)

Observations

Owner was concerned that the dollar would strengthen relative to the EUR and designated a EUR denominated loan as a hedge of its net investment. As a result of entering into this hedge, Owner was able to offset translation gains and losses on its net investment. This was achieved by recording the Statement 52 (ASC Topic 830) remeasurement adjustment on the designated portion of the EUR loan (EUR 10,000,000) in CTA to offset the translation adjustment. Without the designation of the EUR loan as a hedging instrument, the remeasurement adjustment would have been recorded in earnings, creating foreign exchange volatility in Owner’s earnings. Note that the undesignated portion of the loan (EUR 2,000,000) continued to be remeasured at the spot rate through earnings.

QUESTIONS & ANSWERS

Foreign-Currency-Denominated Firm Commitments and Fair Value Hedges
(paragraph 37 of the Standard (ASC paragraph 815-20-25-58))
1. Empire Inc. is a manufacturing company. Its functional currency is the U.S. dollar. A major component in its manufacturing process (CPUs) comes from Asia Corp., an unrelated Japanese supplier. No other supplier has a product that meets Empire’s specifications. In order to ensure CPU availability, Empire Inc. enters into a contract with Asia Corp. to purchase a minimum of 1,000 CPUs each month for the next 12 months. The cost of each CPU is 10,000 yen. There are significant penalties if the contract is broken.

Q(a) Does Empire have a foreign-currency-denominated firm commitment that it can designate as the hedged item?

A. Yes. The definition of a firm commitment is set forth in Appendix F to the Standard (ASC Section 815-10-20). It requires that the commitment have, among other things, a fixed price and quantity, that the timing of the transaction be known, and that the agreement include a sufficiently large disincentive for nonperformance to make performance probable. The fixed price may be expressed as a specific amount of an entity’s functional currency or of a foreign currency. Empire’s commitment has all of these features. The fixed price has been specified in yen, a currency other than Empire’s functional currency.

Q(b). Could Empire designate the hedged item as being the foreign currency exposure associated with any 500 units being acquired each month?

A. No. Paragraph 21(a) of the Standard (ASC paragraphs 815-20-25-12(a) and 25-12(b)) states that the hedged item must be all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. In this instance, Empire has not identified a specific portion as the hedged item. The proposed hedged item could be any 500 units acquired during the month. Without knowing specifically which units are being hedged, Empire cannot properly adjust the basis of those units when applying the fair value hedge accounting model.

Q(c). Could Empire hedge the foreign currency exposure associated with the first 500 units being acquired each month?

A. Yes. In this instance Empire has identified a specific portion of the unrecognized firm commitment and, therefore, there is no uncertainty as to which units acquired should include the effects of any accounting adjustments required under the fair value hedge accounting model.

2. Liberty Inc.’s functional currency is the U.S. dollar. Liberty pays royalties on each of the two products it sells. For one of its products, Liberty pays Samurai Corp. royalties of 10% of sales revenue on all U.S. sales. The royalty payments are made on January 15 and July 15 each year in yen at an exchange rate agreed at the start of the fiscal year. Liberty has a very stable sales history and has consistently achieved its stated budgets. Liberty expects to make royalty payments of the yen equivalent (at the agreed rate) of $5,000,000 on each of January 15 and July 15.
For Liberty’s second product, it pays Queen PLC royalties on all Liberty sales in the United Kingdom of a product licensed from Queen. The royalties are paid in pounds sterling and equal £200,000 per quarter plus two% of the quarterly sales revenue in excess of £5,000,000. The royalties are due 10 business days after the quarter-end. Liberty expects to pay Queen £300,000 per quarter.

In both instances, Liberty is subject to an enforceable contract with a third party and can estimate the quantity/price and timing of the payments with a high level of precision.

Q. Do the payments made pursuant to the royalty agreements meet the definition of a firm commitment?

A. The first agreement with Samurai is not a firm commitment. The definition of a firm commitment is set forth in Appendix F to the Standard (ASC Section 815-10-20). It requires that the commitment have, among other things, a fixed price and quantity to be exchanged. The royalty payments due under this contract depend solely on sales levels. Those sales levels are not determinable in advance and the royalty agreement does not include contractual minimums. Therefore, the fixed price and quantity requirements for a firm commitment have not been satisfied. This contract may, however, qualify as a designated item in a cash flow hedge because the anticipated payments due under the contract may qualify as forecasted transactions.

The second arrangement with Queen is a firm commitment because there is a £200,000 minimum contractual payment. That amount is not variable and is due to Queen regardless of the level of sale revenues. The remaining amounts (i.e., any royalty payable over £200,000) should be considered in the same manner as the agreement with Samurai.

3. ABC is a manufacturing company. Its functional currency is the U.S. dollar. ABC has entered into a contract with a foreign customer to sell to them 10,000 units of product each month. The price of the product is denominated in a foreign currency (FC) and is determined as the market price on the date of shipment. There are significant economic penalties resulting from breaking the contract.

Historically, the price of the product has ranged from FC80 to FC90 per unit. ABC wishes to hedge the currency exposure as a hedge of a firm commitment and has proposed hedging the first FC50 on each of its fixed quantity of units to be sold. ABC contends that sales below FC50 per unit are remote (as that term is used in FASB Statement No. 5 (ASC Topic 450, Contingencies), therefore, effectively, at least this amount (FC500,000) is fixed.

Q. Could ABC designate the first FC50 on each unit sold as the hedged item in a fair value hedge?

A. No. The definition of a firm commitment set forth in Appendix F to the Standard (ASC Section 815-10-20) states, among other things, that there must be a fixed price. In this instance, the price is the market price at the time of shipment and, therefore, it is not fixed until the time of shipment.
However, the transaction could be structured as a cash flow hedge if ABC’s transaction met the requirements for a forecasted transaction. This likely would be the case if ABC designated, say, the first 5,900 units of product to be shipped as the hedged item. Based on a forecasted price of FC85 per unit, the foreign currency hedge would cover sales of FC501,500. To be able to designate the forecasted sales as the hedged item in a cash flow hedge, ABC should be able to accurately estimate the expected currency amount of the sales. Given stable prices in the past and no expectation for significant change in the future, ABC would be able to specify the exact amount of foreign currency being hedged.

4. ERM Inc. is a manufacturing company. Its functional currency is the U.S. dollar. A major component of ERM’s manufacturing process (CPUs) is purchased from Asia Corp., an unrelated Japanese supplier. CPUs are readily available from a number of suppliers and there is little cost associated with switching suppliers. In order to ensure CPU availability, ERM has signed a letter of intent with Asia Corp. that specifies its likely CPU requirements. The letter of intent includes a fixed price.

Q. Does ERM have a foreign-currency-denominated firm commitment that it can designate as the hedged item?

A. No. The definition of a firm commitment set forth in Appendix F to the Standard (ASC Section 815-10-20) states, among other things, that the agreement must include a disincentive for nonperformance that is sufficiently large to make performance probable. ERM does not have a binding agreement for accounting purposes and there is not a sufficiently large economic disincentive restricting ERM from changing suppliers.

Forecasted Foreign-Currency-Denominated Transactions and Cash Flow Hedges
(paragraph 40 of the Standard (ASC paragraphs 815-20-25-28, 25-29, and 25-52))

5. XYZ has forecasted an acquisition of a pound sterling debt security with a three-year maturity. The debt security entitles XYZ to receive interest at a fixed rate of 8%.

Q(a). If XYZ intends to classify this debt security in the available-for-sale category after acquisition, can the foreign currency exposure inherent in the forecasted acquisition of the debt security be designated as the hedged item in a cash flow hedge?

A. Yes. Paragraph 36 of the Standard (ASC paragraphs 815-20-25-28, 25-29, and 25-52) permits a forecasted acquisition of an asset to be designated as a hedged item in a foreign currency cash flow hedge.

Q(b). If, subsequent to acquisition, the security is classified in the available-for-sale category and is the hedged item in a fair value hedge of foreign currency exposure, can XYZ hedge the interest rate risk associated with future interest receipts?

A. Yes. Paragraph 21(f) of the Standard (ASC paragraphs 815-20-25-12(f)) permits more than one risk present in a financial asset or liability to be hedged if the appropriate criteria
are met and the risk of changes in the entire fair value is not one of the designated risks being hedged.

6. PDQ Company, whose functional currency is the U.S. dollar, issues dual-currency bonds that provide for repayment of principal in U.S. dollars and periodic fixed-rate interest payments denominated in a foreign currency. PDQ wishes to lock in the U.S. dollar functional currency future interest expense and enters into a derivative instrument to hedge the foreign currency risk of the fixed foreign-currency-denominated interest coupon payments. For example, PDQ may enter into a series of foreign currency forward contracts to receive an amount of the foreign currency required to satisfy the coupon obligation in exchange for U.S. dollars at each coupon date.

Q. May the fixed-rate interest payments denominated in a foreign currency in the dual-currency bond be designated as the hedged transaction in a cash flow hedge of foreign exchange risk?

A. Yes. Statement 52 (ASC Topic 830) applies to dual-currency bonds and requires the present value of the interest payments denominated in a foreign currency to be remeasured and the transaction gain or loss recognized in earnings. Thus, those fixed-rate interest payments on a dual-currency bond could be designated as the hedged transaction in a cash flow hedge of foreign exchange risk.

7. On January 1, BFE Company enters into an agreement to sell 1,000 tons of inventory, a nonfinancial asset, to an unrelated party on June 30. The agreement meets the definition of a firm commitment in paragraph 540 of the Standard (ASC Section 815-10-20). The firm commitment is denominated in the buyer’s functional currency, which is not BFE’s functional currency. Accordingly, the firm commitment exposes BFE to foreign currency risk.

Q. May BFE choose to hedge that foreign currency exposure under the cash flow hedging model?

A. Yes. Although that definition of a firm commitment requires a fixed price, it permits the fixed price to be denominated in a foreign currency. Consequently, a firm commitment can expose the entities to variability in their functional-currency-equivalent cash flows. The reference in the definition of a forecasted transaction indicating that a forecasted transaction is not a firm commitment focuses on firm commitments that have no variability. The reference is not intended to preclude a cash flow hedge of the variability in functional-currency-equivalent cash flows when the commitment’s fixed price is denominated in a foreign currency. The definition of a forecasted transaction also indicates that the transaction or event will occur at the prevailing market price. From the perspective of the hedged risk (foreign exchange risk), the translation of the foreign currency proceeds from the sale of the nonfinancial assets will occur at the prevailing market price (i.e., current exchange rate). Accordingly, BFE may hedge the foreign currency exposure arising from the firm commitment to sell 1,000 tons of inventory under the cash flow hedging model, even if BFE had previously hedged its foreign
currency exposure arising from another similar firm commitment under the fair value hedging model.

**Intercompany Cash Flow Hedging Transactions**


8. Parent’s functional currency is the U.S. dollar. ABC is a subsidiary of Parent. ABC’s functional currency is the FC. ABC intends to declare dividends of FC100,000 to Parent.

Q. Can Parent hedge the exchange risk associated with the future cash flow?

A. No. Paragraph 485 of the Basis for Conclusions of the Standard states that intercompany dividends do not affect earnings; therefore, a forecasted intercompany dividend cannot qualify as a hedgeable forecasted transaction.

9. Foreign subsidiary ABC has a forecasted foreign-currency-denominated transaction it wishes to designate as the hedged item in a cash flow hedge. ABC does not have any treasury function or significant banking relationships. Parent wishes to hedge the exposure on the subsidiary’s behalf. Parent and ABC share the same functional currency.

Q. Can Parent hedge the foreign currency cash flow exposure related to the forecasted foreign-currency-denominated transaction on ABC’s behalf?

A. Yes. Paragraph 40(a)(2) (ASC paragraph 815-20-25-30(a)(2)) permits another member of a consolidated group that has the same functional currency as that of the operating unit with the foreign currency exposure to be party to the hedging instrument and receive hedge accounting treatment in the consolidated financial statements if there is no intervening subsidiary with a different functional currency. However, if ABC wanted hedge accounting treatment in its stand-alone financial statements, it would have to be party to the hedging derivative. If ABC were to enter into a derivative hedging instrument with Parent, ABC could use hedge accounting in its stand-alone financial statements because it entered into a derivative hedging instrument with a party external to the reporting entity. Pursuant to paragraph 36 of the Standard (ASC paragraphs 815-20-25-28, 25-29, and 25-52), to qualify for cash flow hedge accounting at the consolidated level, Parent must offset the risk acquired through the intercompany derivative contract by entering into an offsetting contract with an unrelated party.

10. Finance Co.’s functional currency is the U.S. dollar. It acts as the central treasury function for all entities within its consolidated group, including London Co. and Tokyo Co. London’s functional currency is the pound sterling (£). Tokyo’s functional currency is the yen.

London has a forecasted transaction in which it expects to receive $100 in three months. To hedge this exposure it enters into a foreign currency forward contract with Finance to sell $100 and receive £75 in three months. Tokyo has a forecasted transaction in which it...
will pay $150 in three months. To hedge its exposure, it enters into a foreign currency forward contract with Finance to buy $150 and pay 15,000 yen in three months.

As a result of these intercompany derivative contracts, Finance has a net position to pay £75 and receive yen 15,000 in three months and therefore has an exposure to both fluctuations in the $/£ exchange rate and the $/yen exchange rate. Finance offsets these two exposures by entering into two foreign currency forward contracts with Bank A, an unrelated third party, to buy £75 for $100 and to sell 15,000 yen for $150 in three months.

Q(a). Can London and Tokyo apply cash flow hedge accounting in their stand-alone financial statements?

A. Yes. The Standard requires that to qualify for cash flow hedge accounting, the operating unit that has the foreign currency exposure must be a party to the hedging transaction. Paragraph 40A of the Standard (ASC paragraph 815-20-25-61) clarifies that a derivative instrument used in a cash flow hedge of a forecasted transaction may be between a parent and its subsidiary. On a stand-alone basis, both London and Tokyo have entered into a derivative instrument, which will be effective in hedging their foreign currency cash flow exposure.

Q(b). Can Finance apply hedge accounting in its stand-alone financial statements?

A. No. The risks acquired from the subsidiaries by Finance were acquired in the form of derivative instruments. The Board does not permit items that are recorded at fair value with adjustments recognized currently through earnings to be designated as hedged items. The internal derivatives entered into by Finance with London and Tokyo will be remeasured at fair value through earnings. Thus, they cannot be designated as hedged items. The derivative contract entered into with Bank A to offset the risks acquired in the internal derivatives with the subsidiaries will be accounted for as speculative (i.e., mark-to-market). The changes in the fair value of all three of these derivative contracts will offset in earnings.

Q(c). Can the consolidated group apply cash flow hedge accounting?

A. Yes. In this circumstance pursuant to paragraph 40A(b)(1) of the Standard (ASC paragraph 815-20-25-61(b)(1)), Finance entered into derivative contracts with an unrelated third party (Bank A) to offset the exposures that resulted from the internal derivatives.

Hedging a Net Investment in a Foreign Operation

11. Investor Inc.’s functional currency is the U.S. dollar. Investor anticipates acquiring a 35% equity interest in a Korean car manufacturer. Investor Inc. has signed a purchase contract and has publicly announced the terms of the acquisition, which include a fixed price of 10 billion Korean won. The expected consummation date is July 1, 20X2. Post
acquisition, Investor plans on accounting for the investment using the equity method of accounting.

Q. Can Investor Inc. enter into a derivative contract and designate it as the hedging instrument in a cash flow hedge of the U.S.$ value of its investment?

A. No. Paragraph 29(f)(3) of the Standard (ASC paragraph 815-20-25-15(g)) prohibits cash flow hedges relating to investments accounted for by the equity method. Because Investor will account for the investment using the equity method it cannot designate the forecasted transaction as the hedged item in a cash flow hedge.

12. Same facts as question 11 above except that Investor Inc. wishes, at consummation, to hedge its recognized 10 billion Korean won investment, as well as the forecasted 500 million won net income forecasted to be earned over the next six months. Investor Inc. believes that the hedge of net income will provide stability in earnings in its U.S. dollar consolidated financial statements.

Q. Can Investor designate the investment and the future net income as the hedged item in a foreign-currency hedge?

A. Investor may designate the recognized net investment as a hedged item. Paragraph 42 (ASC paragraphs 815-20-25-66, 815-35-35-1 and 35-2) permits hedging an existing net investment in a foreign operation with either a derivative financial instrument or a nonderivative financial instrument. Therefore, at consummation, Investor may hedge the recognized 10 billion Korean won investment.

Investor cannot designate the forecasted net income as a hedged item. Paragraph 485 of the Basis for Conclusions of the Standard states that hedges of future earnings are not permitted. The prohibition exists because net income represents the netting of many dissimilar transactions, rather than a series of individual but similar transactions sharing the same risk exposure (see paragraph 40(d) (ASC paragraph 815-20-25-39(c))). Therefore, the expected future net income of 500 million won, although it may be accurately estimable and probable, is not eligible to be designated as a hedged item. Moreover, paragraph 29(f) of the Standard (ASC paragraph 815-20-25-15(g)) prohibits a forecasted dividend involving an equity-method investment from being designated as a hedged item.

13. Parent’s functional currency is the U.S. dollar. Parent has a UK subsidiary and its functional currency is the pound sterling (£). Parent issues a debt obligation denominated in £ and uses the proceeds to finance its U.S. operations.

Q. Can Parent designate the £ debt obligation payable to third parties as a hedge of the net investment in the UK operation?
A. Yes. Paragraph 42 of the Standard (ASC paragraphs 815-20-25-66, 815-35-35-1 and 35-2) permits a nonderivative financial instrument to be used as the hedging instrument in a hedge of a net investment in a foreign operation.


14. Miami Inc.’s functional currency is the U.S. dollar. Miami issued a Swiss franc (SF) 10,000,000 debt obligation. The debt obligation has a term of five years. The debt obligation requires Miami to pay interest in Swiss francs semi-annually at a variable interest rate equal to LIBOR.

Miami prefers a fixed interest rate over a variable interest rate. It also prefers U.S. dollar-denominated debt obligations over debt obligations denominated in foreign currencies. Concurrent with issuing the debt obligation, Miami entered into a cross-currency interest rate swap. The swap contract requires Miami to lend SF10,000,000 to Bank A (on which it will receive a variable rate of interest equal to LIBOR in Swiss francs) and to borrow $6,000,000 from Bank A (on which it will pay a fixed interest rate of 6%). The payment terms and maturity of the cross-currency interest rate swap match the SF debt obligation.

Q(a). Can Miami designate the entire cross-currency interest rate swap as the hedging instrument to hedge both the foreign currency exposure and the interest rate exposure?

A. Yes. Pursuant to paragraph 29(h) of the Standard (ASC paragraph 815-20-25-15(j)), an entity can hedge the risk of variability in cash flows attributable to both interest rate and foreign exchange risk. Furthermore, paragraph 40(e) of the Standard (ASC paragraphs 815-20-25-39(d) and 25-40) permits a foreign currency cash flow hedge if the hedged item is a recognized foreign-currency-denominated asset or liability and all of the variability in the hedged item’s functional-currency-equivalent cash flows is eliminated by the effect of the hedge. In this instance the cross-currency swap eliminates the variability in functional-currency-equivalent cash flows by fixing both the foreign exchange rate and the interest rate in U.S. dollars.

Q(b). Can the cross-currency interest rate swap be designated as a hedging instrument to hedge foreign currency exposures arising from the SF debt obligation?

A. Yes, but most likely it will not be highly effective since the entire cross-currency swap would have to be designated as the hedging instrument. This would include the interest rate component, which would not be highly effective in hedging foreign currency risk. Paragraph 18 of the Standard (ASC paragraph 815-20-25-45) prohibits separating derivatives into components representing different risks and designating the components as hedging instruments.
Q(c). Can the cross-currency interest rate swap be designated as a hedging instrument to hedge the variable-rate interest exposure arising from the SF debt obligation?

A. Yes, but as noted previously it would most likely not be highly effective due to the foreign exchange component. Alternatively, Miami could enter into an interest rate swap to receive variable (LIBOR based) interest payments in Swiss francs and pay 6% fixed in Swiss francs and designate that swap in a cash flow hedge of the variability in interest payments due to the variable rate on the SF debt obligation.
Section Eight: Accounting by Entities that do not Report Earnings as a Separate Caption in a Statement of Financial Performance

43.01 This chapter addresses the effect of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended (Statement 133 or Standard), on entities that do not report earnings as a separate caption in a statement of financial performance, including not-for-profit organizations.

43.02 Paragraph 43 of the Standard (ASC paragraph 815-10-35-3, 815-25-35-19, 815-30-15-2 and 15-3) discusses the requirements in this area as follows:

43. An entity that does not report earnings as a separate caption in a statement of financial performance (for example, a not for profit organization or a defined benefit pension plan) shall recognize the gain or loss on a hedging instrument and a nonhedging derivative instrument as a change in net assets in the period of change unless the hedging instrument is designated as a hedge of the foreign currency exposure of a net investment in a foreign operation. In that case, the provisions of paragraph 42 of this Statement shall be applied. Entities that do not report earnings shall recognize the changes in the carrying amount of the hedged item pursuant to paragraph 22 in a fair value hedge as a change in net assets in the period of change. Those entities are not permitted to use cash flow hedge accounting because they do not report earnings separately. Consistent with the provisions of FASB Statement No. 117, *Financial Statements of Not for Profit Organizations*, this Statement does not prescribe how a not for profit organization should determine the components of an operating measure, if one is presented.

43.03 As discussed in Chapter 2, the Standard applies to all entities including not-for-profit organizations and defined benefit plans that do not report earnings as a separate caption in a statement of financial performance. These entities do not differentiate between earnings and other comprehensive income in their statement of financial performance. The Standard permits an entity that does not report earnings as a separate caption in a statement of financial performance to designate a derivative instrument as a fair value hedge of a recognized asset or liability or a firm commitment. Additionally, these entities are permitted to hedge the foreign currency exposure of a net investment in a foreign operation.

43.04 As the Standard applies to not-for-profit organizations, these organizations must also comply with the requirements for bifurcating embedded derivatives as discussed in detail in Chapter 3. One transaction specific to not-for-profit organizations, which could result in an embedded derivative needing to be bifurcated, is an irrevocable split-interest agreement. Split-interest agreements are agreements in which a donor enters into a trust or other arrangement under which the not-for-profit organization receives benefits that are shared with other beneficiaries. A typical split-interest agreement is comprised of two components - a lead interest and a remainder interest. A lead interest represents the rights to the benefits of the transferred assets during the term of the agreement, which starts on the date the agreement is signed and ends either after a specified number of years (period-certain) or upon the occurrence of an event, commonly death of the donor or lead beneficiary (life-contingent). The remainder interest is the
right to receive all or a portion of the assets remaining at the end of the agreement’s term. With these instruments, while contributed assets are under the control of the not-for-profit organization, the not-for-profit organization has an obligation to make specified cash payments to the designated beneficiary or convey the remaining assets to the donor or its beneficiaries.

43.05 Derivatives Implementation Group (DIG) Issue No. B35, “Application of Statement 133 to a Not-for-Profit Organization’s Obligation Arising from an Irrevocable Split-Interest Agreement,” addresses the accounting for split-interest arrangements under the Standard, specifically whether a split-interest agreement contains an embedded derivative that should be separated and measured at fair value. The FASB staff concluded that a not-for-profit organization’s liability for its obligation to the donor or the donor’s beneficiary under an irrevocable split-interest agreement is not subject to the requirements of the Standard if the obligation is solely life-contingent (i.e., contingent only upon the survival of an identified individual) because the obligation qualifies for the exception in paragraph 10(c) of the Standard (ASC paragraphs 815-10-15-52 through 15-54) relating to certain insurance contracts (refer to Chapter 2 for further discussion). If the obligation is not solely life-contingent, the not-for-profit organization must determine whether that liability meets the definition of a derivative in its entirety or whether it contains an embedded derivative instrument that warrants separate accounting (refer to Chapter 2 for further discussion). As the majority of these agreements are solely life-contingent, we expect this resolution to have limited applicability.

43.06 The not-for-profit organization’s liability for its obligation under a period-certain split-interest agreement would typically not meet the definition of a derivative instrument in its entirety because it would not meet the criterion in paragraph 6(b) of the Standard (ASC paragraph 815-10-15-83(b)). That criterion requires the contract to have no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. In contrast, the initial net investment for the liability recognized for a typical split-interest agreement is its fair value (the present value of the estimated future payments). If the not-for-profit organization’s liability for its obligation under the period-certain split-interest agreement does not, in its entirety, meet the definition of a derivative instrument, the liability must be analyzed to determine whether it contains provisions that constitute an embedded derivative instrument that warrants separate accounting under paragraph 12 of the Standard (ASC paragraphs 815-15-05-1, 25-1, 25-14, and 35-2A). Generally, the liability representing an obligation under a period-certain split-interest agreement contains an embedded derivative that warrants separate accounting if the payments are variable. Following are a few of the examples provided by DIG Issue B35 that illustrate the applicability of the embedded derivative rules, as discussed in Chapter 3, to various split-interest agreements.

**Example 8.1: Remainder Trust (period certain, fixed payments) [also known as a Charitable Remainder Annuity Trust]**

Shares of common stock are contributed to the control of the not for profit organization which is required to pay the donor or the donor’s beneficiary an annual fixed cash payment for 20 years, after which time the remaining shares revert to the not for profit organization. During the term of the agreement (20 years), the not for profit organization has a liability that does not require bifurcation of an embedded derivative. Since the periodic cash payment is a fixed
dollar amount, the liability has no underlying and, thus, does not meet the criterion in paragraph 6(a) of the definition of a derivative instrument. Because there is no underlying, there is also no embedded derivative that warrants separate accounting under paragraph 12.

Example 8.2: Remainder Trust (period-certain, variable payments) [also known as a Charitable Remainder Unitrust]

Shares of common stock are contributed to the control of the not-for-profit organization which is required to make 20 annual cash payments to the donor or the donor’s beneficiary that are equal to a specified percentage of the fair value of the assets as of the beginning of each annual period. After the 20 payments have been made, the remaining shares will revert to the not-for-profit organization. During the term of the agreement (20 years), the not-for-profit organization has a liability that must be bifurcated because it contains an embedded derivative instrument that warrants separate accounting. Under paragraph 12, the liability represents a hybrid instrument that is composed of a debt host contract and an embedded equity-based derivative that is not clearly and closely related to the debt host and would meet the definition of a derivative if it were freestanding. That is, it has an underlying (price of shares) and a notional amount (number of shares in the trust at the beginning of each annual period); it satisfies the no-or-smaller initial net investment characteristic in paragraph 6(b); and it would meet the net settlement characteristic in paragraph 6(c) (because each annual payment is adjusted for the effect of the equity-based derivative). That analysis is consistent with the analysis under paragraph 185 of Statement 133 for equity-indexed debt. (The debt host represents the liability for the series of 20 annual payments that would be required based on the assumption that the fair value of the common stock does not change over the 20-year period. The embedded equity-based derivative relates to the increase or decrease in each of the 20 annual payments due to changes in the fair value of the common stock.)

Example 8.3: Remainder Trust (life-contingent, variable or fixed payments)

Shares of common stock are contributed to the control of the not-for-profit organization which is required to make annual cash payments to the donor or the donor’s beneficiary that are either a fixed dollar amount or a specified percentage of the fair value of the assets at the beginning of each annual period until the death of the donor or the donor’s beneficiary, at which time the remaining shares will revert to the not-for-profit organization. During the term of the agreement, the not-for-profit organization has a liability that is not bifurcated because it is solely life-contingent and, thus, qualifies for the exception in paragraph 10(c) relating to certain insurance contracts.

43.07 Entities that do not report earnings as a separate caption in a statement of financial performance, including not-for-profit organizations and defined benefit plans, like any other
organization, should recognize derivative instruments at fair value in their statement of financial position. Unlike all other entities, however, these entities should recognize currently the change in the fair value of the derivative instruments as a change in net assets, except for a hedging instrument designated as a hedge of the foreign currency exposure of a net investment in foreign operations.

43.08 In order for these entities to designate a derivative instrument as a fair value hedge of a recognized asset or liability or a firm commitment, they must satisfy the hedge criteria discussed in paragraphs 20 - 21 of the Standard (ASC Section 815-20-25) (refer to Chapter 5 for further discussion of these requirements). If the hedge criteria set forth in paragraphs 20 - 21 of the Standard (ASC Section 815-20-25) have been met, an entity would account for the hedging relationship pursuant to the requirements of paragraphs 22 - 27 of the Standard (ASC paragraphs 815-25-35-1 through 35-4, 35-6, 35-8 through 35-10, and 40-1 through 40-5), except that the change in the fair value of the hedged item, as discussed in paragraph 22 of the Standard (ASC paragraphs 815-25-35-1 through 35-4), would be reported as a change in net assets as opposed to recorded in earnings.

43.09 An entity that does not report earnings as a separate caption in a statement of financial performance is also permitted to designate a derivative or a nonderivative instrument as a hedge of the foreign currency exposure inherent in a net investment in a foreign operation provided that the requirements of paragraph 42 of the Standard (ASC paragraph 815-20-25-66, ASC paragraphs 815-35-35-1 and 35-2) have been met. Pursuant to paragraph 42 of the Standard (ASC paragraph 815-20-25-66, ASC paragraphs 815-35-35-1 and 35-2), the foreign currency transaction gain or loss on a hedging derivative or nonderivative instrument that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation should be reported in the same manner as a translation adjustment. The ineffective component (if any) of the gain or loss on the hedging derivative or nonderivative instrument would be reported currently as a change in net assets.

43.10 The Standard prohibits an entity that does not report earnings as a separate caption in a statement of financial performance from designating a derivative instrument as a hedge of the exposure to variability in cash flows associated with a forecasted transaction (cash flow hedge) except as discussed below. The effect of cash flow hedge accounting is to report the effective component of a derivative’s gain or loss in other comprehensive income (OCI) (i.e., outside earnings) in the period in which it occurs and then to reclassify that gain or loss into earnings in a later period. Therefore, it would be impossible for an entity that does not distinguish between earnings and OCI to apply cash flow hedge accounting. For the Standard to permit a not-for-profit entity to apply cash flow hedge accounting, the Financial Accounting Standards Board (FASB or Board) would have had to define a subcomponent of the total change in net assets during a period that would be analogous to earnings for a business enterprise. Neither FASB Concepts Statement No. 6, Elements of Financial Statements, nor FASB Statement No. 117, Financial Statements of Not-for-Profit Organizations (Statement 117) (ASC Topic 958, Not-for-Profit Entities), defines such a measure of operating performance for a not-for-profit entity, and an attempt to define that measure was beyond the scope of the Standard.

43.11 Many health care organizations are organized as not-for-profit organizations and, thus, would appear to be subject to the Standard’s prohibition to apply cash flow hedge accounting, discussed in Paragraph 43.10 above. The reason for this prohibition is the fact that Statement 117
(ASC Topic 958) does not require not-for-profit entities to report earnings. However, not-for-profit health care organizations must report a defined measure of earnings (performance indicator) as a separate caption in the statement of operations, based on requirements contained in the AICPA Audit and Accounting Guide: Health Care Organizations (Health Care Guide). Consequently, some not-for-profit health care organizations believed that paragraph 43 of the Standard (ASC paragraph 815-10-35-3, 815-25-35-19, 815-30-15-2 and 15-3) (including its provisions related to cash flow hedge accounting) did not affect them. Those entities applied the provisions of the Standard in the same manner as for-profit enterprises. Other not-for-profit health care organizations believed they were subject to the guidance in paragraph 43 of the Standard (ASC paragraph 815-10-35-3, 815-25-35-19, 815-30-15-2 and 15-3), but interpreted that guidance in different ways. As a result, diversity in practice arose among not-for-profit health care organizations with respect to the accounting for derivatives.

43.12 The AICPA’s Accounting Standards Executive Committee (AcSEC) resolved the diversity in practice by issuing Statement of Position 02-2, Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of Performance Indicator (SOP 02-2) (ASC Subtopic 954-815, Health Care Entities - Derivatives and Hedging). SOP 02-2 (ASC Subtopic 954-815) applies only to nongovernmental not-for-profit health care organizations within the scope of the Health Care Guide. SOP 02-2 (ASC Subtopic 954-815) addresses how not-for-profit health care organizations should report gains or losses on hedging and nonhedging derivative instruments within the scope of the Standard (ASC Subtopic 954-815) and clarifies certain matters with respect to the performance indicator reported by such organizations. Specifically, SOP 02-2 (ASC Subtopic 954-815) requires the following for entities within its scope:

- Not-for-profit health care organizations should apply the provisions of the Standard (including the provisions pertaining to cash flow hedge accounting) in the same manner as for-profit enterprises.

- Not-for-profit health care organizations should provide all the disclosures required by paragraph 45 of the Standard (ASC Sections 815-25-50, 30-50, and 35-50) (discussed in Chapter 9), including disclosures related to reclassifications into earnings of gains and losses that are reported in accumulated other comprehensive income. Although those organizations are not otherwise required to report changes in the components of comprehensive income pursuant to FASB Statement No. 130, Reporting Comprehensive Income (ASC Subtopic 220-10, Comprehensive Income), such organizations should separately disclose the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator, the related net change associated with current period hedging transactions, and the net amount of any reclassifications into the performance indicator in a manner similar to that described in paragraph 47 of the Standard (ASC paragraph 815-30-50-2) (discussed in Chapter 9).

SOP 02-2 (ASC Subtopic 954-815) also clarifies that the performance indicator reported by not-for-profit health care organizations is analogous to income from continuing operations of a for-profit enterprise.
An entity that does not report earnings as a separate caption in a statement of financial performance is required to recognize the gain or loss on a hedging instrument and a nonhedging derivative instrument as a change in net assets in the period of change. The statement of operations of a not-for-profit health care organization includes a performance indicator which is equivalent to income from continuing operations in a for-profit enterprise’s statement of operations. Neither the Standard nor SOP 02-2 (ASC Subtopic 954-815) address where in the statement of operations a not-for-profit health care organization should present the gain or loss on its nonhedging derivative instruments. The Health Care Guide provides a listing of items which are excluded from the performance indicator. These items are similar to items treated as part of OCI for entities that report earnings in the statement of operations. Because an entity that reports earnings would report the gains or losses on a nonhedging derivative instrument in earnings, a not-for-profit health care organization should report the change in fair value of its nonhedging derivative instruments within the performance indicator.

It is important to note that other not-for-profit entities that are within the AICPA Audit and Accounting Guide: Not-for-Profit Organizations, but not within the Health Care Guide, may choose to report an intermediate measure of operation as a separate caption in the statement of financial performance. However, these entities are not within the scope of SOP 02-2 (ASC Subtopic 954-815). Therefore, they cannot apply cash flow hedge accounting.

Similar to not-for-profit health care organizations, government entities do not report earnings. Government entities, including proprietary activities, (e.g., a water department or a public hospital) account for their activities under principles promulgated by the Governmental Accounting Standards Board (GASB). GASB Statement No. 20, Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting, as amended, (GASB Statement 20) provides guidance on the applicability of FASB pronouncements.

GASB Statement 20 requires all proprietary activities to apply FASB pronouncements issued on or before November 30, 1989 that do not conflict with GASB pronouncements. In addition, these proprietary activities may elect to apply all FASB pronouncements issued after November 30, 1989 developed for business enterprises that do not conflict or contradict with GASB pronouncements. When this election is made, certain provisions of the Standard would need to be complied with by the proprietary fund. Government entities also need to follow the guidance on derivative disclosures included in GASB Technical Bulletin No. 2003-1, Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets.
Section Nine: Disclosure (updated June 2016)

INTRODUCTION

44.01 In addition to providing recognition and measurement principles for derivative instruments and hedging activities, FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended (Statement 133 or Standard), includes specific disclosure requirements. In addition, the disclosures required by FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments (Statement 107) (ASC Topic 825, Financial Instruments), were amended to be consistent with the requirements of the Standard and to include disclosures relating to concentrations of credit risk.

44.02 The intent of the Standard's disclosure requirements is to enable users of an entity's financial statements to understand:

- How and why it uses derivative instruments (and nonderivative hedging instruments);
- How it accounts for its derivative instruments (and nonderivative hedging instruments) and related hedged items; and
- How derivative instruments (and nonderivative hedging instruments) and related hedged items affect its financial position, financial performance, and cash flows.

44.03 This chapter discusses the disclosure requirements of the Standard and provides examples of those disclosures. References to derivative instruments in the requirements include bifurcated embedded derivatives. The Standard's disclosures can be divided into three major types:

- Qualitative disclosures addressing the objectives and strategies for using derivative instruments (and nonderivative hedging instruments) in terms of underlying risk and accounting designation, as well as information regarding certain financial instruments measured at fair value;
- Quantitative disclosures providing an indication as to whether the entity’s hedging objectives were met, the fair value of derivative instruments (and nonderivative hedging instruments) and their gains or losses in a tabular format as well as information about counterparty credit risk and credit-risk-related contingent features; and
- Disclosures relating to other comprehensive income (OCI) and accumulated other comprehensive income (AOCI).

The Standard also specifies classification of a derivative instrument’s cash flows within the statement of cash flows in certain circumstances. The disclosure requirements are set forth in paragraphs 44 through 47 (ASC paragraphs 815-10-50-1 through 50-5; 815-25-50-1 and 50-2; 815-30-50-1 through 50-3; 815-35-50-1, 50-2, and 45-1).

44.04 This chapter also addresses some more common disclosure issues that are not specifically addressed in the Standard. Those issues include:

- Reporting derivative instruments and hedged items in the statement of financial position, including presentation in a classified statement of financial position;
• Reporting changes in derivative instruments and hedged items in the income statement;
• The display of embedded derivative instruments; and
• Presentation by entities that do not report earnings as a separate caption in a statement of financial performance.

ASU 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities* (ASU 2011-11), requires entities to disclose certain information when they offset financial assets and financial liabilities, as well as derivative instruments, and present them on a net basis in their statements of financial position. It also requires entities to disclose certain information about financial instruments and derivative instruments that are subject to certain netting arrangements, regardless of whether they are offset in their financial statements. These disclosures assist financial statement users in evaluating the effect or potential effect of netting arrangements. ASU 2011-11 is effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. It is to be applied retrospectively for any period presented that begins before the date of its initial application. Appendix B of this chapter provides an overview of the required disclosures under ASU 2011-11 (ASC Section 210-20-50).

44.04a Also relevant to the disclosure requirements of the Standard are the disclosure requirements of FASB Statement No. 157, *Fair Value Measurements* (ASC Topic 820, *Fair Value Measurements and Disclosures*). The Statement (ASC Topic 820), among other things, provides disclosure requirements for assets and liabilities measured at fair value on a recurring and non-recurring basis. Derivative instruments would fall within the *recurring basis* category. Statement 157 (ASC Topic 820) requires the following disclosures, generally in both interim and annual periods. The disclosures should be presented separately for each major category of assets and liabilities:

(a) For assets and liabilities that are measured at fair value on a recurring basis (for example, trading securities or derivative instruments), the fair value measurements at the reporting date.

(b) The level of the measurements within the fair-value hierarchy based on the measurement inputs defined in the Statement (ASC Section 820-10-20), segregating measurements with Level 1 (quoted prices in active markets), Level 2 (observable prices in active markets for similar assets or liabilities, directly observable market inputs or inputs derived by observable market data) and Level 3 (unobservable inputs based on the reporting entity’s own assumptions) inputs and, in annual periods only, the valuation technique or techniques used for the measurements.

(c) Disclosure of the following for assets and liabilities that are measured at fair value on a recurring basis using Level 3 inputs, for each interim and annual period and separately for each major category of assets and liabilities (except for derivative assets and liabilities, which may be presented net):

(i) Reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to:
(a) Total realized and unrealized gains or losses for the period, segregating those gains or losses included in earnings and a description of where those gains and losses are reported in the income statement

(b) Purchases, sales, issuances and settlements (net) and

(c) Transfers in and/or out of Level 3 in response to changes in the observability of significant inputs

(ii) The amount of total gains and losses for the period included in earnings attributable to the change in unrealized gains or losses relating to those assets and liabilities still held at the reporting date and a description of where those unrealized gains or losses are reported in the income statement.

As noted above, these disclosures should be presented separately for each major category of assets and liabilities. ASU 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements* (ASU 2010-6) requires that these disclosures should be presented separately for each class of assets and liabilities rather than each major category of assets and liabilities. ASC 820-10-50-2B states, ‘...A class of assets and liabilities will often require greater disaggregation than the line items presented in the statement of financial position.’ ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for separate disclosures about purchases, sales, issuances and settlements related to Level 3 measurements, which are effective for annual reporting periods beginning after December 15, 2010, and for interim periods within those years. In periods after initial adoption, comparative disclosures are required only for periods ending after initial adoption.

ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (ASU 2011-04) was issued to align fair value measurement requirements of U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards. Among other things, ASU 2011-04 amends U.S. GAAP disclosure requirements for assets and liabilities, including derivative instruments. It requires for Level 3 measurements: quantitative disclosure about significant unobservable inputs used to measure fair value; qualitative information about the sensitivity of the fair value measurement to changes in the unobservable inputs and the interrelationship between inputs (not required for nonpublic entities); and a description of the valuation process used. ASU 2011-04 also expands the current disclosure requirement of significant transfers between Level 1 and Level 2 to all transfers between those levels (not required for nonpublic entities). Public entities are required to adopt ASU 2011-04 for interim and annual periods beginning on or after December 15, 2011, with early adoption prohibited. Nonpublic entities are required to adopt ASU 2011-04 for annual periods beginning after December 15, 2011. Nonpublic may early-adopt for any interim period beginning after December 15, 2011.

This chapter does not contain further guidance on the disclosure requirements of Statement 157 (ASC Topic 820). See additional discussion of this topic in other KPMG guidance.

**44.04b** For a complete summary of disclosures required by the U.S. Securities and Exchange Commission (SEC) and industry specific disclosure requirements regarding derivative instruments and hedging activities, please refer to the applicable workpaper 514, Accounting Disclosure Checklist.
Simplified Hedge Accounting Approach

44.04c Entities should disclose the accounting policy and measurement bases when applying the simplified hedge accounting approach in ASU 2014-03. For a discussion of this approach see Section 6 beginning at paragraph A6.70a.

44.04d For interest rate swaps accounted for under the simplified hedge accounting approach, the settlement value of the swap may replace fair value when disclosing the information required by the Standard or in providing other fair value disclosures, such as those required by Statement 157 (ASC 820) on fair value. Amounts disclosed at settlement value are subject to all of the same disclosure requirements as amounts disclosed at fair value. For the purposes of complying with these disclosure requirements, amounts disclosed at settlement value shall be disclosed separately from amounts disclosed at fair value.

44.04e For purposes of evaluating whether the disclosures of Statement 107 (ASC 825) for the fair value of financial instruments are required, swaps recorded under the simplified hedge accounting approach are not considered derivative instruments under the Standard.

QUALITATIVE DISCLOSURES

44.05 Paragraph 44 of the Standard in part (ASC paragraphs 815-10-50-2 through 50-5), calls for entities to make the following qualitative disclosures:

44. An entity that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 37 and 42 (ASC paragraphs 815-20-25-37, 25-58, and 25-59, and 815-35-35-1 and 35-2)) shall disclose the following for every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented:

1) Its objectives for holding or issuing those instruments, the context needed to understand those objectives, and its strategies for achieving those objectives. Information about those instruments shall be disclosed in the context of each instrument's primary underlying risk exposure (for example, interest rate, credit, foreign exchange rate, interest rate and foreign exchange rate, or overall price). Further, those instruments shall be distinguished between those used for risk management purposes and those used for other purposes. Derivative instruments used for risk management purposes include those designated as hedging instruments under this Statement as well as those used as economic hedges and for other purposes related to the entity's risk exposures. For derivative instruments designated as hedging instruments under this Statement, the description shall distinguish between derivative instruments designated as fair value hedging instruments, derivative instruments designated as cash flow hedging instruments, and derivative instruments designated as hedging instruments of the foreign currency exposure in a net investment in a foreign operation. For derivative instruments not designated as hedging instruments under this Statement, the description shall indicate the purpose of the derivative activity.

2) Information that would enable users of its financial statements to understand the volume of its derivative activity. Entities shall select the format and the specifics of
disclosures relating to their volume of derivative activity that are most relevant and practicable for their individual facts and circumstances.

Qualitative disclosures about an entity’s objectives and strategies for using derivative instruments may be more meaningful if such objectives and strategies are described in the context of an entity’s overall risk exposures relating to interest rate risk, foreign currency exchange rate risk, commodity price risk, credit risk, and equity price risk. Those additional qualitative disclosures, if made, should include a discussion of those exposures even though the entity does not manage some of those exposures by using derivative instruments. An entity is encouraged, but not required, to provide such additional qualitative disclosures about those risks and how they are managed.

Throughout this paragraph, the term derivative instrument(s) includes nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 37 and 42.

Derivatives Implementation Group (DIG) Issue related to this paragraph is I1. See DIG Issues Index.

**Required Disclosures**

**44.06** The Standard requires qualitative disclosures to assist financial statement users in understanding the nature of an entity’s derivative activities (and nonderivative hedging activities), evaluating the results of those activities, assessing their importance to the entity, and assessing their effect on the entity’s financial statements. More specifically, paragraph 44 of the Standard (ASC paragraphs 815-10-50-1 through 50-5) requires the following information to be disclosed for every annual and interim reporting period for which an entity presents a statement of financial position and statement of financial performance:

- The entity’s objectives for holding or issuing derivative instruments (and nonderivative hedging instruments);
- The context needed to understand those objectives;
- The entity’s strategies for achieving those objectives; and
- The entity's volume of derivative activity.

**44.07** Derivative instruments (and nonderivative hedging instruments) that are used for risk management purposes (including economic hedges) should be distinguished from other derivatives. An entity should disclose the purpose of derivative instruments it holds or issues that it does not designate as hedging instruments. In addition, the details provided about hedging instruments are to be further disaggregated to distinguish among:

- Fair value derivative instruments (and nonderivative hedging instruments);
- Cash flow derivative instruments (and nonderivative hedging instruments); and
- Derivative instruments (and nonderivative hedging instruments) used to hedge foreign currency exposures inherent in net investments in foreign operations.

**44.08** Prior to the adoption of the Standard, hedging instruments were not generally thought of in these terms. That is, entities did not evaluate whether derivative instruments hedged changes in cash flows or changes in fair values. The Board, however, concluded that distinguishing between
derivative instruments based on their accounting designation helps financial statement users understand the information provided in the financial statements.

OBJECTIVES FOR HOLDING OR ISSUING DERIVATIVE INSTRUMENTS AND NONDERIVATIVE HEDGING INSTRUMENTS

44.09 In simple terms, the disclosure about an entity’s objectives for holding or issuing derivative instruments (and nonderivative hedging instruments) should answer the question as to why the entity entered into such instruments. Thus, to satisfy this requirement, an entity should discuss the goals for holding or issuing derivative instruments (and nonderivative hedging instruments). These goals may range from modifying or eliminating a particular risk (i.e., hedging) to speculating (i.e., trading). These disclosures should be provided in the context of each instrument's primary underlying risk exposure (e.g., interest rate, credit, foreign exchange rate, interest rate and foreign exchange rate, or overall price).

CONTEXT NEEDED TO UNDERSTAND OBJECTIVES

44.10 An entity should disclose information needed to understand why it entered into derivative instruments (and nonderivative hedging instruments). This information, as well as the objectives discussed above, should be provided in the context of an instrument's primary underlying risk exposure (e.g., interest rate, credit, foreign exchange rate, interest rate and foreign exchange rate, or overall price). This is required because the Board feels that making such disclosures helps convey how and why an entity uses derivatives in terms of its risk management. However, the Board views these disclosures as a minimum requirement. An entity may find it appropriate to also provide information of each primary underlying risk by derivative instrument type. For example, an entity could use both interest rate forwards and interest rate swaps to manage interest rate risk. In this case, it may be appropriate for an entity to provide context around interest rate risk exposure managed by interest rate forwards as well as interest rate risk managed by interest rate swaps. Additionally, it may be appropriate to disaggregate a primary underlying risk. For example, if one of an entity's primary underlying risk exposures is foreign currency risk, it may be useful for the entity to distinguish the different foreign currencies that comprise the total foreign currency risk in its disclosure. Further it is possible for one derivative instrument to address more than one underlying risk exposure (e.g., cross currency interest rate swaps address foreign currency and interest rate risks). In this case, an entity could disclose the required information for each underlying risk or for the combined risk (e.g., in the case of a cross currency interest rate swap, the required information could be disclosed as part of the foreign currency disclosure as well as the interest rate disclosure or as a combined foreign currency and interest rate disclosure).

44.11 For those entities that hold or issue derivative instruments (or nonderivative hedging instruments) to hedge risk, these disclosures should address the following matters:

- The nature and source of the entity’s risk (e.g., foreign operations expose an entity to fluctuations in the value of its net investments resulting from changes in a particular exchange rate or foreign-currency-denominated transactions expose an entity to fluctuations in cash flows resulting from changes in a particular exchange rate); and
• The entity’s philosophy toward risk (e.g., an entity’s policy may be to limit its variability in cash flows attributable to interest rates).

44.12 For those entities that hold or issue derivative instruments for speculative purposes, the disclosures should address the entity’s desire to benefit from changes in a particular rate or price.

Strategies For Achieving Objectives And Risk Management Policies

44.13 The Standard also requires entities to discuss their strategies for achieving their objectives for issuing and holding derivative instruments (and nonderivative hedging instruments). In addition, entities should disclose their risk management policies. This disclosure may be accomplished by discussing:

• How risks are identified, monitored, and managed; and
• What types of derivative instruments (and nonderivative hedging instruments) are entered into and how these instruments modify, eliminate, or create risk.

44.14 The following examples illustrate the qualitative disclosure requirements described above of paragraph 44 of the Standard (ASC paragraphs 815-10-50-1 through 50-5):

**Example 9.1: Interest Rate Risk Management**

*Objectives and context*

Adelaide Company (Company) uses variable-rate London Interbank Offered Rate (LIBOR) debt to finance its operations. In particular, it has issued variable-rate long-term debt, medium-term notes (MTN), and commercial paper (CP). These debt obligations expose the Company to variability in interest payments due to changes in the LIBOR rate, which is the primary underlying exposure of the aforementioned debt. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense also decreases.

Management believes it is prudent to limit the variability of a portion of its interest payments. It is the Company’s objective to hedge between 50 to 70% of its variable-rate short-term interest payments and 30 to 40% of its longer term interest payments.

*Strategies*

To meet this objective, management enters into various types of derivative instruments to manage fluctuations in cash flows resulting from interest rate risk attributable to changes in the benchmark interest rate of LIBOR. These instruments include LIBOR-based interest rate swaps, purchased options, and caps.

The interest rate swaps change the variable-rate cash flow exposure on the MTN and long-term debt obligations to fixed-rate cash flows by entering into receive-variable, pay-fixed interest rate swaps. Under the interest rate swaps, the Company receives LIBOR-based variable interest rate payments and makes fixed interest rate payments, thereby creating fixed-rate MTN and long-term debt.
The purchased interest rate option and cap agreements also protect the Company from increases in interest rates from the roll-over re-issuance of commercial paper that would result in increased cash interest payments made under its CP program. Under the agreements, the Company has the right to receive cash if LIBOR increases above a specified level.

The Company does not enter into derivative instruments for any purpose other than cash flow hedging. That is, the Company does not speculate using derivative instruments.

**Risk management policies**

The Company assesses interest rate cash flow risk by continually identifying and monitoring changes in interest rate exposures that may adversely impact expected future cash flows and by evaluating hedging opportunities.

The Company maintains risk management control systems to monitor interest rate cash flow risk attributable to both the Company’s outstanding or forecasted debt obligations as well as the Company’s offsetting hedge positions. The risk management control systems involve the use of analytical techniques, including cash flow sensitivity analysis, to estimate the expected impact of changes in interest rates on the Company’s future cash flows.

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**Example 9.2: Foreign Currency Risk Management**

**Context**

Kelly Co. (a U.S. dollar functional currency entity) operates internationally; therefore, its earnings, cash flows, and financial position are exposed to foreign currency risk from foreign-currency-denominated receivables and payables, forecasted sales transactions, as well as net investments in certain foreign operations. Thus, a foreign currency risk is a primary underlying exposure from these assets, liabilities, transactions, and net investments. Further, these items are denominated in various foreign currencies, including the pound sterling, euros, and Canadian and Australian dollars.

**Risk management and objectives**

Management believes it is prudent to minimize the variability caused by foreign currency risk. Management attempts to minimize foreign currency risk by pricing contracts in U.S. dollars and by using derivative hedging instruments when necessary.

The Risk Management Committee comprises senior management and members of Kelly Co.’s Finance Department. It continually monitors foreign currency risk and the use of derivative instruments.

Kelly Co. does not use derivative instruments for purposes other than hedging.

**Strategies**
Pound sterling exposure: More than one-third of Kelly Co.’s cash flows are denominated in pounds sterling. Exchange fluctuations between the pound sterling and the U.S. dollar historically have had little economic significance to Kelly Co. because its pound sterling assets approximate its pound sterling debt and other obligations. This creates a natural hedge. Accordingly, Kelly Co. normally does not enter into derivative instruments to hedge its pound sterling exposures.

Euros exposure: In 20X2, Kelly Co. earned XX% of its management fee revenues in euros (XX% in 20X1). Kelly Co. manages its euro cash flow exposure through the use of euro/U.S. dollar forward contracts. It is Kelly Co.’s risk management policy to hedge 60 to 70% of its near-term forecasted euro-denominated transactions.

Canadian dollar exposure: Kelly Co. has a net investment in a foreign operation that has the Canadian dollar as its functional currency. In order to eliminate the impact of foreign currency movements on the Company’s financial position, Kelly Co. hedges its Canadian dollar exposure with debt obligations denominated in Canadian dollars.

Australian dollar exposure: Kelly Co. has a net investment in a foreign operation that has the Australian dollar as its functional currency. In order to eliminate the impact of foreign currency movements on the Company’s financial position, Kelly Co. hedges its Australian dollar exposure with Australian dollar/U.S. dollar forward contracts.

**VOLUME OF DERIVATIVE ACTIVITY**

44.14a Entities must provide information that will enable users of their financial statements to understand the volume of their derivative activity. The Standard does not provide detailed guidance about the format and the specifics of what information should be disclosed in this regard. Although we believe that disclosures related to volume of derivative activity will vary based on individual facts and circumstances, the following are examples of information that entities may disclose: (1) the total notional amount of interest rate derivatives, (2) the quantity (e.g., number of tons or bushels) or the percentage of forecasted commodity purchases that are being hedged by derivative instruments, and (3) the quantities of each major foreign currency bought or sold by using derivative instruments.

**Encouraged Qualitative Disclosures**

44.15 Paragraph 44 of the Standard (ASC paragraphs 815-10-50-5) also encourages entities to provide qualitative disclosures about their objectives and strategies related to the use of derivative instruments (and nonderivative hedging instruments) in the context of overall risk exposures relating to interest rate risk, foreign currency exchange rate risk, commodity price risk, credit risk, and equity price risk. We believe that the Board is encouraging entities to be all-inclusive in their disclosures about how risks are managed. Thus, for example, entities may wish to discuss their use of other instruments, such as Treasury notes, in a manner similar to the way derivative instruments are discussed. The Board believes that the qualitative information may be more meaningful if disclosed in this manner. Disclosures for Certain Financial Instruments
44.16 Paragraphs 44A and 44B (ASC paragraphs 815-15-45-1; 815-15-50-1 and 50-2) call for the following information regarding certain financial instruments measured at fair value:

44A. In each statement of financial position presented, an entity shall report hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 16 of this Statement in a manner that separates those reported fair values from the carrying amounts of assets and liabilities subsequently measured using another measurement attribute on the face of the statement of financial position. To accomplish that separate reporting, an entity may either (a) display separate line items for the fair value and non-fair-value carrying amounts or (b) present the aggregate of those fair value and non-fair-value amounts and parenthetically disclose the amount of fair value included in the aggregate amount. For those hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 16, an entity shall also disclose the information specified in paragraphs 18–22 of FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities.

44B. An entity shall provide information that will allow users to understand the effect of changes in the fair value of hybrid financial instruments measured at fair value under the election and under the practicability exception in paragraph 16 on earnings (or other performance indicators for entities that do not report earnings).

44.17 Paragraphs 44A and 44B (ASC paragraphs 815-15-45-1 and 815-15-50-2) are amendments to the Standard as a result of FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments (ASC paragraph 815-15-25-4) and FASB Statement No. 159, Fair Value Option for Financial Assets and Financial Liabilities (ASC paragraphs 825-10-50-28 through 50-32). For certain hybrid financial instruments containing an embedded derivative that would otherwise require bifurcation, Statement 155 (ASC paragraph 815-15-25-4) permits entities to irrevocably elect to initially and subsequently measure that hybrid instrument in its entirety at fair value (with changes in fair value recognized in earnings). Statement 159 permits (ASC paragraphs 825-10-50-24 through 50-32) a similar fair value election for most financial assets and liabilities (and certain other eligible items), whether they contain an embedded derivative or not. These fair value elections may be chosen on an instrument-by-instrument basis upon initial recognition of an instrument (or upon another qualifying event). Instruments subject to a fair value election could be assets or liabilities and could be acquired or issued by the entity. An instrument for which fair value measurement has been elected is not separated into a host and embedded derivatives (because the entire instrument is carried at fair value through earnings), and may not be designated as a hedging instrument under Statement 133. Statement 155 (ASC paragraph 815-15-25-4) does not apply for financial instruments acquired or issued before the beginning of an entity's first fiscal year that begins after September 15, 2006.

44.17a Statement 155 (ASC paragraph 815-15-25-4) requires separate display, either parenthetically or as a separate line item on the face of the statement of financial position, of amounts measured at fair value as a result of electing fair value measurement under this Statement. The intent of requiring this disclosure was to mitigate the effects of using multiple measurement attributes (i.e., measuring an instrument at fair value and a similar instrument in other ways). The decision to require disclosure about the effect on earnings of measuring hybrid

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instruments at fair value was not intended to require a quantification of the effect on earnings of accounting for a hybrid instrument at fair value instead of accounting for the instrument on a bifurcated basis. The Board decided not to prescribe specific disclosures, but rather to require earnings-related disclosures in the form of a general principle. Notwithstanding this conclusion, the following specific quantitative disclosures, including earnings-related disclosures, are required by paragraph 18-22 of Statement 159 (ASC paragraphs 825-10-50-24 through 50-32) for those hybrid financial instruments measured at fair value under the election in Statement 155 (ASC paragraph 815-15-25-4), and under the practicality exception in paragraph 16 of Statement 133 (ASC paragraph 815-10-25-5) as well as those instruments measured at fair value under the election of Statement 159 (ASC paragraph 825-10-50-28):

As of each date for which a statement of financial position is presented, disclose the following:

(a) Reasons for electing a fair value option for each eligible item or group of similar eligible items

(b) If the fair value option is elected for some but not all eligible items within a group of similar eligible items:

(1) A description of those similar items and the reasons for partial election

(2) Information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position

(c) For each line item in the statement of financial position that includes an item or items for which the fair value option has been elected:

(1) Information to enable users to understand how each line item in the statement of financial position relates to major categories of assets and liabilities presented in accordance with Statement 157's (ASC Topic 820) fair value disclosure requirements

(2) The aggregate carrying amount of items included in each line item in the statement of financial position that are not eligible for the fair value option, if any

(d) The difference between the aggregate fair value and the aggregate unpaid principal balance of:

(1) Loans and long-term receivables (other than securities subject to Statement 115 (ASC Topic 320)) that have contractual principal amounts and for which the fair value option has been elected

(2) Long-term debt instruments that have contractual principal amounts and for which the fair value option has been elected

(e) For loans held as assets for which the fair value option has been elected:

(1) The aggregate fair value of loans that are 90 days or more past due

(2) If the entity's policy is to recognize interest income separately from other changes in fair value, the aggregate fair value of loans in nonaccrual status
(3) The difference between the aggregate fair value and the aggregate unpaid principal balance for loans that are 90 days or more past due, in nonaccrual status, or both

(f) For investments that would have been accounted for under the equity method if the entity had not chosen to apply the fair value option, the information required by paragraph 20 of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (ASC paragraph 323-10-50-3) (excluding the disclosures in paragraph 20(a)(3), 20(b), and 20(e) of that Opinion) (ASC paragraphs 323-10-50-3(a)(3), 50-3(b), and 50-3(d)).

The following disclosures are required for items for which the fair value option has been elected as of each date for which an interim or annual income statement is presented:

(a) For each line item in the statement of financial position, the amounts of gains and losses from fair value changes included in earnings during the period and in which line in the income statement those gains and losses are reported (An entity is not precluded from meeting this requirement by disclosing amounts of gains and losses that include amounts of gains and losses for other items measured at fair value, such as items required to be measured at fair value.)

(b) A description of how interest and dividends are measured and where they are reported in the income statement

(c) For loans and other receivables held as assets:

(1) The estimated amount of gains or losses included in earnings during the period attributable to changes in instrument-specific credit risk

(2) How the gains or losses attributable to changes in instrument-specific credit risk were determined

(d) For liabilities with fair values that have been significantly affected during the reporting period by changes in the instrument-specific credit risk:

(1) The estimated amount of gains and losses from fair value changes included in earnings that are attributable to changes in the instrument-specific credit risk

(2) Qualitative information about the reasons for those changes

(3) How the gains and losses attributable to changes in instrument-specific credit risk were determined.

The disclosure requirements in the preceding paragraphs do not eliminate disclosure requirements included in other GAAP pronouncements, including other disclosure requirements relating to fair value measurement.

In annual periods only, the methods and significant assumptions used to estimate the fair value of items for which the fair value option has been elected should be disclosed.

If the fair value option is elected at the time that either (a) the accounting treatment for an investment in another entity changes (i.e., an investment becomes subject to the equity method of accounting or an investor ceases to consolidate a subsidiary or
variable interest entity but retains an interest) or (b) an event occurs that requires the item to be measured at fair value at the time of the event but does not require fair value measurement at each reporting date after that, the following disclosure should be made in the financial statements for the period of the election:

(a) Qualitative information about the nature of the event; and

(b) Quantitative information by line item in the statement of financial position indicating which line items in the income statement include the effect on earnings of initially electing the fair value option for an item.

Disclosures Related to Long-term Obligations

44.18 Some derivative instruments are considered unconditional purchase obligations within the scope of FASB Statement No. 47, Disclosure of Long-Term Obligations (Statement 47) (ASC Topic 440, Commitments). The scope of Statement 47 (ASC Topic 440) includes unconditional purchase obligations “to transfer funds in the future for fixed or minimum amounts or quantities of goods or services at fixed or minimum prices (e.g., as in take-or-pay contracts and throughput contracts).” Some of these purchase obligations may also be derivative instruments subject to the Standard. An instrument that is within the scope of both Statement 47 (ASC Topic 440) and the Standard must comply with the disclosure requirements of both standards. The Standard does not amend or supersede Statement 47 (ASC Topic 440) because the disclosure requirements for the Standard and Statement 47 (ASC Topic 440) are based on different objectives. (See DIG Issue I1 for further reference).

QUANTITATIVE DISCLOSURES

Disclosures Related to the Statement of Financial Position and Statement of Financial Performance

44.19 Paragraph 44C of Statement 133 (ASC paragraphs 815-10-50-4A through 50-4F) requires entities that hold or issue derivative instruments (or nonderivative hedging instruments) to disclose quantitative information related to the fair value and gains and losses of derivative instruments (and nonderivative hedging instruments) in a tabular format for every annual and interim reporting period for which a statement of financial position and statement of financial reporting are presented. The Board feels that a tabular format is best to convey an overall understanding of how and why an entities use derivative instruments. Further, the Board believes that including such tables will improve the transparency of accounting for derivative instruments as well as assist financial statement users understand how derivative activities affect an entity's financial position, financial performance and cash flows. If a proportion of a derivative instrument (or nonderivative instrument) is designated as a hedging instrument and a proportion is not designated as a hedging instrument, an entity would be required to allocate the related amounts to the appropriate categories within the disclosure table. Further, it is possible for one derivative instrument to address more than one underlying risk exposure (e.g., cross currency interest rate swaps address foreign currency and interest rate risks). In this case, an entity could disclose the required information for each underlying risk or for the combined risk (e.g., in the case of a cross currency interest rate swap, the required information could be disclosed as part of the foreign currency disclosure as well as the interest rate disclosure or as a combined foreign...
currency and interest rate disclosure). The major types of derivative instruments presented in the tabular examples below are for illustrative purposes. Entities need to exercise judgment in identifying their major types of derivative instruments that may require additional line items in the tabular disclosures.

44.20 Not-for-profit organizations within the scope of the AICPA Audit and Accounting Guide, *Health Care Organizations*, should present these disclosures in a similarly formatted table. However, those organizations would refer to amounts within their performance indicator, instead of in income, and amounts outside their performance indicator, instead of in other comprehensive income. Other not-for-profit organizations would disclose the gain or loss recognized in changes in net assets using a similar format. All not-for-profit organizations also would indicate which class or classes of net assets (unrestricted, temporarily restricted, or permanently restricted) are affected.

**Disclosures of the Fair Value of Derivative Instruments**

44.21 Paragraph 44C(a) of the Standard (ASC paragraphs 815-10-50-4A through 50-4F) requires the following disclosures be presented in a tabular format for derivative instruments (and nonderivative hedging instruments) that are reported in the statement of financial position:

<table>
<thead>
<tr>
<th>44C(a). The location and fair value amounts of derivative instruments reported in the statement of financial position.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) The fair value of derivative instruments shall be presented on a gross basis, even when the derivative instruments are subject to master netting arrangements and qualify for net presentation in the statement of financial position in accordance with FASB Interpretation No. 39, <em>Offsetting of Amounts Related to Certain Contracts</em> (ASC Subtopic 210-20). Cash collateral payables and receivables associated with the derivative instruments shall not be added to or netted against the fair value amounts.</td>
</tr>
<tr>
<td>(2) Fair value amounts shall be presented as separate asset and liability values segregated between derivatives that are designated and qualifying as hedging instruments under this Statement and those that are not. Within each of those two broad categories (designated and qualifying hedges versus those that are not), fair value amounts shall be presented separately by type of derivative contract—for example, interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit contracts, other contracts, and so forth.</td>
</tr>
<tr>
<td>(3) The disclosure shall identify the line item(s) in the statement of financial position in which the fair value amounts for these categories of derivative instruments are included.</td>
</tr>
</tbody>
</table>

\(^{12a3}\) Amounts required to be reported for nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 37 and 42 (ASC paragraphs 815-20-25-58 and 25-66) shall be the carrying value of the nonderivative hedging instrument, which includes the adjustment for the foreign currency transaction gain or loss on that instrument.
The Board believes that disclosing fair value amounts of derivative instruments on a gross basis will assist financial statement users understand how an entity manages its risks. For example, if an entity had an interest rate swap with a $100 asset fair value and a foreign currency forward contract with a $60 liability fair value that was subject to a master netting arrangement, the entity would report a $40 asset in its statement of financial position assuming certain conditions are met. Displaying the interest rate swap and foreign currency forward contract at their gross amounts aids financial statement users in understanding the risks that an entity manages. Further, the Board feels that netting payables or receivables related to cash collateral would make it difficult to analyze the relationship between the fair value of derivative instruments and the related gains or losses reported. Thus, the Board concluded that cash collateral payables and receivables should not be part of the disclosure table. An example table disclosing the fair value of derivative instruments in accordance with the Standard (ASC paragraph 815-10-55-182) appears below.

<table>
<thead>
<tr>
<th>Derivatives Designated as Hedging Instruments</th>
<th>Asset Derivatives</th>
<th>Liability Derivatives</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20X2</td>
<td>20X1</td>
</tr>
<tr>
<td>Derivatives As of December 31</td>
<td>Balance Location</td>
<td>Fair Value</td>
</tr>
<tr>
<td>Interest rate contracts</td>
<td>Other assets</td>
<td>XX</td>
</tr>
<tr>
<td>Foreign exchange contracts</td>
<td>Other assets</td>
<td>XX</td>
</tr>
<tr>
<td>Equity contracts</td>
<td>Other assets</td>
<td>XX</td>
</tr>
<tr>
<td>Commodity contracts</td>
<td>Other assets</td>
<td>XX</td>
</tr>
<tr>
<td>Credit contracts</td>
<td>Other assets</td>
<td>XX</td>
</tr>
<tr>
<td>Other contracts</td>
<td>Other assets</td>
<td>XX</td>
</tr>
<tr>
<td>Total Derivatives Designated as Hedging Instruments</td>
<td>XX</td>
<td>XX</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Derivatives Not Designated as Hedging Instruments (1)</th>
<th>Asset Derivatives</th>
<th>Liability Derivatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate contracts</td>
<td>Other assets</td>
<td>XX</td>
</tr>
<tr>
<td>Foreign exchange contracts</td>
<td>Other assets</td>
<td>XX</td>
</tr>
<tr>
<td>Equity contracts</td>
<td>Other assets</td>
<td>XX</td>
</tr>
</tbody>
</table>

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Disclosures of the Gains and Losses on Derivative Instruments

44.22 Paragraphs 44C(b) and (c) of the Standard (ASC paragraphs 815-10-50-4A through 50-4F) require that the following disclosures related to the gains and losses on derivative instruments (and nonderivative hedging instruments) be presented in a tabular format:

44C(b). The location and amount of the gains and losses reported in the statement of financial performance (or when applicable, the statement of financial position, for example, gains and losses initially recognized in other comprehensive income [OCI]) on derivative instruments and related hedged items. Gains and losses shall be presented separately for:

1. Derivative instruments designated and qualifying as hedging instruments in fair value hedges and related hedged items designated and qualifying in fair value hedges.

2. The effective portion of gains and losses on derivative instruments designated and qualifying in cash flow hedges and net investment hedges that was recognized in OCI during the current period.

3. The effective portion of gains and losses on derivative instruments designated and qualifying in cash flow hedges and net investment hedges recorded in accumulated other comprehensive income during the term of the hedging relationship and reclassified into earnings during the current period.

4. The portion of gains and losses on derivative instruments designated and qualifying in cash flow hedges and net investment hedges representing (a) the amount of the hedges’ ineffectiveness and (b) the amount, if any, excluded from the assessment of hedge effectiveness.

5. Derivative instruments not designated or qualifying as hedging instruments under this Statement.

The above information shall be presented separately by type of derivative contract, for example, interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit contracts, other contracts, and so forth. The disclosure
shall identify the line item(s) in the statement of financial performance in which the gains and losses for these categories of derivative instruments are included.

The quantitative disclosures required by subparagraphs (a) and (b) above shall be presented in tabular format except for the information required for hedged items by subparagraph 44C(b)(1). Information about hedged items can be presented in a tabular or nontabular format.

The Derivatives Implementation Group (DIG) Issue related to paragraph 44C(b) is K4. See DIG Issues Index.

An example table disclosing the gains and losses on derivative instruments in accordance with the Standard (ASC paragraph 815-10-55-182) appears below.

**Example 9.2B: Table Disclosing the Impact of Derivative Instruments on the Statement of Financial Performance**

<table>
<thead>
<tr>
<th>Derivatives in Fair Value Hedging Relationships</th>
<th>Location of Gain or (Loss) Recognized in Income on Derivative[*]</th>
<th>Amount of Gain or (Loss) Recognized in Income on Derivative</th>
<th>Location of Gain or (Loss) Recognized in Income on Hedged Item [*]</th>
<th>Amount of Gain or (Loss) Recognized in Income on Hedged Item</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate contracts</td>
<td>Interest income (expense)</td>
<td>XX</td>
<td>Interest income (expense)</td>
<td>XX</td>
</tr>
<tr>
<td>Foreign exchange contracts</td>
<td>Foreign currency gain (loss)</td>
<td>XX</td>
<td>Foreign currency gain (loss)</td>
<td>XX</td>
</tr>
<tr>
<td>Equity contracts</td>
<td>Other income (expense)</td>
<td>XX</td>
<td>Other income (expense)</td>
<td>XX</td>
</tr>
<tr>
<td>Credit derivatives</td>
<td>Other income (expense)</td>
<td>XX</td>
<td>Other income (expense)</td>
<td>XX</td>
</tr>
<tr>
<td>Other contracts</td>
<td>Other income (expense)</td>
<td>XX</td>
<td>Other income (expense)</td>
<td>XX</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>XX</td>
<td></td>
<td>XX</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Derivatives in Cash Flow Hedging Relationships</th>
<th>Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion)</th>
<th>Location of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)[*]</th>
<th>Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)</th>
<th>Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) [*]</th>
<th>Amount of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate contracts</td>
<td>XX</td>
<td>Interest income (expense)</td>
<td>XX</td>
<td>Other income (expense)</td>
<td>XX</td>
</tr>
<tr>
<td>Foreign exchange contracts</td>
<td>XX</td>
<td>Sales/Revenue</td>
<td>XX</td>
<td>Other income (expense)</td>
<td>XX</td>
</tr>
</tbody>
</table>
The gains and losses disclosed include those that relate to derivative instruments that exist at the end of the reporting period and those that are no longer held at the end of the reporting period. The amounts are not required to be separately disclosed.

**44.23** Paragraph 44C of the Standard (ASC paragraphs 815-10-50-4A through 50-4F) allows entities to present the location and amounts of gains or losses related to hedged items in either a tabular or nontabular format.

**Trading Activities Exception**

**44.24** Paragraphs 44C(c) of the Standard (ASC paragraphs 815-10-50-4F) allows entities to elect to not separately disclose gains and losses from trading derivatives provided that certain disclosures are made:

44C(c). For derivative instruments that are not designated or qualifying as hedging instruments under this Statement, if an entity’s policy is to include those derivative instruments in its trading activities (for example, as part of its trading portfolio that includes both derivative and nonderivative or cash instruments), the entity can elect to not separately disclose gains and losses as required by subparagraph 44C(b)(5) (ASC paragraph 815-10-50-4C(e)) above provided that the entity discloses all of the following:

1. The gains and losses on its trading activities (including both derivative and nonderivative instruments) recognized in the statement of financial performance, separately by major types of items (such as fixed income/interest rates, foreign exchange, equity, commodity, and credit)

2. The line items in the statement of financial performance in which trading activities gains and losses are included

3. A description of the nature of its trading activities and related risks, and how the entity manages those risks.
**44.24a** Disclosing gains and losses on only derivative instruments that are part of an entity’s trading activity may be problematic because financial institutions generally trade using both derivative instruments and nonderivative instruments. Such trading activity often is included in a trading portfolio that may contain both market-making and proprietary positions. Financial institutions often use both derivative instruments and nonderivative instruments to manage the overall risk in their trading portfolios. In these cases, disclosing only derivative instrument gains and losses may not be meaningful (or may be misleading), because the offsetting losses and gains on the nonderivative instruments included in the same trading portfolio would not be disclosed. Thus, an entity may elect to not separately disclose gains and losses related to derivative instruments that are included in trading activities and are not accounted for as hedging instruments if it discloses the following information:

- The amount of and gains or losses on the entity's trading activities in the statement of financial performance disaggregated by major types of items (e.g., fixed interest rates, foreign exchange, equity, commodity, or credit);
- Location of those gains or losses on the entity's trading activities in the statement of financial performance disaggregated by major types of items; and
- Description of the nature of the trading activities and the related risks and how the entity manages those risks.

**Disclosures of Credit-Risk-Related Contingent Features in Derivative Instruments**

**44.25** Paragraph 44D of the Standard (ASC paragraph 815-10-50-4H) requires additional disclosures for derivatives instruments (and nonderivative hedging instruments) in net liability positions with credit-risk-related contingent features. A typical credit-risk-related contingent feature contained in a derivative instrument may require an entity to maintain a minimum investment grade credit rating. If the entity's credit rating falls below the minimum investment grade credit rating, the entity would be required to pay the derivative liability or post collateral.

**44D.** An entity that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 37 and 42) (ASC paragraphs 815-20-25-37, 25-58, and 25-59, and 815-35-35-1 and 35-2) shall disclose for every annual and interim reporting period for which a statement of financial position is presented:

- The existence and nature of credit-risk-related contingent features and the circumstances in which the features could be triggered in derivative instruments that are in a net liability position at the end of the reporting period
- The aggregate fair value amounts of derivative instruments that contain credit-risk-related contingent features that are in a net liability position at the end of the reporting period
- The aggregate fair value of assets that are already posted as collateral at the end of the reporting period and (1) the aggregate fair value of additional assets that would be required to be posted as collateral and/or (2) the aggregate fair value of assets...
needed to settle the instrument immediately, if the credit-risk-related contingent features were triggered at the end of the reporting period.

12a4 See footnote 12a1
12a5 See footnote 12a3

Disclosures Related to Credit Derivatives and Certain Guarantees

44.26 Paragraph 44DD of the Standard calls for sellers of credit derivatives to disclose additional information about exposure to potential loss from credit risk related events. It states the following:

44DD. For the purpose of this paragraph, a credit derivative is a derivative instrument (1) in which one or more of its underlyings are related to the credit risk of a specified entity (or a group of entities) or an index based on the credit risk of a group of entities and (2) that exposes the seller to potential loss from credit-risk-related events specified in the contract. Examples of credit derivatives within the scope of this paragraph include, but are not limited to, credit default swaps, credit spread options, and credit index products. This paragraph’s scope also includes a hybrid instrument that has an embedded credit derivative (for example, a credit-linked note). A seller of credit derivatives shall disclose information about its credit derivatives and hybrid instruments that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, financial performance, and cash flows. (The term seller refers to the party that assumes credit risk, which could be a guarantor in a guarantee type contract, and any party that provides the credit protection in an option type contract, a credit default swap, or any other credit derivative contract. A seller is also sometimes referred to as a writer of the contract.) With respect to hybrid instruments that have embedded credit derivatives, the seller of the embedded credit derivative shall disclose the required information for the entire hybrid instrument, not just the embedded credit derivatives. For each statement of financial position presented, the seller of a credit derivative shall disclose the following information for each credit derivative, or each group of similar credit derivatives, even if the likelihood of the seller’s having to make any payments under the credit derivative is remote. One way to present the information for groups of similar credit derivatives would be first to segregate the disclosures by major types of contracts (for example, single-name credit default swaps, traded indexes, other portfolio products, and swaptions) and then, for each major type, provide additional subgroups for major types of referenced/underlying asset classes (for example, corporate debt, sovereign debt, and structured finance).

(a) The nature of the credit derivative, including the approximate term of the credit derivative, the reason(s) for entering into the credit derivative, the events or circumstances that would require the seller to perform under the credit derivative, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the credit derivative. For example, the current status of the payment/performance risk of a credit derivative could be based on either recently issued external credit ratings or current internal groupings used by
the seller to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

(b) The maximum potential amount of future payments (undiscounted) the seller could be required to make under the credit derivative. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the credit derivative (which are addressed under (d) below). If the terms of the credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the seller is unable to develop an estimate of the maximum potential amount of future payments under the credit derivative, the seller shall disclose the reasons why it cannot estimate the maximum potential amount.

(c) The fair value of the credit derivative as of the date of the statement of financial position.

(d) The nature of (1) any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the credit derivative, the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. The seller shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the credit derivative. In its estimate of potential recoveries, the seller of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

However, the disclosures required by this paragraph do not apply to an embedded derivative feature related to the transfer of credit risk that is only in the form of subordination of one financial instrument to another, as described in paragraph 815-15-15-9.*

* This guidance was added to ASC paragraph 815-10-50-4K by ASU 2010-11. ASC paragraph 815-15-15-9 refers to the guidance in paragraph 14B of the historical Standard that was effectively revised by ASU 2010-11. See additional guidance in paragraphs 14.17-14.28 of Section 3.

44.27 The Standard requires sellers of credit derivatives, including credit derivatives embedded in hybrid instruments, to disclose additional information about exposure to potential loss from credit risk related events. Credit derivatives, as defined by the Standard, are derivative instruments that have the following two characteristics: (1) one or more of its underlyings are related to the credit risk of a specified entity (or group of entities) or to an index based on the credit risk of a group of entities, and (2) it exposes the seller to potential loss from credit risk related events specified in the contract. Credit derivatives within the scope of the Standard (ASC paragraphs 815-10-15 through 15-82) do not include freestanding instruments that meet the financial guarantee contract scope exception provided in paragraph 10(d) of the Standard (ASC paragraph 815-10-15-58). Examples of credit derivatives within the scope of the Standard (ASC paragraph 815-10-65-2) include credit default swaps, credit spread options, and credit index products. A credit linked note is an example of a hybrid instrument subject to the Standard. The Standard states that a seller of a credit derivative that is embedded in a hybrid instrument must
provide the above disclosures for the entire hybrid instrument, rather than only the embedded credit derivative. ASU 2010-11, Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives, clarifies that the disclosures for credit derivatives do not apply to embedded derivative features related to the transfer of credit risk that is only in the form of subordination of one financial instrument to another (as described in paragraph 14B of the Standard (ASC paragraph 815-15-15-9)).

44.28 Generally, we believe that a total return swap would meet the definition of a credit derivative based on its terms. Typically, a total return swap requires that one party (the buyer) make fixed or variable payments, while the other party (the seller) make payments based on the return of an underlying asset (e.g., a corporate bond), including the income it generates and any capital gains. A total return swap with these terms would meet the definition of a credit derivative, as one of its underlyings is related to the credit risk of a specified entity (i.e., the issuer of the bond) and exposes the seller to potential loss from a credit-risk-related event associated with the issuer of the bond. In the event that the terms of a total return swap are different from those described above, entities should carefully evaluate the instrument to determine if it would meet the definition of a credit derivative as set forth in the Standard (ASC paragraph 815-10-65-2).

44.29 The Standard permits entities to present the above information for groups of similar credit derivatives. It states that one way to present the grouped information is to segregate the disclosures by major types of contracts (e.g., single-name credit default swaps, traded indexes, swaptions, and other portfolio products) and, for each major type of contract, to provide additional subgroups for major types of referenced or underlying asset classes (e.g., corporate debt, sovereign debt, and structured finance).

44.30 [Not used].

44.31 Other derivative instruments in the form of guarantees that are within the scope of Statement 133 (ASC paragraphs 815-10-15-83 through 15-139) (including guarantees that do not meet the definition of a credit derivative under the Standard are not subject to the initial recognition and measurement provisions of FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45) (ASC paragraphs 460-10-30-1 through 30-4), but are subject to the disclosure requirements of FIN 45 (ASC paragraphs 460-10-50-4 through 50-6 and 50-8). Freestanding guarantees that meet the financial guarantee contract scope exception in paragraph 10(d) of Statement 133 (ASC paragraph 815-10-15-58) are subject to the recognition, measurement, and disclosure requirements of FIN 45 (ASC paragraphs 460-10-50-4 through 50-6 and 50-8). FIN 45 (ASC paragraphs 460-10-50-4 through 50-6 and 50-8) requires guarantors to disclose the current status of the guarantee’s payment/performance risk. The disclosures required under FIN 45 (ASC paragraphs 460-10-50-4 through 50-6 and 50-8) for other derivative instruments in the form of guarantees that are within the scope of Statement 133 but do not meet the definition of a credit derivative under the Standard and for freestanding financial guarantees excluded from Statement 133 by paragraph 10(d) (ASC paragraph 815-10-15-58) are similar to the information that must be disclosed by sellers of credit derivatives within the scope of the Standard. Specifically, the disclosure requirements of FIN 45 (ASC paragraph 460-10-50-4) require the following information to be disclosed about each guarantee, or each group of similar guarantees, within its scope:
(1) The nature of the guarantee, including the approximate term, how the guarantee arose, the events or circumstances that would require the guarantor to perform under the guarantee, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the guarantee. For example, the current status of the payment/performance risk of a credit-risk-related guarantee could be based on either recently issued external credit ratings or current internal grouping used by guarantor to manage its risk. An entity that uses internal groupings should disclose how those grouping are determined and used for managing risk.

(2) The maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee.

(3) The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee, regardless of whether the guarantee is freestanding or embedded in another contract.

(4) The nature of any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee and any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee.

44.32 The issuance of Statement 133 did not change the applicability of FASB Statement No. 5, Accounting for Contingencies (ASC Topic 450, Contingencies), and guarantees accounted for as derivative instruments under Statement 133 (ASC Section 815-10-15) have remained subject to the disclosure requirements of paragraphs 9-12 of Statement 5 (ASC Sections 450-20-50 and 450-10-50).

Requirement to Cross Reference Footnotes That Contain Derivative Related Information

44.33 Paragraph 44E (ASC paragraph 815-10-50-4I) requires the following:44E. If information on derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 37 and 42) is disclosed in more than a single footnote, an entity shall cross-reference from the derivative footnote to other footnotes in which derivative-related information is disclosed.

44.34 The Standard requires that when an entity discloses, in more than one footnote, the information related to derivative instruments (including bifurcated derivative instruments and nonderivative hedging instruments) required by paragraph 44 of Statement 133, it should cross-reference from the derivative footnote to the appropriate other footnotes.

Disclosures Related to Concentration of Counterparty Credit Risk

44.35 The term financial instruments used in paragraph 15A of Statement 107 (ASC paragraphs 825-10-50-20 and 50-21) includes derivative instruments accounted for under Statement 133. This means that entities must disclose significant concentrations of credit risk arising from derivative instruments. The disclosures can be presented on an individual counterparty basis or by groups of counterparties if the counterparties are engaged in similar activities and are exposed
to similar risks. Entities must disclose the following information related to derivative instruments:

- Information about the (shared) activity, region, or economic characteristic that identifies the concentration;
- The maximum amount of loss due to credit risk that, based on the gross fair value of the derivative instrument, the entity would incur if parties to the derivative instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity;
- The entity's policy of requiring collateral or other security to support derivative instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those derivative instruments; and
- The entity's policy of entering into master netting arrangements to mitigate the credit risk of derivative instruments, information about the arrangements for which the entity is a party, and a brief description of the terms of those arrangements, including the extent to which they would reduce the entity's maximum amount of loss due to credit risk.

OTHER QUANTITATIVE DISCLOSURES

Required Disclosures

45.01 The purpose of these quantitative disclosures is to provide financial statement users with a gauge as to whether the entity’s hedging objectives were met. The specific nature of the quantitative disclosures required by the Standard depends on whether the derivative instrument is designated as part of a fair value hedge, a cash flow hedge, or a hedge of a net investment in a foreign operation. A brief description of the requirements and examples are presented below.

45.02 Paragraph 45 of the Standard (ASC paragraphs 815-25-50-1 and 50-2, 815-30-50-1 and 50-3, and 815-35-50-2) requires entities to make certain quantitative disclosures in their financial statements:

45. An entity’s disclosures for every annual and interim reporting period for which a statement of financial position and a statement of financial performance is presented also shall include the following:

45.03 The Standard’s (ASC paragraphs 815-25-50-1 and 50-2, 815-30-50-1 and 50-3, and 815-35-50-2) quantitative disclosures are required every annual and interim period for which an entity presents both a statement of financial position and statement of financial performance.

FAIR VALUE HEDGES

45a.01 Paragraph 45(a) (ASC paragraph 815-25-50-1) requires entities to make the following quantitative disclosures about fair value hedges:
45. Fair value hedges

(a) For derivative instruments, as well as nonderivative instruments that may give rise to foreign currency transaction gains or losses under Statement 52, that have been designated and have qualified as fair value hedging instruments and for the related hedged items:

(1) The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges’ ineffectiveness and (b) the component of the derivative instruments’ gain or loss, if any, excluded from the assessment of hedge effectiveness.

(2) The amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge.

DIG Issues related to this paragraph are I1 and K4. See DIG Issues Index.

Example 9.3: Fair Value Hedge

Footnote XX excerpt:

The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges’ ineffectiveness and (b) the component of the derivative instruments’ gain or loss, if any, excluded from the assessment of hedge effectiveness (paragraph 45(a)(1) (ASC paragraph 815-25-50-1)):

During the year ended December 31, 20X2, $XXX (20X1 - $XXX) was recognized in other income. This amount represents the sum of i) the changes in the fair value of the euro hedging forward contract related to the differences between changes in the spot and forward rates (i.e., changes in time value that are excluded from the assessment of hedge effectiveness), and ii) the ineffective portion of the hedge.

The amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge (paragraph 45(a)(2) (ASC paragraph 815-25-50-1)):

The Company previously reported $X of firm commitments (20X1 - $X) in property, plant, and equipment. This amount related to fair value hedges of firm commitments to purchase equipment. During the year ended December 31, 20X2 (20X1), this amount was recognized as an expense in other income as the firm commitments no longer qualified as hedged items.

CASH FLOW HEDGES

45b.01 Paragraph 45(b) the Standard (ASC paragraph 815-30-50-1) requires entities to make the following quantitative disclosures:

45. Cash flow hedges

b. For derivative instruments that have been designated and have qualified as cash flow hedging instruments and for the related hedged transactions:
DIG Issues related to this paragraph are I2 and K4. See DIG Issues Index.

45b.02 The disclosures required by paragraphs 45(b)(4) (ASC paragraph 815-30-50-1) above are similar to the disclosures required for fair value hedges.

45b.03 Paragraph 45(b)(2) (ASC paragraph 815-30-50-1(c)) requires the reporting entity to disclose an estimate of the net amount of the existing gains or losses at the reporting date that will be reclassified from AOCI into earnings during the next 12 months. Entities also are required to describe the transactions or events that will trigger the reclassification. When derivative instruments such as interest rate or commodity swaps are used for cash flow hedges, in effect a single derivative is being used to hedge multiple hedged forecasted transactions because a swap involves multiple cash flows (like a series of forward contracts). For example, a five-year interest rate swap agreement may be designated as the hedging instrument to hedge the variability in cash flows for each of the resets in a five-year variable-rate borrowing. The fair value of the swap may be the net of both positive cash flows (i.e., the right to receive future payments) and negative cash flows (i.e., the obligation to make future payments). This could happen, for instance, if near-term forward rates were below the fixed rate on the swap and far-term forward rates were above the fixed rate on the swap, in which case an entity could have an expectation of having to make cash outflows on the swap for near-term exposures and to receive cash inflows on the swap for the far-term exposures. In this instance, a question arises as to the appropriate way to provide the disclosure required by paragraph 45(b)(2) (ASC paragraph 815-30-50-1(c)). To measure the amount of AOCI to be reclassified into earnings in the coming 12 months when multiple cash flow exposures are designated as the hedged items for a single derivative instrument, the total amount reported in AOCI for the hedging relationship first must be allocated to each of the forecasted transactions within the hedging relationship, taking into account the cumulative gain or loss that has been recognized in earnings as hedge ineffectiveness. After the amount reported in AOCI has been allocated to each forecasted transaction, the entity should sum those estimated amounts to be reclassified into earnings in the next 12 months. This aggregate amount could be greater or less than the net amount reported in AOCI. (See DIG Issue I2 for further reference.)
Paragraph 45(b)(3) (ASC paragraph 815-30-50-1(d)) requires disclosure of the maximum length of time over which the entity hedges its cash flow exposure that is not related to payments of variable interest on existing financial instruments. This disclosure highlights management’s assessment of the probability of these transactions occurring in light of the length of time until the forecasted transactions are projected to occur. We believe this disclosure is required because of the Board’s position that the more distant a forecasted transaction is, the less likely it is that the transaction is probable.

Example 9.4: Cash Flow Hedge - Foreign Currency Exposure

A description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in AOCI, and the estimated net amount of the existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months (paragraph 45(b)(2) (ASC paragraph 815-30-50-1(b))):

Changes in the spot value of the euro forward contracts designated and qualifying as cash flow hedges of forecasted purchases of equipment are reported in AOCI. The gains and losses are reclassified into earnings, as a component of depreciation expense, in the same period as the asset acquired affects earnings.

It is expected that $XX of net gains in AOCI relating to euro forward contracts will be reclassified into depreciation expense during the period ended December 31, 20X3.

Disclosure of the maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments (paragraph 45(b)(3) (ASC paragraph 815-30-50-1(d))):

As of December 31, 20X2, the maximum length of time over which the Company is hedging its exposure to the variability in future cash flows associated with foreign currency forecasted transactions is eight months.

The amount of gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur by the end of the originally specified time period or within the additional period of time discussed in paragraph 33 (paragraph 45(b)(4) (ASC paragraph 815-30-50-1(e))):

Also included in other income are gains (losses) of $XX for the year ended December 31, 20X2 (20X1 - $(XX)) reclassified from AOCI as a result of the discontinuance of foreign currency cash flow hedges because it was probable that the original forecasted transactions would not occur by the end of the originally specified time period or within the permitted additional two-month period of time thereafter.

Example 9.5: Cash Flow Hedge - Interest Rate Exposure

Footnote XX excerpt:

A description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in accumulated other comprehensive income,
and the estimated net amount of the existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months (paragraph 45(b)(2) (ASC paragraph 815-30-50-1(b))):

Changes in the fair value of interest rate swaps designated as hedging instruments of the variability of cash flows associated with floating-rate, long-term debt obligations are reported in AOCI. These amounts subsequently are reclassified into interest expense as a yield adjustment in the same period in which the related interest on the floating-rate debt obligations affects earnings.

During the year ended December 31, 20X3, approximately $XX of gains in AOCI related to the interest rate swap are expected to be reclassified into interest expense as a yield adjustment of the hedged debt obligation.

The amount of gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur by the end of the originally specified time period or within the additional period of time discussed in paragraph 33 (paragraph 45(b)(4) (ASC paragraph 815-30-50-1(e))):

Also included in other income (expense) are gains (losses) of $XX for the year ended December 31, 20X2 (20X1 - $(XX)). These were reclassified from AOCI because of the early extinguishment of a portion of the hedged debt obligation.

**Encouraged Quantitative Disclosures**

**45.04** Paragraph 45 of the Standard (ASC paragraph 815-35-50-2) also encourages entities to make the following quantitative disclosures:

45. The quantitative disclosures about derivative instruments may be more useful and less likely to be perceived to be out of context or otherwise misunderstood if similar information is disclosed about other financial instruments or nonfinancial assets and liabilities to which the derivative instruments are related by activity. Accordingly in those situations an entity is encouraged but not required to present a more complete picture of its activities by disclosing that information.

**45.05** The Standard does not require separate quantitative disclosures about derivative instruments not qualifying as hedging instruments; the Board concluded that the cost of accumulating this information outweighed its benefits. However, paragraph 45 of the Standard (ASC paragraph 815-35-50-2) encourages, but does not require, entities to provide quantitative information about other financial instruments and nonfinancial assets and liabilities.

**45.06** The Board encourages entities to experiment with various ways in which disclosures about derivative instruments might be presented to make them more understandable and useful.

**REPORTING CASH FLOWS OF DERIVATIVE INSTRUMENTS THAT CONTAIN FINANCING ELEMENTS**

**45A.01** Paragraph 45A of the Standard (ASC paragraph 815-10-45-12) requires an entity to classify a derivative instrument’s cash flows as a financing activity in its statement of cash flows.
if the derivative instrument contains an element of borrowing (i.e., a financing element), as follows:

45A. An instrument accounted for as a derivative under this Statement that at its inception includes off-market terms, or requires an up-front cash payment, or both often contains a financing element. Identifying a financing element within a derivative is a matter of judgment that depends on facts and circumstances. If an other-than-insignificant financing element is present at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract), then the borrower shall report all cash inflows and outflows associated with that derivative instrument in a manner consistent with financing activities as described in paragraphs 18–20 of FASB Statement No. 95, Statement of Cash Flows (ASC paragraphs 230-10-45-14 and 45-15).

* An at-the-money plain-vanilla interest rate swap that involves no payments between the parties at inception would not be considered as having a financing element present at inception even though, due to the implicit forward rates derived from the yield curve, the parties to the contract have an expectation that the comparison of the fixed and floating legs will result in payments being made by one party in the earlier periods and being made by the counterparty in the later periods of the swap’s term. If a derivative instrument is an at-the-money or out-of-the-money option contract or contains an at-the-money or out-of-the-money option contract, a payment made at inception to the writer of the option for the option’s time value by the counterparty should not be viewed as evidence that the derivative instrument contains a financing element. In contrast, if the contractual terms of a derivative have been structured to ensure that net payments will be made by one party in the earlier periods and subsequently returned by the counterparty in the later periods of the derivative’s term, that derivative instrument should be viewed as containing a financing element even if the derivative has a fair value of zero at inception.

45A.02 Generally the cash flows from derivative hedging instruments are classified in the same category as the cash flows from the hedged item while cash flows associated with nonhedging derivative instruments are classified based on the nature and purpose for which the nonhedging derivative instruments were acquired. For example, cash receipts and cash payments resulting from purchases and sales of derivative instruments would be classified as operating cash flows if those assets are acquired specifically for the purpose of selling them in the near term, with the objective of generating profits on short-term differences in price, and are carried at market value in a trading account. These classifications may not have provided transparency when the derivative instrument contained a borrowing component. Entities that structured borrowings as derivative instruments may have classified the cash flows associated with the derivative as operating cash flows. For example, the holder of a derivative instrument that requires an up-front cash payment by the issuer as part of a borrowing transaction would initially record the derivative as a liability and may have reflected the proceeds received at inception, as well as any subsequent cash payments or receipts, as operating activities in its statement of cash flows. To improve the disclosure of those types of transactions, paragraph 45A (ASC paragraph 815-10-45-12) requires that, if a derivative instrument contains a financing element at inception, the borrower in the arrangement should report all cash flows associated with that derivative instrument as financing in its statement of cash flows, unless:

- The financing element is insignificant at inception, or
- The financing element is inherently included in an at-the-market derivative instrument with no prepayments.
45A.03 Before discussing the exceptions to the reporting requirement stipulated in paragraph 45A (ASC paragraphs 815-10-45-11 through 45-15), we should first understand when a financing element is present.

When a Derivative Instrument Contains a Financing Element

45A.04 The Board identified several characteristics that are often associated with a derivative instrument that contains a financing element:

- Up-front cash payments (e.g., a partially prepaid forward contract or interest rate swap agreement);
- Off-market terms (e.g., terms, rates, or prices that are not consistent with the current market for that type of contract); or
- A combination of up-front cash payments and off-market terms.

45A.05 The Board stated that the above characteristics indicate that the derivative instrument may contain a financing element at inception. However, some at-the-money derivative instruments that do not call for an up-front cash payment may also contain a financing element. For instance, if the contractual terms of a derivative instrument have been structured to ensure that net payments will be made by one party in the earlier periods and subsequently returned by the counterparty in the later periods of the derivative’s term, that derivative instrument should be viewed as containing a financing element even if the derivative has a fair value of zero at inception.

45A.06 The Board chose not to establish a specific criterion for when a derivative instrument contains a financing element because of the unlimited ways to structure those arrangements. Rather, identification of a financing element will require the application of judgment based on the specific facts and circumstances.

An Other-Than-Insignificant Financing Element

45A.07 If the financing element of the derivative instrument is insignificant at inception then all of the derivative instrument’s cash flows would not be reported as financing activities unless the derivative is a hedging instrument and the hedged item’s cash flows are reported as financing activities. The Board did not illustrate when a financing element is considered to be insignificant and did not provide guidance for measuring significance. Determining whether a financing element is significant is a matter of judgment that depends on the relevant facts and circumstances. We believe there may be several alternatives for measuring significance. For each of these alternatives, the financing element is compared to a reference amount. The reference amount used may include:

- An established percentage of the derivative instrument’s notional amount;
- An established fixed dollar amount applied to all derivative instruments (e.g., a financing element greater than $100,000 is deemed to be other-than-insignificant); or
- For nonfinancial derivatives, an established percentage of the instrument’s expected gross proceeds based on the spot price of the asset related to the underlying at inception of the derivative instrument.
Entities should select an approach that is appropriate considering their facts and circumstances and consistently apply the approach.

**A Financing Element Inherently Included in an At-The-Market Derivative Instruments with No Prepayments**

All derivative instruments contain a financing element. For example, the premium paid for an at-the-money option contract represents the time value of the option. The risk-free interest rate is a component of an option’s time value. The Board chose not to require the cash flow reporting of paragraph 45A (ASC paragraph 815-10-45-12) for at-the-money derivative instruments with no prepayments that inherently include a financing element. As such, the cash flows associated with the following derivative instruments would not be reported as financing cash flows, unless the derivative is a hedging instrument and the hedged item’s cash flows are reported as financing activities:

- An at-the-money plain-vanilla interest rate swap that involves no prepayments;
- An at-the-money forward contract that involves no prepayments; or
- An option contract where the payment made at inception to the writer of the option is only for the option’s time value.

Application of the guidance in paragraph 45A (ASC paragraphs 815-10-45-11 through 45-15) does not impact the classification of the derivative instrument and its related gains and losses in an entity’s statement of financial position and income statement, respectively. An entity would need to apply the other guidance in the Standard, discussed elsewhere in this chapter. In addition, the guidance in paragraph 45A (ASC paragraphs 815-10-45-11 through 45-15) does not apply to the lender in a derivative instrument that contains an other-than-insignificant financing element. Lastly, we believe the inception of the derivative instrument for purposes of determining whether it contains a financing element is the date the entity enters into the derivative instrument. This date may be later than the derivative instrument's original inception date if it was purchased in the secondary market or as part of a business combination.

**REPORTING CHANGES IN THE COMPONENTS OF COMPREHENSIVE INCOME**

**Other Comprehensive Income**

Paragraph 46 of the Standard (ASC paragraph 815-30-45-1) requires entities to make the following disclosures within OCI.

46. An entity shall display as a separate classification within other comprehensive income the net gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments that are reported in comprehensive income pursuant to paragraphs 30 (ASC paragraphs 815-30-35-3 and 41815-20-25-65).

46.02 Although gains and losses arising from cash flow hedging activities may be attributable to different types of risks (e.g., foreign currency risk, interest rate risk, risk of changes in creditworthiness), there is no requirement to categorize and present separately in OCI the net...
gain or loss on designated derivative instruments by the different types of hedged risks. Instead, an entity only is required to present the aggregate net gain or loss relating to cash flow hedging instruments.

46.03 FASB Statement No. 130, *Reporting Comprehensive Income* (Statement 130) (ASC Topic 220, *Comprehensive Income*), requires entities to report comprehensive income. In accordance with paragraph 24 of Statement 130 (ASC paragraph 220-10-45-11), an entity must display components of OCI either (a) individually net of related tax effects, or (b) individually before related tax effects with one amount shown for the aggregate income tax expense or benefit related to the total of all items included in OCI. In addition, paragraph 25 of Statement 130 (ASC paragraph 220-10-45-12) gives the entity the choice of disclosing the amount of income tax expense or benefit allocated to each component of OCI, including reclassification adjustments, either on the face of the statement in which those components are displayed or in the notes to the financial statements.

**Example 9.6: [Not used]**

**Example 9.7: Presentation of Tax Amounts in the Notes to Financial Statements**

Excerpt from the Statement of Income and Comprehensive Income:

| Income from operations before tax | $ XXX |
| Income tax expense | (XX) |
| Net income | $ XXX |
| Other comprehensive income, before tax[^1] | |
| Cash flow hedges: | |
| Net derivative gains | $ X |
| Reclassification adjustment | (X) |
| Other comprehensive income before tax | $ XXX |
| Income tax expense related to items of other comprehensive income | (XX) |
| Other comprehensive income, net of tax | $ XXX |
| Comprehensive income | $ XXX |

[^1]: It has been assumed that the entity has no investment in foreign operations and, therefore, no CTA balance.

Excerpt from footnote to financial statements:

<table>
<thead>
<tr>
<th>Net gains (losses) on derivatives hedging variability of cash flows</th>
<th>Before-Tax Amount</th>
<th>Tax (Expense) Benefit</th>
<th>Net-of-Tax Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ X</td>
<td>(X)</td>
<td>$ X</td>
<td></td>
</tr>
</tbody>
</table>
Reclassification adjustments for gains (losses) reclassified into income

<table>
<thead>
<tr>
<th></th>
<th>(X)</th>
<th>X</th>
<th>(X)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net gains</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>$ XXX</td>
<td>X</td>
<td>$ XXX</td>
</tr>
</tbody>
</table>

Example 9.8: Presentation of Tax Amounts on the Face of the Statement of Income and Comprehensive Income

Excerpt from the Statement of Income and Comprehensive Income:

<table>
<thead>
<tr>
<th>Income from operations before tax</th>
<th>$ XXX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax expense</td>
<td>(XX)</td>
</tr>
<tr>
<td>Net income</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Other comprehensive income, net of tax</td>
<td></td>
</tr>
<tr>
<td>Cash flow hedges:</td>
<td></td>
</tr>
<tr>
<td>Net derivative gains, net of tax effect of ($X)</td>
<td>$ X</td>
</tr>
<tr>
<td>Reclassification adjustment, net of tax effect of $X</td>
<td>(X)</td>
</tr>
<tr>
<td>Net change</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Comprehensive income</td>
<td>$ XXX</td>
</tr>
</tbody>
</table>

Accumulated Other Comprehensive Income

47.01 Paragraph 47 of the Standard (ASC paragraph 815-30-50-2) requires the entity to make the following disclosures within AOCI:

47. As part of the disclosures of accumulated other comprehensive income, pursuant to paragraph 26 of FASB Statement No. 130, Reporting Comprehensive Income (ASC paragraph 220-10-45-14), an entity shall separately disclose the beginning and ending accumulated derivative gain or loss, the related net change associated with current period hedging transactions, and the net amount of any reclassification into earnings.

47.02 Paragraph 26 of Statement 130 (ASC paragraph 220-10-45-14) requires an entity to disclose accumulated balances for each classification in the AOCI separate component of equity in the statement of financial position, in the statement of changes in equity, or in the notes to the financial statements. These classifications must correspond to classifications used elsewhere in the same set of financial statements for components of OCI.

Example 9.9: Accumulated Other Comprehensive Income

Excerpt from Statement of Changes in Equity:

| Opening balance of accumulated net gain (loss) on cash flow hedges | $ XXX |
| Net gain (loss) on cash flow hedges                                  | (XXX) |
OTHER ISSUES

47.03 The measurement and recognition principles of the Standard require entities to consider how derivative instruments (and nonderivative hedging instruments) and hedged items are displayed in the financial statements. This consideration encompasses many issues. Some of the more common issues, which are not addressed specifically in the Standard, include:

- Reporting derivative instruments and hedged items in the statement of financial position;
- Reporting changes in derivative instruments and hedged items in the income statement;
- The display of embedded derivative instruments; and
- Presentation by entities that do not report earnings as a separate caption in a statement of financial performance.

Reporting Derivative Instruments and Hedged Items in the Statement of Financial Position

47.04 The requirement to recognize all derivative instruments at fair value may result in the recognition of new assets and liabilities. The fair value hedging principles also may result in the recognition of assets and liabilities arising from hedged firm commitments. In addition, fair value hedge accounting may cause the carrying amount of recognized assets and liabilities designated as hedged items to change. As a result of these principles, certain issues arise relating to presenting information in the statement of financial position. These include:

- The presentation of derivative instruments;
- The presentation of adjustments to hedged items; and
- The presentation of derivative hedging instruments and hedged items.

THE PRESENTATION OF DERIVATIVE INSTRUMENTS

47.04a While ASC Topic 815 requires derivatives to be recorded at fair value, it provides no specific guidance for entities that issue a classified statement of financial position and are therefore required to separately present assets and liabilities as current or noncurrent. The guidance in ASC Section 210-10-45 results in assets and liabilities being classified in the statement of financial position as either current or noncurrent based on whether they can or will be settled within one year.

47.04b Determining the current or noncurrent classification of a derivative contract may be complex because the value of a derivative is typically computed on a net basis and represents all the expected cash flows throughout its remaining life (as opposed to the actual amount expected...
to be paid or received). Moreover, in one period it may represent a net asset but in another it may represent a net liability, depending on market movements. In addition, when a derivative has multiple settlements, one or more of those expected cash flows may be in a receive position, while one or more of those expected cash flows may be in a pay position; however those offsetting cash flows would be netted together in determining the total fair value of the derivative.

47.04c Given the lack of guidance about the classification of a derivative contract on the statement of financial condition, we believe entities should develop an accounting policy, apply that policy consistently, and disclose their policy accordingly. There may be diversity in practice on these issues, however some best practices for determining the classification are:

- Derivatives that will mature within one year, as a whole, are classified as current;
- Derivatives in a liability position for which the counterparty can terminate the entire contract at any time are treated similar to demand obligations and are classified as current;
- If neither of the above applies, the derivatives are separated into current and noncurrent portions based on the expected timing of the cash flows. In these circumstances, the instrument is split based on the fair value of cash flows occurring within one year and the fair value of cash flows occurring beyond one year. Entities may consider, by analogy, the approach used for determining the amounts to be disclosed in accordance with paragraph 45(b)(2) of Statement 133 (ASC paragraph 815-30-50-4), including the guidance in paragraph 45b.03 (DIG Issue I2 or ASC paragraphs 815-30-45-2 and 45-3) for determining the amount to be released from AOCI within the next 12 months. The guidance in DIG Issue I2 (ASC paragraphs 815-30-45-2 and 45-3) requires entities to separate the individual undiscounted cash flows used in the valuation of the derivative between those occurring within the next 12 months and those occurring later. The present value of the cash flows occurring within the next 12 months would be classified as current and the present value of the cash flows occurring beyond 12 months would be classified as noncurrent.
- ASC paragraph 210-10-45-4 provides that cash designated for acquiring or constructing noncurrent assets or segregated for liquidating long-term debts, would be excluded from current assets, even if those funds are not actually set aside in special accounts. By analogy to that guidance, we believe that a derivative asset that would have otherwise been classified as current could be classified as noncurrent if it is designated as a hedge of the acquisition of a noncurrent asset or the liquidation of debt that is classified as noncurrent. We believe it would be inappropriate to analogize to this guidance when the derivative is in a liability position.

47.05 An issue arises as to whether derivative instruments may be aggregated and presented as either a net asset or net liability in the statement of financial position. As previously discussed, derivative instruments represent rights or obligations that meet the definition of assets or liabilities. Therefore, from a financial reporting perspective, the appropriate GAAP related to aggregating and offsetting assets and liabilities should be followed.
47.06 In practice, items with similar economic characteristics generally are aggregated in the statement of financial position. In this instance, we believe that all derivative instruments could be aggregated and presented as a net asset or net liability in the statement of financial position, subject to the offsetting provisions of FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FIN 39) (ASC Subtopic 210-20, *Balance Sheet - Offsetting*, and ASC Section 815-10-45). Alternatively, a disaggregated presentation (e.g., by instrument type or risk category) may be used.

47.07 The Standard has not changed the statement of financial position offsetting provisions for assets and liabilities as provided in APB Opinion No. 10, *Omnibus Opinion – 1966* (APB 10) (ASC paragraphs 210-20-45-6 and 45-7) and FIN 39 (ASC Subtopic 210-20). Paragraph 8 of FIN 39 (ASC paragraph 815-10-45-4) states that “unless [a right of setoff] exists, the fair value of contracts in a loss position should not be offset against the fair value of contracts in a gain position.” Therefore, derivative instrument assets and liabilities should not be offset unless the FIN 39 (ASC Subtopic 210-20) provisions have been met.

47.08 This presentation is consistent with the Board’s goal of increasing the visibility of the derivative instruments to enable financial statement users to compare different entities’ derivative positions and to understand the magnitude of the risks associated with these instruments.

47.09 FASB Staff Position FIN 39-1, "Amendment of FASB Interpretation No. 39," clarified that if the conditions for offsetting the fair values of derivative instruments under master netting arrangements exist, an entity may also make an accounting policy decision to offset related amounts recognized for the right to reclaim cash collateral (a receivable) or an obligation to return cash collateral (a payable) under those arrangements, as long as those amounts approximate fair value. The choice to offset or not must be applied consistently. An entity cannot offset fair values of derivative instruments without offsetting related fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral. If an entity makes an accounting policy decision to offset the fair value amounts for derivative instruments under master netting arrangements but concludes that the amounts recognized related to the collateral do not approximate fair value, it should continue to offset the fair values of the derivative instruments exclusive of the receivables (payables) associated with the collateral. See FSP FIN 39-1 for additional discussion and disclosure requirements.

47.10 EITF Issue 06-7,” Issuer’s Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133,” provides additional disclosure requirements. When an embedded conversion option in a convertible debt instrument no longer meets the bifurcation criteria in Statement 133, an issuer should account for the previously bifurcated conversion option by reclassifying the carrying amount of the liability for the conversion option (that is, its fair value on the date of reclassification) to shareholders’ equity. An issuer should disclose the following information for the period in which an embedded conversion option previously accounted for as a derivative instrument under Statement 133 no longer meets the separation criteria under that Statement:

(a) A description of the principal changes causing the embedded conversion option to no longer require bifurcation under Statement 133
(b) The amount of the liability for the conversion option reclassified to shareholders’ equity.

47.11 Registration payment arrangements within the scope of paragraph 10(j) of Statement 133 (ASC paragraphs 815-10-15-13(n) and 15-82) are not subject to the requirements of Statement 133. Such a registration payment arrangement is an arrangement in which an issuer of a financial instrument agrees to (1) endeavor to file a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon the exercise or conversion of those financial instruments and for the registration statement to be declared effective by the SEC within a specified grace period and/or (2) to maintain the effectiveness of the registration statement for a specified period of time. For a further discussion of registration payment arrangements, see Section 2, paragraph 10j.01-05 of this guide. This exception relates to both the issuer that accounts for the arrangement pursuant to paragraph 10(j) of Statement 133 (ASC paragraphs 815-10-15-13(n) and 15-82) and the counterparty.

47.11a Although outside the scope of Statement 133 (ASC Section 815-10-15), an issuer of a registration payment arrangement should disclose the following:

(1) Nature of the registration payment arrangement, including term, financial instruments subject to the arrangement and events or circumstances that would require the issuer to transfer consideration under the arrangement;

(2) Any settlement alternatives contained in the terms of the registration payment arrangement, including the party that controls the settlement alternatives;

(3) The maximum potential amount of consideration, undiscounted, that the issuer could be required to transfer under the registration payment arrangement. If there is no limitation on the maximum potential consideration to be transferred, that fact should be disclosed;

(4) The current carrying amount of the liability representing the issuer's obligations under the registration payment arrangement and the income statement classification of any gains or losses resulting from changes in the carrying amount of the liability.

47.12 [Not used]

THE PRESENTATION OF ADJUSTMENTS TO HEDGED ITEMS

47.13 The fair value hedging model requires the carrying amount of the hedged item (i.e., asset, liability, or firm commitment) to be adjusted for the change in its fair value attributable to the risk being hedged. An issue arises as to how to present this adjustment in the statement of financial position.

47.14 For hedged recognized assets and liabilities, the adjustment will become an integral part of the hedged item and does not represent a separate asset or liability. Thus, we believe the adjustment should be presented as part of the hedged item’s carrying amount.

47.15 In addition, for hedged firm commitments, the adjustment is an integral part of the asset to be acquired or liability to be incurred. Thus, we believe the adjustment should be presented in a manner consistent with the statement of financial position presentation of the underlying transaction. For example, if the hedged item is a firm commitment to purchase fixed assets in six
months, the carrying amount of the firm commitment should be aggregated with other fixed assets regardless of whether the carrying amount of the firm commitment is a debit or a credit.

THE PRESENTATION OF DERIVATIVE HEDGING INSTRUMENTS AND HEDGED ITEMS

47.16 An issue arises as to whether a derivative hedging instrument may be aggregated and presented together with its related hedged item. As previously discussed, derivative instruments, including derivative hedging instruments, represent rights or obligations that meet the definition of assets or liabilities. The hedged items also represent separate assets or liabilities. Therefore, the issue centers on whether:

- An asset and a liability can be offset;
- Two assets can be aggregated; and
- Two liabilities can be aggregated.

47.17 With respect to whether items can be aggregated or offset, we believe that GAAP and practice related to aggregating and offsetting assets and liabilities should be followed. As discussed above, FIN 39 (ASC Subtopic 210-20) provides guidance as to when assets and liabilities may be offset. We believe that it would be inappropriate to offset derivative instruments (and nonderivative hedging instruments) against the related hedged item. In addition, items with similar economic characteristics generally are aggregated.\(^1\) ASU 2011-11 (ASC Section 210-20-50)

**Reporting Changes in Derivative Instruments and Hedged Items in the Income Statement**

47.18 The requirement to recognize all derivative instruments at fair value may result in the recognition of gains and losses in the income statement. The fair value hedging principles also result in the recognition of gains and losses arising from hedged items. As a result of these hedging principles, certain income statement presentation issues arise. These include the presentation in the income statement of:

- Gains or losses on hedged items;
- Gains or losses on derivative instruments designated and qualifying as hedging instruments;
- Gains or losses on derivative instruments not designated and qualifying as hedging instruments; and
- The summarization of gains or losses on derivative instruments.

THE PRESENTATION OF GAINS OR LOSSES ON HEDGED ITEMS

\(^1\) This position is consistent with the consensus reached in EITF Issue No. 86-25, "Offsetting Foreign Currency Swaps." (ASC paragraph 815-10-45-2).
The fair value hedging model requires changes in the fair value of a hedged item attributable to the hedged risk to be recognized currently as gains or losses in earnings. An issue arises as to how to present these gains and losses in the income statement.

As stated above, the fair value adjustment to the hedged item attributable to the hedged risk is an integral part of the hedged item and should be presented as part of its carrying amount. Because of this relationship, we believe the gain or loss on the hedged item should be presented in the income statement in a manner consistent with the earnings effect of the hedged risk. Thus, for example, if declines in the credit risk of a loan receivable are designated as the hedged risk, we believe changes in the fair value of the loan due to declines in credit risk should be presented as a component of the provision for loan losses.

THE PRESENTATION OF GAINS OR LOSSES ON DERIVATIVE INSTRUMENTS DESIGNATED AND QUALIFYING AS HEDGING INSTRUMENTS

The gain or loss on a derivative hedging instrument potentially has three elements: the effective portion; the ineffective portion; and the portion excluded from the assessment of hedge effectiveness. An issue arises as to how to present these elements in the income statement. The issue centers on whether gains or losses on derivative hedging instruments: i) must be presented as one line item in the income statement, or ii) can be disaggregated by their elements and presented separately. The Standard is silent on this issue.

In DIG Issue No. K4, “Income Statement Classification of Hedge Ineffectiveness and the Component of a Derivative’s Gain or Loss Excluded from the Assessment of Hedge Effectiveness,” the FASB staff re-affirmed their position not to provide specific income statement classification guidance. While the Standard does not provide guidance on the required income statement classification of the amount of hedge effectiveness, ineffectiveness or the component of a derivative’s gain or loss that is excluded from the assessment of hedge effectiveness, the Standard does contain specific disclosure requirements for those items, as discussed earlier in this chapter.

While the Standard is silent as to the income statement classification of gains and losses on derivative instruments, at the December 2000 American Institute of Certified Public Accountants (AICPA) Conference on Current SEC Developments, the SEC staff expressed their view regarding certain income statement classification issues. The SEC staff indicated that they would expect public companies to:

- Classify the effective portion of the gain or loss on a derivative hedging instrument in the same income statement line item as the hedged item;
- Clearly disclose where the hedge ineffectiveness and the component of the derivative hedging instrument’s gain or loss excluded from the assessment of hedge effectiveness is recorded in the income statement; and
- Consistently apply the company’s income statement classification policy.

We believe that the SEC staff’s guidance on income statement classification is equally applicable to nonpublic companies.

When choosing a policy, there are several alternatives to applying the SEC staff’s guidance in the fair value hedging model:
• The entire change in the fair value of the derivative hedging instrument is presented in a manner consistent with the earnings effect of the hedged item. For example, assume a fair value hedge of interest rate risk inherent in a fixed-rate treasury bond with a purchased put option contract; the total change in the fair value of the put option is presented as a yield adjustment.

• The effective and ineffective portions are presented in a manner consistent with the earnings effect of the hedged item. The portion excluded from the assessment of hedge effectiveness is presented with the earnings effect of nonhedging derivative instruments. For example, assume a fair value hedge of interest rate risk inherent in a fixed-rate treasury bond with a purchased put option contract; the effective and ineffective portions of the hedging instrument’s gain or loss are presented as a yield adjustment and the portion excluded from the assessment of hedge effectiveness is presented together with the earnings effect of nonhedging derivative instruments.

• The effective portion of the derivative hedging instrument is presented in a manner consistent with the earnings effect of the hedged item. The ineffective portion and the portion excluded from the assessment of hedge effectiveness are presented with the earnings effect of nonhedging derivative instruments. For example, assume a fair value hedge of interest rate risk inherent in a fixed-rate treasury bond with a purchased put option contract; the effective portion is presented as a yield adjustment and the ineffective portion and the portion excluded from the assessment of hedge effectiveness are presented together with the earnings effect of nonhedging derivative instruments.

47.26 Although Paragraphs 47.23 and 47.25 focus on the fair value hedging model, the concepts discussed also apply to the cash flow hedging model. The major difference is that the recognition in earnings of the effective portion of the hedging instrument is delayed until the hedged forecasted transaction impacts earnings. Therefore, the timing of the recognition in earnings (i.e., reclassification from AOCI) of the effective portion of the hedging instrument may be different from the timing of the recognition in earnings of the other elements of the derivative hedging instrument. For example, assume a cash flow hedge of a forecasted purchase of equipment. Also assume that the reporting entity chooses the second presentation alternative above. The ineffective portion is recognized currently in earnings as depreciation expense. The portion excluded from the assessment of hedge effectiveness also is recognized currently in earnings, but recognized in other expense. Lastly, the effective portion, when appropriate, is reclassified from AOCI into earnings as depreciation expense.

THE PRESENTATION OF GAINS OR LOSSES ON DERIVATIVE INSTRUMENTS NOT DESIGNATED AND QUALIFYING AS HEDGING INSTRUMENTS

47.27 During the September 2003 meeting of the AICPA SEC Regulations Committee, the SEC staff announced a position they have taken regarding the income statement presentation of realized and unrealized gains and losses on derivative instruments not accounted for as hedges. At issue is the presentation of realized and unrealized gains and losses on derivative instruments not accounted for as hedging instruments in different line items on the income statement before and after settlement of the derivative. Specifically, the SEC staff has noted instances where entities are reporting unrealized gains and losses on such derivative instruments prior to
settlement of the derivative instrument in a “Risk Management Activities” line item in revenues on the income statement. Upon settlement of the derivative, the previously recorded unrealized gains and losses are reclassified from the “Risk Management Activities” line item to another line item on the income statement, usually related to the risk being economically hedged by the derivative instrument. Further, any remaining realized gain or loss on the derivative instrument is also being classified to that same income statement line item. Consider the following example:

ABC Company enters into an interest rate swap agreement to economically hedge its exposure to the variability in future cash flows related to its variable-rate debt. The interest rate swap does not qualify for cash flow hedge accounting (possibly due to a lack of documentation or the presence of certain features that result in ineffectiveness under the Standard). ABC recognizes all gains and losses on the interest rate swap in its income statement as they occur. Because the Standard is silent as to the income statement classification of gains and losses on derivatives, ABC chooses to classify the unrealized gains and losses of the interest rate swap as “Other Income and Expense” in its income statement. Upon the periodic settlement of the interest rate swap, ABC reclassifies the realized portion of the gain or loss from “Other Income and Expense” to “Interest Expense.” ABC discloses its policy for income statement classification of gains and losses on derivatives not held as hedging instruments, including the income statement line items impacted and the amounts reclassified between income statement line items.

47.28 The result of ABC Company’s initial classification of unrealized gains and losses and subsequent reclassification of realized gains and losses is to report interest expense as if the company’s debt were effectively hedged, while excluding from interest expense the volatility caused by recognizing the interest rate swap at fair value through earnings.

47.29 The SEC staff expressed the view that such accounting results in synthetic hedge accounting for arrangements that do not qualify for hedge accounting. Although the SEC staff agrees that the Standard does not prescribe specific placement of derivative instrument gains or losses on the income statement, the SEC staff believes that such split accounting (where unrealized gains or losses are recorded in one line item on the income statement and subsequently reclassified to another line item upon settlement) is inappropriate for arrangements that do not qualify for hedge accounting. Split accounting is contemplated in the Standard only in the hedge accounting model as it applies to the amounts recorded as ineffective and the amounts recorded as effective attributable to a qualifying hedging relationship. Therefore, public companies are precluded from classifying realized and unrealized gains and losses of a derivative instrument not held as a hedging instrument in separate income statement line items. The SEC staff also has stated that entities should apply this guidance for 2003 calendar-year filings. The guidance also should be applied by reclassification to prior period financial statements for comparability.

47.30 Although not stated by the SEC staff, we believe the SEC staff would not object to the presentation of both the realized and unrealized portions of derivative instrument gains and losses in one line item on the income statement (i.e., operating revenues or interest expense), as long as such presentation policy was consistently applied, disclosed appropriately, including amounts, matched the underlying economics of the transaction, and made sense from a financial analysis perspective.
In addition, the classification policy cannot conflict with other generally accepted accounting principles that address income statement line item classification. For example, gains and losses on credit derivatives that synthetically hedge the credit risk of loans receivable should not be included in the provision for loan losses by financial institutions given the importance of that line item to certain credit quality analyses.

47.30a The Staff of the Office of the Chief Accountant in the Division of Investment Management at the SEC (the Staff) has expressed similar views dealing with registered investment companies (Funds). Under Statement 133, a Fund is ineligible to account for a derivative instrument as a hedging instrument when the hedged item is an investment measured at fair value through earnings. The Staff addressed whether it is acceptable to present in the statement of operations, realized gains and losses on interest rate swaps entered into to "economically" hedge a Fund's exposure to changes in interest rates, combined with the related interest income associated with the investment. In other words, the Staff addressed whether a Fund could mark to market swap contracts with changes in value reported as a component of realized and unrealized gains and losses from investments on the statement of operations, while periodic cash payments under the contract are presented net with the related interest income associated with the investment. For the reasons noted in Paragraph 47.29, the Staff objects to this presentation for arrangements that do not qualify for hedge accounting.

47.30b In addition, we understand that the Staff believes that realized and unrealized gains and losses on interest rate swaps should not be presented as a component of net investment income in financial statements of a Fund, even if the Fund combines the mark to market and periodic cash payments in interest income. Rather, such amounts should be presented below net investment income as a component of realized and unrealized gains and losses from investments.

47.30c We believe the above guidance should be applied to any non-hedging derivative instruments, including a purchased interest rate floor or interest rate swap.

47.31 We believe the guidance in Paragraphs 47.27 to 47.30c is equally applicable to nonpublic entities.

THE SUMMARIZATION OF GAINS OR LOSSES ON DERIVATIVE INSTRUMENTS

47.32 EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held For Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" (EITF Issue 02-3) (ASC paragraph 815-10-45-9) and Issue No. 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, and Not “Held for Trading Purposes” as Defined in EITF Issue No. 02-3, “Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities” (EITF Issue 03-11) (ASC paragraph 815-10-55-62), provide guidance as to how gains and losses on derivative financial instruments should be summarized in the income statement. That is, whether gains and losses on derivative instruments should be reported on a gross or net basis in the income statement.

47.33 A key determinant impacting the income statement summarization of gains and losses is whether the derivative instrument is held for trading purposes. The determination of what constitutes trading purposes is based on the intent of the issuer or holder of the derivative
instrument, consistent with paragraph 12(a) of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (ASC Section 320-10-20), which characterizes trading as “active and frequent buying and selling…with the objective of generating profits on short-term differences in price.” Classification of a derivative as held for trading purposes does not preclude that derivative instrument from being designated as a hedging instrument provided all of the applicable criteria in the Standard are met. Thus, the use of the derivative instrument as a hedging instrument has no bearing on whether the derivative’s gains and losses should be reported on a gross or net basis in the income statement.

**Derivative Instruments Held for Trading Purposes**

47.34 In EITF Issue 02-3 (ASC paragraph 815-10-45-9), the Task Force reached a consensus that for derivative instruments held for trading purposes, gains and losses (realized and unrealized) on those derivative instruments should be shown net when recognized in the income statement, whether or not those derivative instruments are settled physically. The following example illustrates net and gross presentation of the realized gains and losses on a derivative instrument that is physically settled:

### Example 9.10: Derivatives Held for Trading Purposes

On January 1, 20X3, a company enters into a forward contract to purchase one barrel of crude oil at $30 for delivery on July 1, 20X3. The forward contract is a derivative pursuant to the Standard, the company does not elect to designate the contract as normal purchases and normal sales pursuant to paragraph 10(b) of the Standard (ASC paragraphs 815-10-15-22 and 15-26), and it designates the derivative instrument as held-for-trading purposes. Assume the following market forward prices for the July 1, 20X3 delivery of one barrel of crude on the following dates:

<table>
<thead>
<tr>
<th>Date</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31, 20X3</td>
<td>$25</td>
</tr>
<tr>
<td>June 30, 20X3</td>
<td>$35</td>
</tr>
<tr>
<td>July 1, 20X3</td>
<td>$35</td>
</tr>
</tbody>
</table>

Further assume that the company sells the barrel of crude, purchased by physically settling the forward contract, on July 31, 20X3, for $37.

**Journal Entries for Net Presentation**

### March 31, 20X3

- Trading revenue, net $5
- Derivative liability $5

(Recognize changes in fair value of forward contact)

### June 30, 20X3

- Derivative liability 5
- Derivative asset 5
- Trading revenue, net 10
(Recognize changes in fair value of forward contact)

**July 1, 20X3**

- Inventory 35
  - Cash (forward contract price) 30
  - Derivative asset 5

(Physically settle forward contract)

**July 31, 20X3**

- Accounts receivable 37
  - Inventory 35
  - Trading revenue, net 2

(Sell one barrel of crude oil from inventory)

**Journal Entries for Gross Presentation**

A gross presentation would yield the same entries as of March 31, June 30, and July 1 (although the account descriptions may differ), but would differ as of July 31, as follows:

**July 31, 20X3**

- Cost of sales $35
  - Inventory $35
- Accounts receivable 37
  - Sales 37

(Sell one barrel of crude from inventory)

Under a gross presentation of the gains and losses on a derivative that is physically settled, the income statement, if presenting only the series of transactions presented in this example, would show sales of $37 and cost of sales of $35.

47.35 The above example presents two methods of recognizing the realized gains and losses from a physically settled derivative that is not designated as a hedging instrument. Now, assume that the forward contract presented above is designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid in the forecasted purchase that will occur upon physical settlement of the forward contract itself. That is, the forward contract is designated as the hedging instrument in an *all-in-one* hedge.

**Example 9.11: All-in-One Hedge**

Assume the same facts as presented in the previous example. Additionally, assume that (a) the contract includes a disincentive for nonperformance that is sufficiently large to make performance probable (i.e., the contract meets the definition of a firm commitment under the Standard), (b) the company designates the forward purchase contract as a hedge of the
variability in cash flows attributable to the price risk associated with the forecasted purchase of one barrel of oil under the contract, and (c) the company documents at inception of the hedge that the assessment of hedge effectiveness will be determined based on changes in the entire fair value of the derivative instrument (the forward contract).

**Journal Entries for All-in-One Hedge**

*March 31, 20X3*

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI</td>
<td>$5</td>
<td></td>
</tr>
<tr>
<td>Derivative liability</td>
<td></td>
<td>$5</td>
</tr>
</tbody>
</table>

(Recognize changes in fair value of forward contact)

*June 30, 20X3*

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivative liability</td>
<td>$5</td>
<td></td>
</tr>
<tr>
<td>Derivative asset</td>
<td></td>
<td>$5</td>
</tr>
<tr>
<td>OCI</td>
<td></td>
<td>$10</td>
</tr>
</tbody>
</table>

(Recognize changes in fair value of forward contact)

*July 1, 20X3*

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$35</td>
<td></td>
</tr>
<tr>
<td>Cash (forward contract price)</td>
<td>$30</td>
<td></td>
</tr>
<tr>
<td>Derivative asset</td>
<td></td>
<td>$5</td>
</tr>
</tbody>
</table>

(Physically settle forward contract)

*July 31, 20X3*

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>$30</td>
<td></td>
</tr>
<tr>
<td>AOCI</td>
<td>$5</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td>$35</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$37</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Sell one barrel of crude oil from inventory)

* Assumes a gross presentation. If using a net presentation, these entries would be netted in one revenue line item.

**Derivatives Not Held for Trading Purposes**

47.36 EITF Issue 03-11 (ASC paragraph 815-10-55-62) indicates that unrealized gains and losses on derivatives and realized gains and losses on net settled derivatives should always be shown on a net basis when reported in the income statement. However, determining whether realized gains and losses on physically settled derivative contracts not held for trading purposes...
should be reported in the income statement on a gross or net basis is a matter of judgment that depends on the relevant facts and circumstances. Consideration should be given to the following:

- The various activities of the enterprise;
- The economic substance of the transaction;
- The guidance in APB Opinion No. 29 (ASC Subtopic 845-10, Nonmonetary Transactions - Overall); and
- The indicators of gross revenue reporting and net revenue reporting contained in EITF Issue No. 99-19 (ASC Subtopic 605-45, Revenue Recognition - Principal Agent Considerations).

Options Granted to Employees

47.36a EITF Issue No. 02-8, "Accounting for Options Granted to Employees in Unrestricted, Publicly Traded Shares of an Unrelated Entity," (ASC paragraph 815-10-55-48) reached a consensus that stock options granted to employees in which the underlying shares are publicly traded stock of an unrelated entity are not subject to Statement 123(R) (ASC paragraph 718-10-15-3), and thus, meet the definition of a derivative and should be accounted for by the employer as derivatives under the Standard. See Paragraphs 11b.01 – 11b.07 of Section 2. In addition, EITF 02-8 (ASC paragraph 815-10-45-10) indicates that changes in fair value of the option award prior to vesting should be characterized as compensation expense in the employer's income statement, while the changes in fair value of the option award after vesting may be reflected elsewhere in the employer's income statement.

The Display of Embedded Derivative Instruments

47.37 Paragraph 12 of the Standard (ASC paragraph 815-15-25-1) requires certain embedded derivative instruments to be separated from the host contract and accounted for as derivative instruments pursuant to the Standard (ASC Subtopic 815-10). The Standard does not, however, specifically state whether the embedded derivative instrument is to be displayed separately from the host contract.

47.38 We expect that most entities will follow the legal form of the instrument such that the carrying amount of the hybrid instrument will reflect the aggregate carrying amount of the host contract (as determined by the accounting standards applicable to instruments of that type) and the fair value of the embedded derivative instrument. An alternative is to present the embedded derivative instrument separately from the host contract. Regardless of the presentation alternative chosen, the policy should be disclosed in the notes to the financial statements.

Presentation By Entities That Do Not Report Earnings as a Separate Caption in a Statement of Financial Performance

47.39 For entities that do not report earnings as a separate caption in a statement of financial performance (e.g., a not-for-profit organization or a defined benefit plan), changes in the fair value of derivative instruments should be recognized in the statement of changes in net assets. The Standard does not prescribe where these changes should be reported in the statement of changes in net assets. We believe the guidance offered in this chapter is equally applicable to
these types of entities. In addition, for further guidance regarding the presentation of derivative activity for entities that do not report earnings as a separate caption in a statement of financial performance see Section 8.

APPENDIX A: QUESTIONS & ANSWERS

The Standard

Income Statement

Q1. When a cash flow hedge is discontinued because it is probable that the original hedged forecasted transaction will not occur by the end of the originally specified time period or within an additional two-month period, paragraph 33 of the Standard (ASC paragraphs 815-30-40-4 and 40-5) requires the related net gain or loss in AOCI to be reclassified immediately into earnings. Similarly, when a hedged firm commitment no longer qualifies as a fair value hedge because it no longer meets the definition of a firm commitment, paragraph 26 of the Standard (ASC paragraphs 815-25-40-3 through 40-05) requires the firm commitment asset or liability to be derecognized and a corresponding loss or gain to be recognized currently in earnings.

Where should reclassified net gains or losses, and gains or losses on derecognized firm commitment assets or liabilities, be presented in the income statement? Can the gain or loss on the derecognized firm commitment be presented as an extraordinary item given the Board’s belief that the circumstances under which derecognition would occur are rare?

A. The Standard requires that the reclassified net gains or losses and the gains or losses on derecognized firm commitments be disclosed, but it is silent on the issue of where the information should be presented.

We believe net gains or losses arising in these circumstances should be presented as part of operating income because these amounts arise in the normal course of an entity’s operations. Further, we believe that gains or losses recognized in earnings when a hedged firm commitment no longer qualifies as a firm commitment also should be presented as part of operating income. Although the Board has stated that it believes that the derecognition of a firm commitment will be rare, we believe the gain or loss does not meet the provisions of APB Opinion No. 30, Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions (ASC Subtopic 225-20, Income Statement - Extraordinary and Unusual Items), and as such, should not be presented as an extraordinary item.

Q2. Paragraph 44C(b)(3) of the Standard (ASC paragraph 815-10-50-4C(c)) requires disclosure of the effective portion of gains and losses on derivative instruments designated and qualifying in cash flow hedges and net investment hedges recorded in AOCI during the term of the hedging relationship and reclassified into earnings during the period.
Under this disclosure requirement, must the entity disclose both (a) the amount recorded in AOCI during the term of the hedging relationship and (b) the amount reclassified from AOCI into earnings during the reporting period?

A. No. Paragraph 44C(b)(3) (ASC paragraph 815-10-50-4C(c)) is intended to require entities to disclose the amount of gain and loss on derivative instruments reclassified from AOCI into earnings during the reporting period. It is not intended to require disclosures of the effective portion of gains and losses on derivative instruments designated and qualifying in cash flow hedges and net investment hedges that were recognized in OCI during the term of the hedging relationship. However, the effective portion of gains and losses on derivative instruments recognized in OCI during the reporting period is required to be disclosed by paragraph 44C(b)(2).

Q3. Where should changes in the fair value (i.e., the gains and losses) of a nonhedging derivative instrument be presented in the income statement (i.e., should they be presented as part of operating income (loss) or non-operating/other income (expense))?

A. The Standard does not prescribe where gains and losses on nonhedging derivative instruments should be presented in the income statement. To the extent that nonhedging derivative activities are part of the normal operations of the entity, we believe these gains and losses are generally best included in operating income, for example, as part of trading activities.

If, however, the nonhedging derivative activities are ancillary to an entity’s operations, we believe the gains and losses on nonhedging derivative instruments may be presented in nonoperating income (loss).

In any case, public companies may not classify realized and unrealized gains and losses of a nonhedging derivative instrument in separate income statement line items. We believe nonpublic companies should also adhere to this guidance.

Statement of Financial Position

Q4. For statement of financial position presentation purposes, may an entity report on a net basis the aggregate fair value of all derivative instruments?

A. No. The Standard has not changed the statement of financial position offsetting provisions for assets and liabilities as provided in APB 10 (ASC Subtopic 210-20, Balance Sheet - Offsetting). Paragraph 8 of FIN 39 (ASC paragraph 815-10-45-4) states that “unless [a right of setoff] exists, the fair value of contracts in a loss position should not be offset against the fair value of contracts in a gain position.” Therefore, we believe derivative instrument assets and liabilities should not be offset unless the FIN 39 (ASC Subtopic 210-20) provisions have been met.

Q5. Paragraph 12 of the Standard (ASC paragraph 815-15-25-1) requires certain embedded derivative instruments to be separated from the host contract and accounted for as derivative instruments pursuant to the Standard. Must embedded derivative instruments be presented separately from the host contract in the statement of financial position?
A. The Standard does not specifically address the issue of whether the embedded derivative instrument is to be displayed separately from the host contract in the statement of financial instrument position.

We expect that most entities will follow the legal form of the instrument to display the embedded derivative instrument such that the carrying amount of the hybrid instrument will reflect the aggregate carrying amount of the host contract (as determined by the accounting standards applicable to instruments of that type) and the fair value of the embedded derivative instrument. An alternative is to present the embedded derivative instrument separately from the host contract. Regardless of the presentation alternative chosen, the policy should be disclosed in the notes to the financial instrument statements.

Statement of Cash Flows

Q6. How should cash receipts and payments arising from derivative activities be classified in the statement of cash flows?

A. For other than derivative instruments that contain an other-than-insignificant financing element, the Standard is silent on this issue. We believe that the cash flows arising from derivative hedging instruments that do not contain an other-than-insignificant financing element generally would be classified in the same category as the cash flows from the hedged item.

Most derivative instruments are entered into with the objective that they be used to manage the risks attributable to an entity’s operating activities (e.g., foreign currency options acquired to fix the price of a nondomestic input). These types of activities are consistent with operating activities as described in paragraphs 22 and 23 of FASB Statement No. 95, Statement of Cash Flows (ASC paragraphs 230-10-45-16 and 45-17).

To the extent that derivative instruments are used to manage the price risk attributable to purchases or sales of capital assets (e.g., property, plant, and equipment), the activities are consistent with investing activities as described in paragraphs 15 to 17 of Statement 95 (ASC paragraphs 230-10-45-12 and 45-13).

To the extent that derivative instruments are used to manage the price risk attributable to the issuance or purchase of nonderivative financial instruments (e.g., issuance of a fixed-rate debt obligation), the activities are consistent with financing activities as described in paragraphs 18 to 20 of Statement 95 (ASC paragraphs 230-10-45-14 and 45-15).

For cash flows associated with the issuance or purchase of nonhedging derivative instruments, we believe the guidance found in paragraph 8 of FASB Statement No. 102, Statement of Cash Flows – Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale (ASC paragraphs 230-10-45-11 and 45-18 through 45-20), as amended by Statement 159 (ASC Topic 825, Financial Instruments), is applicable such that cash receipts and cash payments resulting from nonhedging derivatives would be classified based on the nature and purpose for which those nonhedging
derivatives were acquired. Cash receipts and cash payments resulting from nonhedging derivatives would be classified as operating cash flows if those instruments are acquired specifically for resale in the near term and are carried at market value in a trading account.

If a derivative instrument contains an other-than-insignificant financing element other than one inherently included in an at-the-market derivative with no prepayment, the borrower should report all of the derivative instrument’s cash inflows and outflows as financing activities.

Changes in the fair value of derivative instruments that do not result in cash receipts or payments in the period of change are eliminated to determine cash from operating activities.

Q7. Can derivative instruments be considered cash equivalents for purposes of presentation in the statement of cash flows?

A. No. The Standard did not change the requirements of Statement 95 (ASC Subtopic 230-10). We believe that the nature of derivative instruments is such that even if their original maturity is of three months or less, they are exposed to more than an insignificant risk of change in value and as such fail to meet the criterion listed in paragraph 8(b) of Statement 95 (ASC Section 230-10-20). Accordingly, we believe that derivative instruments should not be considered cash equivalents for purposes of presentation in the statement of cash flows.

General

Q8. The fair value and gains and losses of derivative instruments must be presented separately by type of derivative contract. Are the examples of the types of derivative instruments included in the Standard (including interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, and credit contracts) the only categories of derivative instruments that may be presented?

A. No. The Standard's examples are not meant to be all-inclusive. For example, if an entity enters into a cross-currency-interest-rate swap to hedge interest rate risk and foreign exchange risk, the entity could present contracts with both interest rate and foreign exchange underlyings as a separate type of derivative contract.

Q9. Paragraph 45(b)(2) of the Standard (ASC paragraph 815-30-50-1(c)) requires disclosure of the estimated net amount of existing gains or losses reported in AOCI at the reporting date that is expected to be reclassified into earnings within the next 12 months.

Must the entity separately disclose the nature of the expected income statement impact (e.g., $X will be charged as depreciation expense and $X will be included in net interest expense)? Must this disclosure be updated in the financial statements of subsequent interim periods?

A. There is no requirement to separately disclose the nature of the expected financial statement impact of estimated net amounts that would be reclassified into earnings within the next 12 months. Further, updating the disclosure in the subsequent interim periods for which
APPENDIX B: REQUIREMENTS OF ASU 2011-11, DISCLOSURES ABOUT OFFSETTING ASSETS AND LIABILITIES

INTRODUCTION

B9.01 Current generally accepted accounting principles (GAAP) allow financial assets and financial liabilities, including derivative instruments to be offset if certain conditions are met. In this Appendix, the term offset refers to the presentation a financial asset and a financial liability in the statement of financial position on a net basis. ASU 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities (ASU 2011-11) requires an entity to disclose certain information about:

- Financial instruments and derivative instruments that are offset; and
- Financial instruments and derivative instruments that are subject to an enforceable master netting arrangement or similar agreement, regardless of whether they are offset.

These disclosures are meant to assist financial statement users in evaluating the effect or potential effect of netting arrangements on an entity’s financial position and to allow comparability between financial statements compared under U.S. GAAP and those prepared under International Financial Reporting Standards. The required disclosures are limited to financial instruments and derivative instruments subject to master netting arrangements or similar agreements. ASU 2011-11 is effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. It should be applied retrospectively for any period presented that begins before the date of its initial application.

SCOPE

B9.02 ASU 2011-11 requires disclosures for financial instruments and derivative instruments that are offset under GAAP, as well as other derivative instruments and financial instruments in certain situations. More specifically, ASU 2011-11 provides disclosure requirements for:

- recognized financial instruments and derivative instruments that are offset in accordance with GAAP; and
- other derivative instruments and financial instruments that are subject to an enforceable master netting arrangement or similar agreement (e.g., derivative clearing agreements, global master repurchase agreements, or global master securities lending agreements), regardless of whether they are offset.

B9.03 Instruments in the scope of ASU 2011-11 include derivatives, repurchase and reverse repurchase agreements, and securities lending and borrowing agreements.
Examples of financial instruments that are outside of the scope of ASU 2011-11 are:

- Loans and customer deposits at the same institution (unless they are offset in the statement of financial position).
- Financial instruments that are only subject to a collateral agreement, including those collateralized by nonfinancial collateral (e.g., a loan collateralized by real property).

**REQUIRED DISCLOSURES**

**B9.04** An entity should disclose information to enable financial statement users to evaluate the effect or potential effect of netting arrangements on its financial position. This includes the effect or potential effect of rights of setoff associated with an entity’s recognized assets and recognized liabilities that are not offset in its financial statements. An entity is required to disclose in tabular format (unless another format is more appropriate) at the end of the reporting period all of the following separately for financial assets and financial liabilities:

(A) The gross amounts of those recognized assets and those recognized liabilities.
(B) The amounts offset under GAAP.
(C) The net amounts presented in the statement of financial position (i.e., (A) minus (B)).
(D) The amounts subject to enforceable master netting arrangements or similar agreement that are not offset under GAAP (i.e., not included in (B)):
   - The amounts of recognized financial instruments and other derivative instruments that either:
     (i) Management has elected to present gross; or
     (ii) Does not qualify for offsetting.
   - The amounts related to financial collateral (including cash collateral).
(E) The net amount (i.e., (C) minus (D), but limited to the amount disclosed in (C) for that instrument).

**B9.05** If an entity discloses the information in B9.04 in more than a single note to the financial statements, it should cross-reference between those notes.

**QUANTITATIVE DISCLOSURES FOR RECOGNIZED ASSETS AND LIABILITIES**

**B9.06** Not all financial instruments are recorded using the same measurement attribute (e.g., a payable related to a repurchase agreement may be measured at amortized cost, while a derivative will be measured at fair value). If an entity offsets financial instruments, it should describe any resulting measurement differences in the related disclosures.

**GROSS AMOUNTS OF RECOGNIZED ASSETS AND LIABILITIES**
The disclosures required in B9.04(A) do not relate to any amounts recognized as a result of collateral agreements that do not meet the offsetting guidance. Instead, these amounts should be disclosed in B9.04(D).

AMOUNTS OFFSET IN ACCORDANCE WITH GAAP

As noted in B9.04(B), ASU 2011-11 requires disclosing the gross amounts that were offset to determine the net amounts presented in the statement of financial position. The amounts of both the recognized assets and the recognized liabilities subject to setoff under the same arrangement are disclosed in the respective tables. However, the amounts included in the tables are limited to the amount that is subject to setoff. For example, if an entity has a $100 recognized derivative asset and an $80 recognized derivative liability that it offsets, the asset disclosure table will include the entire amount of the derivative asset ($100) and the entire amount of the derivative liability ($80). However, the liability disclosure table will include the entire amount of the derivative liability ($80), but it will only include the amount of the derivative asset equal to the amount of the derivative liability ($80).

NET AMOUNTS PRESENTED IN THE STATEMENT OF FINANCIAL POSITION

If an entity has financial instruments that meet the scope for disclosure but do not qualify for offset, or management does not elect to offset, the amounts required to be disclosed in B9.04(C) would equal those disclosed in B9.04(A).

The amount disclosed in B9.04(C) should be reconciled to the individual line item amount(s) presented in the statement of financial position. For example, if an entity, in the notes to its financial statements, aggregates or disaggregates amounts that it presents in individual financial statement line items, it should reconcile the aggregated or disaggregated disclosed amounts to the individual financial statement line items.

AMOUNTS SUBJECT TO MASTER NETTING ARRANGEMENTS OR SIMILAR AGREEMENTS THAT ARE NOT OFFSET

An entity may elect to not offset financial assets and financial liabilities that qualify for offset or it may wish to offset but fail to meet the offsetting guidance. Nonetheless, an entity should disclose other amounts related to recognized financial instruments and derivative instruments that are subject to an enforceable master netting arrangement or similar agreement that are not offset. Financial statement users would likely be interested in arrangements an entity has entered into that mitigate its financial exposures in the events of bankruptcy, default, or insolvency of their counterparties.

An entity should also disclose the fair value amounts related to cash or financial instrument collateral pledged or received whether recognized or not. Collateral mitigates risk, and thus, the Board believes that disclosing collateral whether recognized or not would provide financial statement users with relevant information.

An entity should consider the effect of overcollateralization by instrument in its disclosures. To do so, an entity first reduces the amount that is presented net in the statement of...
financial position by the other amounts related to recognized financial instruments and derivative instruments that are subject to an enforceable master netting arrangement or similar agreement that are not offset. An entity should then limit the collateral amounts disclosed to the \textit{remaining} amount for the related instrument. The underlying rationale is to prevent an entity from inappropriately obscuring undercollateralized financial instruments with others that are overcollateralized. However, if rights to collateral can be enforced across financial instruments, such rights may be disclosed.

\textbf{RIGHTS OF SETOFF SUBJECT TO ENFORCEABLE MASTER NETTING ARRANGEMENTS AND SIMILAR AGREEMENTS}

\textbf{B9.14} An entity should describe the types of rights of setoff (including the nature of those rights) and similar agreements related to amounts that are not offset. For example, for a conditional right of setoff, an entity should describe the reason that such conditional right exists and the related condition(s) necessary to allow for setoff. For any financial collateral received or pledged, an entity should describe the terms of the collateral agreement (e.g., when the collateral is restricted).

\textbf{DISCLOSURE BY TYPE OF FINANCIAL INSTRUMENT OR BY COUNTERPARTY}

\textbf{B9.15} The offsetting disclosures may be grouped by instrument or transaction type (e.g., derivatives, repurchase and reverse agreements, and securities borrowing and lending agreements). Alternatively, an entity may group the amounts required to be disclosed in B9.04(A) through (C) by type of instrument and the amounts required to be disclosed in B9.04(C) through (E) by counterparty. The Board permitted this flexibility because they understand that many financial statement preparers manage credit risk by counterparty rather than by financial instrument type. The names of the counterparties are not required to be disclosed, but rather the designation of the counterparties would be on a no-names basis (e.g., Counterparty A or Counterparty B). However, such designation should remain consistent from year to year for comparability, and qualitative disclosures should be considered to give further information about the types of counterparties. The amounts related to individually significant counterparties with respect to total counterparty amounts should be separately disclosed, and the remaining individually insignificant counterparties should be aggregated into one line item.

\textbf{OTHER CONSIDERATIONS}

\textbf{B9.16} The disclosures discussed above are minimum requirements. An entity may need to supplement these with additional (qualitative) disclosures depending on its facts and circumstances.

\textbf{B9.17} An entity should present the disclosures in a manner that clearly explains to financial statement users the nature of rights of setoff and related arrangements and their effect on the entity’s assets and liabilities and its financial position. Judgment will be required to determine the appropriate level of information detail to provide to the users of its financial statements about offsetting financial instruments.
### Example B9.1 – Offsetting of Financial Assets and Derivative Assets

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<tr>
<th></th>
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<th>(ii)</th>
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<th>(iv) Gross Amounts Not Offset in the Statement of Financial Position</th>
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### Example B9.2 – Offsetting of Financial Liabilities and Derivative Liabilities

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<td>Derivatives</td>
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<td>Reverse repurchase, securities borrowing, and similar arrangements</td>
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<td>Other financial instruments</td>
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<td>Total</td>
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<td>Financial Instruments</td>
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<td>Cash Collateral Received</td>
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<td>Net Amount</td>
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Example B9.4 – Offsetting of Financial Liabilities and Derivative Liabilities (including Financial Liabilities, Derivative Liabilities, and Collateral Pledged by Counterparty)

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<th>$ million</th>
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<td>Counterparty B</td>
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<td>Other</td>
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<td>Total</td>
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<tr>
<td>Derivatives</td>
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<td>Repurchase, securities lending, and similar arrangements</td>
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$ million

As of December 31, 20XX

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<th>Financial Instruments</th>
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<tr>
<td>Counterparty A</td>
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<td>Counterparty B</td>
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<tr>
<td>Total</td>
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Sophisticated entities who engage in significant derivative activity may not only disclose the required information for their derivative instruments by primary underlying risk exposure (e.g., interest rate, foreign exchange, equity price), they may further distinguish each of the aforementioned exposures (e.g., by over the counter, exchanged traded, and exchange cleared).
Section Ten: Transition Issues (updated December 2007)

INTRODUCTION

FASB Statement No. 133 Accounting for Derivative Instruments and Hedging Activities, as amended (Statement 133 or Standard), was effective as of the beginning of the first fiscal quarter of the fiscal year beginning after June 15, 2000. Therefore, the discussion in this chapter assumes that entities already adopted the Standard, including its transition provisions. This chapter discusses the transition requirements for applying the guidance in new Derivatives Implementation Group (DIG) Issues and discusses other transition issues related to the effect on an entity’s hedging activities of adopting new accounting pronouncements. Appendix A to this chapter includes a summary of the Standard's transition provisions as well as the relevant paragraphs from the Standard that address the Standard's original effective date and transition.

Note that certain issues of the Emerging Issues Task Force (EITF) may affect an entity’s application of the Standard. This chapter does not address the transition requirements of EITF Issues. Entities should refer to the individual EITF Issues for the specific transition requirements.

TRANSITION PROVISIONS FOR APPLYING THE GUIDANCE IN DIG ISSUES

DIG Issue No. K5, “Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues,” dictates when and how an entity that has adopted the Standard before the issuance of a new DIG Issue should account for the effects of initially complying with that new DIG Issue. This section of the chapter describes the guidance in DIG Issue K5.

When an Entity Should Initially Apply a DIG Issue

An entity that has adopted the Standard before the issuance of a DIG Issue cleared by the Financial Accounting Standards Board (FASB or Board) should account for the effects of initially complying with that new DIG Issue as of the first day of its first fiscal quarter following the date on which the DIG Issue is posted on the FASB web site unless the FASB directs otherwise in the cleared DIG Issue. FASB-cleared DIG Issues generally are posted to the FASB web site between the sixth day and tenth day of each month unless the FASB directs otherwise. The first day of an entity’s first fiscal quarter following the posting of the cleared DIG Issue is considered the effective date of that DIG Issue for the entity. For example, if the entity has a calendar year-end and the FASB-cleared DIG Issue was posted on August 10th, the DIG Issue would be effective for the entity as of October 1st. Before adopting a new DIG Issue, public entities will need to consider the disclosure requirements of SEC Staff Accounting Bulletin No. 74, Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period (ASC paragraph 250-10-S99-5).
How an Entity Should Initially Apply a DIG Issue

APPLICATION OF GUIDANCE ON THE DEFINITION OF A DERIVATIVE, SCOPE EXCEPTIONS, AND THE RECOGNITION AND MEASUREMENT OF DERIVATIVES

An entity that applied the provisions of the Standard about the definition of a derivative and scope exceptions (as described in Section 2), and the recognition and measurement provisions (as described in Section 4) differently from those required by a new DIG Issue should account for the effects of initially complying with the new DIG Issue prospectively for all existing contracts and future transactions, as of the DIG Issue’s effective date. Financial statements for either interim or annual periods before the DIG Issue’s effective date should not be restated. In addition, to be consistent with the transition provisions of the Standard and because retroactive designation of hedging relationships and retroactive application of the new DIG Issue are not permitted, pro forma disclosures of the effects of retroactive application are not required or permitted. This guidance encompasses situations in which:

- An entity did not account for a contract as a freestanding derivative instrument under the Standard, but is required to do so under the new DIG Issue; and
- An entity accounted for a contract as a derivative instrument under the Standard, but will not account for that contract as a derivative instrument under the new DIG Issue.

Accounting for a contract as a freestanding derivative instrument to comply with a new DIG Issue could result in reporting a cumulative-effect-type adjustment in that period. The treatment described above is consistent with the Standard’s transition provisions, which require application to derivative instruments existing at the date of adoption, not just to contracts entered into after the Standard's adoption. If an entity was accounting for a contract as a derivative under the Standard, but will not do so under a new DIG Issue, the contract’s fair value at the DIG Issue’s effective date should become its net carrying amount at that date. The entity should apply other generally accepted accounting principles (GAAP) that are applicable to that contract prospectively from the date that the contract ceased to be accounted for under the Standard. (Prospective application only to future transactions would not be appropriate). For entities that transferred securities subject to FASB Statement No. 115 Accounting for Certain Investments in Debt and Equity Securities (Statement 115) (ASC Topic 320, Investments--Debt and Equity Securities, and ASC paragraphs 942-320-50-1 through 50-3), between categories of investments pursuant to paragraphs 54 and 55 of the Standard in conjunction with the initial application of the Standard, the posting of a new DIG Issue does not justify reversing those transfers.

SEPARATE ACCOUNTING FOR EMBEDDED DERIVATIVES

This aspect of the Standard (dealing with embedded derivatives) has two dimensions:

- Determining whether an embedded derivative must be accounted for separately; and
- Different mechanics for separating an embedded derivative from a host instrument.
Determining Whether an Embedded Derivative Must Be Accounted for Separately

An entity that has or has not separately accounted for an embedded derivative in a manner that is different from the requirements of a new DIG Issue should account for the effects of initially complying with that DIG Issue prospectively, for all existing contracts and future transactions, as of the DIG Issue’s effective date, except for the existing contracts that qualify for the grandfathering provisions of paragraph 50 of the Standard that exempt certain hybrid instruments from the embedded derivative provisions of the Standard on an all-or-none basis. (For example, if a company elected on adoption of the Standard under paragraph 50 to bifurcate only those hybrid instruments acquired or substantively modified after December 31, 1998, the company could not apply newly-issued implementation guidance to hybrid instruments acquired before January 1, 1999.) Financial statements for either interim or annual periods before the DIG Issue’s effective date should not be restated. Additionally, because neither retroactive designation of hedging relationships nor retroactive application are permitted, pro forma disclosures of the effects of retroactive application are neither required nor permitted. For entities that transferred securities subject to Statement 115 (ASC Topic 320, Investments--Debt and Equity Securities and ASC paragraphs 942-320-50-1 through 50-3) between categories of investments pursuant to paragraphs 54 and 55 of the Standard in conjunction with the initial application of the Standard, the posting of a new DIG Issue does not justify reversing those transfers.

This guidance encompasses situations in which an entity:

- Did not separately account for an embedded derivative but is required to do so under the new DIG Issue;
- Accounted separately for an embedded derivative, but may not account for that embedded derivative separately under the new DIG Issue; and
- Accounted for the entire hybrid instrument at fair value, such as when it determined that it could not reliably identify and measure the separate embedded derivative (discussed in Paragraphs 16.13 - 16.15 of Section 3), but the embedded derivative may not be accounted for separately under the new DIG Issue (and, therefore, there is no justification for accounting for the hybrid instrument at fair value).

Consistent with the effect of applying a new DIG Issue on the definition of a derivative and scope exceptions, prospective application only to hybrid contracts entered into on or after the effective date of the new DIG Issue would not be appropriate. If under the new DIG Issue an entity may not account separately for an embedded derivative that has been separately accounted for under the entity’s application of the Standard, the carrying amount of the related hybrid instrument at the DIG Issue’s effective date should be the sum of the carrying amount of the host contract and the fair value of the embedded derivative.

Different Mechanics for Separating an Embedded Derivative From a Host Instrument

A new DIG Issue that addresses the mechanics of separating an embedded derivative from a host instrument (rather than the fundamental determination of whether an embedded derivative must be accounted for separately) should be applied prospectively; that is, only to hybrid contracts entered into on or after the effective date of the DIG Issue.
HEDGING RELATIONSHIPS

This aspect of the Standard (dealing with hedge accounting) has two dimensions:

- Not qualifying for hedge accounting; and
- Different mechanics of hedge accounting.

Not Qualifying for Hedge Accounting

An entity that designated a qualifying hedging relationship that no longer qualifies for hedge accounting based on a new DIG Issue must de-designate that hedging relationship prospectively (i.e., the hedging relationship must be de-designated at the effective date of the new DIG Issue). The subsequent accounting depends on whether the hedging relationship was a fair value hedge, cash flow hedge, or hedge of a net investment in a foreign operation.

- If the hedging relationship was a fair value hedge, the recognition in earnings of the adjustment of the carrying amount of the hedged asset or liability for the periods before the DIG Issue’s effective date should not be reversed. Rather, the adjustment of the carrying amount of the hedged item should be accounted for in the same manner as other components of the carrying amount of that asset or liability (as described in Paragraphs 24.01 and 24.02 of Section 5).

- If the hedging relationship was a cash flow hedge, the derivative’s gain or loss for the period before the DIG Issue’s effective date remains in accumulated other comprehensive income (AOCI) and is reclassified into earnings in the same period or periods in which the hedged forecasted transaction affects earnings, subject to certain conditions (discussed in Paragraphs 31.01 - 31.06 of Section 6).

- If the hedging relationship was a hedge of a net investment in a foreign operation, the derivative’s gain or loss for the period before the DIG Issue’s effective date remains in AOCI and is reclassified into earnings generally when the net investment is sold, liquidated, or when it is to be disposed of and is impaired, consistent with FASB Statement No. 52 Foreign Currency Translation (ASC Topic 830, Foreign Currency Matters).

A hedging relationship may no longer qualify for hedge accounting based on an entity’s being required to consolidate, or deconsolidate, another entity by the provisions of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, as originally issued or as revised (FIN 46) (ASC Section 810-10-15) (see discussion later in this chapter).

Different Mechanics of Hedge Accounting

An entity that applied the mechanics of hedge accounting (e.g., the measurement of hedge ineffectiveness or the application of the shortcut method) differently from the application required by a new DIG Issue must apply that guidance prospectively to existing and future hedging relationships. Thus, for example, an entity with an existing hedging relationship that now cannot be accounted for under the shortcut method would have to discontinue prospectively use of the shortcut method at the DIG Issue’s effective date and apply, instead, regular fair value or cash flow hedge accounting for that relationship, without changing (1) amounts previously...
recognized in other comprehensive income (OCI) or (2) previous adjustments of the carrying amount of the hedged item. Essentially, this is analogous to requiring dedesignation of hedging relationships with the previously used hedge accounting mechanics and redesignation of hedging relationships with the hedge accounting mechanics that are consistent with the new DIG Issue. For dedesignated cash flow hedges, the derivative’s gain or loss for the periods before the DIG Issue’s effective date remains in AOCI and is reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, subject to certain conditions. Thus, it is consistent with requiring the dedesignation of previous hedging relationships that under the new DIG Issue no longer qualify as a fair value hedge, cash flow hedge, or net investment hedge.

Other Aspects of the Standard

An entity that adopted the Standard before the issuance of a new DIG Issue related to other areas (e.g., DIG Issues addressing disclosure and miscellaneous topics), with the exception of the type of guidance in DIG Issue No. K1, “Determining Whether Separate Transactions Should Be Viewed As a Unit,” should apply that DIG Issue prospectively; that is, only to future events and transactions and future designated hedging relationships. DIG Issues related to those areas may not be applied to hedging relationships designated and contracts entered into before the issuance of those DIG Issues.

Application of the Transition Provisions

The application of the transition provisions of DIG Issue K5 are as follows:

- If an instrument was previously accounted for as a derivative, but may not be under the new DIG Issue, and that instrument was designated as a hedging instrument, the entity must dedesignate the hedging relationship at the DIG Issue’s effective date. That dedesignation has only a prospective impact, although if a cash flow hedge is dedesignated, certain gains and losses in AOCI may need to be reclassified into earnings on the DIG Issue’s effective date if the original forecasted transaction’s probability of occurrence has changed (as discussed in Paragraphs 33.01-33.10 of Section 6). Similarly, if an embedded derivative was previously accounted for separately, but may not be under the new DIG Issue, and that instrument was designated as a hedging instrument, the entity must dedesignate the hedging relationship at the DIG Issue’s effective date.

- If an instrument was not previously accounted for as a derivative, but must be under the new DIG Issue, an entity is not permitted to retroactively designate that instrument in a hedging relationship. Similarly, if an embedded derivative was not previously accounted for separately, but must be under the new DIG Issue, an entity is not permitted to retroactively designate that embedded derivative as a hedging instrument. The separated derivative may be designated as a hedging instrument on a prospective basis.

- If a new DIG Issue permits hedge accounting for a certain scenario (for which no hedging relationship was designated), an entity is not permitted to retroactively apply hedge accounting; that is, an entity may not retroactively designate a hedging...
relationship. Hedge accounting may be applied for that scenario only on a prospective basis from the date that the relationship is designated and documented.

- If an entity determined that an embedded derivative must be accounted for separately, but also determined that it could not reliably separate and measure the embedded derivative at fair value and therefore accounted for the entire hybrid instrument at fair value (as discussed in Paragraphs 16.13 – 16.15 of Section 3), and if the new DIG Issue indicates that the embedded derivative may not be accounted for separately, the entity must discontinue mark-to-market accounting for the hybrid instrument as of the DIG Issue’s effective date and account for the hybrid instrument under relevant GAAP prospectively. In that case, the carrying amount of the hybrid instrument is its fair value at the DIG Issue’s effective date.

The transition guidance for applying a new DIG Issue does not apply to situations in which an entity’s previous accounting was not reasonable or was inconsistent with the Standard and previously posted DIG Issues. Therefore, errors in the application of the Standard cannot be corrected by following the guidance described in this section of the chapter. The guidance in FASB Statement No. 154 Accounting Changes and Error Corrections (Statement 154) (ASC Topic 250, Accounting Changes and Error Corrections), or, for corrections of errors made in fiscal years beginning on or before December 15, 2005, APB Opinion No. 20, Accounting Changes (APB 20) (ASC Topic 250), should be followed in those situations. (The provisions of Statement 154 and APB 20 (ASC Topic 250), relating to correction of an error, are the same.)

Lastly, the FASB may direct the FASB staff to specify effective dates or retroactive application of certain DIG Issues, or both, differently from the guidance described in this section of the chapter if circumstances so warrant. In addition, other FASB pronouncements, such as Standards, Interpretations, or Staff Positions, may also provide guidance on effective dates and transition provisions related to application of DIG issues. For example, FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (ASC Topic 815, Derivatives and Hedging), specifies that DIG Issue D1 remains effective for instruments recognized prior to the effective date of Statement 155 (ASC Topic 815). Therefore, entities should review new FASB-cleared DIG Issues and other pronouncement to identify possible exceptions to the guidance described herein.

**APPLICATION OF FIN 46 OR FIN 46(R) (ASC TOPIC 810) TO EXISTING QUALIFYING HEDGING RELATIONSHIPS**

At the initial application of FIN 46 or FIN 46(R) (ASC Topic 810, Consolidation), an entity may be required to consolidate a variable interest entity (VIE) or remove a VIE from its consolidated financial statements. Consequently, a pre-existing hedging relationship may need to be discontinued because (a) a hedged transaction with a third party becomes an intercompany transaction that is not eligible for hedge accounting, or (b) a hedged item ceases being an asset or liability of the consolidated entity. At issue is what to do, for example, with amounts deferred in AOCI when the previous hedged transaction becomes an intercompany transaction (cash flow hedge), or when the basis-adjusted asset is no longer on the entity’s balance sheet (fair value hedge), and when to recognize these amounts in earnings related to pre-existing hedging relationships. DIG Issue No. E22, “Accounting for the Discontinuance of Hedging Relationships Arising from Changes in Consolidation Practices Related to Applying FASB Interpretation No. 46 (FIN 46) (ASC Topic 810).”
46 or 46(R) (ASC Subtopic 810-10),” specifies the adjustments that must be made with respect to pre-existing hedge accounting when an entity must discontinue the pre-existing hedging relationship upon its initial adoption of FIN 46 or FIN 46(R) (ASC Topic 810). Essentially, the guidance requires the discontinuation of the pre-existing hedging relationships; however, it also provides for continued recognition of basis adjustments for hedged items (fair value hedges), or continued deferral of amounts in AOCI related to forecasted transactions (cash flow hedges) of these relationships by requiring an entity to identify and designate surrogate hedged items or hedged forecasted transactions. The guidance also requires the recording of hedge ineffectiveness when the surrogate hedged items or forecasted transactions do not have the same terms as the original hedged transactions. The following examples illustrate application of the guidance:

Example 10.1: Discontinued Cash Flow Hedge Arising From Consolidation

A special-purpose leasing entity is established based on a $3,000 equity contribution by an independent equity participant. The equity contribution is mandatorily redeemable for a fixed amount. The leasing entity borrows $97,000 with interest payable quarterly based on the London Interbank Offered Rate (LIBOR) and principal repayable as a lump sum at maturity and purchases a $100,000 asset. Company A leases the asset for a variable quarterly lease payment equal to the sum of (a) the leasing entity’s LIBOR-based quarterly interest payment, (b) a LIBOR-based return to the equity participant that is paid quarterly, and (c) a fixed amount to cover the leasing entity’s insurance, maintenance, and other costs. Company A enters into a receive-LIBOR, pay-fixed interest rate swap (with a $100,000 notional amount) and designates the swap as a cash flow hedge of all of its exposure to the variability of its LIBOR-based cash outflows under the lease. Before the initial application of FIN 46 or FIN 46(R) (ASC Topic 810), Company A did not consolidate the special-purpose leasing entity.

On initial application of FIN 46 or FIN 46(R) (ASC Topic 810), the special-purpose leasing entity is considered a variable interest entity; assume that it must be consolidated by Company A. The original cash flow hedge must be discontinued because the hedged forecasted transactions (the LIBOR-based lease payments) are no longer eligible forecasted transactions of the consolidated entity with a third party (because they are now intercompany transactions that are eliminated in consolidation). Assume that upon consolidation of the variable interest (leasing) entity, the noncontrolling interest in the newly consolidated leasing entity will be reported as a liability in the consolidated financial statements.

At issue is the accounting upon consolidation for the net gain or loss that was reported in AOCI related to that discontinued cash flow hedge. Because the hedged forecasted transactions (i.e., the LIBOR-based lease payments to the special-purpose leasing entity) on the discontinued cash flow hedge were related to (a) the quarterly LIBOR-based interest payments on the leasing entity’s LIBOR-based variable-rate debt and (b) the LIBOR-based return to the equity participant that is being paid quarterly, Company A should, upon consolidation of the variable interest (leasing) entity, designate both the quarterly LIBOR-based interest payments on that newly consolidated debt and the quarterly payments on the newly consolidated liability to the equity participant as the surrogate hedged forecasted
transactions for purposes of the subsequent accounting for the amounts in AOCI related to the discontinued cash flow hedge at the date the hedge was discontinued.

Under that surrogate designation, only 97% of the amounts in AOCI related to the discontinued cash flow hedge would relate to the LIBOR-based interest payments (on that newly consolidated debt) that are being designated as the surrogate hedged forecasted transactions (for 97% of the hedging swap). Because the noncontrolling interest is reported as a liability, the remaining 3% of the amounts in AOCI related to the discontinued cash flow hedge would relate to the LIBOR-based payments to that noncontrolling interest (the equity participant), which would be designated as the surrogate hedged forecasted transactions (for 3% of the hedging swap). In contrast, if the noncontrolling interest would have been reported as equity (minority interest) in the consolidated financial statements, the LIBOR-based payments to that noncontrolling interest would not be eligible under paragraph 29(f) of Statement 133 (ASC paragraphs 815-20-25-15(g) and 25-15(h)) for designation as the hedged forecasted transaction. Assuming that the surrogate forecasted transaction met the applicable hedge accounting requirements on a retroactive basis (including hedge effectiveness, but excluding contemporaneous documentation), the remaining 3% of the amounts in AOCI related to the discontinued cash flow hedge would be removed from AOCI and recorded in earnings immediately upon the adoption of FIN 46 or FIN 46(R) (ASC Topic 810) as part of the cumulative effect of an accounting change in the entity’s income statement.

In addition, any timing differences between the LIBOR-based lease payments to the special-purpose leasing entity (the original hedged transaction) and the LIBOR-based interest payments on the leasing entity’s variable-rate debt and noncontrolling interest liability (the surrogate hedged transaction) may create ineffectiveness with respect to the surrogate hedged transaction. Assuming that the surrogate hedged transaction met the applicable hedge accounting requirements on a retroactive basis (including hedge effectiveness but excluding contemporaneous documentation), the entity would calculate the cumulative ineffectiveness associated with the surrogate hedged transaction in accordance with paragraph 30 of Statement 133 (ASC paragraphs 815-30-35-3, 35-4, 35-7 and 815-20-35-1) and recognize that ineffectiveness as part of the cumulative effect of an accounting change in the entity’s income statement. In addition, to offset this entry the entity would adjust the amounts in AOCI related to this ineffectiveness.

Of the amounts in AOCI related to the discontinued cash flow hedge 97% would be reclassified into earnings in the same period or periods during which the LIBOR-based interest payments on the newly consolidated debt affect earnings, pursuant to the provisions of paragraph 31 of Statement 133 (ASC paragraphs 815-30-35-38 through 35-41). Similarly, assuming the noncontrolling interest is reported as a liability, the remaining 3% of those amounts in AOCI would be reclassified into earnings in the same period or periods during which the LIBOR-based payments on the liability to the equity participant affect earnings.

Example 10.2: Discontinued Fair Value Hedge Arising from Deconsolidation

Bank B establishes a special-purpose trust to issue preferred stock to investors. The preferred stock is mandatorily redeemable on a specified date and specifies a fixed periodic (such as
quarterly or annual) dividend. The proceeds of the issuance ($100,000) are paid to Bank B and the bank records a liability to the trust. However, because Bank B consolidates the trust, the bank’s liability to the trust is eliminated in its consolidated financial statements. Assume that the trust’s mandatorily redeemable preferred stock is reported as a “trust preferred certificates” liability in the consolidated financial statements. Bank B enters into a receive-fixed, pay-LIBOR interest rate swap (with a $100,000 notional amount) and designates the swap as a fair value hedge of its exposure to changes in the fair value of the liability for the trust preferred certificates. (Had the trust’s mandatorily redeemable preferred stock not been reported as a liability in the consolidated financial statements, the preferred stock could not have been designated as the hedged item in a fair value hedge under Statement 133 (ASC Topic 815, Derivatives and Hedging).

Assume that on initial application of FIN 46 or FIN 46(R) (ASC Topic 810, Consolidation), Bank B concludes that the special-purpose trust is a variable interest entity and that the bank is not the primary beneficiary of the trust; consequently, Bank B deconsolidates the trust, thereby excluding the trust preferred certificates from the consolidated financial statements. However, Bank B would report its liability to the trust in the consolidated financial statements. The original fair value hedge must be discontinued because the hedged item (i.e., the liability for the trust preferred certificates) no longer exists as a liability in Bank B’s consolidated financial statements.

If the adoption of FIN 46 or FIN 46(R) (ASC Topic 810) results in the deconsolidation of a hedged item, the basis adjustment and the related impact on earnings that was originally associated with that hedged item no longer would be part of the entity’s financial statements. At issue is the accounting for the basis adjustment and whether that net effect on the date of deconsolidation can be reported as an adjustment of the carrying amount for the bank’s liability to the trust. Because the original hedged item (i.e., the liability for the trust preferred certificates) on the discontinued fair value hedge was related to Bank B’s liability to the trust, Bank B should, upon deconsolidation of the variable interest entity (the trust), designate its liability to the trust as the surrogate hedged item for purposes of removing the trust from the consolidated financial statements. The net basis adjustment recorded as part of the original hedged item (the liability for the trust preferred certificates) should be used to adjust the carrying amount of the surrogate hedged item (Bank B’s liability to the trust).

To illustrate this entry, assume the original hedged item had a basis adjustment of $100, which was originally recorded as a debit to the carrying amount of the original hedged item and a credit to other income in the trust’s financial statements before deconsolidation. To reflect the ongoing effects of the previous hedge accounting of the discontinued hedging relationship, the basis adjustment would be carried over to the bank’s financial statements by recording an entry to debit the carrying amount of the surrogate hedged item for $100 and credit other income for $100. This entry would be recorded in conjunction with the bank’s deconsolidation entries for the variable interest entity. The carryover of the original basis adjustment in the bank’s income statement is reported in the same manner that it was originally reported in the consolidated financial statements before deconsolidation and it would not be reported as a cumulative effect of an accounting change.

If the surrogate hedged item had the same terms as the original hedged item, except that the amount being hedged was 70% of the original hedged item, assuming the surrogate hedged
The above examples assume that the entity chose not to restate prior periods, as permitted under paragraph 29 of FIN 46 or paragraph 40 of FIN 46(R) (ASC paragraph 810-10-30-9) and, therefore, the adjustments recorded due to differences in the terms of the original hedged transaction and the surrogate hedged transaction are reported in the entity’s financial statements as a cumulative effect of an accounting change. However, if an entity chose to restate previous periods on the adoption of FIN 46 or FIN 46(R) (ASC Topic 810), the surrogate hedging relationship and any of the adjustments discussed above would be included as part of that restatement and would be reflected in previous periods as if the surrogate hedging relationship item had always been in place.

The identification and designation of the surrogate hedged items for discontinued fair value hedges and surrogate hedged forecasted transactions for discontinued cash flow hedges should be consistent with the entity’s risk management policy and objectives for those discontinued hedging relationships. The surrogates would need to have met (on a retroactive basis) the qualifying criteria applicable to those items and transactions, other than the requirement for contemporaneous documentation. The identification and designation of surrogates relate solely to reflecting the ongoing effect of the discontinued hedging relationships (i.e., how the basis adjustments or amounts in AOCI should affect earnings in future periods). After designation of the surrogates, the entity is not required to continue hedge accounting on a prospective basis and can immediately redesignate the surrogates.

If the initial application of FIN 46 or FIN 46(R) (ASC Topic 810) causes the discontinuation of a pre-existing hedging relationship for which the shortcut method was being applied, DIG Issue E22 provides for special application of the shortcut method for the new relationship if the following criteria are met:
• The new hedging relationship meets all conditions in paragraph 68 of the Standard (ASC paragraphs 815-20-25-102 and 25-104 through 25-106) other than the condition in paragraph 68(b) (ASC paragraphs 815-20-25-104(b) and 25-104(c)) (fair value of the swap is zero at inception of relationship);

• The designation of the new hedging relationship was completed at the same time that the pre-existing hedging relationship was discontinued;

• The hedging derivative in the new hedging relationship is all or a proportion of the hedging derivative used in the discontinued pre-existing hedging relationship;

• The hedged item or hedged transaction in the new hedging relationship is the surrogate for the discontinued pre-existing hedging relationship; and

• The discontinued pre-existing hedging relationship qualified for and was accounted for under the shortcut method.

If an entity already applied FIN 46 (ASC Topic 810) and designated a new hedging relationship (that meets all of the above criteria) contemporaneous with the discontinuance of a pre-existing hedging relationship due to the change in consolidation practices, the entity is allowed to apply the shortcut method to that new hedging relationship even though the use of the shortcut method was not documented at inception of that new hedging relationship.

The guidance in DIG Issue E22 does not address the discontinuation of hedging relationships attributable to the consolidation or deconsolidation of another entity due to a change in ownership, control, or other circumstances. Accordingly, its guidance should not be applied by analogy to transactions such as business combinations. The guidance should, however, be applied by analogy to situations in which the issuance of new authoritative guidance results in a reporting entity becoming a primary beneficiary (or ceasing to be a primary beneficiary) under FIN 46(R) (ASC Topic 810) and, therefore, must consolidate (or deconsolidate) the related VIE.

The effective date(s) of the guidance in DIG Issue E22 is the date of initial application of FIN 46 and/or FIN 46(R) (ASC Topic 810). Consequently, the identification and designation of the surrogate hedged items and hedged transactions may need to be made retroactively as of that date(s). If an entity has already applied FIN 46 (ASC Topic 810) and issued financial statements for the period that reported the resulting change in accounting principle, the entity should report the accounting effects of initially applying the guidance in DIG Issue E22 as a cumulative effect of an accounting change in its first fiscal quarter that ends after November 10, 2003, the date on which the FASB posted DIG Issue E22 to its web site.

APPENDIX A EFFECTIVE DATE AND TRANSITION

This appendix includes the relevant paragraphs from the Standard that address the effective date of the Standard and its transition provisions, and provides references to the related DIG Issues. In addition, it includes a summary of the transition provisions.

Effective Date

48. This Statement shall be effective for all fiscal quarters of all fiscal years beginning after June 15, 2000. Initial application of this Statement shall be as of the beginning of an entity’s
fiscal quarter; on that date, hedging relationships shall be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all of the provisions of this Statement is encouraged but is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. Earlier application of selected provisions of this Statement is not permitted. This Statement shall not be applied retroactively to financial statements of prior periods.

DIG Issues related to this paragraph are J3, J9, J16, and K5. See DIG Issues Index.

The Standard provides that on adoption by an entity, all hedging relationships must be designated anew and documented in conformity with the provisions of the Standard. Thereafter, an entity may use hedge accounting for those hedging relationships that at inception of those relationships were documented and designated in a manner that satisfies the requirements of the Standard. The Standard does not provide special transitional provisions for foreign entities. A foreign entity applying U.S. GAAP for the first time must account for derivative instruments and hedging activities in accordance with the Standard in all fiscal years beginning after June 15, 2000. Therefore, a foreign entity applying U.S. GAAP for the first time in a period after the required adoption date of the Standard must account for all derivative instruments at fair value in all fiscal years beginning after June 15, 2000, but may not apply hedge accounting until the entity formally documents its hedging relationships consistent with the Standard’s requirements.

Transition

The transition provisions of the Standard are complex. Implementing those provisions requires an understanding of the concepts (e.g., scope and definition, fair value, cash flow, and foreign currency hedge accounting) embodied in the Standard and a number of specific rules related to, among other things, embedded derivative instruments, compound derivative instruments, and Statement 115 (ASC Topic 320, Investments--Debt and Equity Securities) securities.

In general, the intent of the transition provisions is to have entities designate all hedging relationships anew and recognize all freestanding derivative instruments as either assets or liabilities measured at fair value. In addition, entities are required to recognize offsetting gains and losses on the hedged items by adjusting their carrying amounts to fair value, to the extent of the losses or gains on the related derivative hedging instruments. Also, deferred gains and losses on derivative hedging instruments that are reported independently as assets and liabilities in the statement of financial position at adoption of the Standard are to be derecognized.

The aforementioned gains and losses (i.e., transition adjustments) are presented in a manner similar to the cumulative effect of a change in accounting principle as described in APB 20 (ASC Topic 250, Accounting Changes and Error Corrections). The location of those adjustments (i.e., net income or AOCI) depends on how the derivative hedging instrument was used before adoption of the Standard. In general, fair value type hedges require transition adjustments to be reported in net income, and cash flow type hedges require transition adjustments to be reported in AOCI. Even though APB 20 was superseded by Statement 154 (ASC Topic 250), which was issued in May 2005, the transition provisions under the Standard are not affected.

As a result of entities being required to modify how they account for existing and future derivative instruments, the Board decided to incorporate several transition provisions intended to decrease the burden of initially adopting the Standard. These provisions include, among other
things, the ability for entities to separate into two dissimilar components existing compound
derivative instruments with a foreign currency exchange risk component and to transfer any
hold-to-maturity securities into the available-for-sale or trading categories without calling into
question an entity’s intent to hold other debt securities to maturity in the future.

**Accounting on Date of Initial Application**

49. At the date of initial application, an entity shall recognize all freestanding derivative
instruments (that is, derivative instruments other than embedded derivative instruments) in
the statement of financial position as either assets or liabilities and measure them at fair
value, pursuant to paragraph 17.\(^{13}\) The difference between a derivative’s previous carrying
amount and its fair value shall be reported as a transition adjustment, as discussed in
paragraph 52. The entity also shall recognize offsetting gains and losses on hedged assets,
liabilities, and firm commitments by adjusting their carrying amounts at that date, as
discussed in paragraph 52(b). Any gains or losses on derivative instruments that are reported
independently as deferred gains or losses (that is, liabilities or assets) in the statement of
financial position at the date of initial application shall be derecognized from that statement;
that derecognition also shall be reported as transition adjustments as indicated in paragraph
52. Any gains or losses on derivative instruments reported in other comprehensive income at
the date of initial application because the derivative instruments were hedging the fair value
exposure of available-for-sale securities also shall be reported as transition adjustments; the
offsetting losses and gains on the securities shall be accounted for pursuant to paragraph
52(b). Any gain or loss on a derivative instrument reported in accumulated other
comprehensive income at the date of initial application because the derivative instrument
was hedging the variable cash flow exposure of a forecasted (anticipated) transaction related
to an available-for-sale security shall remain in accumulated other comprehensive income
and shall not be reported as a transition adjustment. The accounting for any gains and losses
on derivative instruments that arose prior to the initial application of the Statement and that
were previously added to the carrying amount of recognized hedged assets or liabilities is not
affected by this Statement. Those gains and losses shall not be included in the transition
adjustment.*

\(^{13}\) For a compound derivative that has a foreign currency exchange risk component (such as a foreign currency
interest rate swap), an entity is permitted at the date of initial application to separate the compound derivative
into two parts: the foreign currency derivative and the remaining derivative. Each of them would thereafter be
accounted for at fair value, with an overall limit that the sum of their fair values could not exceed the fair value
of the compound derivative. An entity may not separate a compound derivative into components representing
different risks after the date of initial application.

* If immediately prior to the application of Statement 133 an entity has a fair value or cash flow hedging
relationship in which an intercompany interest rate swap is the hedging instrument and if that relationship
would have qualified for the shortcut method under the criteria in paragraph 68 had that swap not been an
intercompany transaction, that entity may qualify for applying the shortcut method to a newly designated
hedging relationship that is effectively the continuation of the preexisting hedging relationship provided that (a)
the post-Statement 133 hedging relationship is hedging the same exposure to interest rate risk (that is, exposure
to changes in fair value of the same hedged item or exposure to changes in variable cash flows for the same
forecasted transaction) and (b) the hedging instrument is a third-party interest rate swap whose terms exactly
match the terms of the intercompany swap with respect to its remaining cash flows. In that case, if the shortcut
method is applied to the new hedging relationship upon adoption of Statement 133, the transition adjustment
should include the appropriate adjustments at the date of adoption to reflect the retroactive application of the shortcut method.

DIG Issues related to this paragraph are B6, J5, J6, J15, J17, and K5. See DIG Issues Index.

**Grandfather Provisions**

50. At the date of initial application, an entity shall choose to either (a) recognize as an asset or liability in the statement of financial position all embedded derivative instruments that are required pursuant to paragraphs 12-16 to be separated from their host contracts or (b) select either January 1, 1998 or January 1, 1999 as a transition date for embedded derivatives. If the entity chooses to select a transition date, it shall recognize as separate assets and liabilities (pursuant to paragraphs 12-16 only those derivatives embedded in hybrid instruments issued, acquired, or substantively modified by the entity on or after the selected transition date. That choice is not permitted to be applied to only some of an entity’s individual hybrid instruments and must be applied on an all-or-none basis.

DIG Issues related to this paragraph are J1, J13, and K5. See DIG Issues Index.

**Determination of Transition Adjustments for Embedded Derivatives**

51. If an embedded derivative instrument is to be separated from its host contract in conjunction with the initial application of this Statement, the entity shall consider the following in determining the related transition adjustment:

   (a) The carrying amount of the host contract at the date of initial application shall be based on its fair value on the date that the hybrid instrument was issued or acquired by the entity and shall reflect the appropriate adjustments for subsequent activity, such as subsequent cash receipts or payments and the amortization of any premium or discount on the host contract arising from the separation of the embedded derivative.

   (b) The carrying amount of the embedded derivative instrument at the date of initial application shall be its fair value.

   (c) The transition adjustment shall be the difference at the date of initial application between (1) the previous carrying amount of the hybrid instrument and (2) the sum of the new net carrying amount of the host contract and the fair value of the embedded derivative instrument. The entity shall not retroactively designate a hedging relationship that could have been made had the embedded derivative instrument initially been accounted for separate from the host contract.

DIG Issue related to this paragraph is K5. See DIG Issues Index.
Reporting Transition Adjustments

52. The transition adjustments resulting from adopting this Statement shall be reported in net income or other comprehensive income, as appropriate, as the effect of a change in accounting principle and presented in a manner similar to the cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, *Accounting Changes* (ASC Topic 250, Accounting Changes and Error Corrections). Whether a transition adjustment related to a specific derivative instrument is reported in net income, reported in other comprehensive income, or allocated between both is based on the hedging relationships, if any, that had existed for that derivative instrument and that were the basis for accounting under generally accepted accounting principles before the date of initial application of this Statement.

DIG Issues related to this paragraph are J2, J8, J9, J10, J11, J13, J15, J16, J17, J18, and K5. See DIG Issues Index.

CASH FLOW TYPE HEDGE TRANSITION ADJUSTMENTS

52a. If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment shall be reported as a cumulative-effect-type adjustment of accumulated other comprehensive income.

FAIR VALUE TYPE HEDGE TRANSITION ADJUSTMENTS

52b. If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the fair value exposure of an asset, a liability, or a firm commitment, the transition adjustment for the derivative shall be reported as a cumulative-effect-type adjustment of net income. Concurrently, any gain or loss on the hedged item shall be recognized as an adjustment of the hedged item’s carrying amount at the date of initial application, but only to the extent of an offsetting transition adjustment for the derivative. Only for purposes of applying the preceding sentence in determining the hedged item’s transition adjustment, the gain or loss on the hedged item may be either (1) the overall gain or loss on the hedged item determined as the difference between the hedged item’s fair value and its carrying amount on the date of initial application (that is, not limited to the portion attributable to the hedged risk nor limited to the gain or loss occurring during the period of the preexisting hedging relationship) or (2) the gain or loss on the hedged item attributable to the hedged risk (limited to the hedged risks that can designated under paragraph 21 of this Statement) during the period of the preexisting hedging relationship. That adjustment of the hedged item’s carrying amount shall also be reported as a cumulative-effect-type adjustment of net income. The transition adjustment related to the gain or loss reported in accumulated other comprehensive income on a derivative instrument that hedged an available-for-sale security, together with the loss or gain on the related security (to the extent of an offsetting
transition adjustment for the derivative instrument), shall be reclassified to earnings as a cumulative-effect-type adjustment of both net income and accumulated other comprehensive income.

MULTIPLE HEDGE TRANSITION ADJUSTMENTS

52c. If a derivative instrument had been designated in multiple hedging relationships that addressed both the fair value exposure of an asset or a liability and the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment for the derivative shall be allocated between the cumulative-effect-type adjustment of net income and the cumulative-effect-type adjustment of accumulated other comprehensive income and shall be reported as discussed in paragraphs 52(a) and 52(b) above. Concurrently, any gain or loss on the hedged item shall be accounted for at the date of initial application as discussed in paragraph 52(b) above.

OTHER TRANSITION ADJUSTMENTS

52d. Other transition adjustments not encompassed by paragraphs 52(a), 52(b), and 52(c) above shall be reported as part of the cumulative-effect-type adjustment of net income.

Subsequent Recognition of AOCI Transition Adjustments

53. Any transition adjustment reported as a cumulative-effect-type adjustment of accumulated other comprehensive income shall be subsequently reclassified into earnings in a manner consistent with paragraph 31. For those amounts, an entity shall disclose separately in the year of initial application the amount of gains and losses reported in accumulated other comprehensive income and associated with the transition adjustment that are being reclassified into earnings during the 12 months following the date of initial application.

DIG Issues related to this paragraph are J16 and K5. See DIG Issues Index.

(ASC Topic 320) Held-to-Maturity Securities

54. At the date of initial application, an entity may transfer any held-to-maturity security into the available-for-sale category or the trading category. An entity will then be able in the future to designate a security transferred into the available-for-sale category as the hedged item, or its variable interest payments as the cash flow hedged transactions, in a hedge of the exposure to changes in the designated benchmark interest rate or changes in its overall fair value. (Paragraph 21(d) precludes a held-to-maturity security from being designated as the hedged item in a fair value hedge of interest rate risk or the risk of changes in its overall fair value. Paragraph 29(e) similarly precludes the variable cash flows of a held-to-maturity security from being designated as the hedged transaction in a cash flow hedge of interest rate risk.) The unrealized holding gain or loss on a held-to-maturity security transferred to another category at the date of initial application shall be reported in net income or accumulated other.
comprehensive income consistent with the requirements of paragraphs 15(b) and 15(c) of Statement 115 and reported with the other transition adjustments discussed in paragraph 52 of this Statement. Such transfers from the held-to-maturity category at the date of initial adoption shall not call into question an entity’s intent to hold other debt securities to maturity in the future.

14 EITF Topic No. D-51, “The Applicability of FASB Statement No. 115 to Desecuritizations of Financial Assets,” indicates that certain financial assets received or retained in a desecuritization must be held to maturity to avoid calling into question the entity’s intent to hold other debt securities to maturity in the future. In conjunction with the initial adoption of this Statement, the held-to-maturity restriction on those financial assets held on the date of initial application is removed, and those financial assets that had been received or retained in a previous desecuritization are available in the future to be designated as the hedged item, or their variable interest payments as the hedged transaction, in a hedge of the exposure to changes in interest rate risk. Consequently, the sale of those financial assets before maturity would not call into question the entity’s intent to hold other debt securities to maturity in the future.

DIG Issues related to this paragraph are J3 and K5. See DIG Issues Index.

Statement 115 (ASC Topic 320) Available-for-Sale Securities

55. At the date of initial application, an entity may transfer any available-for-sale security into the trading category. After any related transition adjustments from initially applying this Statement have been recognized, the unrealized holding gain or loss remaining in accumulated other comprehensive income for any transferred security at the date of initial application shall be reclassified into earnings (but not reported as part of the cumulative-effect-type adjustment for the transition adjustments), consistent with paragraph 15(b) of Statement 115. If a derivative instrument had been hedging the variable cash flow exposure of a forecasted transaction related to an available-for-sale security that is transferred into the trading category at the date of initial application and the entity had reported a gain or loss on that derivative instrument in other comprehensive income (consistent with paragraph 115 of Statement 115), the entity also shall reclassify those derivative gains and losses into earnings (but not report them as part of the cumulative-effect-type adjustment for the transition adjustments).

DIG Issues related to this paragraph are J3, J7, and K5. See DIG Issues Index.

Restratification of Servicing Rights Portfolio

56. At the date of initial application, mortgage bankers and other servicers of financial assets may choose to restratify their servicing rights pursuant to paragraph 63(g) of Statement 140 in a manner that would enable individual strata to comply with the requirements of this Statement regarding what constitutes “a portfolio of similar assets.” As noted on footnote 9 of this Statement, mortgage bankers and other servicers of financial assets that designate a hedged portfolio by aggregating servicing rights within one or more risk strata used under paragraph 63(g) of Statement 140 would not necessarily comply with the requirement in paragraph 21(a) of this Statement for portfolios of similar assets, since the risk stratum under paragraph 63(g) of Statement 140 can be based on any predominant risk characteristic, including date of origination or geographic location. The restratification of servicing rights is
a change in the application of an accounting principle, and the effect of that change as of the initial application of this Statement shall be reported as part of the cumulative-effect-type adjustment for the transition adjustments.

DIG Issue related to this paragraph is F1. See DIG Issues Index.
Section Eleven: Tax Issues Relating to Derivative Instruments (Updated December 2006)

INTRODUCTION

FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended (Statement 133 or Standard), does not affect the basic principles of accounting for income taxes; therefore, except for providing a discussion of the requirement to record deferred taxes for derivative and hedging transactions, this chapter does not discuss those principles. It provides a general overview of the taxation of certain commonly used derivative instruments. This discussion does not apply to companies entering into derivative instruments on their own stock.

The information provided herein is not exhaustive and is intended to be general in nature. The discussion is based on U.S. federal income tax authorities existing as of September 1, 2006, which are subject to change. In addition, the discussion does not address U.S. state and local or foreign tax matters.¹

DEFERRED TAXES

As noted above, the Standard does not affect the basic principles of accounting for income taxes, including the recognition of temporary differences. Temporary differences are differences between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Those basis differences result in the recognition of deferred taxes. For example, in situations in which a hybrid instrument requires bifurcation of an embedded derivative for financial statement purposes, deferred taxes should be established related to both the host instrument and the bifurcated embedded derivative. Bifurcation of an embedded derivative results in the allocation of proceeds into two separate instruments for financial statement purposes (i.e., the host contract and the bifurcated embedded derivative); however, the hybrid remains one instrument for tax purposes. Two temporary differences arise because the bifurcated embedded derivative is recognized as an asset or liability separately from the host contract. Accordingly, deferred taxes would be established for both the host contract and the bifurcated embedded derivative. While those deferred tax balances will offset at issuance, the temporary differences will not remain in lock-step since the bifurcated embedded derivative will be marked to fair value on an ongoing basis while the premium or discount on the host contract will be accounted for under the applicable GAAP for that host contract (e.g., under the effective interest rate method if the host were a debt instrument or a note receivable). Other situations in which temporary differences may occur include a fair value hedge when the hedged item’s book basis is adjusted for changes in fair value for the risk being hedged.

¹ For purposes of this chapter, all Section references are to the U.S. Internal Revenue Code of 1986, as amended, and any references to Treas. Reg. refer to the U.S. Federal Treasury Regulations promulgated thereunder.
Example 11.1: Convertible Noted with Separation of Call Option as a Liability

On January 1, 20X7, Company A issues a 10-year note that has a $1,000 par value, accrues interest at an annual rate of 4% and is convertible into 100 shares.

On the conversion date Company A must settle the accreted value of the note in cash and has the option to settle the conversion spread in either cash or stock. Because Company A cannot assert that it has a sufficient number of shares available to share-settle the conversion spread, Company A concludes that it must bifurcate the conversion option and account for it separately under Statement 133.

The conversion option is valued at $50 on January 1, 20X7 and the discount will accrete on the convertible note at $5 each year (straight line accretion is assumed for simplicity). The tax rate for Company A is 40%.

Accounting on January 1, 20X7

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000</td>
</tr>
<tr>
<td>Discount – Convertible note</td>
<td>$50</td>
</tr>
<tr>
<td>Deferred tax asset (($50-0)*40%)</td>
<td>$20</td>
</tr>
<tr>
<td>Convertible note</td>
<td>$1,000</td>
</tr>
<tr>
<td>Conversion option liability</td>
<td>$50</td>
</tr>
<tr>
<td>Deferred tax liability (($1,000-$950)*40%)</td>
<td>$20</td>
</tr>
</tbody>
</table>

A deferred tax liability will be recorded on the difference between the tax basis of the convertible note of $1,000 and the carrying amount including the discount of $950.

A deferred tax asset will also be recorded on the difference between the tax basis of the bifurcated conversion option (i.e., zero) and the carrying value of $50.

As of December 31, 20X7 the fair value of the conversion option liability has increased to $200 (change in fair value of $150). Accretion on the note is $5.

Accounting on December 31, 20X7

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense – convertible note</td>
<td>$5</td>
</tr>
<tr>
<td>Deferred tax asset ($150*40%)</td>
<td>$60</td>
</tr>
<tr>
<td>Other expense</td>
<td>$150</td>
</tr>
<tr>
<td>Deferred tax liability ($5*40%)</td>
<td>$2</td>
</tr>
<tr>
<td>Discount - convertible note</td>
<td>$5</td>
</tr>
<tr>
<td>Conversion option liability</td>
<td>$150</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>$62</td>
</tr>
</tbody>
</table>

The deferred tax liability on the convertible note has decreased as the interest accretes on the note. The deferred tax asset on the conversion option has increased in line with the increase in its fair value.
GENERAL TAX PRINCIPLES

In taxation, the key issues with respect to derivative instruments are:

- The timing of recognition of income, expense, gain, and loss items;
- The character of income, expense, gain, and loss items; and
- The source of income, expense, gain, and loss items.

Timing of Recognition

Timing of recognition refers to when the income, expense, gain, or loss from a derivative instrument would be reflected in the entity’s tax return. There are a number of tax identifications and elections that the taxpayer can or must make that affect such timing.

Character of Income

For U.S. tax purposes, the character of the income, expense, gain, or loss refers to whether the item can be classified as capital or ordinary. The character of these items is significant for U.S. tax purposes because:

- Ordinary losses generally are deductible against ordinary income when recognized;
- For corporate taxpayers, capital losses may reduce taxable income only to the extent of capital gains; and
- For individual taxpayers, (1) only $3,000 of capital losses in excess of capital gains may be utilized to reduce adjusted gross income; and (2) long-term capital gains are subject to Federal tax at a maximum rate of 15%, while short-term capital gains and ordinary income (other than qualified dividend income) are subject to Federal tax at a maximum rate of 35%.²

SOURCE OF INCOME

The source of income (i.e., U.S.-source or foreign-source) is important in determining whether withholding taxes apply to payments made or received with respect to a particular transaction. In addition, sourcing is an important consideration in the computation of a taxpayer’s foreign tax credit. For foreign entities, the source of income may also affect whether payments are subject to U.S. taxation. Generally, the source of payments made or received in relation to a derivative instrument is based on the residence of the taxpayer (e.g., a company incorporated in the United States would generally be U.S. resident). Different rules may apply to derivative instruments recorded on the books and records of qualified business units of the taxpayer with different residences from the taxpayer (e.g., a European branch of a U.S. corporation).

TAXATION OF DERIVATIVE INSTRUMENT TRANSACTIONS

The tax law does not tax all derivative instruments in the same manner. The tax law focuses on a number of factors, including the type of derivative and the purpose for holding the derivative, to establish the proper method of taxation. For example, in the case of derivatives entered into to manage risk, a number of provisions require or allow taxpayers to make certain identifications or elections to match the character and timing of recognition of the derivative instrument with the character and timing of recognition of the risks being managed. These rules may also affect the source of the income or expense.

The proper method of taxation generally depends on the following four factors:

- The tax classification of the entity as a dealer or non-dealer;
- The characterization of the derivative instrument;
- The purpose of the derivative instrument; and
- The placement of the derivative instrument.

Tax Classification of the Entity as a Dealer or Non-Dealer

For tax purposes, a dealer in securities is a taxpayer that:

- Regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business; or
- Regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.³

For this purpose, the term securities, includes debt instruments, corporate equities, and derivatives (other than certain futures contracts and exchange-traded options). A taxpayer generally cannot elect to be a dealer; dealer status is generally mandatory based on the taxpayer’s business. Entities such as banks, broker-dealers, and specialty finance companies (e.g., mortgage lenders) are usually considered dealers for tax purposes. Insurance companies and treasury centers may also be considered dealers depending on the level and nature of their securities transactions.

Generally, dealers in securities are required for tax purposes, to mark all of their securities to market at the end of each taxable year (or, where applicable, account for them as inventory).⁴ The resulting gain or loss is usually ordinary provided the security is held in connection with the entity’s activities as a dealer in securities. In some cases (e.g., some futures contracts and exchange-traded options), the tax characterization of the derivative instrument will override the dealer provisions in determining the tax treatment.

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³ Section 475(c)(1).
⁴ The Tax Court recently held that fair value for financial accounting purposes is not the same as fair market value for tax purposes. Bank One Corporation v. Commissioner, 120 T.C. 174 (2003). Since then, the IRS and Treasury have proposed regulations that would allow a taxpayer to elect to use the value reported for financial accounting purposes as fair market value for tax purposes.
A dealer can exempt the following derivatives from the dealer mark-to-market timing and ordinary character rules:

- Derivatives that are held for investment (provided the taxpayer is not a dealer in derivatives); and
- Derivatives that hedge securities, assets, or liabilities that are not marked-to-market under these rules.\(^5\)

These exemptions are generally elective and are made by properly identifying the securities on the date of acquisition.

There is an election for entities that, for U.S. federal tax purposes, are considered to be traders in securities or commodities or dealers in commodities to elect to treat their trader or dealer activity in a similar manner to the method prescribed for securities dealers.\(^6\)

**Characterization of the Derivative Instrument**

For U.S. tax purposes, there is no general definition of a derivative instrument. Instead, derivative instruments are classified based on specific characteristics of the instrument. Each type of derivative instrument has different timing and character rules. Below is a summary of the general timing and character provisions that apply to various types of derivative instruments (the definition of each type of derivative instrument is included in Appendix A of the chapter).

**NOTIONAL PRINCIPAL CONTRACTS (NPC)**

**Instruments.** Swaps, caps, and floors.

**Timing.** The NPC timing rules separate all payments into three categories: periodic payments (i.e., payments due at least annually), nonperiodic payments (i.e., all scheduled payments other than periodic payments and termination payments), and termination payments (i.e., any payment to terminate or assign interests in a swap). The ratable daily portions of periodic payments are recognized in the tax year to which the payment relates. Nonperiodic payments (including the premium paid or received under a cap or floor and prepayments of one side of a NPC) are generally recognized over the term of the NPC in a manner that reflects the economic substance of the contract. Swaps with significant non-periodic payments, however, are bifurcated into a lending transaction and an on-market swap (i.e., a swap that does not require an upfront payment). Termination payments are recognized in the year the contract is terminated or assigned.

**Character.** Periodic and nonperiodic payments are generally ordinary in character. The character of a termination payment is based on the character of the underlying property or index. The character of termination and assignment payments on NPCs based on interest rates, equities, or commodities is generally capital, while the character of such payments

\(^{5}\) For purposes of these rules, a hedge is defined as any position that manages the dealer’s risk of interest rate or price changes or currency fluctuations, including any position that is reasonably expected to become a hedge within 60 days after the acquisition of the position. This definition generally overlaps with the more general definition of a tax hedging transaction. Thus, a hedging transaction entered into by a dealer that is exempt from the mark-to-market rules may be subject to the tax hedging rules.

\(^{6}\) Sections 475(e), 475(f).
made with respect to NPCs on currencies or property that the taxpayer treats as ordinary property is generally ordinary.

**SECTION 1256 CONTRACTS**

**Instruments.** Regulated futures contracts, exchange-traded nonequity options (including exchange-traded broad-based equity index options such as options on the Standard and Poor’s (S&P) 500 or Dow Jones Industrial Average), certain over-the-counter foreign currency contracts, exchange-traded equity options entered into by a dealer, and, upon issuance of IRS guidance, securities futures contracts entered into by a dealer.

**Timing.** At the end of the taxable year, the instrument is marked-to-market and gains and losses are recognized.

**Character.** Generally, 60% of the recognized gain or loss is long-term capital gain or loss while the remaining 40% is short-term capital gain or loss without regard to the length of time the taxpayer holds the contracts. However, gain or loss from over-the-counter foreign currency contracts (and any other section 1256 contract that is otherwise considered to be ordinary property) is generally ordinary.

**SECTION 1234 OPTIONS**

**Instruments.** Exchange-traded equity options (other than dealer equity options) and over-the-counter options on debt securities, equity securities, commodities, and indices.

**Timing.** Gain or loss is recognized on the lapse, sale, or termination of the option. If the option is physically settled, the premium paid (or received) is added to (or deducted from) the basis in the property delivered (or received). The premium is *not* amortized.

**Character.** As to option holders, the character and holding period of the gain or loss from an option is generally based on the character of the underlying property or index. Options based on debt securities, equities, or commodities generally generate capital gains or losses. Grantors of these options generally recognize short-term capital gain regardless of their holding period.

**FORWARD CONTRACTS**

**Instruments.** Contracts to buy or sell an underlying property or index at a specified price and at a specified future time, which settle in cash or by the delivery of the underlying property.

**Timing.** Generally, any gain or loss is recognized on the close of the transaction. If the contract is settled by delivery of the underlying property, the price paid by the buyer under the contract (including any upfront premium or prepayment) becomes the tax basis of the asset acquired (and the amount realized by the seller).

**Character.** The character of the gain or loss on a forward contract is based on the character of the underlying property or index. Forwards based on debt securities, equities, or commodities generally generate capital gain or loss, while contracts on currencies generally generate ordinary gain or loss.
SEcurities Futures Contracts

Instruments. Exchange-traded contracts for the sale or future delivery of a single security or a narrow-based security index. Securities futures contracts entered into by dealers in such contracts are Section 1256 contracts.

Timing. Gain or loss from non-dealer securities futures contracts is recognized upon the lapse, termination, or assignment of the contract. If the contract is physically settled, gain or loss is recognized when the underlying property is sold.

Character. The character of gain or loss from the sale or exchange of a non-dealer securities futures contract is the same as the character of the underlying property. Gain or loss on the sale of a non-dealer, securities futures contract to sell a capital asset is treated as short-term capital gain or loss regardless of the holding period.

compound instruments and separation

The tax law generally does not address the treatment of financial or derivative instruments that are created by combining equity instruments with derivative instruments, debt instruments with embedded derivative instruments, or multiple derivative instruments (e.g., swaps with embedded options). As a general rule, taxpayers usually follow the treatment of the dominant instrument. In limited situations, the taxpayer is required to bifurcate the instrument.

Examples of instruments that are taxed based on the instrument’s dominant characteristics are swaptions (i.e., an option to enter into a specified interest rate swap at a future date), forward swaps, and contingent debt instruments (i.e., hybrid instruments consisting of a debt instrument and a derivative). Swaptions and forward swaps are subject to the general rules of taxation for options and forward contracts, respectively. Any payment with respect to the option or forward contract is treated as a nonperiodic payment of the underlying NPC.7 Contingent debt instruments are generally accounted for as noncontingent fixed-rate debt instruments with projected payments based on the expected values of the contingent payments. Adjustments are made to reflect actual payments attributable to the embedded derivative component in the period in which the payments are made.

Bifurcation is required for nonpublicly-traded contingent debt instruments that are issued for nonpublicly traded property. These instruments are bifurcated into a contingent component (i.e., the derivative) and a non-contingent component. Some derivative features (e.g., conversion features, certain prepayment options, and remote or incidental contingencies) are disregarded, while other clearly and closely related derivative features are treated as contingencies. Bifurcation is also required for swaps with significant non-periodic payments. Those instruments are bifurcated into a debt instrument and an on-market, level payment swap.

Purpose of Derivative Instrument

Certain types of transactions are subject to special timing and character rules which could change the general rules discussed above. Specific tax rules apply to the following types of transactions:

7 Treas. Reg. Section 1.446-3(g)(3).
- Tax hedging transactions;
- Tax straddles;
- Integrated transactions; and
- Constructive sale and constructive ownership transactions.

If none of these particular rules applies, the tax treatment of the derivative instrument generally follows the guidance outlined previously in connection with the characterization of the instrument. Dealer status may or may not affect the rules described below, and entities would be required to determine the interaction of dealer status with those rules.

**TAX HEDGING TRANSACTIONS**

If the derivative instrument qualifies as a tax hedging instrument and is properly identified, the character of the gain or loss on the tax hedging instrument will be ordinary, and the income, gain, loss, and deductions will be recognized in the same period the income, gain, loss, and deductions are recognized on the hedged item.8 For example, gain from closing an interest rate future that hedges interest rate risk on a debt instrument will be recognized over the period for which the future hedged the debt instrument’s interest rate risk. Any property, other than a debt instrument, equity security, or annuity contract, can be a tax hedging transaction.

A transaction qualifies as a tax hedging transaction if:

- The transaction is entered into to manage risk for the taxpayer;
- The item being hedged is ordinary property, a borrowing, or an ordinary obligation; and
- The transaction is entered into in the ordinary course of business.9

A transaction that is not characterized as a tax hedging transaction will not receive ordinary treatment, even if it can be shown that the transaction serves a hedging function.

Whether a transaction manages a taxpayer’s risk is determined based on all of the facts and circumstances as evidenced in the taxpayer’s policies and records. A tax hedging transaction can manage the risk of one item, a group of similar or dissimilar items, or the entire enterprise. One type of transaction that manages risk is a transaction that reduces the risk attributable to the item being hedged as well as reduces the overall risk of the taxpayer’s operations. A second type of transaction that manages risk is a transaction that converts interest rates from fixed to floating, or vice versa.

Whether a transaction manages risk depends on the purpose for entering into the transaction, not whether the transaction would be effective or ineffective. A tax hedging instrument continues to be treated as a tax hedging instrument regardless of its actual effectiveness. However, the extent to which the hedge is considered ineffective may be weighed in evaluating whether the taxpayer has in fact satisfied the risk management criteria of the tax guidance.

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8 Even if proper identification is not made, a tax hedging instrument may still be subject to the hedge timing rules. See Rev. Rul. 2003-127, 2003-2 C.B 1245.

9 See generally Treas. Reg. Section 1.1221-2(b).
Property generally is considered ordinary if the sale or exchange of that property would only produce ordinary gain or loss. For example, a U.S. dollar-denominated bond purchased for investment would not be considered ordinary property since the gain or loss generated from a sale would generally be capital in character.10 Whether a taxpayer enters into a hedging transaction in the ordinary course of business is based on all of the facts and circumstances. Investment and speculative transactions are not considered transactions in the normal course of business.

To qualify as a tax hedging transaction, the taxpayer must identify the hedge and the hedged items. The taxpayer must identify the hedge on the day it is entered into, and the hedged item within 35 days. Identification of a hedge or hedged item for financial accounting purposes is not sufficient unless the books and records indicate that the hedge is also being made for tax purposes. Failure to identify the transaction properly may subject the taxpayer to an anti-abuse rule under which gain on the hedge is ordinary but losses are capital.

**Hedging Within a Consolidated Group**

The favorable hedging rules also apply to tax consolidated groups.11 The tax consolidated group is a narrower concept than the concept of entities consolidated for financial reporting purposes and generally only includes U.S. corporations. Thus, for example, foreign subsidiaries and most partnerships and LLCs are not included in the tax consolidated group.

The hedging rules generally only permit a tax entity to hedge its own risks. In the case of a tax consolidated group, the hedging rules generally apply as if the members of the consolidated group were divisions of a single corporation. By treating the group as a single entity, one member of a tax consolidated group is permitted to enter into a hedging transaction with a third party to hedge the exposure of another group member. At the same time, transactions entered into between members of the same consolidated group would not qualify as hedging transactions because these transactions are deemed not to alter the risks of the single entity.

A tax consolidated group that does not want this treatment can make a separate-entity election. The separate-entity election generally turns off the special single entity rule for consolidated groups. Thus, transactions entered into by one member of the tax consolidated group to hedge the risks of another member would not qualify as a tax hedging transaction. However, transactions between members of a consolidated group would only qualify as hedging transactions if:

- The position of the member with the risk being hedged would qualify as a hedging transaction if entered into with an unrelated party; and
- The position of the other member is marked to market.

Therefore, a separate-entity election would permit the parent of the group to enter into transactions with third parties and then enter into almost identical and offsetting contracts with its subsidiaries and account for these transactions the same for tax purposes regardless of

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10 If the holder is a bank or similar deposit-taking institution, the gain or loss would be ordinary.
11 A consolidated group includes all members of an affiliated group that qualify for and have elected to be included in the U.S. federal consolidated return. See Section 1502.
whether the subsidiary is a member of the U.S. tax consolidated group. This election would only be available, though, if the parent is a dealer in securities or is only using Section 1256 contracts.

**TAX STRADDLES**

The term *straddle* refers to offsetting positions with respect to actively traded personal property. Generally, offsetting positions are present if the taxpayer’s risk of loss from holding any position with respect to actively traded personal property is substantially diminished by another interest (whether or not held or entered into by the same legal entity in the U.S. tax consolidated return group) in actively traded personal property (whether or not of the same kind). A derivative that is an identified tax hedging transaction would not be a straddle in connection with the hedged item.

There are three primary tax consequences that result from entering into a straddle:

- Loss deferral;
- Capitalization of interest and carrying costs; and
- Holding period suspension.

According to the loss deferral rule, a loss realized by a taxpayer on one component, or leg of a straddle, is deferred (i.e., not currently deductible) to the extent of the amount of the unrecognized gain on the offsetting leg of the straddle. The loss is also deferred if the taxpayer replaces the loss position with a substantially identical position within 30 days before or after the disposition.

Another straddle rule generally requires the taxpayer to capitalize otherwise deductible interest and certain carrying charges (e.g., insurance and storage) properly allocable to personal property that is part of a straddle to the extent the amounts exceed the property’s taxable ordinary income (e.g., interest and dividends). The capitalized amounts are added to the property’s basis. Capitalization generally results in a deferral of recognition and may result in a change in the character of the item. For example, this rule may require taxpayers to capitalize periodic payments on swaps into the basis of the offsetting position.

The holding period suspension rule generally affects non-corporate taxpayers for which there is a difference in the long-term versus short-term capital gains rates. Specifically, it requires taxpayers to suspend the holding period of any position that is part of a straddle for the period the straddle exists. In addition, losses realized on the disposition of one leg of a straddle will be long-term capital loss if part of the straddle has been held for greater than one year at the time the straddle is entered into.

There are several potentially beneficial elections that taxpayers can make with respect to straddles and mixed straddles (i.e., straddles in which at least one of the positions is a Section 1256 contract):

- An identified straddle election;
- A mixed straddle election;
- An identified mixed straddle election; and
- A mixed straddle account election.
The purpose of such elections is to match the timing and/or character of the offsetting positions. A summary of these elections is contained in Appendix B of this chapter.

INTEGRATED TRANSACTIONS

Taxpayers are permitted to treat a qualifying debt instrument and a derivative instrument for which cash flows match the cash flows of the debt instrument as one synthetic debt instrument if certain requirements are met (see Appendix C of this chapter for an overview of the requirements). For example, a U.S. dollar-denominated qualified debt instrument and certain derivative hedging instruments can be integrated. Debt instruments or executory contracts may be combined with foreign currency derivative instruments if certain requirements are met (see Appendix D of this chapter for an overview of the requirements). Under both of these provisions, there must be a high degree of correlation between the derivative instrument and the related hedged item, and both instruments must be entered into by the same entity. In addition, the taxpayer must identify the derivative instrument and the related hedged item before the end of the day the derivative instrument is entered into.

These provisions are attractive to taxpayers because an integrated transaction is treated as a single transaction taxed under the rules that apply to the transaction the instruments are attempting to replicate instead of the rules that would apply to each instrument. As a result, integration can help a taxpayer avoid mismatches of timing or character on the combination of the derivative instrument and the corresponding debt instrument.

APPLICATION OF CONSTRUCTIVE SALE AND CONSTRUCTIVE OWNERSHIP RULES

Certain derivative hedging transactions can have the effect, for tax purposes, of accelerating the built-in, unrecognized gain in the hedged security. More specifically, the constructive sale rule provides that, upon a constructive sale of an appreciated financial position, a taxpayer must recognize gain (but not loss) as if the position were sold, assigned, or otherwise terminated at fair market value on the date of the constructive sale. The basis of the appreciated financial position is increased by any gain realized on the constructive sale, and a new holding period begins for the position on the date of the constructive sale.

A constructive sale occurs when a taxpayer (or related person) enters into one of the following transactions with respect to the same or substantially identical property: a short sale, an offsetting NPC, a futures or forward contract, or any other transaction described in the Treasury Regulations that has substantially the same effect. There is an exception for certain short-term transactions. An appreciated financial position is generally any position (including a futures or forward contract, short sale, or option) in stock, a partnership interest, or certain debt instruments if there is a built-in gain on such position. Any position that is marked-to-market would not be treated as an appreciated financial position.

In other circumstances, where derivatives are used to simulate the return of an investment, the constructive ownership rules may recharacterize the character of the gain or loss from the derivative to reflect the character of the income from the underlying position. Three transactions are enumerated as constructive ownership transactions:

- Holding a long position under a notional principal contract;
• Entering into a forward or futures contract to acquire property; or
• Granting a put option and holding a call option with respect to the financial asset and such options have substantially equal strike prices and substantially contemporaneous maturity dates.

Entering into a transaction that has substantially the same effect as the enumerated transactions would also be treated as a constructive ownership transaction. The constructive ownership rules apply to constructive ownership transactions of certain pass-through entities, such as real estate investment trusts (REITs) and partnerships, but do not currently apply to debt or stock in a widely-held corporation.

If a taxpayer has a gain from a constructive ownership transaction and the gain would be treated as long-term capital gain with respect to a financial asset, the constructive ownership rules will recharacterize a portion of the gain. The gain is treated as ordinary income to the extent such gain exceeds the net underlying long-term capital gain. The net underlying long-term capital gain is generally the amount of capital gain that the taxpayer would have recognized if it had owned the underlying financial asset. In addition, interest is imposed on recharacterized income from the date the income should have been recognized. This rule does not apply if all of the positions are marked to market.

**Placement of Derivative Instruments**

Placement of the derivative instrument in one type of entity versus another can have a significant effect on taxable income or the validity of tax identifications. In determining the optimal placement of the derivative instrument for tax purposes, the taxpayer should consider:

• The tax treatment of the transaction in the foreign jurisdiction;
• The treatment of the transaction for U.S. earnings and profits purposes; and
• The current inclusion rules of the U.S. tax law.

**WITHIN THE U.S. CONSOLIDATED TAX RETURN GROUP**

Many companies would prefer to control their derivative trading activities in the parent company or in one designated subsidiary (a hedging center). As previously mentioned, provided the consolidated group is utilizing the single-entity approach, a derivative instrument entered into with a third party by one member of a consolidated group can qualify as a derivative hedging instrument of an exposure of another member of the group. The resulting tax effect on the federal consolidated tax return would be the same as if the member with the exposure entered into the derivative hedging instrument directly with the third party. However, if the transactions are not entered into by the same entity, for state and local tax purposes, there may be a mismatch in:

• The amounts recognized in one or more state tax returns; and/or
• The timing of recognition and character of income, expense, gain, or loss if a particular state does not follow the federal definition of a tax hedging transaction.

If the group makes a separate-entity election, one entity (either the parent company or a designated subsidiary) could aggregate the risks of the other members of the group and
subsequently enter into back-to-back derivative instruments with the other group members. However, an intercompany transaction can be a hedging transaction only if it is entered into with a member that accounts for its position in the transaction by marking the position to market. Because generally only dealers in securities use mark to market accounting for tax purposes, the entity acting as the hedging center (i.e., the entity issuing the derivative instruments) must generally be considered a dealer in securities and, in this capacity, regularly enter into these types of derivative instruments with customers. Other members of the consolidated group can be considered customers for this purpose, but the entity’s status as a dealer will be based on all of the facts and circumstances. Therefore, if a taxpayer wants to use this arrangement for its derivative hedging instruments, it must:

- Ensure that the entity would be considered a dealer for tax purposes, and
- Consider the implications of dealer status on the other activities of that entity.

In practice, the consolidated groups that have elected the separate-entity approach have generally involved banks. Several non-banking companies that have a business need to keep the derivative trading activities in one entity have continued to use the single-entity approach, but have entered into intercompany arrangements to centralize the management of this function.

**EFFECT OF CONTROLLED FLOW-THROUGH ENTITIES**

In general, for financial reporting purposes, a flow-through entity (e.g., partnerships and trusts) controlled by the reporting entity is consolidated and equity ownership of the flow-through entity by third parties is reflected in the financial statements as a minority interest. For U.S. tax purposes, however, partnerships and trusts are treated as separate flow-through or transparent entities with taxes assessed at the individual ownership level instead of at the entity level.

**FOREIGN CORPORATIONS**

An affiliated foreign corporation is another example of an entity that is consolidated for financial reporting but not consolidated for tax purposes. As a result, the placement of the derivative instrument may present opportunities for tax planning. The tax treatment of derivative instruments varies greatly among jurisdictions. However, in most countries, the tax law is relatively vague as to the treatment of many of the sophisticated derivative instruments existing in the market today. Some taxpayers place derivative instruments in U.S. entities to reduce the uncertainty of the tax treatment under foreign tax law.

In a cross-border context, one consequence of not placing derivative instruments in the entity with the exposure is a potential mismatch of timing and character. There may also be a mismatch in calculating U.S. earnings and profits (E&P) for the foreign entity. E&P is a recalculation of the foreign entity’s income utilizing modified U.S. tax principles. E&P is important for determining the U.S. tax treatment of dividends and items of current inclusion from foreign subsidiaries, as well as the calculation of foreign tax credits.

When considering the placement of a derivative instrument in a U.S. entity within or outside of the U.S. consolidated group, the mismatches that could occur generally will result in temporary differences (except, for example, if a transaction creates a capital loss that expires unutilized). The potential mismatches are further complicated by special tax rules that could characterize the
gain or loss of certain derivative transactions as Subpart F income, resulting in current inclusion (and U.S. tax) on the U.S. tax return of the U.S. shareholder(s) of the foreign entity.

**Administrative Requirements**

**TAX POLICIES, IDENTIFICATIONS, AND ELECTIONS**

As mentioned previously, the documentation created and maintained by taxpayers with respect to their financial instrument transactions is very important. In particular, if a taxpayer wishes to make identifications and/or elections to secure a particular tax treatment, the procedures set forth by the Internal Revenue Code and the Treasury Regulations generally must be completed by the end of the day on which the taxpayer enters into the transaction. Therefore, it is important to have the proper tax policies and procedures in place. In connection with elections to be made by taxpayers, the statutes and regulations generally provide sufficient guidance for making such elections. However, there is little guidance as to what constitutes a proper identification.

We generally suggest the following procedures for taxpayers who solely use derivative instruments for hedging purposes:

1. Develop a written tax policy regarding the use of derivative instruments. This statement should:
   - State that all derivative instruments entered into by the taxpayer are identified as derivative hedging instruments pursuant to the appropriate statutory or regulatory provision;
   - State that all derivative instruments are identified in accordance with the prescribed requirements before the end of the day on which the transaction is entered into;
   - State that the item or aggregate risk being hedged is identified substantially contemporaneously with the hedging transaction, and in all cases within 35 days; and
   - Refer to each of the subsequent steps the taxpayer will take in creating documentation (i.e., steps 2 - 4 below).

2. Maintain a separate ledger account on the books for the particular hedging transaction or group of hedging transactions and for the transactions being hedged.

3. Prepare a memorandum describing the derivative instruments and the intended tax treatment. For example, in the case of tax hedges, the memorandum would identify the item, items, or aggregate risk that the derivative instrument is hedging. The memorandum should include the number(s) of the general ledger accounts relating to the derivative instruments and the related hedged items. The memorandum also should include specific information relating to the timing of recognition for each type of derivative instrument and the corresponding hedged item.

4. If possible, depending on the number of derivative instruments entered into, an appropriate identification should be noted on the taxpayer’s trade confirmation for each transaction.
FILING REQUIREMENTS

Amounts recognized from derivative instruments generally are included on the return as other income or expense, or capital gain or loss. Income or loss is included on the tax return as interest income or expense if the derivative instrument is integrated with a debt instrument. In addition, straddles and Section 1256 contracts that are marked-to-market must be reported on Form 6781.

Appendix A  Tax Definitions of Certain Derivative Instruments

The purpose of this appendix is to summarize the tax definitions of certain derivative instruments.

DEFINITIONS

Notional Principal Contract: A financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified objective index (e.g., London Interbank Offered Rate (LIBOR)) upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. Examples include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity-indexed swaps, and similar agreements.

Section 1256 Contract: A Section 1256 contract is one of the following instruments:

1. Regulated Futures Contract. A contract that generally depends on a system of marking to market, and is traded on or subject to the rules of a qualified board or exchange;

2. Foreign Currency Contract. A contract that meets three requirements: (1) the contract contemplates delivery or settlement by reference to a foreign currency traded on a qualified board or exchange, (2) the contract is traded in the interbank market, and (3) the contract uses an arm’s length price determined by reference to the price on the interbank market;

3. Nonequity Option. An exchange-traded option other than an option on a particular stock or narrow-based equity index;

4. Dealer Equity Option. An equity option (including options on a particular stock or a narrow-based index) that is purchased or granted by an options dealer in its activity of dealing in options and that is listed on the qualified board or exchange on which the dealer is registered; or

5. Dealer Securities Futures Contract. Any securities futures contract or option on such contract entered into by the dealer (or, if an option, is purchased or granted) in the normal course of its activity in dealing in such contracts/options that is traded on a qualified board or exchange.

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12 Treas. Reg. Section 1.446-3.
Section 1234 Option: An option to buy or sell property (e.g., stock, securities, commodities, and certain indices), including options that are cash-settled.

Securities Futures Contract: A contract of sale for future delivery of a single security or a narrow-based security index, including any interest therein based on the value thereof.

Appendix B  Tax Straddle Elections

There are several potentially beneficial elections that taxpayers can make with respect to straddles and mixed straddles. The purpose of this appendix is to summarize these elections.

SECTION 1092(A) IDENTIFIED STRADDLE ELECTION

The identified straddle election is found in Section 1092(a)(2). An identified straddle is any straddle:

- Which is clearly identified as an identified straddle before the close of the day on which the straddle is established;
- Which is not part of a larger straddle; and
- To the extent provided in future regulations, the value of each position of which is not less than the basis of such position in the hands of the taxpayer at the time the straddle is established.

Positions identified as part of an identified straddle are not treated as offsetting any positions not so identified. The general loss deferral rule, which defers loss to the extent of an unrecognized gain on the offsetting leg of the straddle, does not apply to identified straddles. Instead, any loss is capitalized into the basis of the offsetting positions.

SECTION 1256(D) MIXED STRADDLE ELECTION

The Section 1256(d) mixed straddle election is made on a straddle-by-straddle basis. If properly made, this election provides that Section 1256 does not apply to the Section 1256 contracts that are part of the mixed straddle in question. Avoiding Section 1256 generally has two effects:

- **Timing.** The position in the mixed straddle normally subject to mark-to-market treatment (i.e., the Section 1256 contract) would no longer need to be marked-to-market for tax purposes. This should enable the taxpayer to avoid, or at least minimize, a mismatch in the timing of recognition of gains and losses.
- **Character.** Section 1256 contains a general rule providing that gain or loss on a Section 1256 contract is characterized as capital (60% long-term, 40% short-term). If a mixed straddle election is made, the character of the Section 1256 contract is determined under other provisions.

SECTION 1092(B)(2) IDENTIFIED MIXED STRADDLE ELECTION

The identified mixed straddle election is discussed in Section 1092(b)(2) and Temp. Treas. Reg. Section 1.1092(b)-3T. The election is made on a straddle-by-straddle basis; however, the straddle
itself could consist of several positions. For example, a bond portfolio combined with several futures contracts may comprise a single mixed straddle.

Generally, the election enables the taxpayer to offset gains and losses from Section 1256 contract positions with non-Section 1256 contract positions before the character of the net gain or loss is determined. The election can, therefore, be beneficial for individuals for whom there is different treatment of long-term and short-term capital gains and losses.

**SECTION 1092(B)(2) MIXED STRADDLE ACCOUNT ELECTION**

The mixed straddle account election is discussed in Section 1092(b)(2) and Temp. Treas. Reg. Section 1.1092(b)-4T. This election permits the taxpayer to offset gains and losses from positions that comprise mixed straddles by maintaining a separate account for all offsetting positions within a designated class of activities. The election to establish one or more mixed straddle accounts is made on a yearly basis on Form 6781 and is effective only for the taxable year for which it is made.

Each day the same netting procedure used with regard to identified mixed straddles is used. The daily gains or losses are then combined on an annual basis. Certain limitations reduce the possibility of conversion of the character of gains and losses within the straddle account. If there is an annual net gain and over 50% of the gain is long-term, then the excess over 50% is converted to short-term gain. If there is an annual net loss and over 40% of the net loss is short term, then the excess over 40% is converted to long-term loss.

Establishing a mixed straddle account normally reduces potential character mismatches. In addition, mark-to-market treatment reduces potential mismatches in the timing of recognition of gains and losses from positions in a mixed straddle account, and, in effect, provides a way for non-dealers to mark-to-market their bond portfolios for U.S. tax purposes.

**Appendix C Integration Under Treas. Reg. §1.1275-6**

Taxpayers may treat a debt instrument and a derivative instrument as one synthetic debt instrument if certain requirements are met. The purpose of this appendix is to summarize the most significant requirements.

**REQUIREMENT CHECKLIST FOR INTEGRATION UNDER TREAS. REG. SECTION 1.1275-6**

(1) The debt instrument is any debt instrument other than:

- Tax-exempt obligations;
- Debt instruments defined in IRC Section 1272(a)(6), such as a REMIC regular interest; and
- Contingent payment debt instruments issued for non-publicly traded property.

(2) The hedging instrument is not stock. The hedging instrument can generally be any derivative financial instrument, a debt instrument (subject to certain limitations), or any other similar instrument.
(3) The hedging instrument does not hedge currency risk.

(4) The combined cash flows of the derivative instrument and the qualifying debt instrument permit the calculation of a yield to maturity, or the right to the combined cash flows would qualify under Treas. Reg. Section 1.1275-5 as a variable-rate debt instrument that pays interest at a qualified floating rate.

(5) The resulting synthetic debt instrument has the same term as the remaining term of the qualifying debt instrument.

(6) The identification of the integrated transaction is completed properly on or before the date the taxpayer enters into the hedge.

(7) Both the debt instrument and the hedging instrument are entered into by the same individual, partnership, trust, estate, or corporation.

(8) The debt instrument is issued or acquired by the taxpayer on, or substantially contemporaneously with, the date of the first payment on the hedge.

(9) Neither the hedge nor the debt instrument was, with respect to the taxpayer, a straddle prior to the issue date of the synthetic debt instrument.

Appendix D Integration Under Treas. Reg. Section 1.988-5

In the foreign currency area, taxpayers may treat a debt instrument or executory contract and a derivative instrument as a synthetic instrument if certain requirements are met. The purpose of this appendix is to summarize the most important requirements.

PART I - INTEGRATION OF FOREIGN CURRENCY DENOMINATED DEBT INSTRUMENTS

(1) The qualifying debt instrument is any debt instrument (including dual currency debt instruments, multicurrency debt instruments, and contingent payment debt instruments) denominated in, or determined by reference to, either the taxpayer’s functional currency or any nonfunctional currency.

(2) A qualifying debt instrument does not include accounts payable, accounts receivable, or similar items of income or expense.

(3) The hedging instrument is generally any currency-based derivative financial instrument that, when integrated with a qualifying debt instrument, permits the calculation of a yield to maturity in the currency in which the synthetic debt instrument is denominated.

(4) The identification of the integrated transaction is completed properly on or before the date the acquisition of the hedging instrument is settled.

(5) The debt instrument and the hedging instrument are entered into by the same taxpayer.
PART II - INTEGRATION OF FOREIGN CURRENCY DENOMINATED EXECUTORY CONTRACTS

(1) The executory contract is an agreement entered into before the accrual date to pay nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the purchase of property used in the ordinary course of the taxpayer’s trade or business, or the acquisition of services in the future. An executory contract can also be an agreement entered into before the accrual date to receive nonfunctional currency in the future with respect to the sale of property used or held for sale in the ordinary course of the taxpayer’s business, or the performance of a service in the future.

(2) The hedging instrument is a deposit of nonfunctional currency in a hedging account, or a forward or futures contract, or combination thereof, which reduces the risk of exchange rate fluctuations by reference to the taxpayer’s functional currency with respect to nonfunctional currency payments made or received under an executory contract. An option contract qualifies as a hedging instrument only if the option’s expiration date is on or before the accrual date.

(3) The identification of the executory contract and the hedging instrument as a hedged executory contract is completed properly before the close of the date the hedging instrument is entered into.

(4) The hedging instrument is entered into (or a nonfunctional currency is acquired and deposited in an account with a bank) on or after the date the executory contract is entered into and before the accrual date.

(5) The executory contract is hedged in whole or in part throughout the period beginning with the date the hedging instrument is identified and ending on or after the accrual date.

(6) The same taxpayer enters into both the executory contract and the hedging instrument.
Glossary

AICPA
American Institute of Certified Public Accountants.

Available-For-Sale Securities
Debt or equity securities that are not classified as trading securities or as held-to-maturity securities under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (ASC Topic 320, Investments -- Debt and Equity Securities).

Basis Swap
A derivative instrument that is used to modify the receipts or payments from one variable rate to another variable rate.

Benchmark Interest Rate
A widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions.

In theory, the benchmark interest rate should be a risk-free rate (i.e., has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate. In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government and, for practical reasons, the LIBOR swap rate are considered to be benchmark interest rates. In each financial market, only the one or two most widely used and quoted rates that meet the above criteria may be considered benchmark interest rates.

Call Option
An option contract giving the holder the right, but not the obligation, to buy a specific quantity of an asset for a fixed price during a specific period of time (or on a set date).

Cap
An option contract that protects the holder from a rise in interest rates or other underlying index beyond a certain point.

Capacity Contract
An agreement by an owner of capacity to sell the right to that capacity to another party so that it can satisfy its obligations. For example, in the electric industry, capacity (sometimes referred to as installed capacity) is the capability to deliver electric power to the electric transmission system.
of an operating control area. A control area is a portion of the electric grid that schedules, dispatches, and controls generating resources to serve area load (ultimate users of electricity) and coordinates scheduling of the flow of electric power over the transmission system to neighboring control areas. A control area requires entities that serve load within the control area to demonstrate ownership or contractual rights to capacity sufficient to serve that load at time of peak demand and to provide a reserve margin to protect the integrity of the system against potential generating unit outages in the control area.

**Cash Flow Hedge**

A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or a forecasted transaction, that is attributable to changes in variable rates or prices.

**Collar**

A combination of options that protects against a movement outside a band of interest rates or some other underlying. For example, a combination of a purchased put option and a written call option.

**Compound Derivative Instrument**

A contract or instrument comprising two or more derivative instruments. For example, a derivative instrument that combines a foreign currency forward contract with an interest rate swap.

**Comprehensive Income**

The change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

**Counterparty**

A principal party to a transaction, other than an intermediary (when looking from the buyer’s point of view, the seller is the counterparty and vice versa).

**Covered Call**

A written call option for which the writer owns an instrument or commodity that could be delivered if the option is exercised by its holder.

**Credit Risk**

The risk of changes in the obligor’s creditworthiness and changes in the spread over the designated benchmark interest rate (as defined herein) with respect to the hedged item’s credit sector at inception of the hedge that will affect the fair value or cash flows of recognized assets or liabilities, firm commitments, or forecasted transactions.
Cross-Currency Interest Rate Swap
An agreement by two parties to exchange a series of cash flows. The exchange of cash flows is denominated in different currencies as well as being on different interest rate bases.

CTA
Cumulative translation adjustments which result from the process of translating a foreign entity’s financial statements from its functional currency into the parent (investor) company’s reporting currency for consolidation purposes.

Derivative Instrument
Refer to paragraphs 6-9 of FASB Statement No. 133, Accounting for Derivative Investments and Hedging Activities, as amended (ASC paragraph 815-10-15-83).

Dollar-Offset Method
A method used to assess effectiveness or measure ineffectiveness that compares historical changes in fair value or cash flows of the derivative hedging instrument with changes in fair value or cash flows of the hedged item attributable to the hedged risk during a specified period or periods. The method for assessing effectiveness can be applied on a period-to-period basis or on a cumulative-period basis. The method for measuring ineffectiveness must be on period-to-period basis for a fair value hedge and on a cumulative-period basis for a cash flow hedge.

EITF
The Emerging Issues Task Force, which is a task force established to assist the Financial Accounting Standards Board in improving financial reporting through the timely identification, discussion, and resolution of financial issues within the framework of existing authoritative literature.

Embedded Derivative Instrument
Implicit or explicit term(s) in a nonderivative contract that affects some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument.

Exercise Period
The period of time during which an option may be exercised.

Exercise Price
The price at which the underlying instrument, commodity, or index can be bought, sold, or settled upon exercise of an option. See Strike Price.
**FASB**

The Financial Accounting Standards Board, which is the organization responsible for issuing accounting standards in the United States.

**Fair Value**

The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement of fair value, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using discount rates commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring assets and liabilities should be consistent with the objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring forward contracts, such as foreign currency forward contracts, at fair value by discounting estimated future cash flows, an entity should base the estimate of future cash flows on the changes in the forward rate (rather than the spot rate). In measuring financial liabilities and nonfinancial derivatives that are liabilities at fair value by discounting estimated future cash flows (or equivalent outflows of other assets), an objective is to use discount rates at which those liabilities could be settled in an arm’s-length transaction.

**Fair Value Hedge**

A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to its fixed terms.
Financial Instrument

Cash, evidence of an ownership interest in an entity, or a contract that both:

(a) Imposes on one entity a contractual obligation:¹
   - to deliver cash or another financial instrument² to a second entity; or
   - to exchange other financial instruments on potentially unfavorable terms with the second entity.

(b) Conveys to that second entity a contractual right:³
   - to receive cash or another financial instrument from the first entity; or
   - to exchange other financial instruments on potentially favorable terms with the first entity.

Firm Commitment

An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

(c) 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 an entity’s functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield.

(d) The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable.

Floor

An option contract that protects the holder against a decline in interest rates or other underlying below a certain point.

¹ Contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of liability as set forth in Concepts Statement 6, although some may not be recognized as liabilities in financial statements - may be “off-balance-sheet” - because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

² The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligation that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

³ Contractual rights encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of asset set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements - may be “off-balance-sheet” - because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity.
**Forecasted Transaction**

A transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

**Foreign Currency**

A currency other than the functional currency of the entity being referred to.

**Foreign Currency Risk**

The risk of changes in foreign currency exchange rates that will affect the fair value or cash flows of recognized assets, liabilities, firm commitments, or forecasted transactions.

**Foreign Entity**

An operation (e.g., subsidiary, division, branch, joint venture) for which financial statements (a) are prepared in a currency other than the reporting currency of the reporting enterprise and (b) are combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting enterprise.

**Forward Contract**

A non-exchange traded contract obligating one party to buy, and the other to sell, a specific asset for a fixed price at a future date.

**Forward Premium/Discount**

The notional amount of the contract multiplied by the difference between the contracted forward rate and the spot rate at inception of the contract.

**Forward Rate**

The exchange rate used in an agreement to exchange at a specified future date a specified amount of a commodity, currency or other asset.

**Functional Currency**

The currency of the primary economic environment in which an entity operates. This is usually the currency of the environment in which the entity primarily generates and expends cash. See Appendix A of FASB Statement No. 52, *Foreign Currency Translation* (ASC Section 830-10-55) or KPMG’s *Guide to Accounting for Foreign Currency*.

The currency of the primary economic environment in which an entity operates. This is usually the currency of the environment in which the entity primarily generates and expends cash. See Appendix A of FASB Statement No. 52, Foreign Currency Translation (ASC paragraphs 830-10-45-3, 45-6, 45-9, and 45-10; 830-10-55-4 through 55-7), or KPMG’s Guide to Accounting for Foreign Currency.
Futures Contract
A forward contract that has standardized terms and is exchange traded.

Held-To-Maturity Securities
Investments in debt securities that are measured at amortized cost in the statement of financial position because the reporting enterprise has the positive intent and ability to hold those securities to maturity.

Host Contract
The portion of the hybrid instrument that is not the embedded derivative component. For example, for a debt instrument convertible into common stock, the host contract would be the debt instrument exclusive of the conversion feature.

Hybrid Instrument
A contract that embodies both an embedded derivative component and a host contract. For example, a debt instrument convertible into common stock.

Interest Rate Risk
The risk of changes in the designated benchmark interest rate (as defined herein) that will affect the right to receive (or obligation to pay or transfer) cash or other financial instruments in the future or the fair value of that right (or obligation).

In-The-Money
A call option in which the exercise price is lower than the spot price of the underlying instrument or a put option in which the exercise price is greater than the spot price of the underlying instrument.

Intrinsic Value
The total fair value of an option less the component of its fair value attributable to time value.

IO (Interest Only)
The holder of an IO instrument receives interest payments from a specific regular interest class or from a piece of collateral. The holder receives no principal payments.

LIBOR
London Interbank Offered Rate.
**LIBOR Swap Rate**

The fixed rate on a single-currency, constant-notional interest rate swap that has its floating-rate leg referenced to the London Interbank Offered Rate (LIBOR) with no additional spreads over LIBOR on that floating-rate leg. The fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equates to the present value of the floating cash flows.

**Market Price Risk**

The exposure to changes in fair value or cash flows of an entire item.

**Mark-To-Market**

The adjustment of a position to reflect accrued profits and losses (i.e., the adjustment of a position to its current market value).

**Minimum Value**

An amount attributed to an option that is calculated without considering the expected volatility of the underlying stock. Minimum value may be computed using a standard option-pricing model and a volatility of effectively zero. It also may be computed as (a) the current price of the stock reduced to exclude the present value of any expected dividends during the option’s life minus (b) the present value of the exercise price. Different methods of reducing the current price of the stock for the present value of the expected dividends, if any, may result in different computed minimum values.

**Notional Amount**

A number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument.

**Option**

An contract between two parties, which gives one party the right, but not the obligation, to buy or sell an asset, currency or rate for a specific price.

**Option Premium**

The amount paid by the buyer or received by the seller for an option.

**Out-Of-The-Money Option**

A call option in which the exercise price is greater than the spot price of the underlying instrument or a put option in which the exercise price is lower than the spot price of the underlying instrument.
**Payment Provision**

A provision that specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

**PO (Principal Only)**

The holder of a PO instrument receives principal payments only and does not receive any interest. POs are offered at a discount to their original principal amounts.

**Probable**

The future event or events are likely to occur.

**Put Option**

An option contract giving the holder the right, but not the obligation, to sell a specific quantity of an asset for a fixed price during a specific period of time (or on a set date).

**Regression Analysis**

A statistical method used to analyze how a single dependent variable is affected by changes in one or more independent variables.

**Related Party**

Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

**SEC**

Securities and Exchange Commission, a governmental agency established in the U.S. to oversee the capital markets and protect the rights of investors.

**Spot Rate**

The exchange rate for immediate delivery of a commodity, currency, or other asset to be exchanged.
**Strike Price**

The price at which the underlying instrument, commodity, or index can be bought, sold, or settled upon exercise of an option. See *Exercise Price*.

**Swap**

An agreement by two parties to exchange a series of cash flows (e.g., fixed-rate payments for variable-rate payments) in the future.

**Swaption**

An option giving the holder the right, but not the obligation, to enter into or cancel a swap agreement at a future date.

**Synthetic Forward**

An agreement to purchase a call and write a put at the same strike price and expiration date or to purchase a put and write a call at the same strike price and expiration date.

**Synthetic Instrument Accounting**

A previously accepted accounting practice that viewed two or more distinct financial instruments (generally a cash instrument and a derivative instrument) as having synthetically created another single cash instrument. The objective of synthetic instrument accounting was to present those multiple instruments in the financial statements as if they were the single instrument that the entity sought to create. For example, the combination of a pound sterling denominated debt and a pound sterling/U.S. dollar swap was presented as U.S. dollar debt.

**Take-Or-Pay Contract**

A contract that requires an entity to pay a specified price for a specified quantity of product whether or not it takes delivery of the product.

**Time Value**

The difference between the total value (fair value) of an option and the option’s intrinsic value.

**Trading Securities**

Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time). Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.

**Transaction**

An external event, namely, an external event involving transfer of something of value (future economic benefit) between two (or more) entities. Transferring materials to production
processes, using plant and equipment for which wear and tear is represented by depreciation, and other events that happen within an entity are internal events and, therefore, are not transactions.

**Underlying**

A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

**Volatility**

The degree of price fluctuation for a given asset, rate or index. Usually expressed as variance or standard deviation.

**Volatility Value**

The entire value of an out-of-the-money (forward) option.
# DIG Issues Index

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FASB ASC Cross Reference Table

The following represents the FASB Accounting Standards Codification (ASC) cross reference table for FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. A FASB ASC Cross Reference Table also is included in KPMG's FASB Derivatives Implementation Group: Final Resolutions, Including KPMG's Observations.

Sequence Numbers

As part of the FASB’s Codification process, a sequence number is assigned to each object in a standard that was followed by a paragraph mark, including a single line of content, a paragraph heading, a paragraph, a table, and so forth. The sequence numbers for each standard began at the number 1 and increased in increments of 1. The sequence numbers represent the sequential or relative order of the original content from the beginning of the standards, which may have been split into smaller fragments for various reasons. Decimal places are used to indicate the relative position of each fragment after the split.

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