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Perspectives on a complex area

When the first comprehensive hedge accounting guidance was issued in 1998, the accounting requirements in this area were widely acknowledged as the most detailed and complex in US GAAP.

Since then, we have seen ongoing changes made to the requirements. For a long time, the changes added to the rules and complexity. But more recently, the changes have been focused on reducing operational burden, expanding the use of hedge accounting and better reflecting risk management practices.

Throughout all of these changes, one constant has been that hedge accounting itself has remained optional. Even after electing to apply hedge accounting, optionality has been a hallmark of the underlying accounting requirements. The guidance in this area has always included various alternatives for different strategies and methods for aspects such as measuring and assessing hedging relationships – and now those options have expanded.

Our objective with this publication is to help you focus effectively and efficiently on the hedge accounting alternatives and requirements. We provide you with insights, examples and perspectives based on our years of experience in this area – so you can understand your options and decide which alternatives are right for you.

Kimber Bascom and Mark Northan

Department of Professional Practice, KPMG LLP
About this publication

The purpose of this Handbook is to assist you in understanding the new hedging standard following the targeting improvements issued in August 2017.

Accounting literature and scope

This Handbook focuses on hedge accounting under ASC 815, Derivatives and Hedging, as amended by Accounting Standards Update No. 2017-12, Targeted Improvements to Accounting for Hedging Activities, which was issued in August 2017 and first becomes effective in 2019.

The scope of ASC 815 (including the definition of a derivative) and embedded derivatives will be addressed in future updates to this Handbook. In the meantime, guidance on these topics is included in KPMG’s publication, Derivatives and hedging (pre-ASU 2017-02), which provides guidance for entities that have not yet adopted 2017-12.

In addition, KPMG’s publication on the targeted improvements to hedge accounting under ASU 2017-12 provides a focused discussion of the specific amendments in the ASU.

Organization of the text

Each chapter of this Handbook includes excerpts from FASB’s Accounting Standards Codification® and overviews of the relevant requirements. Our in-depth guidance is explained through Q&As that reflect the questions we are encountering in practice. We include observations and examples to explain key concepts.

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples.

— 815-20-25-3 is paragraph 25-3 of ASC Subtopic 815-20.
— ASU 2017-12.BC148 is paragraph 148 of the basis for conclusions to ASU 2017-12.
— FAS 133.BC423 is paragraph 423 of the basis for conclusions to FASB’s Statements of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities.
— DIG Issue is in relation to the Derivative Implementation Group
— 2006 AICPA Conf is the 2006 AICPA National Conference on Current SEC and PCAOB Developments. These references are hyperlinked to the source material on the SEC’s website.
Pending content

In some cases, the Codification is subject to content that becomes effective after ASU 2017-12. For example, ASU 2016-13, Financial Instruments—Credit Losses (Topic 326), includes consequential amendments to Topic 815.

When an excerpt from the Codification is affected by pending content:
— the specific sentences that have been superseded are struck out and the added text is underlined; and
— the amended sentences are marked as pending content.

Future developments

As more people turn their attention to the application of the new hedging standard, more questions are arising and the interpretations of the principles in the standard continue to evolve. This means that some positions may change, and positions on new issues will emerge, as we get closer to implementation.

For the Questions in this Handbook where we are aware of ongoing discussions and the potential for a position to change, we have indicated that in our interpretive response.

In addition, the FASB is currently working on a project to provide further guidance on when an entity would be able to change the hedged risk and/or the hedged forecasted transaction when the guidance on cash flows hedging is applied. This project has the potential to significantly impact our guidance for cash flow hedges. Currently the FASB is collecting external feedback related to this project. Summaries of the potential Codification improvements discussed at the March 2018 Board meeting are included in chapters 2, 5 and 6 (see Future Developments).

Abbreviations

We use the following abbreviations in this Handbook.

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFS</td>
<td>Available-for-sale</td>
</tr>
<tr>
<td>AOCI</td>
<td>Accumulated other comprehensive income</td>
</tr>
<tr>
<td>CTA</td>
<td>Cumulative translation adjustment</td>
</tr>
<tr>
<td>DIG</td>
<td>Derivatives Implementation Group</td>
</tr>
<tr>
<td>FCD</td>
<td>Foreign currency denominated</td>
</tr>
<tr>
<td>HTM</td>
<td>Held-to-maturity</td>
</tr>
<tr>
<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
</tr>
<tr>
<td>NYMEX</td>
<td>New York Mercantile Exchange</td>
</tr>
<tr>
<td>OCI</td>
<td>Other comprehensive income</td>
</tr>
<tr>
<td>PEH</td>
<td>Perfectively effective hypothetical (derivative)</td>
</tr>
<tr>
<td>SIFMA</td>
<td>Securities Industry and Financial Markets Association</td>
</tr>
</tbody>
</table>
1. Executive summary

Topic 815 provides guidance on accounting for derivative instruments and hedging activities.

Derivative instruments are assets or liabilities that are recorded on the balance sheet at fair value. If the derivative instrument does not qualify for hedge accounting, changes in fair value are recorded in earnings.

Hedge accounting is designed to allow an entity to hedge risks inherent in certain transactions by using derivative instruments. It is elective and subject to several criteria. If a hedging relationship meets these criteria, the accounting varies based on the type of risk(s) being hedged and the type of hedge.

Topic 815 provides for three different types of hedges.

— **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 is attributable to a particular risk.

— **Cash flow hedge.** A hedge of the exposure to variability in the future cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk.

— **Net investment hedge.** A hedge of the exposure to foreign currency risk of a net investment in a foreign operation.

**General qualifying criteria**

Hedge accounting is permitted only if all applicable criteria are met. There are five general criteria that apply to fair value hedges and cash flow hedges, some of which also apply to net investment hedges.

There are also specific qualifying criteria based on the type of hedge and the type of risk(s) being hedged. Topic 815 also specifically prohibits certain items and transactions from hedge accounting.

If any eligibility criteria cease to be met, the hedging relationship must be discontinued – i.e. hedge redesignation.

Read more: chapter 2
Qualifying criteria for fair value hedges

In addition to the general qualifying criteria, Topic 815 specifies certain items, risks and hedging instruments that are eligible to be designated in a fair value hedge.

**Criterion 1: Items eligible for fair value hedges**

Only recognized assets or liabilities, or unrecognized firm commitments, are eligible to be designated as the hedged item in a fair value hedge. Topic 815 allows different strategies when hedging certain risks.

<table>
<thead>
<tr>
<th>Individual recognized assets and liabilities</th>
<th>Firm commitments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolios of similar assets and liabilities</td>
<td></td>
</tr>
<tr>
<td>Portion (or percentage) of hedged item</td>
<td></td>
</tr>
<tr>
<td>Hedging only benchmark interest rate component</td>
<td>Partial-term hedge of interest rate risk</td>
</tr>
<tr>
<td></td>
<td>Embedded put or call option</td>
</tr>
<tr>
<td></td>
<td>Last-of-layer method</td>
</tr>
<tr>
<td></td>
<td>Residual value in a lease</td>
</tr>
</tbody>
</table>

**Criterion 2: Risks eligible for fair value hedges**

The risks eligible to be designated in a fair value hedge are different for financial and nonfinancial items.

<table>
<thead>
<tr>
<th><strong>Financial items</strong></th>
<th><strong>Nonfinancial items</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Changes in the benchmark interest rate for recognized fixed-rate financial instruments</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Changes in the obligor’s creditworthiness; and changes in the credit spread over the benchmark interest rate</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Changes in the related foreign currency exchange rates</td>
<td>Changes in the related foreign currency exchange rates if the firm commitment is denominated in a foreign currency.</td>
</tr>
</tbody>
</table>
Criterion 3: Hedging instruments eligible for fair value hedges

There are no additional eligibility criteria or limitations specific to fair value hedges, other than fair value hedges involving foreign currency risk.

Read more: chapter 3

Accounting for fair value hedges

The fair value hedge accounting model can change how the hedged item is measured on the balance sheet.

Hedged items are subject to other applicable US GAAP – e.g. an asset or liability measured at amortized cost. However, the hedging instrument is measured at fair value with changes in fair value reported in earnings. This creates a mismatch between the measurement of the hedged item and hedging instrument. Fair value hedge accounting allows an entity to measure the hedged item at fair value based on changes in the hedged risk.

In general, the fair value hedge accounting model has two main elements.

The following diagram shows the general accounting and presentation for a highly effective fair value hedge (assuming there are no excluded components).
The effect is to offset gains or losses on the hedging instrument with gains or losses on the hedged item that are attributable to the hedged risk within one line item of the income statement.

The adjustment to the amortized cost basis of the hedged item from applying fair value hedge accounting is referred to as a basis adjustment. Basis adjustments are accounted for in the same manner as other components of the amortized cost basis of the hedged item.

Read more: chapter 4

Qualifying criteria for cash flow hedges

In addition to the general qualifying criteria, Topic 815 specifies certain transactions, risks and hedging instruments that are eligible to be designated in a cash flow hedge.

Criterion 1: Transactions eligible for cash flow hedges

Cash flows from existing recognized assets or liabilities or forecasted transactions are eligible to be designated as the hedged transaction in a cash flow hedge.

<table>
<thead>
<tr>
<th>Cash flows from existing recognized assets and liabilities</th>
<th>Forecasted transactions – e.g. forecasted purchases or sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group of similar forecasted transactions</td>
<td>All-in-one hedge</td>
</tr>
</tbody>
</table>

Criterion 2: Risks eligible for cash flow hedges

The risks eligible to be designated in a cash flow hedge are different for financial and nonfinancial assets and liabilities.

Financial assets and liabilities

Either:
- changes in a contractually specified interest rate for variable-rate financial instruments or forecasted issuances or purchases of variable-rate financial instruments; or
- changes in the benchmark interest rate for forecasted issuances or purchases of fixed-rate financial instruments.

Nonfinancial assets and liabilities

Not applicable.
### Financial assets and liabilities

**Credit risk**
- Includes:
  - risk of default;
  - changes in the obligor’s creditworthiness; and
  - changes in the credit spread over the contractually specified interest rate or the benchmark interest rate.

**Nonfinancial assets and liabilities**
- Not applicable.

### Foreign currency risk
- Changes in the related foreign currency exchange rates.

### Price risk
- Total change in the cash flows related to the asset or liability – e.g. all changes in the purchase price or sales price.

### Criterion 3: Hedging instruments eligible for cash flow hedges

In addition to the general qualifying criteria and limitations of hedging instruments, there are eligibility criteria specific to cash flow hedges. This includes additional requirements that must be met in order to designate a basis swap as the hedging instrument in a cash flow hedge.

Read more: chapter 5

### Cash flow hedge accounting

The cash flow accounting model allows changes in the fair value of the derivative instrument to be recorded in OCI instead of earnings.

Hedged transactions are probable future transactions that are not yet recognized on the balance sheet or in earnings. Instead of recognizing the forecasted transaction in advance, cash flow hedge accounting defers the recognition of changes in the fair value of the derivative instrument.

In general, the cash flow hedge accounting model works as follows.

- A derivative hedging instrument is recorded at fair value in the balance sheet. Changes in its fair value that are included in the assessment of hedge effectiveness are reported in OCI.
The amounts in AOCI are recognized in earnings – in the same income statement line item as the effect of the hedged transaction – when the hedged transaction affects earnings.

The following shows the general accounting and presentation for a highly effective cash flow hedging relationship (assuming there are no excluded components).

The effect of the above is to defer earnings recognition of changes in fair value of the hedging instrument (that are included in the assessment of effectiveness) until the hedged transaction affects earnings.

When a cash flow hedge is discontinued, the net derivative gain or loss reported in AOCI generally is not recognized immediately in earnings. Instead, it is reclassified into earnings when the hedged forecasted transaction is reported in earnings. However, the net derivative gain or loss reported in AOCI is immediately reclassified into earnings if it is probable that the hedged forecasted transaction will not occur in the original period specified in the hedge documentation or within an additional two-month period (unless extenuating circumstances apply).

Read more: chapter 6

**Hedging foreign currency exposures**

*Foreign currency risk* is the risk of changes in a hedged item’s fair value or functional currency equivalent cash flows attributable to changes in the related foreign currency exchange rates.

Foreign currency hedges use the cash flow, fair value or net investment models. However, there are additional criteria for hedged items or transactions and hedging instruments to be eligible for designation in a foreign currency hedge.

There are general qualifying criteria applicable to all foreign currency hedges:

— **Hedging instrument**. The entity with the foreign currency exposure needs to be a party to the hedging instrument.
— **Hedged item or transaction.** The hedged transaction needs to be denominated in a currency other than the entity’s functional currency.

In addition, there are qualifying criteria specific to the type of foreign currency hedge. For foreign currency fair value and cash flow hedges, only certain hedged items or transactions and hedging instruments are eligible.

<table>
<thead>
<tr>
<th>Foreign currency fair value hedge</th>
<th>Criterion 1: Eligibility of hedged items or transactions</th>
<th>Criterion 3: Eligibility of hedging instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>FCD asset or liability</td>
<td>Derivative</td>
<td></td>
</tr>
<tr>
<td>Unrecognized FCD firm commitment</td>
<td>Derivative</td>
<td>Nonderivative financial instrument</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Foreign currency cash flow hedge</th>
<th>FCD asset or liability</th>
<th>Derivative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrecognized FCD firm commitment</td>
<td></td>
<td>Derivative</td>
</tr>
<tr>
<td>FCD forecasted transaction</td>
<td></td>
<td>Derivative</td>
</tr>
</tbody>
</table>

The accounting for foreign currency fair value and cash flow hedges is the same as for all other fair value hedges and cash flow hedges, respectively. However, Topic 815 provides additional guidance for certain items and transactions designated in a fair value or a cash flow hedge of foreign currency risk.

Read more: chapter 7

### Net investment hedges

Net investment hedges are subject only to the following hedging criteria.

<table>
<thead>
<tr>
<th>General qualifying criteria for all foreign currency hedges</th>
<th>Hedging instrument. The entity with the foreign currency exposure needs to be a party to the hedging instrument.</th>
<th>Hedged item or transaction. The hedged net investment needs to be denominated in a currency other than the entity’s functional currency.</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Hedge effectiveness</th>
<th>The hedging instrument must be both designated and effective as an economic hedge of the net investment. The entity assesses effectiveness at least quarterly and whenever financial statements are issued or earnings are reported.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formal documentation</td>
<td>The entity formally documents the hedging relationship.</td>
</tr>
</tbody>
</table>
In general, the net investment hedge accounting model works as follows.

— When a net investment is translated into the entity’s reporting currency, the effects of translation are recognized in CTA in AOCI.
— The changes in fair value of the derivative hedging instrument (or foreign currency transaction gains or losses of a FCD nonderivative hedging instrument) that are included in the effectiveness assessment are recognized in CTA in AOCI. These amounts remain in CTA until the sale, exchange or liquidation of the foreign operation.

The following diagram shows the general accounting and presentation for a net investment hedging relationship (assuming there are no excluded components).

Note:
1. In certain situations, a portion of the translation gain or loss should be reclassified from CTA to noncontrolling interest.

Read more: chapter 8

Hedge effectiveness

Hedge accounting is permitted only if the hedging relationship is highly effective at managing the risk being hedged (for a net investment hedge, the hedging relationship must be effective as an economic hedge). Effectiveness assessments are required to be performed prospectively at hedge inception and both prospectively and retrospectively periodically thereafter (at least quarterly).

— For a prospective assessment, the entity evaluates whether the hedging relationship is expected to be highly effective.
— For a retrospective assessment, the entity evaluates whether the hedging relationship has actually been highly effective.
The following diagram summarizes how effectiveness is assessed.

![Diagram showing calculations for effectiveness assessment]

**Quantitative vs. qualitative.** Topic 815 requires the initial (prospective) assessment to be performed on a quantitative basis unless the hedging relationship meets certain conditions. Subsequent assessments may be performed on a quantitative basis, or on a qualitative basis if certain conditions are met.

Additionally, Topic 815 provides the methods that allow an entity to assume a hedging relationship is perfectly effective if certain conditions are met:

- shortcut method; and
- critical terms match method.

If a hedge was not highly effective in a period, hedge accounting is not applied for that period. Additionally, if an entity can no longer support its expectation of high effectiveness, hedge accounting is discontinued prospectively.

Read more: chapter 9

### Private companies

Although hedge accounting can be an effective way to mitigate income statement volatility from reporting derivative instruments at fair value, many private companies find the hedging requirements under the general hedge accounting guidance to be onerous.

To provide relief to private companies seeking to meet hedge accounting requirements, the FASB provided some relief.

**Simplified hedge accounting approach**

Topic 815 provides a simplified hedge accounting approach to account for interest rate swaps that are used to hedge the variability in cash flows of variable-rate borrowings. If the criteria to apply the simplified hedge accounting approach are met, a private company:

*Hedge effectiveness*

- may assume perfect hedge effectiveness for the qualifying cash flow hedging relationships;
- is exempt from quarterly hedge effectiveness testing because perfect effectiveness is assumed;

*Hedge documentation*

- has additional time to prepare the required hedge documentation; and
Additional relief when simplified hedge accounting is not applied

For hedging relationships not under simplified hedge accounting, a private company may take advantage of the following relief:

<table>
<thead>
<tr>
<th><strong>Hedge documentation</strong></th>
<th>relaxed timing of documentation requirements; and</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Hedge effectiveness</strong></td>
<td>relaxed timing of initial and subsequent quarterly hedge effectiveness assessments.</td>
</tr>
</tbody>
</table>

These relaxed requirements are also available to certain not-for-profit entities.

Read more: chapter 10
2. General hedging requirements

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**Observation**

Some entities may not benefit from the ability to delay initial quantitative prospective effectiveness assessments

**Question**

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2.10.30 Is a fair value hedging relationship required to be discontinued if an entity repurchases and subsequently resells (reissues) some of its own debt?

2.10.40 How does a decrease in the balance of the last of layer expected to remain outstanding at the end of the hedge term affect a last-of-layer hedging relationship?

2.10.50 How is hedge accounting discontinued for a hedged item that no longer meets the definition of a firm commitment?

2.10.60 Is a hedging relationship required to be discontinued if the hedging instrument is a combination of derivatives and the combination is rebalanced?

2.10.70 Does modification of a hedging instrument’s collateral requirements require a hedge to be discontinued?

2.10.80 Why would a derivative novation occur?

2.10.90 If a hedging relationship has not been highly effective retrospectively, but is expected to be prospectively, is hedge accounting required to be discontinued prospectively?
2.10.100 Under what conditions may an entity partially dedesignate a hedging relationship?

2.10.110 How does an entity partially dedesignate a hedging instrument?

2.10.120 What should an entity consider when redesignating an existing derivative instrument?

2.10.130 Is there a limit on the frequency of dedesignating and redesignating a hedging relationship?

**Examples**

2.10.10 Discontinuance of hedging relationship when an unrelated party is acquired

2.10.20 Hedge discontinuation because the hedging relationship is no longer highly effective

2.10.30 Partial decrease of hedged item in a fair value hedge

2.10.40 Partial reduction of items in a group of hedged forecasted transactions (cash flow hedge)

2.10.50 Partial termination of a hedging instrument
2.1 How the standard works

Hedge accounting is designed to allow an entity to hedge risks inherent in certain transactions by using derivative instruments. It is elective and subject to several criteria. If a hedging relationship meets these criteria, the accounting varies based on the type of risk(s) being hedged and the type of hedge.

The basic risks that an entity may hedge include:

- **Interest rate risk**
- **Foreign currency risk**
- **Credit risk**
- **Price risk**

Topic 815 provides for three different types of hedges.

— **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 is attributable to a particular risk.

— **Cash flow hedge.** A hedge of the exposure to variability in the future cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk.

— **Net investment hedge.** A hedge of the exposure to foreign currency risk of a net investment in a foreign operation.

Subtopic 815-20 requires an entity to meet certain criteria for the combination of the hedging instrument and the hedged item or transaction (the ‘hedging relationship’) to qualify for hedge accounting.

Hedge accounting is permitted only if all of the applicable criteria are met.
| General qualifying criteria (chapter 2) | The five general criteria that apply to **fair value hedges** and **cash flow hedges** are described in this chapter. Some of the general qualifying criteria also apply to **net investment hedges**, as discussed in **section 8.2**. |
| Qualifying criteria for fair value hedges (chapter 3) | Qualifying criteria specific to the eligibility of hedged items, hedged risks and hedging instruments in a fair value hedge is described in **chapter 3**. |
| Qualifying criteria for cash flow hedges (chapter 5) | Qualifying criteria specific to the eligibility of hedged items, hedged risks and hedging instruments in a cash flow hedge is described in **chapter 5**. |
| Qualifying criteria for hedges of foreign currency risk (chapter 7) | The general qualifying criteria applicable to all foreign currency hedges is described in **section 7.3.10**. This chapter also focuses on criteria specific to foreign currency **fair value** and **cash flow hedges**. |
| Qualifying criteria for net investment hedges (section 8.2) | Net investment hedges are only subject to certain qualifying criteria. |
| Hedge effectiveness (chapter 9) | This chapter discusses the general requirements for assessing hedge effectiveness and the specific requirements for various assessment methods. |
2.2 Hedged items and transactions

2.2.10 Overview

The objective of a hedge is to reduce or eliminate exposures to changes in the fair value or cash flows associated with an asset, liability or transaction. Topic 815 specifies certain items and transactions that are eligible for designation as hedged items or transactions in a fair value or cash flow hedge. These are summarized in the table below.

### Criterion 1: Items and transactions eligible for hedge accounting

#### Fair value hedge (section 3.3)
- All or a specific portion (or percentage) of a recognized asset or liability – e.g. a financial or nonfinancial asset or liability (section 3.3.10).
- Foreign currency denominated assets or liabilities (sections 7.4.30 and 7.4.40). [815-20-25-12(a)]

#### Cash flow hedge (section 5.3)
- All or specified future cash flows from an existing recognized asset or liability – e.g. all or certain future interest payments on variable-rate debt (section 5.3.10). [815-20-25-13(a)]
- Foreign currency denominated assets or liabilities (section 7.6.50). [815-20-25-38(b)]

#### Firm commitments
- All or a specific portion of an unrecognized firm commitment (section 3.3.20). [815-20-25-12(a)]
- Foreign currency denominated unrecognized firm commitments (section 7.4.50). [815-20-25-37(d)]

#### Forecasted transactions
- Prohibited for fair value hedges.

- A forecasted transaction – e.g. a forecasted purchase or sale (section 5.3.20). [815-20-25-13(b)]
2. General hedging requirements

**Criterion 1: Items and transactions eligible for hedge accounting**

<table>
<thead>
<tr>
<th></th>
<th><strong>Fair value hedge (section 3.3)</strong></th>
<th><strong>Cash flow hedge (section 5.3)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Portfolio or group</strong></td>
<td>A portfolio of similar assets or liabilities (section 3.3.40). [815-20-25-12b(1)] The last of layer associated with a closed portfolio of prepayable financial assets (section 3.3.100). [815-20-25-12A]</td>
<td>A group of similar forecasted transactions (section 5.3.60). [815-20-25-15(a)]</td>
</tr>
<tr>
<td><strong>Portion (or percentage)</strong></td>
<td>A specific portion (or percentage) of a recognized asset or liability or unrecognized firm commitment (section 3.3.60), including: — hedging only the benchmark interest rate component (section 3.3.70); — partial-term hedge of interest rate risk (section 3.3.80); — embedded put or call options (section 3.3.90); or — residual value in a lessor’s net investment in a lease. [815-20-25-12b(2), 815-25-35-13, 35-13B]</td>
<td>Any specified cash flows, including (but not limited to) the first cash flows received or paid in a particular period (sections 5.3.70 and 5.3.80). [815-20-55-21, 55-33A]</td>
</tr>
</tbody>
</table>

Recognized financial instruments, nonfinancial assets and liabilities, firm commitments and forecasted transactions need to meet the following thresholds to be eligible hedged items.
Is the item or transaction a type specifically prohibited from being hedged? (section 2.5)

Yes  
No

Does the item or transaction have exposure to changes in fair value or cash flows for the risk being hedged that could affect earnings? (section 2.2.30)

Yes  
No

Does the item or transaction meet the criteria specific to a fair value (section 3.3), cash flow (section 5.3) or net investment (section 8.2) hedge (as applicable)?

Yes  
No

Item or transaction not eligible to be hedged

Item or transaction eligible to be hedged

Cash flow hedges. For the remainder of this Handbook, both the cash flows related to a recognized asset or liability and the cash flows related to a forecasted transaction are referred to as the forecasted transaction or the hedged transaction.

All or certain future cash flows from existing recognized assets and liabilities  
Forecasted transactions

Both referred to as a forecasted transaction or a hedged transaction

Net investment hedges. In addition to the items and transactions eligible for fair value and cash flow hedges, an entity can hedge its net investment in a foreign operation. Investments in foreign operations include investments in incorporated and unincorporated foreign operations with a functional currency other than the functional currency of the parent. See section 8.2 for guidance on qualifying criteria specific to net investment hedges.
Question 2.2.10

What is the difference between a firm commitment and a forecasted transaction?

Interpreative response: The following table summarizes the key characteristics of a firm commitment and a forecasted transaction.

| Firm commitment | A firm commitment is a (legally) binding agreement between unrelated parties that specifies all significant terms and includes a disincentive for nonperformance that is sufficiently large to make performance probable. 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. For further guidance and discussion of qualifying criteria related to firm commitments, see section 3.3.20. |
| Forecasted transaction | A forecasted transaction is essentially a future transaction that is probable and does not meet the definition of a firm commitment. Forecasted transactions can be contractually established or probable because of an entity’s past or expected business practices. For further guidance and discussion of qualifying criteria related to forecasted transactions, see section 5.3.20. |

One of the key differences is that firm commitments have fixed prices, which create exposures that are similar to those that exist for recognized assets and liabilities with fixed terms. In contrast, forecasted transactions will occur at prevailing market rates or prices in the future, which cause exposure to variability in future cash flows.

Forecasted transactions are only eligible for cash flow hedge accounting. In contrast, firm commitments are only eligible for fair value hedge accounting, with the exception of the following, which are eligible to be designated in cash flow hedges:

- foreign currency risk related to firm commitments for which payment is fixed in a currency other than the functional currency of the entity (see section 7.6.40)
- firm commitments that meet the definition of a derivative – i.e. all-in-one hedges (see section 5.3.90).

In certain cases, an entity may select, designate and document the hedging relationship in a manner that allows the entity to use the hedging model that it wishes. For example, an entity may designate existing inventory as the hedged item in a fair value hedge or the forecasted sale of that inventory as the hedged transaction in a cash flow hedge.

Therefore, it is important that the hedged item or transaction be appropriately identified and documented.
2.2.20 Overview of hedged risks

In addition to the requirements for hedged items and transactions, the risk associated with these items and transactions needs to qualify for hedge accounting. The primary requirement is that it must result in exposure to a change in fair values or cash flows that could affect reported earnings (see section 2.2.30).

The basic risks that an entity may hedge include:

- **Interest rate risk**
- **Foreign currency risk**
- **Credit risk**
- **Price risk**

The risks eligible to be hedged depend on whether the hedged item or transaction is (or is related to) a financial instrument or a nonfinancial asset or liability, and whether it results in an exposure to changes in fair values or future cash flows.

<table>
<thead>
<tr>
<th>Fair value hedge</th>
<th>Cash flow hedge</th>
</tr>
</thead>
<tbody>
<tr>
<td>The hedged risks relate to changes in fair value due to <strong>fixed</strong> rates or prices. For example, a fixed-rate financial instrument exposes its owner to the risk of changes in the financial instrument’s fair value because of its fixed terms.</td>
<td>The hedged risks relate to changes in cash flows due to <strong>variable</strong> rates and prices. For example, a variable-rate debt instrument exposes its issuer to changes in interest payments due to its variable terms.</td>
</tr>
</tbody>
</table>

In many cases, an entity can designate certain portions, or components, of the total risk within the hedged item or transaction. Specifically, an entity is not necessarily required to hedge the entire change in fair value or cash flows of the hedged item or transaction.

Sections 2.3 and 2.4 provide an overview of the risks eligible to be hedged for both financial instruments and nonfinancial assets and liabilities, respectively.

**Net investment hedges.** Topic 815 allows an entity to hedge the foreign currency risk of a net investment in a foreign operation. An entity is exposed to foreign currency risk when the functional currency of the foreign operation is different from the functional currency of the parent. Section 8.2 provides guidance on qualifying criteria specific to net investment hedges.

2.2.30 Exposure to earnings requirement

Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

**25-12(c)** 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 entity (NFP), as discussed in paragraphs 815-30-15-2 through 15-3.

**Hedged Transaction Criteria Applicable to Cash Flow Hedges Only**

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:

...  
c. The forecasted transaction meets both of the following conditions: ...  
   2. It presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

Hedge accounting is allowed only for hedged items or transactions that have an exposure to changes in fair value or variability in cash flows for the risk being hedged that could affect reported earnings. [815-20-25-12(c), 25-15(c)(2)]

Exposure to changes in fair values and variations in cash flows are different for fair value and cash flow hedges.

<table>
<thead>
<tr>
<th>Fair value hedge</th>
<th>Cash flow hedge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed cash flows create exposure to changes in the fair value of the associated asset, liability or firm commitment. The exposure includes increases or decreases in fair value.</td>
<td>Variable-rate financial instruments and cash flows from forecasted transactions create exposure to variability in expected future cash flows.</td>
</tr>
</tbody>
</table>

Some transactions may subject an entity to variations in fair value or cash flows, but lack the potential to affect reported earnings. These transactions would not qualify as hedged items.

Overall, this requirement limits the items and transactions that are eligible for hedge accounting. For example, intercompany transactions that will be eliminated in consolidation would not affect earnings and therefore are not eligible for hedge accounting at the consolidated level.

Section 2.5 outlines items and transactions that are not eligible for hedge accounting due to this requirement, along with other items that are explicitly prohibited from hedge accounting.

**Foreign currency risk.** An entity is permitted to hedge intercompany transactions for foreign currency risk (see section 7.3.40). This risk is not eliminated in consolidation, and therefore affects consolidated earnings. [815-20-25-43(b)(4)]]
Question 2.2.20  

Must it be probable that variability in the hedged transaction will actually occur and affect earnings?

Excerpt from ASC 815-20

Exposure to Variability in Cash Flows

The future sale of an asset or settlement of a liability that exposes an entity (consistent with the criterion in paragraph 815-20-25-15(c)(2)) to the risk of a change in fair value may result in recognizing a gain or loss in earnings when the sale or settlement occurs. Changes in market price could change the amount for which the asset or liability could be sold or settled and, consequently, change the amount of gain or loss recognized. Forecasted transactions that expose an entity to cash flow risk have the potential to affect reported earnings because the amount of related revenue or expense may differ depending on the price eventually paid or received. Thus, an entity could designate the forecasted sale of a product at the market price at the date of sale as a hedged transaction because revenue will be recorded at that future sales price.

Interpretive response: No. Neither the cash flow hedging model nor the fair value hedging model require it to be probable that the variability in cash flows or fair value will actually occur and affect earnings. For cash flow hedges, Topic 815 requires only that the forecasted transaction is probable to occur and that the variability in cash flows is possible and would affect earnings. Similarly, for fair value hedges the risk must only have the potential to change the amount that could be recognized in earnings. [815-20-25-15(b), 25-16(f), 55-18]

Cash flow hedges. For example, an insurance entity wants to enter into a cash flow hedge to hedge the possibility that it may need to voluntarily increase the interest rate used to credit interest on certain contract liabilities. The insurance entity is not precluded 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 entity 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 entity’s discretionary adjustment to the interest rate on the contract liabilities.

Fair value hedges. A mortgage bank wants to enter into a fair value hedge of a fixed-rate mortgage loan. That mortgage loan may present an earnings exposure to a bank because, as interest rates change, the amount at which the bank can sell the loan also would change. There is no requirement for the mortgage bank to sell the loan and realize the earnings effect. Nevertheless, the bank is able to hedge the exposure related to the fixed-rate mortgage loan.
Example 2.2.10
Future sale of inventory that does not create exposure to variations in cash flows

ABC Corp. 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/unit on March 31, Year 1. The forecasted sale does not meet the definition of a firm commitment and the sale agreement does not meet the definition of a derivative.

Can ABC hedge the future sale in a cash flow hedge?
No. The forecasted sale does not present an exposure to variations in cash flows that could affect reporting earnings. This is because the sales price of the units to be sold is fixed.

In contrast, if the sales price is based on the market price on March 31, Year 1, the forecasted transaction qualifies for designation in a cash flow hedging relationship, assuming all other criteria are met.

Can ABC hedge the future sale in a fair value hedge?
No. Forecasted transactions cannot be designated as hedged items in a fair value hedge.

In contrast, if there is a contract that meets the criteria for a firm commitment, it would be eligible for fair value hedge accounting. The fixed price creates exposure to changes in fair value due to changes in market prices to the date of the sale.

2.3 Hedged risks of financial items and transactions
2.3.10 Overview

Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-12(f) 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 any of the following:

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)
4. The risk of changes in its fair value attributable to both of the following (referred to as credit risk):
   i. Changes in the obligor’s creditworthiness
   ii. Changes in the spread over the benchmark interest rate with respect to the hedged item’s credit sector at inception of the hedge.
5. If the risk designated as being hedged is not the risk in paragraph 815-20-25-12(f)(1), two or more of the other risks (interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged.

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15(j) 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 any of the following:

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. For forecasted interest receipts or payments on an existing variable-rate financial instrument, the risk of changes in its cash flows attributable to changes in the contractually specified interest rate (referred to as interest rate risk). For a forecasted issuance or purchase of a debt instrument (or the forecasted interest payments on a debt instrument), the risk of changes in cash flows attributable to changes in the benchmark interest rate or the expected contractually specified interest rate. See paragraphs 815-20-25-19A through 25-19B for further guidance on the designation of interest rate risk in the forecasted issuance or purchase of a debt instrument.
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)
4. The risk of changes in its cash flows attributable to all of the following (referred to as credit risk):
   i. Default
   ii. Changes in the obligor’s creditworthiness
ii. Changes in the spread over the contractually specified interest rate or benchmark interest rate with respect to the related financial asset’s or liability’s credit sector at inception of the hedge.

If the risk designated as being hedged is not the risk in paragraph 815-20-25-15(j)(1), two or more of the other risks (interest rate risk, foreign exchange risk, and credit risk) simultaneously may be designated as being hedged.

The following table outlines the risks associated with a financial instrument or transaction that are eligible to be hedged.

<table>
<thead>
<tr>
<th>Risk Type</th>
<th>Fair value hedge</th>
<th>Cash flow hedge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate risk</td>
<td>Changes in the benchmark interest rate for recognized fixed-rate financial instruments. [815-20-25-12(f)(2)]</td>
<td>Either: changes in a contractually specified interest rate for variable-rate financial instruments or forecasted issuances or purchases of variable-rate financial instruments; or changes in the benchmark interest rate for forecasted issuances or purchases of fixed-rate financial instruments. [815-20-25-15(j)(2)]</td>
</tr>
<tr>
<td>Credit risk</td>
<td>Includes: changes in the obligor’s creditworthiness; and changes in the credit spread over the benchmark interest rate. [815-20-25-15(j)(4)]</td>
<td>Includes: risk of default; changes in the obligor’s creditworthiness; and changes in the credit spread over the contractually specified interest rate or the benchmark interest rate. [815-20-25-15(j)(4)]</td>
</tr>
<tr>
<td>Price risk</td>
<td>Total change in the fair value. [815-20-25-12(f)(1)]</td>
<td>Total change in the cash flows related to the asset or liability – e.g. all changes in the purchase or sales price. [815-20-25-15(j)(1)]</td>
</tr>
</tbody>
</table>

Topic 815 focuses on these four risks because changes in the price associated with any of these risks will directly affect the fair value or cash flows of a financial asset or liability in a determinable or predictable manner.
Although recognized loan servicing rights and nonfinancial firm commitments with financial components are not financial assets or liabilities, an entity can hedge the same risks for them as those associated with financial items. [815-20-25-12(f)]

The following sections provide an overview of risks for financial items and transactions, as well as limitations on their eligibility to qualify for fair value or cash flow hedge accounting.

### 2.3.20 Interest rate risk

#### Excerpt from ASC 815-20

**Hedged Item and Transaction Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges**

**Hedged Items Involving Interest Rate Risk**

25-6 Hedges involving a **benchmark interest rate** are addressed in paragraphs 815-20-25-12(f) and 815-20-25-12A (for fair value hedges) and paragraph 815-20-25-15(j) (for cash flow hedges). Hedges involving a contractually specified interest rate are addressed in paragraph 815-20-25-15(j) (for cash flow hedges). The benchmark interest rate or the contractually specified interest rate being hedged in a hedge of **interest rate risk** shall be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Paragraphs 815-20-25-19A through 25-19B provide guidance on the interest rate risk designation of hedges of forecasted issuances or purchases of debt instruments. An entity shall 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 shall be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option shall be considered in designating a hedge of interest rate risk.

#### 20 Glossary

**Interest Rate Risk** – For recognized variable-rate financial instruments and forecasted issuances or purchases of variable-rate financial instruments, interest rate risk is the risk of changes in the hedged item’s cash flows attributable to changes in the contractually specified interest rate in the agreement.

For recognized fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item’s fair value attributable to changes in the designated benchmark interest rate. For forecasted issuances or purchases of fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item’s cash flows attributable to changes in the designated benchmark interest rate.
The interest rate risks eligible for hedge accounting depend on whether the item or transaction has fixed or variable cash flows, and whether it is designated in a fair value or cash flow hedge.

For example, for fixed-rate financial assets (or liabilities), changes in interest rates may affect the fair value of a right to receive (or obligation to pay) cash or other financial instruments in the future. An entity may want to lock in a maximum (or minimum) value. Or, an entity may want to economically convert cash flows (e.g. interest payments or receipts) from a fixed-rate to a variable-rate.

**Fair value hedges of interest rate risk.** In a fair value hedge, interest rate risk is the risk of changes in an item’s fair value attributable to changes in the designated benchmark interest rate for fixed-rate financial instruments. [815-20-25-12(f)(2)]

<table>
<thead>
<tr>
<th>Fair value hedges of interest rate risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognized fixed-rate financial instruments</td>
</tr>
</tbody>
</table>

**Cash flow hedges of interest rate risk.** A relationship that hedges exposure to variability in interest payments or receipts on existing variable-rate financial instruments is a cash flow hedge.

For recognized variable-rate financial instruments, interest rate risk is the risk of changes in cash flows attributable to changes in the interest rate that is contractually specified in the agreement (see section 2.3.40).

For the forecasted issuance or purchase of a debt instrument, an entity may want to hedge exposure to variability in cash proceeds or the forecasted interest payments on the future issuance or purchase of a debt instrument. An entity may designate the hedged risk as the variability in cash flows attributable to changes in the:

- benchmark interest rate (if the entity expects to issue or purchase fixed-rate debt); or
- contractually specified interest rate (if the entity expects to issue or purchase variable-rate debt).

For further guidance related to hedging the forecasted issuance or purchase of debt instruments, see section 5.4.40. That section includes considerations for entities that do not know whether the debt instrument will be fixed- or variable-rate.
The following summarizes the interest rate risks for hedged transactions in cash flow hedges.

### Cash flow hedges of interest rate risk

<table>
<thead>
<tr>
<th>Recognized variable-rate financial instruments</th>
<th>Contractually specified interest rate (section 2.3.40)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecasted issuance or purchase of fixed-rate debt (section 5.4.40)</td>
<td>Benchmark interest rate (section 2.3.30)</td>
</tr>
<tr>
<td>Forecasted issuance or purchase of variable-rate debt (section 5.4.40)</td>
<td>Contractually specified interest rate (section 2.3.40)</td>
</tr>
</tbody>
</table>

### Question 2.3.10

Can a variable-rate debt instrument qualify to be designated in a fair value hedge?

**Interpretive response:** Yes, under certain circumstances. A variable-rate debt instrument is exposed to changes in fair value due to changes in interest rates between two interest reset dates. Therefore, an entity may be able to designate a fair value hedge of a variable-rate debt instrument for a partial term between the current and the next repricing dates. This is illustrated in **Example 2.3.10**.

### Example 2.3.10

**Fair value hedge of changes in the benchmark interest rate for a variable-rate debt obligation**

On January 1, Year 1 ABC Corp. issues a floating-rate non-amortizing debt instrument with a maturity of two years. The variable-rate liability resets every six months at the six-month LIBOR rate. The six-month LIBOR rate on January 1, Year 1 is 2.5%.

At the same time, ABC 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, ABC will receive the six-month LIBOR rate and pay the one-month LIBOR rate.

ABC 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.
The variable-rate debt obligation has fair value exposure due to changes in interest rates during the six-month period between LIBOR reset dates (e.g. January 1, Year 1 to June 30, Year 1), even though the obligation would be at fair value (due to changes in interest rates) on each reset date. Therefore, the hedged risk could be the changes in fair value of the debt instrument due to the six-month fixed nature of the LIBOR-based interest rate. ABC could hedge the fixed six-month LIBOR rate (i.e. 2.5%) interest payments with a partial-term hedge that ends on June 30, Year 1.

For guidance on partial-term hedges, see section 3.3.80.

### Question 2.3.20

**Can an entity hedge prepayment risk related to a financial instrument?**

**Interpretive response:** No. An entity may wish to hedge the prepayment risk of financial instruments that have specific call/put dates, or are prepayable at any time after issuance. However, prepayment risk is a subcomponent of interest rate risk and cannot be designated as the hedged risk. An entity is not permitted to hedge subcomponents of interest rate risk, credit risk or foreign exchange risk. [815-20-25-6]

**Fair value hedges.** Although prepayment risk cannot be designated as the hedged risk, an entity may achieve its objective of hedging prepayment risk by designating the embedded option component of the prepayable instrument as the hedged item in a fair value hedge (see section 3.3.90). Specifically, the exposure would be limited to changes in the overall fair value of the prepayment option. [815-20-25-6, 25-12(b)(2)(iii)]

### Question 2.3.30

**Should prepayment risk be considered when assessing effectiveness for a fair value hedge of interest rate risk?**

**Interpretive response:** It depends. Although an entity is prohibited from hedging prepayment risk (see Question 2.3.20), it is required to consider prepayment risk when assessing hedge effectiveness and measuring the change in fair value of the hedged item attributable to interest rate risk, with certain exceptions.

If an entity uses the following fair value hedges of interest rate risk, it does not consider prepayment risk for assessing hedge effectiveness and measuring the change in fair value of the hedged item:

- partial-term hedges, depending on the term selected (see section 3.3.80); and
- last-of-layer method (see sections 3.3.100 and 9.2.100).

Topic 815 also allows an entity to consider only the effect of changes in the benchmark interest rate on the decision to prepay a financial instrument. If an
entity elects this approach, it does not consider in its assessment of hedge effectiveness how other factors (e.g. credit risk) might affect the decision to prepay the financial instrument. [815-20-25-6B]

For further discussion of hedging interest rate risk on prepayable financial instruments, see section 3.4.10.

### 2.3.30 Interest rate risk: Benchmark interest rate

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**Excerpt from ASC 815-20**

>>> Hedged Item and Transaction Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

>>>> Hedged Items Involving Interest Rate Risk

>>>>> Benchmark Interest Rate

25-6A In the United States, the interest rates on direct Treasury obligations of the U.S. government, the London Interbank Offered Rate (LIBOR) swap rate, the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate), and the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate are considered to be benchmark interest rates. In each financial market, generally only the most widely used and quoted rates may be considered benchmark interest rates.

**20 Glossary**

**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 (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.

The benchmark interest rate can be designated as the hedged risk in fair value hedges of interest rate risk for fixed-rate financial assets and cash flow hedges of interest rate risk for forecasted issuances or purchases of fixed-rate financial instruments (see section 5.4.40).

The benchmark interest rate is defined as “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.” [815-20 Glossary]
Hedging
2. General hedging requirements

Topic 815 specifically identifies benchmark rates that are eligible to be designated in a hedge.

<table>
<thead>
<tr>
<th>Benchmark Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Treasury Rate</td>
</tr>
<tr>
<td>London Interbank Offered Rate (LIBOR)</td>
</tr>
<tr>
<td>Swap Rate</td>
</tr>
<tr>
<td>Fed Funds Effective Swap Rate (Overnight Index Swap Rate)</td>
</tr>
<tr>
<td>SIFMA Municipal Swap Rate</td>
</tr>
</tbody>
</table>

**Question 2.3.40**

**Can other rates in the United States be used as benchmark rates?**

**Interpretive response:** No. There are numerous indices outside of those designated as benchmark interest rates that serve as a basis for pricing financial instruments. Changes in indices other than those specifically identified as benchmark interest rates (e.g. US Treasury Rate) cannot be the designated hedged risk. This is because prime rates and other interest rate indices could contain an element of credit risk.

However, an entity may apply 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. This is on the condition that the risk being hedged is either the change in fair value or cash flows due to changes in a benchmark interest rate or the change in the total fair value or cash flows of the fixed-rate hedged item or forecasted transaction (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 is required to determine whether the changes in the fair value of the Prime-based swap will be highly effective in offsetting the change in the total fair value of the debt instrument. High effectiveness is more likely if the fair value of the debt instrument is not affected by changes in credit risk or foreign currency risk or both.

**Future developments**

A proposed Accounting Standards Update was issued in February 2018 to add the overnight index swap rate based on the secured overnight financing rate (SOFR OIS) as a benchmark interest rate. [Proposed ASU]

At a September 2018 meeting, the FASB discussed comments received on the proposed ASU and is expected to issue the final ASU by the end of 2018.
Question 2.3.50

What rates can be used as benchmark rates outside the United States?

Interpretive response: In theory, the benchmark rate should be a risk-free rate that meets the definition of a ‘benchmark interest rate’ in 815-20 Glossary. In some foreign markets, the rate of interest on sovereign debt is considered the risk-free rate, and is therefore considered the benchmark rate. However, in other markets, the relevant interbank offered rate may be the best reflection of the benchmark interest rate.

For example, we believe the Euro Interbank Offered Rate (Euribor swap rate) may be used as the benchmark rate in euro currency countries. 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.

2.3.40 Interest rate risk: Contractually specified interest rate for cash flow hedges

Excerpt from ASC 815-20

>>> Effect of Interest Rate Indexes

55-62 The effectiveness of a cash flow hedge of the variability in interest payments of a variable-rate financial asset or liability, either existing or forecasted, is affected by the contractually specified interest rate on which the variability is based and the extent to which the hedging instrument provides offset. If the cash flows on the hedging instrument and the contractually specified interest rate of the hedged cash flows of the existing financial asset or liability or the contractually specified interest rate of the variable-rate financial asset or liability that is forecasted to be acquired or issued are based on different indexes, the basis difference between those indexes would affect the assessment of hedge effectiveness.

55-62A An entity may designate as the hedged risk only the change in cash flows of the contractually specified interest rate, not an implied rate embedded in the interest rate. For example, if an entity issues variable-rate debt based on its own prime rate, it cannot designate the change in cash flows of the Fed Funds Target rate or the Wall Street Journal prime rate as the hedged risk.

For cash flow hedges of interest rate risk of variable-rate financial instruments or forecasted issuances or purchases of variable-rate financial instruments, Topic 815 permits an entity to designate the hedged risk as the variability in cash flows attributable to a contractually specified interest rate explicitly referenced in the agreement. [815-20-25-15(j)(2)]
The contractually specified interest rate does not need to be a benchmark interest rate. An entity can designate non-benchmark rates (e.g. prime lending rates) as the hedged risk instead of hedging the overall changes in cash flows.

However, an entity is not permitted to designate an implied rate embedded in a contractually specified interest rate. For example, if an entity issues variable-rate debt based on its own prime rate, it cannot designate the hedged risk as exposure to the Fed Funds Target rate or the Wall Street Journal prime rate.

**Hedge effectiveness.** If the hedged item’s contractually specified rate (e.g. entity-specific prime rate) does not exactly match the hedging instrument’s variable rate, an entity needs to consider this difference in its hedge effectiveness assessment. [815-20-25-6, 25-77, 55-62]

For example, assume a debt contract specifies the rate as a specified bank’s prime lending rate plus 100 basis points. Although the specified bank’s prime lending rate is not a benchmark interest rate, it can be the hedged risk because it is contractually specified. If the bank entered into a LIBOR-based interest rate swap to hedge the variable prime-based cash flows, it should consider the variability in the prime lending rates compared to the LIBOR interest rates in assessing hedge effectiveness.

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**Question 2.3.60**

**Can an entity hedge the variability in a contractually specified inflation index that is a component of an interest coupon?**

**Interpretive response:** No. Topic 815 specifies that only contractually specified interest rates are eligible to be designated in a cash flow hedge of interest rate risk related to variable-rate financial instruments. [815-20-25-15(j)(2)]

An inflation index (e.g. Consumer Price Index) is not an interest rate, and therefore is not eligible to be designated as the hedged risk even though it is contractually specified.

At a September 2018 Board meeting, the FASB noted that an interest rate with a fixed component plus a variable rate inflation index must be considered together as the contractually specified interest rate. In addition, an entity could not separately designate the benchmark rate component of the fixed-rate coupon as the hedged risk in a **fair value hedge** (see Question 3.3.180). [FASB meeting 09-18]
Question 2.3.70

Can a variable rate set via an auction process qualify as a contractually specified interest rate?

20 Glossary

**Auction rate notes** – Auction rate notes are notes that 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 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.

**Interpretive response**: Yes. A variable rate set via an auction process – e.g. a ‘clearing rate’ on an auction rate security – qualifies as a contractually specified interest rate if the rate is explicitly referenced in the variable-rate financial instrument being hedged. [ASU 2017-12.BC81]

Therefore, we believe an entity can designate the forecasted interest payments on an auction rate security as a contractually specified component in a cash flow hedge if all other qualifying criteria are met.

**Hedging instrument and hedge effectiveness**. It may be difficult for an entity to find a derivative instrument indexed to the auction rates. An entity could designate a receive-variable, pay-fixed LIBOR interest rate swap as the hedging instrument. However, the entity would need to demonstrate the hedging relationship is highly effective at hedge inception and on an ongoing basis. This includes considering the basis difference between the auction rates and LIBOR (see section 9.2.10).

**Failed auction**. If there is a lack of demand and no clearing rate can be established, the auction ‘fails’ and the entity needs to evaluate whether the original hedging relationship can continue. In some instances, a failed auction results in the existing holders retaining their positions at a rate set by using a formula established by the instrument’s contractual terms. If the interest rate changes from variable to fixed, the forecasted interest payments from the auction rate security no longer create exposure to variability in expected future cash flows and would no longer be eligible for hedge accounting.

In addition, if the hedged transaction (i.e. the variable interest payments) is not probable or if the hedge is no longer highly effective as a result of a failed auction, hedge accounting must be discontinued. See section 2.10 for guidance on the discontinuation of hedge accounting.
2.3.50 Credit risk

Excerpt from ASC 815-20

20 Glossary

Credit Risk – For purposes of a hedged item in a fair value hedge, credit risk is the risk of changes in the hedged item’s fair value attributable to both of the following:

a. Changes in the obligor’s creditworthiness
b. Changes in the spread over the benchmark interest rate with respect to the hedged item’s credit sector at inception of the hedge.

For purposes of a hedged transaction in a cash flow hedge, credit risk is the risk of changes in the hedged transaction’s cash flows attributable to all of the following:

a. Default
b. Changes in the obligor’s creditworthiness
c. Changes in the spread over the contractually specified interest rate or the benchmark interest rate with respect to the related financial asset’s or liability’s credit sector at inception of the hedge.

Some financial instruments involve future performance by a counterparty, such as a counterparty’s obligation to deliver cash or another financial instrument. In this instance, the holder of the instrument is subject to credit risk.

In theory, the benchmark rate represents the rate of interest required to compensate an investor for its investment without consideration of default (e.g. a risk-free rate). 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.

<table>
<thead>
<tr>
<th>Counterparty risk</th>
<th>Risk that a counterparty will fail to comply with its contractual obligations because of credit problems or other reasons.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit sector risk</td>
<td>Risk inherent in the counterparty’s sector (e.g. industry, geography and location). For example, a corporate bond issued by an entity in Venezuela would likely have a higher credit spread than a corporate bond issued by an entity in the United States.</td>
</tr>
</tbody>
</table>

Counterparty risk and credit sector risk both directly affect the fair value of a financial asset and its cash flows.
2.3.60 Foreign currency risk

Excerpt from ASC 815-20

20 Glossary

Foreign Exchange Risk – The risk of changes in a hedged item’s fair value or functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates.

Foreign currency denominated financial assets or liabilities are generally exposed to changes in foreign exchange rates. Foreign exchange risk is the risk related to changes in the related foreign exchange rates.

For further guidance on foreign currency risk and hedges, see chapter 7.

2.3.70 Price risk

Price risk is the risk related to the total change in fair value or cash flows. Interest rate risk, credit risk and foreign currency risk are all subcomponents of price risk, which relates to the entire hedged item or transaction.

Price risk

- Interest rate risk
- Credit risk
- Foreign currency risk

An entity is permitted to hedge more than one risk at a time, with the exception of price risk because it 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 a fixed-rate financial instrument if interest rate risk is also designated as a hedged risk. However, an entity could designate both the interest rate risk and credit risk.

2.3.80 Hedging multiple risks: Simultaneous hedges

Topic 815 considers each risk exposure separately. Therefore, an entity may hedge more than one risk at a time, as long as each designated risk is accounted for separately. [FAS 133.BC423]

This includes:

- more than one fair value or cash flow hedge of the same hedged item or transaction (when different risk exposures are hedged with different hedging instruments);
both a fair value hedge and cash flow hedge of a single instrument (when different risk exposures are being hedged); and
different risk exposures within a single hedging relationship.

For example, an entity may designate the benchmark interest rate and credit risk related to the same commercial loan in simultaneous fair value hedges.

Alternatively, an entity could designate a cash flow hedge of a variable-rate investment security related to the contractually specified interest rate and a fair value hedge related to that issuer’s credit risk.

Continuing the example, if the variable-rate security was denominated in a foreign currency, an entity could designate a single cash flow hedge of both interest rate risk and foreign currency risk using a cross-currency interest rate swap.

When the designated risk is the risk of overall changes in fair value or cash flows related to a financial asset or liability (i.e. price risk), an entity is prohibited from designating another risk associated with the same item. Otherwise the same risk would be hedged more than once. [815-20-12(f)(5), 25-15(j)]
Because simultaneous hedges are permitted and the hedged item or transaction may be subject to another hedge, it is critical to specify and document at inception which item or transaction and its associated risk are being hedged.

**Example 2.3.20**

**Hedging more than one risk at a time**

Investor Co., a US dollar functional currency entity, owns variable-rate (three-month LIBOR) debt securities denominated in a foreign currency. These debt securities are classified as AFS under Topic 320 (debt securities).

Assuming all hedge criteria have been met, Investor 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.

Therefore, Investor could (1) enter into an interest rate swap to lock in the amount of cash flows expected from interest earned on the securities; (2) enter into a foreign currency forward contract to hedge foreign currency changes on the principal amount; or (3) enter into a derivative instrument to compensate Investor if the issuer’s credit deteriorates.

However, if Investor enters into another derivative to hedge the total changes in fair value of the debt securities, and designates that derivative in a qualifying hedging relationship, it cannot also simultaneously designate one of the above risks as a hedged risk for the same debt securities. This is because Investor would effectively be hedging the same risk(s) twice.

**2.3.90 Limitations on hedged risks for HTM securities**

**Excerpt from ASC 815-20**

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-12(d) 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 Topic 320, 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. If the hedged item is other than an option component of a held-to-maturity security that permits its prepayment, the designated hedged risk also shall not be the risk of changes in its overall fair value.
Hedging

2. General hedging requirements

Hedging Transaction Criteria Applicable to Cash Flow Hedges Only

25-15(f) If the variable cash flows of the forecasted transaction relate to a debt security that is classified as held to maturity under Topic 320, the risk being hedged is the risk of changes in its cash flows attributable to any of the following risks:

1. Credit risk
2. Foreign exchange risk.

Items Specifically Ineligible for Designation as a Hedged Item or Transaction

25-43 Besides those hedged items and transactions that fail to meet the specified eligibility criteria, none of the following shall be designated as a hedged item or transaction in the respective hedges: …

c. With respect to fair value hedges only: …
   1. For a held-to-maturity debt security, the risk of changes in its fair value attributable to interest rate risk

d. With respect to cash flow hedges only: …
   2. If variable cash flows of the forecasted transaction relate to a debt security that is classified as held-to-maturity under Topic 320, the risk of changes in its cash flows attributable to interest rate risk

If the hedged item or forecasted transaction relates to a debt security that is classified as HTM under Topic 320 (debt securities), neither interest rate risk nor price risk (e.g. total change in fair value or cash flows) are eligible to be designated as the hedged risk. [815-20-25-12(d), 25-15(f), 25-43(c)(2), 25-43(d)(2)]

<table>
<thead>
<tr>
<th>Type of risk</th>
<th>Eligible for HTM debt securities?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate risk</td>
<td>✗</td>
</tr>
<tr>
<td>Credit risk</td>
<td>✓</td>
</tr>
<tr>
<td>Foreign currency risk</td>
<td>✓</td>
</tr>
<tr>
<td>Price risk</td>
<td>✗</td>
</tr>
</tbody>
</table>

Topic 320 requires specific accounting for securities classified as HTM (i.e. measurement at amortized cost) because the entity has indicated its intent to hold the security to maturity, regardless of changes in interest rates or market rates. Hedging exposure to these risks is thought to undermine the intent of the HTM classification. [FAS 133, BC428]

An entity is permitted to hedge the risk of changes in the fair value or cash flows of a HTM security attributable to credit risk and/or foreign currency risk. The FASB decided to allow credit risk to be a designated hedged risk because it is not inconsistent with Topic 320, which allows a sale or transfer of a HTM debt security in response to significant deterioration in the credit quality of the issuer of the security. [815-20-25-12(d), 25-15(f), FAS 133, BC430]
Foreign currency denominated HTM securities are monetary assets that are exposed to changes in foreign exchange rates. Since guidance is provided in Topic 830 (foreign currency) for reflecting the effect of changes in foreign exchange rates on HTM securities, the Board concluded that the risk of changes in foreign exchange rates in those securities qualifies as a hedgeable risk. [FAS 133.BC411(c)]

Question 2.3.80
Can interest rate risk or price risk related to the forecasted purchase of a debt security that will be classified as HTM be hedged in a cash flow hedge?

Interpretive response: Yes. We believe an entity may hedge 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 HTM at acquisition. This assumes all cash flow hedge criteria are met.

This type of hedge is not inconsistent with the assertion that amortized cost is the appropriate measurement basis for a HTM security since the security is not yet recognized.

This is different from forecasted transactions relating to debt securities that are currently held and classified as HTM, for which an entity is prohibited from hedging the variable cash flows attributable to interest rate risk or price risk. In that case, the securities are already recognized and classified as HTM.

2.3.100 Limitations on financial assets and liabilities measured at fair value

Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15(e) 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.

>> Items Specifically Ineligible for Designation as a Hedged Item or Transaction

25-43 Besides those hedged items and transactions that fail to meet the specified eligibility criteria, none of the following shall be designated as a hedged item or transaction in the respective hedges:

c. With respect to fair value hedges only:
   3. An asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings
An asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported in earnings is not eligible for hedge accounting. [815-20-25-15(e), 25-43(c)(3)]

Therefore, the following financial instruments are not eligible for hedge accounting:

— debt securities classified as trading under Topic 320;
— assets or liabilities measured using the fair value option in Topic 825 (financial instruments) or Topic 815; or
— all equity securities in the scope of Topic 321 (see section 2.5.30).

A financial instrument measured at fair value through earnings should reflect the total change in fair value required by other relevant accounting Topics, rather than changes in fair value specific to only certain risks (e.g. interest rate risk).

As a practical matter, an entity could offset earnings between the changes in the fair value of the asset or liability and the derivative instrument without applying hedge accounting (i.e. economic hedging).

For example, if an entity wants to use a derivative instrument to hedge the exposure associated with changes in the fair value of a trading security, accounting for the derivative instrument in accordance with Topic 815 would naturally achieve offsetting changes (though not necessarily exact offset). This is because changes in the fair values of each financial instrument would be reflected in earnings each period.

### 2.4 Hedged risks of nonfinancial items and transactions

#### Excerpt from ASC 815-20

**>> Hedged Item Criteria Applicable to Fair Value Hedges Only**

25-12(e) 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 shall 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.

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15(i) If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged is any of the following:

1. The risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates
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.
3. The risk of variability in cash flows attributable to changes in a contractually specified component. (See additional criteria in paragraphs 815-20-25-22A through 25-22B for designating the variability in cash flows attributable to changes in a contractually specified component as the hedged risk.)

>>> Hedged Items in Cash Flow Hedges Only

>>>> Variable Price Component of a Purchase Contract as Hedged Item

55-19 This guidance discusses the implementation of paragraph 815-20-25-15(i). An entity enters into a contract that requires it to pay a total contract price based on the VWX sugar index on the date of purchase plus a variable basis differential related to transportation costs. The entity may use a derivative instrument whose underlying is the price of sugar or any other underlying for which the derivative would be highly effective in achieving offsetting cash flows in a cash flow hedge of its forecasted purchases under the contract. In accordance with paragraph 815-20-25-15(i), the entity may designate as the risk being hedged the risk of changes in the cash flows relating to all changes in the purchase price of the items being acquired under the contract. The entity also may designate the variability in cash flows attributable to changes in the contractually specified component (VWX sugar index) as the hedged risk. In that case, the entity not only must consider whether the VWX sugar index is explicitly referenced in the purchase agreement but also must ensure that the requirements in paragraph 815-20-25-22A are met. In both scenarios, the entity must determine that all the criteria for cash flow hedges are satisfied, including that the hedging relationship is highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge.

20 Glossary

Contractually Specified Component – An index or price explicitly referenced in an agreement to purchase or sell a nonfinancial asset other than an index or price calculated or measured solely by reference to an entity’s own operations.

The following table outlines the risks associated with a nonfinancial asset or liability or transaction that are eligible to be hedged.
Nonfinancial assets, or a forecasted transaction that involves nonfinancial assets, may expose an entity to numerous risks. For example, inventory consisting of chocolate bars exposes the entity to fair value risk, or cash flow price risk, associated with each major ingredient that goes into manufacturing a chocolate bar – e.g. cocoa, sugar, butter and milk.

The aggregate components encompass the risk of all changes in the fair value or cash flows related to the sales price of the chocolate bar.

<table>
<thead>
<tr>
<th>Price risk Component</th>
<th>Price risk Component</th>
<th>Price risk Component</th>
</tr>
</thead>
<tbody>
<tr>
<td>(cocoa)</td>
<td>(sugar)</td>
<td>(milk &amp; butter)</td>
</tr>
</tbody>
</table>

**Cash flow hedges.** For a cash flow hedge, an entity is permitted to designate either:

- total price risk – e.g. the entire chocolate bar; or
- a contractually specified component of the purchase or sale of a nonfinancial asset or liability – e.g. price risk related to cocoa in chocolate bars.

Example 2.4.10 illustrates the different cash flow hedging strategies available for a forecasted transaction to sell inventory. Section 5.4.10 provides guidance for designating the contractually specified component as the hedged risk in a cash flow hedge.

For a cash flow hedge of total price risk involving a forecasted transaction to acquire a nonfinancial asset with a purchase price denominated in a foreign currency, an entity is allowed to exclude the foreign currency component of a
hedged transaction (see Example 2.4.20). In other words, an entity is not required to hedge the risk of changes in its functional currency equivalent cash flows (i.e. all cash flows). [815-20-25-15(i)(2)]

**Fair value hedges.** For a fair value hedge, Topic 815 does not allow an entity to designate a component of price risk. Rather, the designated risk is required to be changes in the fair value of the *entire* asset or liability – i.e. total price risk. For further discussion, see section 3.4.20.

This restriction on hedging a specific component of a nonfinancial item differs from guidance on fair value hedges of financial assets or liabilities and cash flow hedges of nonfinancial assets or liabilities, both of which allow an entity to hedge only certain risk exposure(s).

See guidance on foreign currency risk and hedges in chapter 7.

**Hedge effectiveness.** Entities commonly use standardized contracts traded on exchanges (e.g. futures contracts) to hedge risk exposures related to nonfinancial items or transactions. These contracts may have critical terms that do not exactly match the hedged item or transaction – i.e. different quantities, locations, etc. A hedging relationship may not be perfectly effective when there is a mismatch between the hedged item or transaction and the hedging instrument (see section 9.2.10).

---

**Example 2.4.10**

**Comparison of cash flow hedges and fair value hedges of inventory**

**Cash flow hedges**

Candy Co. has inventory consisting of chocolate bars, which exposes it to variations in cash flows associated with the forecasted purchases of each major ingredient that goes into manufacturing a chocolate bar (e.g. cocoa, sugar, butter and milk), as well as the forecasted sales of the chocolate bars.

**Total price risk**

Candy could use a cocoa beans futures contract to hedge the forecasted sale of chocolate bars, provided it can demonstrate that cocoa bean futures are highly effective in offsetting the changes in the cash flows related to all changes in the sales price – i.e. total price risk.

**Contractually specified component price risk**

Candy enters into a forward contract to sell chocolate bars at a price that is based on a sugarcane index plus a fixed spread. The forward contract meets the definition of a derivative in its entirety. The underlying (price of sugarcane) is clearly and closely related to the asset being sold (chocolate bars).

Assuming that the forward contract is outside the scope of Topic 815 (for example, if Candy applies the normal purchases and normal sales scope exception), Candy may designate the contractually specified component (the sugarcane index) of the forward contract as the hedged risk in the forecasted sale of chocolate bars.
See guidance on the conditions that must be met for a contractually specified component in an existing contract to be designated as the hedged risk in section 5.4.20.

**Foreign currency risk**

Candy’s functional currency is the pound sterling (£).

On January 1, Year 1 Candy forecasts it will sell 10,000 chocolate bars on March 31, Year 1 for $10,000. The forecasted sale meets the criteria to qualify as a forecasted transaction.

Candy can hedge the risk of changes in functional currency equivalent cash flows from January 1, Year 1 through the sale date (March 31, Year 1) by entering into a forward contract to sell $10,000 and buy pound sterling based on the current forward rate for an exchange on March 31, Year 1 – e.g. £0.75 = $1.00.

**Fair value hedges**

Candy’s inventory of chocolate bars also exposes it to fair value risk associated with each major ingredient that goes into manufacturing a chocolate bar – e.g. cocoa, sugar, butter and milk.

**Total price risk**

Candy would not be able to designate the cocoa component of the chocolate bar as the hedged risk.

However, Candy would be able to qualify for fair value hedge accounting if it used a cocoa bean futures contract to hedge the fair value risk of its chocolate bar inventory provided it can demonstrate that the cocoa bean futures are highly effective in offsetting the changes in fair value associated with the inventory of chocolate bars – i.e. total price risk.

**Foreign currency risk**

Candy’s functional currency is the pound sterling. Candy enters into a contract to sell 10,000 chocolate bars at a fixed price of $1 per chocolate bar on March 31, Year 1. The contract meets the definition of a firm commitment.

Candy can hedge the risk of changes in fair value of the firm commitment resulting from changes in the £/$ exchange rates by entering into a foreign currency forward contract to sell $10,000 and buy pound sterling on March 31, Year 1, based on the current forward rate for an exchange on March 31, Year 1 – e.g. £0.75 = $1.00.

This hedging strategy should enable the sale of chocolate bars to be recorded at £7,500 (the forward price inherent in the foreign currency forward contract), regardless of the spot rate on the date of sale.
Hedging

2. General hedging requirements

Example 2.4.20
Cash flow hedge of total price risk excluding the foreign currency component

Goldco, an Australian gold producer, uses the Australian dollar (A$) as its functional currency. Goldco wishes to hedge its exposure to US dollar denominated forecasted gold sales and enters into a gold futures contract denominated in US dollars (which are more readily available).

Goldco designates the hedged risk as all changes in cash flows excluding the component of the cash flows related to changes in $/A$ exchange rates.

Hedge effectiveness. The hedge effectiveness assessment excludes the effect of changes in currency exchange rates and instead is based primarily on changes in gold prices. This enables Goldco to achieve a higher level of assessed effectiveness.

If Goldco 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.

2.5 Limitations on hedged items, transactions and risks

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Criterion 5: Formal documentation

2.5.10 Overview

Excerpt from ASC 815-20

>> Items Specifically Ineligible for Designation as a Hedged Item or Transaction

25-43 Besides those hedged items and transactions that fail to meet the specified eligibility criteria, none of the following shall be designated as a hedged item or transaction in the respective hedges:

a. Subparagraph not used
b. With respect to both fair value hedges and cash flow hedges:
   1. An investment accounted for by the equity method in accordance with the requirements of Subtopic 323-10 or in accordance with the requirements of Topic 321
2. General hedging requirements

- A noncontrolling interest in one or more consolidated subsidiaries
- Transactions with stockholders as stockholders, such as either of the following:
  i. Projected purchases of treasury stock
  ii. Payments of dividends.
- Intra-entity transactions (except for foreign-currency-denominated forecasted intra-entity transactions) between entities included in consolidated financial statements
- 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.

  c. With respect to fair value hedges only:
   1. If the entire asset or liability is an instrument with variable cash flows, an implicit fixed-to-variable swap (or similar instrument) perceived to be embedded in a host contract with fixed cash flows
   2. For a held-to-maturity debt security, the risk of changes in its fair value attributable to interest rate risk
   3. An asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings
   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 noncontrolling interest, or an equity method investee
   6. An equity instrument issued by the entity and classified in stockholders’ equity in the statement of financial position
   7. A component of an embedded derivative in a hybrid instrument—for example, embedded options in a hybrid instrument that are required to be considered a single forward contract under paragraph 815-10-25-10 cannot be designated as items hedged individually in a fair value hedge in which the hedging instrument is a separate, unrelated freestanding option.

  d. With respect to cash flow hedges only:
   1. Subparagraph not used
   2. If variable cash flows of the forecasted transaction relate to a debt security that is classified as held-to-maturity under Topic 320, the risk of changes in its cash flows attributable to interest rate risk

25-44 The earnings exposure criterion specifically precludes hedge accounting for derivative instruments used to hedge items in (b)(3) through (b)(5) in the preceding paragraph. However, intra-entity transactions may present an earnings exposure for a subsidiary in its freestanding financial statements; a hedge of an intra-entity transaction would be eligible for hedge accounting for purposes of those statements.

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15 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: …

d. 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.
2. General hedging requirements

e. 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.

f. If the variable cash flows of the forecasted transaction relate to a debt security that is classified as held to maturity under Topic 320, the risk being hedged is the risk of changes in its cash flows attributable to any of the following risks:
   1. Credit risk
   2. Foreign exchange risk.

g. The forecasted transaction does not involve a business combination subject to the provisions of Topic 805 or a combination accounted for by an NFP that is subject to the provisions of Subtopic 958-805.

h. The forecasted transaction is not a transaction (such as a forecasted purchase, sale, or dividend) involving either of the following:
   1. A parent entity’s interests in consolidated subsidiaries
   2. An entity’s own equity instruments.

In addition to those items and transactions that fail to meet the eligibility criteria for designation in a hedge outlined in section 2.2, Topic 815 specifically prohibits certain items and transactions from hedge accounting.

This section discusses the items and transactions that are prohibited from hedge accounting, as well as limitations on the hedgeable risks for certain items and transactions.

2.5.20 Equity method investments and noncontrolling interests

Topic 815 prohibits equity method investments and noncontrolling interests from being designated as hedged items or transactions in a fair value or cash flow hedge. [815-20-25-43b(1) – 25-43b(2)]

Under the equity method of accounting, an entity recognizes its share of profits or losses in earnings, and adjusts the carrying amount of its investment. [323-10-35-4]

Changes in the carrying amount are not based on changes in the market value of the equity method investee’s shares, but are affected by changes in its earnings. Under fair value hedge accounting, changes in the market value of the shares would become part of the basis of an equity method investment. This conflicts with the accounting prescribed in Topic 323 (equity method and joint ventures) and could result in some amount of double counting the investor’s share of its earnings. In addition, the FASB was concerned it would be difficult to develop a method of implementing fair value or cash flow hedge accounting for equity method investments that would be reasonable to understand. [FAS 133.BC455, BC472]

For reasons similar to equity method investments, an entity is also prohibited from hedging noncontrolling interests. [815-20-25-43b(2), FAS 133.BC456]

These restrictions also apply to firm commitments or forecasted transactions to acquire or dispose of these investments. [815-20-25-15(h)(1), 25-43(c)(5)]
**Net investment hedges.** Topic 815 allows an entity to hedge the foreign currency risk of a net investment in a foreign operation, which includes subsidiaries, joint ventures and equity method investments (see chapter 8).

**Question 2.5.10**

Can an entity apply hedge accounting to an item or transaction of an equity method investee?

**Interpretive response:** Generally, no. We believe an entity cannot apply hedge accounting to the following items or transactions:

- recognized assets or liabilities of an equity method investee;
- a forecasted transaction between an equity method investee and a third party; or
- a firm commitment of an equity method investee.

This is because there is no direct exposure to changes in fair value or variability in cash flows that is attributable to an entity’s interest in the equity method investment. Topic 815 does not necessarily require a subsidiary with exposure to the hedged risk to be a party to the hedging instrument to apply hedge accounting at the consolidated level (see Question 2.7.20). However, this only applies to a consolidated subsidiary and is not available for equity method investees. [815-20-25-46A]

**Fair value hedges.** A firm commitment between an entity and its equity method investee is not permitted. This is because a firm commitment must be between two unrelated parties (see section 3.3.20).

**Cash flow hedges.** An entity is not precluded from designating forecasted transactions with equity method investees as hedged transactions, assuming the effects of the forecasted transaction will not be eliminated and other eligibility criteria are met (see Question 5.3.40).

**Example 2.5.10**

**Forecasted transaction of an equity method investee**

ABC owns 50% of JV (a joint venture) and uses the equity method to account for its investment. JV has a $10 million LIBOR-rate debt obligation.

ABC 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, ABC enters into a pay-fixed, receive-LIBOR interest rate swap to lock in the cost of JV’s debt obligation.

**Is ABC permitted to use cash flow hedge accounting?**

No. To qualify for cash flow hedge accounting the forecasted transaction must:

1. be a transaction; and
2. present an exposure to cash flows for the hedged risk that could affect reported earnings.
The effect of changes in LIBOR on JV’s income statement is not a transaction from ABC’s perspective. In addition, neither ABC nor any of its consolidated subsidiaries have any direct exposure to variability in cash flows that is attributable to JV’s debt obligation. Therefore, we believe ABC may not use cash flow hedge accounting in this instance.

**Example 2.5.20**

**Contract to sell a wholly owned subsidiary**

Parent enters into a contract to sell its wholly owned subsidiary to XYZ Corp. at a fixed price in one year.

**Can Parent hedge changes in the fair value of its wholly owned subsidiary?**

No. This transaction does not qualify as a **fair value hedge** because Topic 815 prohibits an equity investment in a consolidated subsidiary from being designated as the hedged item in a fair value hedge. [815-20-25-43(c)(4)]

**Can Parent hedge changes in the cash flows attributed to the sale of its wholly owned subsidiary?**

No. This transaction does not qualify as a **cash flow hedge** because Topic 815 prohibits hedging a transaction involving a parent entity’s interest in a consolidated subsidiary. [815-20-25-15(h)(1)]

**Question 2.5.20**

**Can an entity hedge exposure to assets or liabilities of an investee that is proportionately consolidated?**

**Interpretive response:** Yes. The proportionate consolidation method is applied frequently in extractive industries when the investee is an unincorporated entity (such as a partnership) and no investor is considered to have control.

A proportion of the underlying assets and/or liabilities of an investee that is proportionately consolidated would be recognized in an entity’s financial statements. Therefore, we believe an entity could hedge the recognized assets or liabilities as if the investee were a consolidated subsidiary, subject to all of the other qualifying criteria in Topic 815.

**2.5.30 Equity securities in scope of Topic 321**

Topic 815 prohibits designating equity securities in the scope of Topic 321 (equity securities) as hedged items in a fair value or cash flow hedge. [815-20-25-43(b)(1)]

This includes the following:

— equity securities with readily determinable fair values that are measured at fair value with gains/losses recognized currently in earnings; and [321-10-35-1]
2. General hedging requirements

2.5.40 **Equity instruments issued by the entity and transactions with shareholders**

Equity instruments issued by the entity and classified in stockholder’s equity are not eligible for hedge accounting, because they do not meet the definition of assets or liabilities. Only recognized assets and liabilities are eligible to be designated in a fair value hedge or a cash flow hedge. [815-20-25-12(a), 25-43(c)(6)]

Furthermore, changes in the market value of an entity’s own equity instruments do not affect earnings, which is also a requirement to be designated as a hedged item.

This restriction also applies to the following transactions:

- transactions with shareholders (including projected purchases of treasury stock and payments of dividends); [815-20-25-43(b)(3)]
- firmly committed issuances of common and preferred stock; [815-20-25-43(c)(6)]
- forecasted transactions (such as a forecasted purchase, sale or dividend) involving an entity’s own equity instruments; and [815-20-25-15(h)(2)]
- forecasted stock issuances that are related to a stock option plan for which no compensation expense (based on changes in stock prices after the date of grant) is recognized. [815-20-25-43(b)(5)]

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**Question 2.5.30**

Are items classified in temporary or mezzanine equity eligible for designation as a hedged item?

**Interpretive response:** No. We believe that items classified in temporary or mezzanine equity (e.g. certain preferred stock instruments) cannot be designated as hedged items because they do not meet the definition of an asset or liability.
Can an entity hedge compensation expense related to stock appreciation rights?

Excerpt from ASC 815-20

>>> Hedged Items in Cash Flow Hedges Only
>>> Stock-Appreciation-Right Obligation as a Hedged Item

55-33 This guidance addresses the application of the criteria in Section 815-20-25 to an unrecognized, nonvested stock appreciation right as a hedged item. An unrecognized, nonvested stock appreciation right relates to the portion of the stock appreciation right liability that has not yet been accrued. It does not refer to future fair value changes in the recognized liability for the vested portion of the stock appreciation right. To the extent that vesting of stock appreciation rights is probable, a purchased call option indexed to an entity’s own stock that is recorded as an asset and accounted for as a derivative instrument may be designated as the hedging instrument in a hedge of cash flow variability of expected future obligations associated with unrecognized, nonvested stock appreciation rights if the option is classified as an asset in the entity’s financial statements and the option is a derivative instrument subject to Subtopic 815-10. Presumably, if using this strategy, hedge effectiveness typically would be assessed based on changes in the entire value of the purchased call option, rather than just the intrinsic value of the option because the fair value of the unrecognized, nonvested stock appreciation rights likewise consists of a time value portion and an intrinsic value portion. Because an unrecognized, nonvested stock appreciation right results in exposure to cash flow variability of expected future obligations that affects reported earnings, it is eligible to be designated as being hedged. A stock appreciation right that is recognized as a liability may not be designated as being hedged in a cash flow hedge because the hedged cash flow variability in a recognized stock appreciation right relates to a liability that is remeasured with changes in fair value reported currently in earnings. The hedge of exposure to cash flow variability in an unrecognized, nonvested stock appreciation right could be expected to be highly effective. The entity’s stock price is the underlying for both the unrecognized, nonvested stock appreciation right and the option on the entity’s own stock. Changes in fair value of the purchased call option on the entity’s own stock would be recorded in other comprehensive income consistent with paragraph 815-30-35-3. As required by paragraphs 815-30-35-38 through 35-41, the amount in other comprehensive income would be reclassified into earnings concurrent with the recognition in earnings of compensation cost on the stock appreciation right that relates to those fair value changes that occurred during the hedge period over the requisite service period.

Background: A stock appreciated right (SAR) is a form of compensation that 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 based on a stated number of shares of the employer’s stock.

Various factors, including the method of settlement, determine whether the entity accounts for the SAR as a liability or an equity instrument. SAR awards classified as liabilities are adjusted to fair value each reporting period with gains and losses recognized as compensation expense. [718-30-35]

SAR awards also generally have vesting provisions (e.g. pro rata vesting over a specified service period or vesting at a single date), and an entity recognizes the related compensation expense over a service period. Typically, an entity will want to hedge this compensation expense by using a purchased cash settled call option on its own stock.

**Interpretive response:** An unrecognized nonvested SAR obligation presents exposure to cash flow variability of expected future obligations that affects reported earnings, and therefore is eligible to be designated as the hedged forecasted transaction in a cash flow hedge (assuming vesting of the SAR is probable).

Once a SAR is recognized as a liability, it may not be hedged because the recognized liability is remeasured at fair value through earnings. This creates complexity in hedging an unrecognized SAR obligation because the recognition of the SAR liability occurs before vesting.

There are also considerations around whether the purchased call option would meet the definition and scope of a derivative, which is a requirement to be designated as the hedging instrument (see section 2.6). For the purchased call option to be a derivative instrument, it needs to be classified as an asset. However, certain contracts involving an entity’s own equity are classified as equity, and therefore are not eligible to be considered a derivative instrument. [815-10-15-74(a)]

Lastly, although an entity may want to hedge a SAR obligation, it may be difficult to assert that the hedging relationship will be highly effective. Therefore, cash flow hedges of SAR obligations are uncommon.

### 2.5.50 Intercompany transactions

Cash flows from intercompany transactions are eliminated in consolidation, and therefore are not eligible for hedge accounting except for variability due to changes in foreign currency exchange rates. This is because they do not represent an exposure to earnings, which is a requirement for hedge accounting. [815-20-25-12(c), 25-15(c)(2), 25-43(b)(4)]

For example, the risk of variable cash flows attributable to interest rate risk related to variable-rate intercompany debt could not be hedged because earnings of the consolidated entity are not affected by the transaction. Similarly, equity investments in a consolidated entity are eliminated in consolidation and are therefore not eligible for hedge accounting. [815-20-25-15(h)(1), 25-43(c)(4)]

In contrast, the risk of variable cash flows attributable to foreign currency 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.

**Foreign currency risk.** An entity is permitted to hedge intercompany transactions for foreign currency risk (see section 7.3.40). This risk is not eliminated in consolidation, and therefore affects consolidated earnings. [815-20-25-43(b)(4)]

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**Question 2.5.50**

Can intercompany transactions be hedged for eligible risks at the stand-alone financial statement level of a subsidiary?

**Interpretive response:** Yes. Hedging intercompany transactions for other eligible risks (such as interest rate risk) is permitted at the stand-alone financial statement level of a subsidiary. At this level the risk affects earnings. However, the effect of the hedge accounting needs to be reversed in the consolidated financial statements that include the intercompany entities to the transaction.

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**2.5.60 Business combinations**

The following items and transactions are ineligible for hedge accounting:

— firm commitment to either enter into a business combination or to acquire or dispose of a subsidiary; [815-20-25-43(c)(5)]

— forecasted transaction involving a business combination; and [815-20-25-15(g)]

— forecasted purchase or sale involving a parent entity’s interest in a consolidated subsidiary. [815-20-25-15(h)(1)]

For example, if an entity enters into a contract to acquire a business in exchange for shares and/or cash, it may not apply hedge accounting for a derivative instrument used to lock in the cost of acquiring the business.

Similarly, if an entity wishes to dispose of its 60% investment in a subsidiary, it may not apply hedge accounting for a derivative instrument used to lock in the forecasted sales price of the subsidiary.

The FASB prohibited firm commitments and forecasted transactions involving a business combination from being designated as a hedged item or transaction for reasons similar to the prohibition of equity method investments (see section 2.5.20) and equity investments in a consolidated entity (see section 2.5.50). [FAS 133.BC456, BC472–BC473]
Question 2.5.60

Is an entity allowed to hedge a forecasted issuance of debt that is contingent on a business combination?

**Background:** An entity may issue debt to finance the acquisition of another business. While those debt issuances are contingent on a business acquisition, they do not form part of the actual acquisition.

**Interpretive response:** We believe it may be acceptable to hedge the forecasted issuance of debt that is contingent on consummation of a business combination if the forecasted transaction does not directly affect the purchase price or the acquisition accounting associated with the acquisition.

The forecasted issuance of debt in the functional currency of an acquirer that provides it with the consideration necessary to complete a business combination does not directly affect the purchase price or the acquisition accounting associated with the acquisition. Rather, it is considered a financing transaction separate from the acquisition.

To be eligible for cash flow hedge accounting, an entity needs to determine it is probable that the business combination will be consummated and the forecasted transaction will occur. The facts and circumstances related to the forecasted business combination need to be evaluated to determine whether the transaction is probable.

To the extent an entity concludes that a business combination is probable for purposes of hedge accounting, an entity would also conclude that the business combination is probable for purposes of SEC Rule 3-05 of Regulation S-X. This regulation requires an entity to prepare audited financial statements of a significant business acquired (or to be acquired) if the consummation of the business combination is considered probable.

If the forecasted issuance of debt that is contingent on a business combination qualifies for designation as a hedged transaction, an entity may wish to use a deal contingent interest rate swap as the hedging instrument to hedge the interest rate risk. This requires the entity to assess whether the deal contingent swap is expected to be highly effective at achieving offsetting cash flows attributable to the hedged risk. However, a deal contingent term in this type of hedging instrument would generally be expected to reduce the effectiveness of the hedging relationship, and could result in the hedging relationship being less than highly effective. See Question 9.7.50 for further guidance on assessing effectiveness of a hedging relationship that includes a deal contingent swap.

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Question 2.5.70

Can an entity hedge total assets or liabilities of a disposal group classified as held-for-sale?

**Interpretive response:** No. Topic 205 (presentation) requires an entity to present total assets and total liabilities of a disposal group classified as held-for-sale on the face of the balance sheet. [205-20-45-10]
The assets or liabilities of a disposal group classified as held-for-sale would not qualify for fair value or cash flow hedge accounting. This is because (like hedges of forecasted business combinations) they represent a group of dissimilar assets and liabilities.

### 2.5.70 Assets and liabilities remeasured with changes in fair value reported in earnings

An asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported in earnings is not eligible for hedge accounting. This restriction also applies to the forecasted acquisition (or incurrence) of an asset (or liability) that will be remeasured at fair value. [815-20-15(d), 25-43(c)(3)]

Specifically, the FASB believes 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 currently recognized in earnings. [FAS 133.BC405]

Section 2.3.100 provides guidance on this restriction as it relates to financial assets and liabilities.

Topic 815 requires items that meet the definition of a derivative to be measured at fair value, unless the item qualifies for any of the scope exceptions in Subtopic 815-10. Therefore, contracts that meet the definition of a derivative may not be designated as the hedged item or transaction unless they qualify for one of the scope exceptions. Section 3.3.30 (fair value hedges) and Question 5.3.10 (cash flow hedges) provide further guidance on the eligibility of contracts that meet the definition of a derivative and a commonly used scope exception (e.g. normal purchases and normal sales).

### Question 2.5.80

**Can assets measured at the lower of cost or market be designated as hedged items?**

**Interpretive response:** Yes. An entity is not prohibited from designating items that are (or will be) measured at the lower of cost or market as the hedged item in a fair value or cash flow hedge. For example, mortgage loans held for sale, inventory held or the forecasted purchase of inventory.

These items may affect earnings as a result of the risk being hedged, such as the risk of decrease in fair value of mortgage loans held for sale due to a change in interest rates, or the risk of decrease in the cash flows of the forecasted sale of inventory. However, they are (or will be, when recognized) measured at fair value if the fair value declines below cost.

Consequently, they are not remeasured with changes in the fair value reported currently in earnings. Therefore, assets measured at the lower of cost or market are eligible to be designated as hedged items.
2. General hedging requirements

Example 2.5.30

**Forecasted transaction to purchase debt securities that will be classified as trading under Topic 320**

**Cash flow hedge**

ABC Corp. wants to acquire municipal bonds three months from now. ABC will classify them as trading debt securities under Topic 320.

The forecasted acquisition of trading securities does not qualify as a hedged transaction in a cash flow hedge. These securities will be measured at fair value with subsequent changes in fair value reported currently in earnings under Topic 320. Therefore, hedge accounting is prohibited.

**Fair value hedge**

Similarly, ABC would be prohibited from applying fair value hedge accounting to a firm commitment to purchase debt securities that will be classified as trading debt securities under Topic 320.

Example 2.5.40

**Forecasted transaction to purchase a derivative instrument**

ABC Corp. is considering entering into a derivative instrument three months from today with a value indexed to the market price of XYZ Corp.’s common stock. The instrument is a derivative under Topic 815.

The forecasted acquisition of the derivative instrument does not qualify as a hedged transaction in a cash flow hedge. Derivative instruments are measured at fair value with subsequent changes in fair value reported currently in earnings under Topic 815. Therefore, hedge accounting is prohibited.

2.5.80 **Strategic risk**

**Excerpt from ASC 815-20**

>>> Strategic Risk Ineligible as Hedged Risk

55-40 The offset criterion in paragraph 815-20-25-75 precludes hedge accounting for certain risk management techniques, such as hedges of strategic risk. For example, a U.S. manufacturer, with no export business, that designates a forward contract to buy U.S. dollars (USD) for Japanese yen (JPY) as a hedge of its USD sales 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. A weakened JPY 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. However, it would be difficult for the U.S. manufacturer to expect 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 hedging derivative typically would be quite indirect, would depend on price elasticities, and would be only one of many factors influencing future results. In addition, the risk that a desired or expected number of transactions will not occur, that is, the potential absence of a transaction, is not a hedgeable risk for accounting purposes.

Topic 815 focuses on four risks that are expected to directly affect the fair value of an asset or liability (or the cash flows of a forecasted transaction) in a determinable or predictable manner. These are interest rate risk, credit risk, foreign exchange risk and price risk.

An entity may engage in various activities to control or reduce other types of economic risks (e.g. strategic risks); however, these may not be as determinable or predictable. As such, these types of economic risks are not eligible for hedge accounting.

### 2.5.90 Macro hedges

A macro hedging strategy is a risk management technique that uses derivatives to manage risk – typically interest rate risk – from a portfolio of financial assets and/or liabilities. However, this strategy does not link the derivative instrument to identifiable assets, liabilities, firm commitments or forecasted transactions. Instead, the risk is managed from a macro (or enterprise-wide) perspective. Topic 815 does not permit a macro hedging strategy. [FAS 133.BC449]

To qualify for hedge accounting, the hedging instrument needs to be linked to a specific hedged item or transaction. This is necessary to objectively assess whether the hedging relationship is highly effective, and ultimately to apply hedge accounting to the hedged items or transactions.

### 2.6 Hedging instruments

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Criterion 5: Formal documentation
2.6.10 Overview

Excerpt from ASC 815-20

> Eligibility of Hedging Instruments

25-45 Either all or a proportion of a derivative instrument (including a compound embedded derivative that is accounted for separately) may be designated as a hedging instrument. Two or more derivative instruments, or proportions thereof, may also be viewed in combination and jointly designated as the hedging instrument. A proportion of a derivative instrument or derivative instruments designated as the hedging instrument shall be expressed as a percentage of the entire derivative instrument(s) so that the profile of risk exposures in the hedging portion of the derivative instrument(s) is the same as that in the entire derivative instrument(s). Subsequent references in the Derivatives and Hedging Topic to a derivative instrument as a hedging instrument include the use of only a proportion of a derivative instrument as a hedging instrument. Whether a written option may be designated as a hedging instrument depends on the terms of both the hedging instrument and the hedged item as discussed beginning in paragraph 815-20-25-94.

The combination of the hedged item or transaction and the hedging instrument is referred to as the hedging relationship.

Only financial instruments or contracts that meet the definition of a derivative under Topic 815 can be designated as the hedging instrument, with the exception of certain foreign currency transactions. [815-20-25-71(a)(1)]

Topic 815 provides an entity with choices when designating the hedging instrument, including: [815-20-25-45]

— all of a derivative instrument;
— a proportion of a derivative instrument (see section 2.6.30); or
— a combination of two or more derivative instruments (see section 2.6.40).

There are also limitations on certain derivatives being hedging instruments (see section 2.7).

If the derivative does not meet the criteria for hedge accounting, or if it is not designated as a hedging instrument, it is treated as a trading derivative instrument under Topic 815. These instruments are recorded at fair value, with any changes immediately recognized in earnings.

Foreign currency risk. For guidance on the eligibility of hedging instruments in foreign currency hedges, see chapter 7.

Net investment hedges. For guidance on the eligibility of hedging instruments in net investment hedges, see section 8.3.
2.6.20 Common types of derivative instruments

There are three general categories of derivatives: options, swaps and futures/forwards. The following table includes examples of derivatives that are commonly used as hedging instruments (not exhaustive).

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<tr>
<td>Foreign currency swaps</td>
<td></td>
<td>Interest rate floors</td>
</tr>
<tr>
<td>Cross-currency interest rate swaps</td>
<td></td>
<td>Interest rate collars</td>
</tr>
<tr>
<td>Credit default swaps</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total return swaps</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

There are other types of instruments that are a combination of two categories of derivatives. For example, a forward-starting swap is an agreement to enter into a swap that starts at a future date. Likewise, a swaption is an option to enter into an interest rate swap when exercised.

**Interest rate swaps**

A swap is a contractual agreement between two parties to exchange cash flows from one type of financial instrument for another.

The most widely used swap is the interest rate swap. 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 both fair value and cash flow hedging relationships is a fixed-for-floating interest rate swap. This type of swap involves the exchange of fixed interest 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 is usually 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.

The hedging strategy when using a fixed-for-floating interest rate swap is different for a fair value hedge and a cash flow hedge.

<table>
<thead>
<tr>
<th>Fair value hedge</th>
<th>Cash flow hedge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Converts fixed interest payments (or receipts) to variable.</td>
<td>Converts variable-rate cash flows to fixed cash flows.</td>
</tr>
</tbody>
</table>

Other types of swaps with periodic interest exchanges include the following.

<table>
<thead>
<tr>
<th>Basis swaps</th>
<th>An interest rate swap that exchanges two variable-rate interest payments (e.g. a floating-for-floating interest rate swap). For limitations on designating basis swaps in a cash flow hedge, see section 5.5.10.</th>
</tr>
</thead>
</table>
| Cross-currency interest rate swaps | A contractual agreement between two parties to exchange interest payments and principal denominated in two different currencies. This exchange includes the following at different points in time.  
  - Initial 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 exchanges: 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 or variable rate of interest.  
  - Final exchange (at maturity): fixed principal amounts exchanged at inception.  
A cross-currency interest rate swap (CCIRS) can be structured to accomplish different objectives. For example, an entity can hedge its 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. Alternatively, it could hedge its exposure only to foreign currency risk – e.g. a foreign currency denominated fixed-rate debt hedged using a receive-fixed, pay-fixed CCIRS. |

Example 2.6.10

**Hedging strategy using a fixed-for-floating interest rate swap**

**Fair value hedge**

ABC Corp. issues a fixed-rate debt instrument and wishes to hedge its exposure to changes in fair value related to interest rate risk (i.e. benchmark interest rate).
ABC can convert the fixed interest paid to variable by entering into an interest rate swap to receive interest at a fixed rate and pay interest at a variable rate.

The floating interest rates protect ABC against fluctuations in the fair value of its issued debt due to changes in interest rates. Converting the fixed interest expense to variable interest expense that fluctuates with the market benchmark interest rate allows ABC to benefit if the market benchmark interest rate declines, and vice versa.

**Cash flow hedge**

ABC issues a variable-rate debt instrument and wishes to hedge its exposure to variations in cash flows related to interest rate risk (i.e. contractually specified interest rate).

ABC can convert interest paid to fixed by entering into an interest rate swap to pay interest at a fixed rate and receive interest at a floating rate.

The interest rate swap essentially locks in a fixed rate and eliminates the variability of the interest rate in ABC’s debt instrument. The fixed interest rate does not fluctuate with the market.

**Other swaps**

The other basic types of swaps are summarized below.

<table>
<thead>
<tr>
<th>Commodity swaps</th>
<th>Contractual agreement between two parties to exchange the market (or spot) price of an underlying commodity for a fixed price.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity swaps</td>
<td>Contractual agreement between two parties to exchange a set of future cash flows (i.e. ‘legs’ of the swap). One leg is usually based on a floating rate (e.g. the floating leg) and the other leg is based on the performance of shares or a share index (e.g. the equity leg).</td>
</tr>
<tr>
<td>Foreign currency swaps</td>
<td>Contractual agreement between two counterparties to exchange foreign currency.</td>
</tr>
<tr>
<td>Credit default swaps</td>
<td>Buyer makes periodic payments to a seller (i.e. fee or premium) in exchange for an agreement that the seller will compensate the buyer in the event that a debt issuer (i.e. the reference entity) defaults or experiences a credit event.</td>
</tr>
</tbody>
</table>

**Forwards/futures**

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).
Question 2.6.10

What is the difference between a forward contract and a futures contract?

Interpretive response: Futures contracts are standardized and traded on a regulated exchange, whereas forward contracts are agreements between two parties that have varied terms and conditions.

The other key differences between forward contracts and futures contracts are as follows.

<table>
<thead>
<tr>
<th></th>
<th>Forward contracts</th>
<th>Futures contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Underlying</strong></td>
<td>Available for essentially any underlying if two parties agree to the contract.</td>
<td>Available only for certain underlyings (i.e. those underlyings with liquid markets) due to their standardized nature.</td>
</tr>
<tr>
<td><strong>Credit risk</strong></td>
<td>Affected by the creditworthiness of the counterparty and the entity’s own nonperformance risk.</td>
<td>Affected by the creditworthiness of the exchange on which the contract trades.</td>
</tr>
<tr>
<td><strong>Settlement</strong></td>
<td>Can either be gross (physically) settled or net cash settled.</td>
<td>Generally provide for net cash settlement.</td>
</tr>
</tbody>
</table>

**Options**

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 as follows.

<table>
<thead>
<tr>
<th>Terms of contract</th>
<th>An option contract defines a price, referred to as the <em>strike price</em>, and establishes the term of the option, referred to as the <em>exercise period</em>.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Call or put option</td>
<td>An option contract normally provides an option holder a <em>call option</em> or a <em>put option</em>.</td>
</tr>
<tr>
<td></td>
<td>— A call option is an agreement that gives the holder the right to buy an underlying asset. This enables the holder to benefit from an increase in the value of the underlying instrument above the exercise price.</td>
</tr>
<tr>
<td></td>
<td>— A put option is an agreement that gives the holder the right to sell an underlying asset. This enables the holder to benefit from a decrease in the value of the underlying instrument below the exercise price.</td>
</tr>
<tr>
<td>American or European options</td>
<td>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.</td>
</tr>
</tbody>
</table>
An option holder 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 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. 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).

Before an entity can consider an option contract or a combination of option contracts as a hedging instrument, it must determine whether the option or combination is a net purchased option (i.e. an option purchased by the entity) or a net written option (i.e. an option written by the entity). This determination is not always as simple as it may seem.

If the option or combination is a net written option, the hedging relationship must meet the written option test for the option to be a hedging instrument. For further guidance, see sections 2.7.50 and 2.7.60.

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**Example 2.6.20**

**Hedging strategy using a purchased option**

**Fair value hedge**

ABC Corp. issues a fixed-rate debt instrument and wishes to hedge its exposure to changes in fair value related to decreases in the benchmark interest rate.

When hedging only one side of a prescribed risk exposure (e.g. a decrease), the hedging instrument must be effective at providing a one-sided offset.

ABC locks in a maximum value for the fixed-rate debt instrument by purchasing an interest rate floor option. ABC will receive payment at the end of each period in which the benchmark interest rate is below the agreed floor strike price.
Cash flow hedge

ABC issues a variable-rate debt instrument and wishes to hedge its exposure to an increase in the contractually specified interest rate.

ABC locks in the maximum interest to be paid for the variable-rate debt instrument by purchasing an interest rate cap option. ABC will receive payment at the end of each period in which the benchmark interest rate is above the agreed cap strike price.

Question 2.6.20
Can an option with multiple underlyings be used as a hedging instrument?

Background: The financial marketplace develops complex option contracts that simultaneously mitigate the effects of a variety of risks. Often, these complex options contain multiple underlyings and are structured to achieve certain economic results.

Interpretive response: Yes, if all hedge criteria are met, an option with multiple underlyings can be used as a hedging instrument. This includes the following.

— The hedging relationship must be expected to be (and actually be) highly effective throughout the hedge period. It is not permissible to designate (as the hedged risk) a specific risk but only when another specific risk is also present, even when a 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.

— If the hedged item or forecasted transaction is a group of individual items or transactions, each item in the group must share the same risk exposure for which they are designated as being hedged. See sections 3.3.30 and 5.3.60 regarding similarity for fair value and cash flow hedges, respectively.

See Example 16 in Subtopic 815-20 (reproduced below) for an example of attempting to use an option with multiple underlyings as a hedging instrument.
FASB Example: Oil-linked interest rate cap as hedging instrument

Excerpt from ASC 815-20

>> Example 16: Oil-Linked Interest Rate Cap as Hedging Instrument

55-156 This Example illustrates whether an oil-linked interest rate cap can be designated in a qualifying hedging relationship.

55-157 Entity A enters into a complex option contract with multiple underlyings for which no net premium is received. The payoffs under the contract are nontraditional. Entity A wishes to designate the option in a cash flow hedging relationship. Specifically, Entity A is an oil producer with five-year variable-rate debt (indexed to three-month LIBOR) and is concerned that an environment of falling oil prices and rising interest rates could affect its ability to meet increasing interest payments on the variable-rate debt. To limit its exposure, Entity A enters into a five-year oil-linked interest rate cap with a notional amount equal to the principal amount of Entity A’s three-month LIBOR-based variable-rate debt.

55-158 Under the terms of the oil-linked interest rate cap (a complex option), Entity A receives specified payments if both of the following conditions exist:

a. 3-month LIBOR is greater than 7 percent
b. The price of oil is less than $25 per barrel.

55-159 Specifically, if both of the conditions in the preceding paragraph are met, Entity A receives payments under the oil-linked interest rate cap equal to the increased interest payments (that is, for floating-rate amounts above 7 percent) due on their floating-rate debt.

55-160 However, if the daily price of oil goes above $25 per barrel at any time during a quarter, the option is knocked out for only that specific quarter. The option’s knock-out feature is reset each quarter such that the interest rate coverage is knocked out for a specific quarter only if the daily price of oil goes above $25 per barrel at any time during that specific quarter. Thus, the option limits Entity A’s exposure to increases in interest rates for all quarters in which oil prices remain under $25 per barrel throughout the quarter.

55-161 The oil-linked interest rate cap cannot be designated in a hedge of the variability in the difference between interest payments and sales proceeds on oil. The oil-linked interest rate cap purchased by Entity A is attempting to hedge Entity A’s exposure to variability in the net cash flows related to certain revenue inflows and certain expense outflows. Entity A wishes to reduce the risk that an increase in cash outflows due to increases in interest rates will occur without a concurrent increase in cash inflows due to increases in the price of oil per barrel. Those are separate and dissimilar risks that Entity A wishes to hedge with a single derivative instrument. Thus, the hedged forecasted transaction cannot be a group of oil sales inflows and interest payment outflows. This Subtopic is not structured to permit hedge accounting...
for strategies involving hedges of a spread between revenues and expenses as Entity A is attempting to accomplish.

55-162 The oil-linked interest rate cap cannot be designated in a hedge of the variability in interest cash flows attributable to changes in LIBOR above 7 percent. Entity A could not simply define its hedged risk as the risk of changes in cash flows attributable to changes in the three-month LIBOR rate for only those periods when the price of oil per barrel is below a specified dollar amount.

55-163 If Entity A wanted to designate the oil-linked interest rate cap as a cash flow hedge of the variability in interest payments on the LIBOR-based variable-rate debt due to changes in interest rates above the contractually specified 7 percent rate in the interest rate cap, Entity A would be required to assess effectiveness whenever interest rates were above that 7 percent rate. Because the cap also has an underlying related to oil prices, there could be times when interest rates will be above the contractually specified interest rate in the cap but the complex option will not result in any cash flows because the selling price of oil is not below the contractually specified price per barrel ($25). In other words, the complex option will be out of the money but Entity A will be required to assess the option’s effectiveness in offsetting the increase in interest payments for the effect of the excess of 3-month LIBOR over 7 percent.

55-164 Generally, it would be unlikely that Entity A could conclude that the oil-linked interest rate cap is expected to be highly effective in achieving offsetting cash flows if it is reasonably possible that the oil-linked option will knock out the cash inflows from the derivative instrument. In its assessment of the effectiveness of the hedge of the interest payments on the variable-rate debt, Entity A must consider the likelihood that the interest-rate protection from the oil-linked interest rate cap may be knocked out due to oil prices exceeding the contractually specified amount per barrel and it may not exclude from its assessment of effectiveness those periods when the interest rate protection is knocked out. For those quarters when the cap is knocked out, there are no cash flows from the cap to be used to offset the change in the cash flows on the hedged forecasted transaction.

55-165 In the unlikely event that Entity A was able to conclude that the relationship was expected to be highly effective (because the complex option was expected to be highly effective for all changes in the three-month LIBOR rate above the contractually specified rate due to the remoteness that the price of oil per barrel would not be below the contractually specified amount over the contractual life of the debt), the complex option could be used as the hedging derivative.

55-166 The oil-linked interest rate cap cannot be designated in a hedge of the variability in proceeds from the forecasted sale of oil. If Entity A wanted to designate the oil-linked interest rate cap as a cash flow 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, the hedging relationship would fail to qualify under paragraph 815-20-25-75(b) because the cash inflows from the oil-linked interest rate cap are calculated based on the debt’s principal amount and the excess of 3-month LIBOR over 7 percent. Because the cash inflows from the oil-linked interest rate cap are unrelated to
2.6.30 Proportion of a derivative

An entity may designate all or a proportion of a derivative as the hedging instrument. If a proportion is designated, it must be a percentage of the entire derivative instrument.

This means the risk exposure profile in a proportion of a derivative instrument must be the same as the entire derivative instrument. [815-20-25-71(a)(2)]

Similarly, an entity cannot separate a compound derivative instrument and designate one dissimilar component as the hedging instrument (see section 2.7.40). [815-20-25-71(a)(2)]

The following table includes examples of separate components of derivatives that are not permitted as hedging instruments.

<table>
<thead>
<tr>
<th>Type of derivative instrument</th>
<th>Example components not permitted to be designated as hedging instrument (not exhaustive)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Six-year interest rate swap</td>
<td>Separating periods of the interest rate swap as the hedging instrument – e.g. a swap for the first three years and another swap for the remaining three years.</td>
</tr>
</tbody>
</table>
| Cross-currency interest rate swap | Separating the interest rate swap component to solely hedge interest rate risk.  
|                                | Separating the foreign currency swap component to solely hedge foreign currency risk. |
| Interest rate swap containing an embedded written option (e.g. an indexed-amortizing swap) | Separating the swap and written option components, and using only one component as the hedging instrument. |

Designating a proportion of a hedging instrument is a significantly different concept from designating a portion of an asset, liability, firm commitment or forecasted transaction as the hedged item or transaction.

The designated portion of the item or transaction can have characteristics different from the entire item or transaction. For example, a call option embedded in a debt obligation could be separately designated as the hedged item. In contrast, as demonstrated in the table above, an embedded written option within a derivative instrument cannot be separately designated as the hedging instrument.
Can different proportions of the same derivative instrument be designated in different hedging relationships?

Interpretive response: Yes. Topic 815 does not explicitly prohibit an entity from designating different proportions of the same derivative instrument in different hedging relationships.

For example, an entity with a $70 million debt instrument designates 70% of an interest rate swap with a notional amount of $100 million to hedge interest rate risk. The remaining 30% of the interest rate swap – i.e. $30 million notional amount of the swap – is eligible to be designated in a different hedging relationship, provided all other qualifying criteria have been met.

If the remaining proportion is not designated in a hedging relationship, it is accounted for as a derivative instrument under Topic 815 with changes in fair value recognized in earnings.

Can the first 10 years of a 15-year interest rate swap be designated as a portion of the hedging instrument?

Interpretive response: No. An entity is prohibited from 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.

Separating an interest rate swap into components that represent different risks

ABC Corp. issues a 10-year variable-rate debt instrument based on LIBOR. At the same time, ABC enters into a 15-year interest rate swap to receive interest at a variable rate (based on LIBOR) and to pay interest at a fixed rate.

ABC cannot hedge 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 (as opposed to a proportion) of the entire derivative instrument.
Example 2.6.40  
**Interest rate swap to hedge a portion of a hedged item or transaction**

**Cash flow hedge**
Assume the same facts as Example 2.6.30, except that ABC enters into a five-year interest rate swap.

ABC is permitted to hedge the variability in cash flows during the first five years of the 10-year variable-rate debt instrument using a five-year interest rate swap.

Similarly, ABC can hedge variability in cash flows during the last five years of the 10-year variable-rate debt instrument if the swap was entered into at the beginning of the sixth year of the variable-rate debt instrument, or in the first year if the swap was forward-starting.

**Fair value hedge**
ABC can designate a partial-term hedge for the last five years of a 10-year fixed-rate debt instrument using a five-year forward-starting interest rate swap that starts in Year 6. For guidance on partial-term hedges, see section 3.3.80.

### 2.6.40 Combination of derivatives
An entity can designate a combination of two or more derivative instruments as the hedging instrument. For example, put and call options can be combined and treated as one hedging instrument. In addition, either all or a proportion of the combined derivative hedging instruments may be designated as the hedging instrument.

Combining derivatives as the hedging instrument may be necessary for a hedging relationship to be considered highly effective.

The following table demonstrates how an interest rate swap and an option contract could be designated in a fair value or cash flow hedge for a hedged item or transaction with an embedded option.
The debt security’s fair value or cash flows could be affected in amounts that are different from the interest rate swap’s fair value or cash flows due to the embedded option.

The combination of two or more derivatives must be formally documented (see section 2.9.20).

Example 2.6.50

Combination of an interest rate swap and put option to hedge fixed-rate debt with an embedded call option

ABC issues a 10-year fixed-rate debt instrument with a 7% interest coupon that is callable at par at the end of Year 6. The embedded option is not required to be bifurcated under Topic 815.

ABC decides to effectively convert the interest payments from fixed to variable by entering into a 10-year receive-fixed, pay-variable interest rate swap.

For the interest rate swap to be designated as the hedging instrument, it needs to be highly effective in offsetting changes in fair value of the debt attributable to interest rate risk taking into account the effect of the embedded call option (see section 3.4.10). This is because the embedded prepayment option is exercisable during the hedge period – i.e. ten years.

In combination with the interest rate swap, ABC writes a put option on a swap (i.e. a swaption) that provides ABC with the option to put (sell) an interest rate swap in six years. The terms of the interest rate swap are such that ABC will receive LIBOR and pay 7% interest.

To designate the combination of the interest rate swap and put option as the hedging instrument, Topic 815 requires symmetry of the gain and loss potential of the combined hedged position – i.e. the written option test (see section 2.7.50).

Example 2.6.60

Multiple instruments to hedge interest rate risk

ABC Corp. has five-year variable-rate debt that is based on the Prime rate. ABC wants to hedge the variability in interest payments and enters into the following interest rate swaps:

— Pay LIBOR + 175 bps and receive Prime
— Pay fixed of 4.75% and receive LIBOR + 175 bps

In combination, these interest rate swaps would hedge the variability of the contractually specified interest payment cash flows on the Prime-based debt. ABC may jointly designate the swaps as the hedging instrument.
Question 2.6.50
Can additional derivative instruments be added to an existing hedging relationship?

Interpretive response: No. When using multiple derivatives in a hedge, they must be designated at the same time. An entity is not permitted to add derivative instruments to an existing hedging relationship. This would be considered a change in the hedging relationship and would require its redesignation (see section 2.10.30).

However, derivative instruments entered into at different times could be used in a new hedging relationship involving an item that is already subject to another hedge, assuming there is no duplication of hedged risk.

For example, an entity has a 10-year financial instrument denominated in a foreign currency. In Year 1, the entity may wish to hedge interest rate risk by entering into an interest rate swap in the foreign currency. If the entity wishes to hedge foreign currency exposure at a later date, it could enter into a forward contract to lock in an exchange rate. These are simultaneous hedges and would be considered separate hedging relationships. For guidance on simultaneous hedges, see section 2.3.80.

Question 2.6.60
When should two freestanding derivatives be viewed as a single derivative instrument?

Interpretive response: Topic 815 generally does not provide for the combination of separate financial instruments to be evaluated as a unit, unless two or more derivative instruments in combination are jointly designated as a hedging instrument. [815-10-25-6, 815-20-25-45]

However, there may be situations where an entity attempts to circumvent US GAAP by entering into two separate derivative instruments. In this case, Topic 815 requires the separate derivative instruments to be viewed as a unit for recognition purposes. [815-10-25-6]

If the separate derivative instruments have all of the following characteristics, an entity needs to consider whether the overall intent is to circumvent US GAAP. [815-10-15-9, 815-10-25-6]

— separate derivative contracts are entered into contemporaneously and in contemplation of one another;
— they are entered into with the same counterparty;
— they relate to the same risk; and
— there is no substantive business purpose for structuring the transactions separately.

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. Simultaneously it enters into another interest rate swap with the same counterparty, with terms that are the exact mirror image of the first swap, and treats the second swap as speculative.
In this instance, the entity needs to assess whether the combination of derivatives should be considered as a unit. To make this assessment, the entity needs to determine if the interest rate swaps were entered into in contemplation of one another for the sole purpose of obtaining fair value hedge accounting for the debt (which is not appropriate under US GAAP). If that was the sole purpose, the entity should conclude that the purpose of the transaction was not to enter into a bona fide hedging relationship involving the first swap.

If that is the case, the two swaps are viewed as a unit and do not qualify in the hedging relationship because the two derivatives would not be expected to be highly effective in offsetting changes in the fair value of the debt.

Such a determination will often be highly subjective and difficult to apply in practice. Therefore, it will require a significant amount of judgment and will be based on the facts and circumstances associated with the specific transaction in question.

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**Example 2.6.70**

**Two concurrent swaps not viewed as a unit**

The following example is adapted from Example 18 in Subtopic 815-10.

ABC Corp. is the issuer of fixed-rate debt. To hedge the fair value exposure of the debt to interest rate risk, ABC enters into an interest rate swap (Swap 1). Assume all criteria are met to apply hedge accounting.

ABC simultaneously enters into a second interest rate swap (Swap 2) with the same counterparty and the exact mirror terms as Swap 1. ABC does not designate Swap 2 as part of a hedging relationship.

For purposes of this example, ABC has a substantive business purpose for structuring the transactions separately, and both Swap 1 and Swap 2 are entered into in arms-length transactions (i.e. at market rates). Therefore, Swap 2 is not entered into in contemplation of Swap 1.

**Is ABC required to view the two swaps as a unit?**

The swaps are entered into simultaneously with the same counterparty and relate to the same risk, both of which may indicate the overall intent of the transaction is to circumvent US GAAP.

However, Swap 2 is not entered into in contemplation of Swap 1 and the overall transaction is not executed for the sole purpose of obtaining fair value hedge accounting treatment for the debt. In other words, there is a substantive business purpose for structuring the transactions separately and both swaps are entered into in arms-length transactions. Therefore, the swaps should not be viewed as a unit.

If it was determined that ABC entered into the transaction to circumvent US GAAP, the two swaps would be viewed as a unit and ABC would not be permitted to adjust the carrying amount of the debt to reflect changes in fair value attributable to interest rate risk.
2.7 Limitations on hedging instruments

2.7.10 Overview

Excerpt from ASC 815-20

>> Instruments Specifically Ineligible for Designation as Hedging Instruments

25-71 Besides those hedging instruments that fail to meet the specified eligibility criteria, none of the following shall be designated as a hedging instrument for the respective hedges:

a. With respect to fair value hedges, cash flow hedges, and net investment hedges:
   1. A nonderivative instrument, such as a U.S. Treasury note, except as provided in paragraphs 815-20-25-58 through 25-59 and 815-20-25-66
   2. Components of a compound derivative instrument representing different risks
   3. A hybrid financial instrument that an entity irrevocably elects under paragraph 815-15-25-4 to initially and subsequently measure in its entirety at fair value (with changes in fair value recognized in earnings)
   4. A hybrid instrument for which an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 815-15-25-1 requires be separated from the host contract
   5. Any of the individual components of a compound embedded derivative that is separated from the host contract.

b. With respect to fair value hedges only:
   1. A nonderivative financial instrument as the hedging instrument in a fair value hedge of the foreign currency exposure of a recognized asset or liability.
   2. A nonderivative financial instrument as the hedging instrument in a fair value hedge of the foreign currency exposure of an available-for-sale security.

c. With respect to cash flow hedges only:
   1. A nonderivative financial instrument as a hedging instrument in a foreign currency cash flow hedge.

d. With respect to net investment hedges only:
   1. A compound derivative instrument that has multiple underlyings—one based on foreign exchange risk and one or more not based on foreign exchange (for example, the price of gold or the price of an S&P 500
contract), except as indicated in paragraph 815-20-25-67 for certain cross-currency interest rate swaps
2. A derivative instrument and a cash instrument in combination as a single hedging instrument (that is, an entity shall not consider a separate derivative instrument and a cash instrument as a single synthetic instrument for accounting purposes)

 Topic 815 specifically prohibits the instruments listed in the above excerpt from being designated as hedging instruments. This section discusses these prohibited instruments, as well as limitations involving written options.

2.7.20 Nonderivative instruments

Nonderivative instruments are not eligible to be designated as hedging instruments for fair value or cash flow hedges, except in limited circumstances for fair value hedges of foreign currency risk and net investment hedges. [815-20-25-71]

In general, the FASB believes that accounting for a nonderivative instrument as a hedging instrument is inappropriate because: [FAS 133.BC246–BC247]

— 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.

If an entity uses a nonderivative instrument to economically hedge an item or a forecasted transaction (e.g. a fixed-rate asset to hedge a fixed-rate liability), the nonderivative instrument must be accounted for based on the relevant accounting requirements for those instruments. Hedge accounting is generally only allowed for hedging relationships that involve instruments that meet the characteristics-based definition of a derivative.

Foreign currency risk. In a foreign currency fair value hedge, an unrecognized FCD firm commitment may be hedged with a derivative or nonderivative financial instrument (see section 7.4.60). [815-20-25-58]

Net investment hedges. An entity may designate a nonderivative FCD financial liability as a hedging instrument for a net investment hedge (see section 8.3.10).
Can a contract that meets the definition of a derivative after acquisition by an entity qualify as a hedging instrument?

Excerpt from ASC 815-20

>>> Contingent Designation of a Hedging Instrument

55-44A A contract that meets the definition of a derivative instrument after acquisition by an entity may be designated as a hedging instrument.

55-44B During the period in which the contract does not meet the definition of a derivative instrument, that contract cannot be designated as the hedging instrument in any hedging relationship. (However, the contract could potentially be the hedged item in a fair value hedge or its cash flows could potentially be the hedged transactions in a cash flow hedge.)

55-44C The contingent designation of a hedging relationship in which the hedging instrument is not currently a derivative instrument but may become one cannot justify the application of hedge accounting to fair value changes occurring before inception of the hedge; the inception of that hedging relationship would be the date on which the contract meets the definition of a derivative instrument. If an entity had anticipated that a contract that was not a derivative instrument at inception might later meet the definition of a derivative instrument and has made a contingent designation of an all-in-one hedging relationship to be effective upon the date that the contract meets the definition of a derivative instrument, only the changes in the fair value of the new derivative instrument occurring after the date the contract became a derivative instrument would be recognized in other comprehensive income.

Interpretive response: Yes. However, the contract cannot be designated as a hedging instrument during the period in which the contract does not meet the definition of a derivative. [815-20-55-44A – 55-44B]

An entity cannot designate a hedging relationship based on an instrument that is not currently a derivative, but may become one in the future. The inception of that hedging relationship would not be until the contract meets the definition of a derivative instrument. [815-20-55-44C]
2.7.30 Intercompany derivatives

> Eligibility of Hedging Instruments

>> Intra-entity Derivatives

25-46A There is no requirement in this Subtopic that the operating unit with the interest rate, market price, or credit risk exposure be a party to the hedging instrument. Thus, for example, a parent entity’s central treasury function can enter into a derivative instrument with a third party and designate it as the hedging instrument in a hedge of a subsidiary’s interest rate risk for purposes of the consolidated financial statements. However, if the subsidiary wishes to qualify for hedge accounting of the interest rate exposure in its separate-entity financial statements, the subsidiary (as the reporting entity) shall be a party to the hedging instrument, which can be an intra-entity derivative obtained from the central treasury function. Thus, an intra-entity derivative for interest rate risk can qualify for designation as the hedging instrument in separate-entity financial statements but not in consolidated financial statements. (As used in this guidance, the term subsidiary refers only to a consolidated subsidiary. This guidance shall not be applied directly or by analogy to an equity method investee.)

25-46B An intra-entity derivative shall not be designated as the hedging instrument if the hedged risk is any of the following:

a. The risk of changes in the overall fair value or cash flows of the entire hedged item or transaction
b. The risk of changes in hedged item’s or transaction’s fair value attributable to changes in the designated benchmark interest rate or cash flows attributable to changes in the contractually specified interest rate or designated benchmark interest rate
c. The risk of changes in hedged item’s or transaction’s fair value or cash flows attributable to changes in credit risk.
d. The risk of variability in cash flows attributable to changes in a contractually specified component to purchase or sell a nonfinancial asset.

Similarly, a derivative instrument contract between operating units within a single legal entity shall not 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.

Intra-entity derivatives (i.e. intercompany derivatives) are derivative instruments between two members of a consolidated group. [815-20 Glossary]

Topic 815 explicitly prohibits an entity from designating an intercompany derivative as the hedging instrument in the consolidated financial statements for certain hedged risks, which is illustrated in the following table. [815-20-25-46B]
2. General hedging requirements

<table>
<thead>
<tr>
<th>Type of risk</th>
<th>Intercompany derivative permitted in consolidated financial statements?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate risk</td>
<td>✗</td>
</tr>
<tr>
<td>Credit risk</td>
<td>✗</td>
</tr>
<tr>
<td>Foreign currency risk</td>
<td>✓</td>
</tr>
<tr>
<td>Price risk</td>
<td>✗</td>
</tr>
</tbody>
</table>

This prohibition is because an intercompany derivative would be eliminated in consolidation, thereby leaving the consolidated financial statements exposed to changes in fair value or variability in cash flows.

**Foreign currency risk.** Topic 815 allows intercompany derivatives to be designated as hedging instruments for hedges of foreign exchange risk if certain conditions are met. See the following sections for further guidance:

- **Fair value hedges** (section 7.4.70);
- **Cash flow hedges** (section 7.6.60); and
- **Net investment hedges** (section 8.3.10).

For interest rate risk, credit risk and price risk, only a derivative instrument with a third party can be designated as the hedging instrument in the consolidated financial statements. [815-20-25-46B]

**Question 2.7.20**

**Is a subsidiary with exposure to the hedged risk required to be a party to the hedging instrument to apply hedge accounting at the consolidated level?**

**Interpretive response:** There is no requirement in Topic 815 that a subsidiary with the exposure to the hedged risk(s) be a party to the hedging instrument. For example, a parent entity’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 wishes to qualify for hedge accounting in its stand-alone financial statements, the subsidiary must be a party to the hedging instrument.

**Foreign currency risk.** There are additional requirements when a subsidiary with exposure to foreign currency risk is not a party to the hedging instrument – i.e. the foreign currency derivative (see section 7.3.20): [815-20-25-30]

- another member of the consolidated group that has the same functional currency as the operating unit must be a party to the hedging instrument; and
- there is no intervening subsidiary with a different functional currency.
Question 2.7.30
Is an intercompany derivative eligible to be designated as a hedging instrument in the stand-alone financial statements of a subsidiary?

**Interpretive response:** Yes. A subsidiary could enter into an intercompany derivative obtained from a parent entity’s central treasury function and designate it as the hedging instrument in its stand-alone financial statements.

However, that intercompany derivative instrument cannot be the hedging instrument in the consolidated financial statements. Therefore, unless the parent entity enters into an offsetting third-party derivative (see Question 2.7.40), the hedge accounting applied at the subsidiary’s stand-alone financial statements has to be reversed in consolidation.

Question 2.7.40
Can a parent offset an intercompany derivative with a third-party derivative and apply hedge accounting in the consolidated financial statements?

**Interpretive response:** Yes. If a parent entity’s central treasury function enters into a derivative contract with an unrelated third party to completely offset the risk arising from an 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.

**Cash flow hedges.** There is an exception for foreign currency cash flow hedges of a forecasted transaction or an unrecognized firm commitment, whereby the third-party derivative may offset the exposure to multiple intercompany derivatives on a net basis for each foreign currency (see section 7.6.70).

### 2.7.40 Hybrid instruments and compound derivatives

The following table summarizes the limitations on designating certain hybrid instruments and compound derivatives (or portions thereof) as hedging instruments.

<table>
<thead>
<tr>
<th>Type of instrument</th>
<th>Definition</th>
<th>Limitations on designation as hedging instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hybrid instrument</td>
<td>A contract that contains both an embedded derivative and a host contract. [815-15 Glossary]</td>
<td>Hybrid instruments that are elected to be measured at fair value in their entirety cannot be designated as hedging instruments. [815-15-25-4, 815-20-25-71(a)(3)]</td>
</tr>
</tbody>
</table>
### Type of instrument | Definition | Limitations on designation as hedging instruments
---|---|---
**Embedded derivative** | A derivative within a nonderivative host contract. [815-15 Glossary]
An embedded derivative instrument must be separated from the host contract and accounted for as a derivative instrument if certain criteria are met. [815-15-25-1] | Bifurcated embedded derivatives may be designated as a hedging instrument. An entity cannot separate the components of a compound derivative and designate a component with dissimilar risks as a hedging instrument. [815-20-25-71(a)(2)] For example, an entity cannot separately designate the option component of a swaption as the hedging instrument. |
**Compound derivative** | The combination of two derivatives into a single instrument. An example of a compound derivative is an option to enter into an interest rate swap when exercised – i.e. a swaption. | An entity cannot separate the components of a compound derivative and designate a component with dissimilar risks as a hedging instrument. [815-20-25-71(a)(2)] For example, an entity cannot separately designate the option component of a swaption as the hedging instrument. |
**Compound derivative with more than one embedded derivative** | If a hybrid instrument contains more than one embedded derivative feature that would individually warrant separate accounting as a derivative instrument, those embedded features must be bundled together as a single, compound embedded derivative instrument. [815-15-25-7] The compound embedded derivative is then bifurcated and accounted for separately from the host contract. [815-15-25-7 – 25-10] | An entity cannot designate as the hedging instrument any of the individual components of a compound derivative instrument that has been bifurcated from the host contract. [815-20-25-71(a)(5)] |

#### 2.7.50 Special rule for written options

**Excerpt from ASC 815-20**

>>> **Hedge Effectiveness of Written Options**

**25-94** If a written option is designated as hedging a recognized asset or liability or an unrecognized firm commitment (if a fair value hedge) or the variability in cash flows for a recognized asset or liability or an unrecognized firm commitment (if a cash flow hedge), the combination of the hedged item and the written option provides either of the following:

a. At least as much potential for gains as a result of a favorable change in the fair value of the combined instruments (that is, the written option and the hedged item, such as an embedded purchased option) as exposure to losses from an unfavorable change in their combined fair value (if a fair value hedge)
b. At least as much potential for favorable cash flows as exposure to unfavorable cash flows (if a cash flow hedge).

25-95 The written-option test in the preceding paragraph shall be applied only at inception of the hedging relationship and is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide either of the following:

a. At least as much gain as the loss that would be incurred from an unfavorable change in the underlying of the same percentage (if a fair value hedge)

b. 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 (if a cash flow hedge).

25-96 The time value of a written option (or net written option) may be excluded from the written-option test if, in defining how hedge effectiveness will be assessed, the entity specifies that it will base that assessment on only changes in the option’s intrinsic value. In that circumstance, the change in the time value of the options would be excluded from the assessment of hedge effectiveness in accordance with paragraph 815-20-25-82(a).

25-97 When applying the written-option 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.

When hedging with a written option, Topic 815 requires that additional conditions be met along with all the other hedge criteria.

In general, an option is a contract that provides the holder with the right, but not the obligation, to buy or sell something 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 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.

With option contracts, the holder and the writer have different exposures.
Option holder

The option holder acquires the option to offset a possible future risk.
The option is exercised when the terms are favorable to the option holder. When market conditions cause the option to have no value to the holder (i.e. the option is out of the money), the option is not exercised.
Therefore, the maximum potential for loss is limited to the premium paid.

Option writer

The option writer is compensated up-front by a premium and remains exposed to the risk of fluctuations in the price of the underlying.
There is no limit to the option writer’s downside exposure if the option is in the money, which is when terms are unfavorable to the option writer.
The maximum potential for gain is limited to the initial premium received. This is because the holder will not exercise an option when it is out of the money, which is when terms are favorable to the option writer.

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.

The FASB 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. However, the FASB decided to allow written options to be the derivative hedging instrument in very limited circumstances. [FAS 133.BC396–BC 397]

For a written option to be designated as a hedging instrument: [815-20-25-94 – 25-95]
— the hedged item or transaction must involve recognized assets or liabilities or unrecognized firm commitments; and
— there must be symmetry of the gain and loss potential of the combined hedged position (i.e. the written option test).

Hedge effectiveness. There are also a variety of issues associated with assessing hedge effectiveness in hedging relationships involving option contracts. These issues are discussed in section 9.2.90.

Question 2.7.50

Is an interest rate swaption a purchased option or a written option?

Background: 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.

**Interpretive response:** We believe an interest rate swaption represents a purchased option from the perspective of the buyer.

In contrast, an interest rate swaption represents a written option from the perspective of the writer and must pass the written option test to be eligible as a hedging instrument (see Question 2.7.110).

### Written option test

To qualify for hedge accounting, Topic 815 requires symmetry of the gain and loss potential of the combined hedged position. The combination of the hedged item or transaction and the written option needs to provide at least as much potential for gains (or favorable cash flows) as potential for losses (or unfavorable cash flows).

<table>
<thead>
<tr>
<th>Hedged item or transaction</th>
<th>Written option</th>
<th>Potential for gains (favorable cash flows)</th>
<th>≥</th>
<th>Potential for losses (unfavorable cash flows)</th>
</tr>
</thead>
</table>

The written option test is met for a fair value or cash flow hedge if the following is true.

**Fair value hedge**

Combination of the hedged item and 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. [815-20-25-95(a)]

**Cash flow hedge**

Combination of the hedged transaction and 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. [815-20-25-95(b)]

For example, this condition is 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 (e.g. because they are clearly and closely related).
An entity may also use hedging strategies that involve a combination of option contracts, which is discussed in section 2.7.60.

**Question 2.7.60**

**How does an entity measure the potential gain or loss on the combination of the written option (or net written option) and the hedged item?**

**Interpretive response:** For the written option test to be met, there needs to be symmetry of gains and losses (or favorable and unfavorable cash flows) for all possible percentage changes in the underlying. When applying the written option test, an entity is permitted to exclude the time value of a written option (or net written option) if the entity specifies that it will base its effectiveness assessment only on changes in the option’s intrinsic value. For guidance on excluding the time value from effectiveness assessments when using options as the hedging instrument, see section 9.2.90. [815-20-25-96 – 25-97]

Therefore, when performing the written option 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. Using this approach results in a higher chance of achieving a symmetrical return.

Examples 2.7.10, 2.7.20 and 2.7.30 illustrate how to perform a written option test considering only changes in the option’s intrinsic value.

**Question 2.7.70**

**How often should the written option test be performed?**

**Interpretive response:** An entity is required to perform the written option test only at the inception of the hedging relationship that involves a written option. [815-20-25-95]

The requirement to consider this 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.

The other hedge criteria must be met throughout the life of the hedging relationship.
Question 2.7.80

Is the written option test performed using the strike price contained in the option contract or the current price of the underlying?

Interpretive response: We believe the written option 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, with the exception of collar-based hedging relationships (see Example 2.7.50).

For example, if the strike price of the written option is $50 and the current price of the underlying is $20, the written option test is based on changes in prices of the underlying from $50 (the strike price of the option).

If the written option test were based on changes from the current price of the underlying, the written option test typically would be met when the written option is significantly out of the money. This would permit an entity to apply hedge accounting, which is contradictory to the limitations in Topic 815 for written options.

Question 2.7.90

Can a covered call strategy qualify for hedge accounting?

Excerpt from ASC 815-20

>>> No Hedge Accounting for Covered Call Strategies

55-45 This Subtopic does not permit hedge accounting for covered call strategies (strategies in which an entity writes an option on an asset that it owns) unless that asset is a call option that is embedded in another instrument. In a covered call strategy, any loss on the written option will be covered by the gain on the owned asset. A covered call strategy will not qualify for hedge accounting because the risk profile of the combined position is asymmetrical (the exposure to losses is greater than the potential for gains). In contrast, the risk profile of the asset alone is symmetrical or better (the potential for gains is at least as great as the exposure to losses). The symmetry requirement for hedges with written options precludes a written option that is used to sell a portion of the gain potential on an asset or liability from being eligible for hedge accounting.

Background: A covered call strategy is when an entity owns an asset and writes a call option on that same asset in an attempt to generate premium income.

For example, ABC Corp. owns inventory with a market value of $10,000. ABC writes a call option such that XYZ can purchase inventory from ABC at a price of
$10,000 (i.e. the strike price) at any time over the next 12 months. ABC receives a premium of $1,000 for entering into the contract.

**Interpretive response:** Topic 815 explicitly prohibits an entity from applying hedge accounting to covered call strategies. [815-20-55-45]

Although the fair value attributable to the written option is covered by the increase in the fair value attributable to the owned asset (i.e. the inventory), the covered call strategy changes the risk profile from symmetrical to asymmetrical.

<table>
<thead>
<tr>
<th>Symmetrical exposure</th>
<th>Asymmetrical exposure</th>
</tr>
</thead>
<tbody>
<tr>
<td>The potential for favorable changes in fair value is at least as great as the exposure to unfavorable changes in fair value.</td>
<td>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.</td>
</tr>
</tbody>
</table>

Continuing the example, ABC is provided with a premium of $1,000. However, the written option exposes ABC to unlimited economic loss in the event that the market value of its inventory increases above $10,000. This is because ABC is required to sell XYZ inventory at a price of $10,000, regardless of the market price above $10,000.

**Example 2.7.10**

**Written option does not qualify for hedge accounting**

Farm Inc. has 1 million pounds of cotton with a carrying amount of $800,000. The market value of cotton is currently 90 cents per pound ($900,000).

Farm believes the market value of cotton is going to decline over the next six months. To limit exposure from a decline in value, Farm writes a call option that provides Jeans Co. with the ability to purchase Farm’s cotton at a price of 88 cents per pound. In return for writing this call option, Farm receives a premium of $10,000.

All other criteria for hedge accounting have been met.

**Written option test**

The combination of the written option and the hedged item (i.e. 1 million pounds of cotton) must provide as much potential for gain as potential for loss.

<table>
<thead>
<tr>
<th>Potential for gain</th>
<th>Potential for loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>— 15% increase in market value of cotton to $1.01 as compared to the 88 cent strike price.</td>
<td>— 15% decrease in market value of cotton to 75 cents as compared to the 88 cent strike price.</td>
</tr>
<tr>
<td>— Results in a cumulative net economic gain of $10,000 on the combination of the written option and hedged item.</td>
<td>— Results in economic loss of $120,000 from the combination of the written option and hedged item.</td>
</tr>
</tbody>
</table>
Notes:

1. The $130,000 potential economic gain on cotton for the increase in market value, as compared with the 88 cent strike price of the written option, is fully offset by the intrinsic value loss on the written option. This leaves Farm with $10,000 premium received on the written option.

2. The $130,000 economic loss on cotton, as compared to the 88 cent strike price of the written option, less $10,000 premium received on the written option. The written option’s intrinsic value is zero.

This written option does not qualify for hedge accounting because the combination of the written option and the hedged cotton inventory does not always provide as much potential for gain as potential for loss.

**Could Farm apply hedge accounting with a purchased option contract?**

Yes, assuming all other hedge criteria are met. Farm could purchase a put option from a third-party at a similar strike price of 88 cents per pound. This would give Farm the right to sell 1 million pounds of cotton.

If the market value of cotton decreased to 75 cents, the option would be in the money and Farm would exercise the option.

Unlike written options, purchased options do not expose the holder to unlimited loss.

**Example 2.7.20**

**Written option qualifying as a hedge of an embedded call option in a debt obligation**

ABC Corp. 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 ABC in three years at par.

ABC wishes to hedge the risk of a decrease in the fair value of the embedded call option attributable to increases in interest rates. For guidance on designating embedded put or call options in a fair value hedge, see section 3.3.90.

ABC writes an option on a swap (i.e. a swaption) that provides Bank with the option to put (sell) an interest rate swap to ABC in three years. The terms of the interest rate swap are such that ABC will receive LIBOR and pay 10% on a notional amount of $100,000 for two years. ABC receives a premium of $1,000 for writing this option.

All other criteria for hedge accounting have been met.

**Written option test**

Although many swaptions will not pass the written option test, in this instance the written option (i.e. the swaption) qualifies for hedge accounting. In this specific case, the combination of the written option and the embedded call option will 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.
### Potential for gain

If interest rates decrease:
- ABC will call the debt obligation; and
- Bank will exercise its option.

### Potential for loss

If interest rates increase:
- ABC will not call the debt obligation; and
- Bank will not exercise its option.

In either case, ABC will receive $1,000 in premium for writing the option.

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### Example 2.7.30

**Written option qualifying as a hedge of an embedded cap in a long-term supply contract**

ABC Corp. enters into a long-term supply contract with a vendor to purchase a specified amount of a certain material. The purchase price is the current monthly average list price for the quantity delivered each month, but not to exceed $20 per pound. The current list price at the contract signing date is $15 per pound.

The contract meets the definition of a firm commitment and the embedded price cap is not required to be separated under Topic 815 (see Question 3.3.290).

ABC 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. For guidance on designating embedded put or call options in a fair value hedge, see section 3.3.90.

Accordingly, ABC writes a net cash settled call option with Bank with a strike price of $20 per pound and a notional amount equal to the quantity specified in the supply contract. ABC receives a premium of $1,000 for writing this option.

#### Written option test

This written option would qualify for hedge accounting because the combination of the written option and the embedded purchased call option will always provide as much potential for gain as potential for loss. This is because the terms of the options are the same.

<table>
<thead>
<tr>
<th>Potential for gain</th>
<th>Potential for loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>If market prices rise to $22 per pound:</td>
<td>If the price of materials remains below $20 per pound, neither the purchased nor the written call option has intrinsic value.</td>
</tr>
<tr>
<td>- 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 $20 per pound while the market price has risen; and</td>
<td></td>
</tr>
<tr>
<td>- 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.</td>
<td></td>
</tr>
</tbody>
</table>

In either case, ABC will receive $1,000 in premium for writing the option.
FASB Example: Attempted hedge of a forecasted sale with a written call option

Excerpt from ASC 815-30

>> Example 4: Attempted Hedge of a Forecasted Sale with a Written Call Option

55-17 This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to an attempted hedge of a forecasted sale with a written call option.

55-18 Entity J forecasts the sale in 9 months of 100 units of product with a current market price of $95 per unit. Entity J’s objective is to sell the upside potential associated with the forecasted sale by writing a call option for a premium. Entity J plans to use the premium from the call option as an offset to decreases in future cash inflows from the forecasted sale that will occur if the market price of the product decreases below $95. Accordingly, Entity J sells an at-the-money call option on 100 units of product with a strike price of $95 for a premium. The premium represents only the time value of the option. The option is exercisable at any time within nine months.

55-19 Entity J’s objective of using the premium from the written call option as an offset to any decrease in future cash inflows does not meet the notion of effectiveness in this Subtopic. Future changes in the market price of the entity’s product will not affect the premium that Entity J received, which is all related to time value in this example and thus is the maximum amount by which Entity J can benefit. That is, Entity J cannot expect the cash flows on the option to increase so that, at different price levels, a decrease in cash flows from the forecasted sale would be offset by an increase in cash flows on the option.

FASB Example: Fair value hedge of an embedded purchased option with a written option

Excerpt from ASC 815-25

>> Example 6: Fair Value Hedge of an Embedded Purchased Option with a Written Option

55-27 This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value hedge of an embedded purchased option with a written option. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.
**55-28** Entity F issues five-year, fixed-rate debt with an embedded (purchased) call option and, with a different counterparty, writes a call option to neutralize the call feature in the debt. The embedded call option and the written call option have the same effective notional amount, underlying fixed interest rate, and strike price. (The strike price of the option in the debt usually is referred to as the call price.) The embedded option also can be exercised at the same times as the written option. Entity F designates the written option as a fair value hedge of the embedded prepayment option component of the fixed-rate debt.

**55-29** To assess whether the hedge is expected to be highly effective in achieving offsetting changes in fair value, Entity F could estimate and compare the changes in fair values of the two options for different market interest rates. Because this Subtopic does not permit derivative instruments, including embedded derivatives whether or not they are required to be accounted for separately, to be separated into components, Entity F can only designate a hedge of the entire change in fair value of the embedded purchased call option. The resulting changes in fair value will be included currently in earnings. Changes in the fair value of the written option also will be included currently in earnings and presented in the same income statement line item as the earnings effect of the hedged item. Any mismatch between the changes in fair values of the hedging instrument and the hedged item attributable to the hedged risk, thus, will be automatically reflected in earnings. (The hedge is likely to have some earnings effect because the premium for the written call option is unlikely to be the same as the premium for the embedded purchased call option.)

### 2.7.60 Special rule: Combination of options

**Excerpt from ASC 815-20**

>>> Determining Whether a Combination of Options is Net Written

25-88 This guidance addresses how an entity shall determine whether a combination of options is considered a net written option subject to the requirements of paragraph 815-20-25-94. 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. Furthermore, a derivative instrument that results from combining a written option and any other non-option derivative instrument shall be considered a written option. The determination of whether a combination of options is considered a net written option depends in part on whether strike prices and notional amounts of the options remain constant.

An entity may use a hedging strategy that involves a combination of option contracts, for example an interest rate collar. If the combination of options includes a written option, an entity first determines whether the combination of options is a net purchased option or a net written option. This determination
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2. General hedging requirements

partially depends on whether the strike prices and notional amounts of the options remain constant (see further guidance below). [815-20-25-88]

If the combination is considered a net written option, the entity then determines if the combination of option contracts meets the requirements of the written option test. If the combination of options meets this test, it is eligible to be a hedging instrument if the hedging criteria specific to the type of hedge (e.g. fair value, cash flow) are met. The specific hedging criteria are discussed in subsequent chapters.

Question 2.7.100
What is a collar?

Interpretive response: Collars are common derivative instruments that involve combining a purchased option (which requires an entity to pay a premium) with a written option (where an entity receives a premium).

This combination of options provides an entity with a desired amount of protection against changes in fair values outside of a range of values (or changes in cash flows outside a range of cash flows), while offsetting a portion of the cost of the purchased option through the premium received on the written option.

Question 2.7.110
Is the written option test required for a combination of a written option and a non-option derivative?

Interpretive response: Yes. A derivative that results from combining a written option and any other non-option derivative is considered a written option and must pass the written option test to be eligible as a hedging instrument. [815-20-25-88]

Examples of derivative instruments that combine a written option and a non-option derivative include a swaption (a written option on a swap) and an indexed-amortizing swap.

In addition, when a derivative instrument is embedded in another derivative instrument (e.g. an embedded written option), the entire derivative instrument must 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 (see section 2.7.40). [815-20-25-71(a)(2)]
Conditions for combination to be a net purchased option

Excerpt from ASC 815-20

>>>>> Strike Prices and Notional Amounts Remain Constant

25-89 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, that combination of options would be considered a net purchased option or a zero cost collar (that is, the combination shall not be considered a net written option subject to the requirements of paragraph 815-20-25-94) provided all of the following conditions are met:

a. No net premium is received.
b. The components of the combination of options are based on the same underlying.
c. The components of the combination of options have the same maturity date.
d. The notional amount of the written option component is not greater than the notional amount of the purchased option component.

25-90 If the combination of options does not meet all of those conditions, it shall be subject to the test in paragraph 815-20-25-94. For example, a combination of options having different underlying indexes, such as a collar containing a written floor based on three-month U.S. Treasury rates and a purchased cap based on three-month London Interbank Offered Rate (LIBOR), shall not be considered a net purchased option or a zero cost collar even though those rates may be highly correlated.

>>>>> Strike Prices and Notional Amounts Do Not Remain Constant

25-91 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, the assessment to determine whether that combination of options can be considered not to be a written option under paragraph 815-20-25-88 shall be evaluated with respect to each date that either the strike prices or the notional amounts change within the contractual term from inception to maturity.

25-92 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 815-20-25-94), it shall 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, such as either of the following circumstances:

a. If strike prices fluctuate over the life of a combination of options and no net premium is received at inception, a net premium will typically be received as a favorable term in one or more reporting periods within the contractual term from inception to maturity.
b. If notional amounts fluctuate over the life of a combination of options and no net premium is received at inception, a net premium or a favorable term...
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will typically be received in one or more periods within the contractual term from inception to maturity.

25-93 In addition, a combination of options in which either the written option component or the purchased option component has either strike prices or notional amounts that do not remain constant over the life of the respective component shall satisfy all of the conditions in paragraph 815-20-25-89 to be considered not to be a written option (that is, to be considered to be a net purchased option or zero cost collar) under paragraph 815-20-25-88. For example, if the notional amount of the written option component is greater than the notional amount of the purchased option component at any date that the notional amount changes within the contractual term from inception to maturity, the combination of options shall be considered to be a written option under paragraph 815-20-25-88 and, thus, subject to the criteria in the following paragraph.

All of the following conditions must be met at inception of the hedging relationship for a combination of options to be considered a net purchased option: [815-20-25-89]

— 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.

Strike prices and notional amounts remain constant

If a combination of options with strike prices and notional amounts that remain constant fails to meet all of the above criteria at inception of the hedging relationship, it cannot be considered a net purchased option and is subject to the written option test.

Strike prices and notional amounts do not remain constant

If the strike price or notional amount in either component does not remain constant over the life of the respective component, the assessment of whether the combination of options is a net written option or a net purchased option should be assessed at each date that either the strike prices or the notional amounts change. This includes considering a receipt of a net premium (in cash, other assets 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. [815-20-25-91 – 25-92]

In addition, if any of the four conditions discussed 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. [815-20-25-89]
Question 2.7.120
When a hedging relationship is redesignated, is a combination of options reassessed to determine if it is a net written or net purchased option?

Interpretive response: Yes. When redesignating a hedging relationship that involved a combination of options, an entity must reassess whether the combination is a net purchased option or a net written option. The new assessment should be based on the current fair values of the options.

If the combined options are in a net liability position from a fair value perspective, the combination is a net written option. This is because an entity would have received proceeds from a net premium if it had entered into the options at that time. Because it is considered a net written option, the entity must perform the written option test at the inception of the new hedging relationship.

If the combined options are in a net asset position from a fair value perspective, the combination is a net purchased option and the entity does not need to perform the written option test.

Example 2.7.40
Evaluation of whether a combination of options is a net written option

The following is adapted from Example 20 in Subtopic 815-20 (reproduced below).

On January 1, Year 1, ABC Corp. entered into two collar arrangements. The details of the collar arrangements are as follows.

— No net premium was received by ABC 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></th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>5-year avg.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collar 1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<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>
<tr>
<td>Collar 2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<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>
<tr>
<td>Written call</td>
<td>108.5</td>
<td>108.5</td>
<td>108.5</td>
<td>110.4</td>
<td>117.2</td>
<td>110.6</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).

**Collar 1: Net written option assessment**

Collar 1 is a zero-cost collar and not a net written option. Because 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, the following conditions are assessed at inception of the hedging relationship:

- no net premium was received;
- 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.

Therefore, the combination of options is not considered a written option and ABC does not need to perform the written option test.

**Collar 2: Net written option assessment**

Collar 2 is a net written option. Because the strike prices of the written option component and the purchased option component are not constant over the life of the contract, ABC assesses whether the combination of options is a net written option as of 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 Year 2 and Year 3, the strike price of the purchased put option (108.5) is greater than that average.

ABC can put the underlying to the counterparty during Year 2 and Year 3 at a price that is higher than the average for all of the years combined. This premium is received by ABC for Year 2 and Year 3 in return for accepting a lower than average strike price of the purchased put option in Years 4 to 6 (i.e. 91.5).

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. Therefore, the collar is a net written option and the additional written option test must be met for the collar to be the hedging instrument in a hedging relationship.
Example 2.7.50

Applying the net written option test to collar-based hedging relationship

The following is adapted from Example 30 in Subtopic 815-20 (reproduced below).

ABC Corp. has LIBOR-indexed floating-rate debt. The current LIBOR rate is 6%. To hedge its exposure to variability in expected future cash flows attributable to changes in LIBOR swap rate (the contractually specified interest rate), ABC enters into an interest rate collar with the following terms:

— purchased cap option with a strike rate of 8%; and
— written floor option with a strike rate of 5%.

The interest collar has the effect of limiting the interest rate of the floating-rate debt to a range between 5% and 8%. ABC receives a net premium from the bank based on market conditions as of the transaction date of the collar.

Net written option assessment

The combination of options (i.e. the interest rate collar) is a net written option because ABC received a net premium. Therefore, ABC must perform the written option test to determine whether the net written option is eligible to be designated as the hedging instrument.

Written option test

The combination of the hedged transaction and the net written option must provide at least as much potential for favorable cash flows as exposure to unfavorable cash flows for all possible percentage changes in the LIBOR index.

<table>
<thead>
<tr>
<th>Potential for gain</th>
<th>Potential for loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>If LIBOR rates decrease by 50% to 3%:</td>
<td>If LIBOR rates increase by 50% to 9%:</td>
</tr>
<tr>
<td>— economic gain on LIBOR-indexed debt based on 3% decrease in LIBOR;</td>
<td>— economic loss on LIBOR-indexed debt based on 3% increase in LIBOR;</td>
</tr>
<tr>
<td>— cash outflows of 2% on written floor option – i.e. intrinsic value loss based on difference between strike rate of 5% and decreased rate of 3%;</td>
<td>— intrinsic value of the written floor option is zero;</td>
</tr>
<tr>
<td>— intrinsic value of the purchased cap is zero; and</td>
<td>— cash inflows of 1% on purchased cap option – i.e. intrinsic value gain based on difference between strike rate of 8% and increased rate of 9%;</td>
</tr>
<tr>
<td>— total potential economic gain of 100 bps¹, based on net cash outflows of 5%.</td>
<td>— total potential economic loss of 200 bps², based on net cash outflows of 8%.</td>
</tr>
</tbody>
</table>

Notes:
1. Economic gain of 3% less loss on intrinsic value of written floor option of 2%.
2. Economic loss of 3% less gain on intrinsic value of purchased cap option of 1%.

The interest rate collar does not pass the written option test. This is because the combined hedged position does not have symmetry of gain and loss.
potential. Therefore, the combination of options is not an eligible hedging instrument.

Example 2.7.60

Indexed-amortizing swap considered to be a net written option

Interest rate swaps with notional amounts that amortize based on an index are referred to as indexed-amortizing swaps. They are considered to be written options because they combine an interest rate swap (a non-option derivative) with a written option. As such, they are subject to the written option 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, an entity must consider whether it is 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. If an entity receives a net premium, the combination of options will be considered a net written option and the written option test must be performed to determine if it is an eligible hedging instrument.

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. Therefore, amortizing swaps are neither net written options nor a combination of options.

Question 2.7.130

Are knock-out and knock-out/knock-in provisions considered written options?

Background: 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 buyer 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.

For example, 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. Therefore, when the entity 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 entity would be higher (e.g. the pay-fixed leg may have been more than 6%).

**Interpretive response:** 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 non-option derivative (e.g. the interest rate swap), the entire contract is considered a net written option. Therefore, the written option test must be performed to determine whether the net written option is eligible to be designated as the hedging instrument.

**Written option test**

The combination of the hedged item or transaction and the net written option must provide at least as much potential for favorable cash flows as exposure to unfavorable cash flows for all possible percentage changes in the LIBOR index.

<table>
<thead>
<tr>
<th>Potential for gain</th>
<th>Potential for loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>— The written option provision reduces the potential gain or favorable cash flows in the derivative when it is beneficial to the entity.</td>
<td>— When the derivative is detrimental to the entity, there is no offsetting knock-out or knock-in provision.</td>
</tr>
<tr>
<td>— <em>Fair value hedge.</em> When the written option provision is combined with the hedged item’s concurrent negative effect, the net result is a loss on the combined derivative and hedged item position.</td>
<td>— <em>Fair value hedge.</em> When combined with the hedged item’s concurrent positive effect, the result is a neutral effect of the combined derivative and hedged item position.</td>
</tr>
<tr>
<td>— <em>Cash flow hedge.</em> When the written option provision is combined with the hedged transaction’s unfavorable cash flows, the net result is an unfavorable cash flow on the combined derivative and hedged transaction position.</td>
<td>— <em>Cash flow hedge.</em> When combined with the hedged transaction’s concurrent favorable cash flows, the result is a neutral effect of the combined derivative and hedged transaction position.</td>
</tr>
</tbody>
</table>

This table indicates a lack of symmetry in the potential for gains and losses. Therefore, we believe circumstances are rare in which a derivative contract containing a knock-out or knock-in provision meets the written option test to qualify for hedge accounting.
**FASB Example: Combination of options in which strike prices or notional amounts do not remain constant**

Excerpt from ASC 815-20

<table>
<thead>
<tr>
<th>Example 20: Combination of Options in Which Strike Prices or Notional Amounts Do Not Remain Constant</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-179 The following Cases illustrate the application of paragraph 815-20-25-91 to combinations of options in which either the strike price or the notional amount in either the written option component or the purchased option component can fluctuate over the life of the respective component:</td>
</tr>
</tbody>
</table>
| a. Changes in strike prices (Case A)  
| b. Changes in notional amounts (Case B). |
| 55-180 Cases A and B share the following assumptions: |
| a. An entity wishes to hedge its forecasted sales of a commodity by entering into a five-year commodity-price collar. |
| b. Under the collar, the entity will do both of the following: |
| 1. Purchase commodity-price put option components (a floor)  
| 2. Write commodity-price call option components (a cap). |
| c. Each of the alternative collars discussed otherwise meets the criteria established in paragraphs 815-20-25-89 through 25-90 including all of the following: |
| 1. No net premium is received at inception of the combination of options. Paragraph 815-20-25-94 addresses, in part, whether a net premium is received at any point during the life of the combination of options that the strike price or notional amount is changed. |
| 2. The components of the combination of options are based on the same underlying (that is, the same commodity price). |
| 3. The components of the combination of options have the same maturity date. |
| 4. The notional amount of the written option component is not greater than the notional amount of the purchased option component. Paragraph 815-20-25-94 addresses, in part, whether this criterion should be applied to only the entire contractual term to maturity or to some part thereof. |

>>> Case A: Changes in Strike Prices

55-181 The following table presents both of the following:

| a. Commodity prices implied by the forward price curve based on market prices  
| b. The strike prices of two alternative collars. |

The minimum prices for each collar represent the strike prices of the purchased put options. The maximum prices for each collar represent the strike prices of the written call options. (Assume that the notional amounts of the two option components are identical and constant over the life of the option components.)
2. General hedging requirements

(Cents Per Unit)

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
<th>20X5</th>
<th>20X6</th>
<th>5-Year Average</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Forward price</strong></td>
<td>100.0</td>
<td>103.9</td>
<td>105.6</td>
<td>106.4</td>
<td>106.7</td>
<td>104.5</td>
</tr>
<tr>
<td><strong>Collar 1</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum</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>Maximum</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>
<tr>
<td><strong>Collar 2</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum</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>
<tr>
<td>Maximum</td>
<td>108.5</td>
<td>108.5</td>
<td>108.5</td>
<td>110.4</td>
<td>117.2</td>
<td>110.6</td>
</tr>
</tbody>
</table>

55-182 Note that the 5-year averages of the minimum prices (98.3 cents) and the maximum prices (110.6 cents) of the 2 collars are identical and are consistent with the 5-year average implied by the forward price curve. (That is, 104.5 cents equals the average of the 98.3-cent minimum strike price and the 110.6-cent maximum strike price.) No net premium is received at inception for either collar taking into consideration the entire contractual term of the combination of options from inception to maturity.

55-183 For Collar 2, premiums are received in early periods as consideration for entering into net written options in later periods. Specifically, the (higher-than-average) strike prices in years 20X2 and 20X3 are received (that is, receipt of a net premium) in return for accepting less favorable (lower-than-average) strike prices in years 20X4 through 20X6 (that is, net written options). Thus, at the inception of the hedge and over its life, Collar 2 would be subject to the provisions of paragraph 815-20-25-94.

>>> Case B: Changes in Notional Amounts

55-184 The following table presents the notional amounts of two alternative collars. (Assume that the strike prices of the two collars are identical and constant over the life of the collars.)

(Notional Units)

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
<th>20X5</th>
<th>20X6</th>
<th>Total Notional Amount</th>
<th>5-Year Average</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Collar 3</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum</td>
<td>750</td>
<td>750</td>
<td>750</td>
<td>750</td>
<td>750</td>
<td>3,750</td>
<td>750</td>
</tr>
<tr>
<td>Maximum</td>
<td>750</td>
<td>750</td>
<td>750</td>
<td>750</td>
<td>750</td>
<td>3,750</td>
<td>750</td>
</tr>
<tr>
<td><strong>Collar 4</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum</td>
<td>1,240</td>
<td>1,240</td>
<td>1,240</td>
<td>15</td>
<td>15</td>
<td>3,750</td>
<td>750</td>
</tr>
<tr>
<td>Maximum</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>1,500</td>
<td>1,500</td>
<td>3,750</td>
<td>750</td>
</tr>
</tbody>
</table>

55-185 Note that both the sum and average of the notional amounts of the written option component for all periods are not greater than the sum and average of the notional amounts of the purchased option component for all periods.
For Collar 4, favorable terms are received in early periods (net purchased options) as consideration for entering into net written options in later periods. Specifically, the (higher-than-average) notional amounts on the purchased put option in years 20X2 through 20X4 are received in return for accepting a less favorable notional amount in years 20X5 and 20X6. Thus, at the inception of the hedge and over its life, Collar 4 in Case B would be subject to the provisions of paragraph 815-20-25-94.

**FASB Example: Applying the net written option test to collar-based hedging relationship**

This Example illustrates the application of paragraph 815-20-25-95. Entity X has LIBOR-indexed floating-rate debt. To hedge its exposure to variability in expected future cash outflows attributable to changes in LIBOR swap rate (the contractually specified interest rate), it enters into an interest rate collar with a bank when the current LIBOR swap rate is 6 percent. The collar also is indexed to LIBOR and consists of a purchased cap with the strike rate equal to 8 percent and a written floor with the strike rate equal to 5 percent. The purchased cap goes into effect when LIBOR increases above 8 percent, and the written floor goes into effect when LIBOR decreases below 5 percent. Thus, the interest collar has the effect of limiting the interest rate of the floating-rate debt to a range between 5 percent and 8 percent. On the basis of market conditions as of the collar transaction date, Entity X received a net premium from the bank.

In accordance with paragraphs 815-20-25-88 through 25-90, the combination of options in the collar in this Example is a net written option from Entity X’s perspective. Therefore, the written-option test in paragraphs 815-20-25-94 through 25-95 must be applied to determine whether the hedging relationship between the debt and the collar qualifies for cash flow hedge accounting. That test requires that 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 for all possible percentage changes (from zero percent to 100 percent) in the LIBOR index.

The following table shows the calculation of the favorable cash flows and unfavorable cash flows for LIBOR changes of 50 percent.
Potential Cash Flows of the Combination of the Hedged Item and the Net Written Option if LIBOR Moves Each Direction by the Same Percentage

<table>
<thead>
<tr>
<th></th>
<th>LIBOR at Inception</th>
<th>LIBOR Increase 50%</th>
<th>LIBOR Decrease 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash outflows on LIBOR-indexed debt</td>
<td>6.00%</td>
<td>9.00%</td>
<td>3.00%</td>
</tr>
<tr>
<td>Cash outflows on written floor</td>
<td>0.00</td>
<td>0.00</td>
<td>2.00</td>
</tr>
<tr>
<td>Less: Cash inflows on purchased cap</td>
<td>0.00</td>
<td>1.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Net cash flow (outflows + / inflows -)</td>
<td>6.00%</td>
<td>8.00%</td>
<td>5.00%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Unfavorable</th>
<th>Favorable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in cash flows of combination from inception (in basis points)</td>
<td>200</td>
<td>-100</td>
</tr>
<tr>
<td>Percentage change in cash flows of combination from inception</td>
<td>33.33%</td>
<td>-16.67%</td>
</tr>
</tbody>
</table>

The calculations in the table in paragraph 815-20-55-233 demonstrate that for a 50 percent fluctuation in the LIBOR rate, the collar would fail the written-option test in paragraph 815-20-25-94 because a 50 percent favorable change in LIBOR (that is, a decrease) would not provide at least as much favorable cash flows as unfavorable cash flows that would result from a 50 percent unfavorable change in LIBOR (that is, an increase). Therefore, the combination of options would not be an eligible hedging instrument.

2.8 Hedge effectiveness

2.8.10 Overview

Hedge accounting is permitted only if the hedging relationship is highly effective at managing the risk being hedged (for a net investment hedge, the hedging relationship must be effective as an economic hedge). Effectiveness assessments are required to be performed prospectively at hedge inception and both prospectively and retrospectively periodically thereafter (at least quarterly).
The following diagram summarizes how effectiveness is assessed.

```
| Absolute value of change in fair value or cash flows of hedging instrument (other than excluded components) |
| Absolute value of change in fair value or cash flows of hedged item or transaction due to hedged risk |
| Percentage of offset |
| To be highly effective, should be within the range of 80%–125% |
```

Topic 815 requires the initial (prospective) assessment to be performed on a quantitative basis unless the hedging relationship meets certain conditions. Subsequent assessments may be performed on a quantitative basis, or on a qualitative basis if certain conditions are met.

Additionally, Topic 815 provides the three methods that allow an entity to assume a hedging relationship is perfectly effective if certain conditions are met:

- shortcut method (see section 9.3);
- critical terms match method (see section 9.4); and
- simplified hedge accounting approach (see section 10.2).

Chapter 9 discusses the general requirements for assessing hedge effectiveness and the specific requirements for various assessment methods.

For a net investment hedge, the hedging instrument must be both designated and effective as an economic hedge of the net investment (see section 8.4).

### 2.9 Hedge documentation requirements

<table>
<thead>
<tr>
<th>Criterion 1</th>
<th>Criterion 2</th>
<th>Criterion 3</th>
<th>Criterion 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligibility of hedged items or transactions</td>
<td>Eligibility of hedged risk(s)</td>
<td>Eligibility of hedging instruments</td>
<td>Hedge effectiveness</td>
</tr>
</tbody>
</table>

**Criterion 5: Formal documentation**

### 2.9.10 Overview

> Excerpt from ASC 815-20

> **> Formal Designation and Documentation at Hedge Inception**

**25-3** Concurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged transaction, or a method of assessing effectiveness to achieve a desired accounting result.
To qualify for hedge accounting, there shall be, at inception of the hedge, formal documentation of all of the following:

a. Subparagraph not used
b. Documentation requirement applicable to fair value hedges, cash flow hedges, and net investment hedges:
   1. The hedging relationship
   2. The entity’s risk management objective and strategy for undertaking the hedge, including identification of all of the following:
      i. The hedging instrument.
      ii. The hedged item or transaction.
      iii. The nature of the risk being hedged.
      iv. The method that will be used to retrospectively and prospectively assess the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value (if a fair value hedge) or hedged transaction’s variability in cash flows (if a cash flow hedge) attributable to the hedged risk. There shall be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness.

To qualify for hedge accounting, an entity must formally designate and document certain elements of the hedging relationship.

While the form of this documentation is at the discretion of an entity’s management, it must include the following.

<table>
<thead>
<tr>
<th>General documentation requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risk management objective and strategy</strong></td>
</tr>
<tr>
<td><em>(section 2.9.20)</em></td>
</tr>
<tr>
<td><strong>Hedging instrument</strong></td>
</tr>
<tr>
<td><strong>Hedged item or transaction</strong></td>
</tr>
<tr>
<td><strong>Nature of risk</strong></td>
</tr>
<tr>
<td><strong>Assessment of hedge effectiveness</strong></td>
</tr>
<tr>
<td><em>(section 2.9.30)</em></td>
</tr>
</tbody>
</table>

There are general documentation requirements that must be met for all types of hedges. In addition, there are incremental documentation requirements specific to **fair value hedges** *(see section 2.9.50)* and **cash flow hedges** *(see section 2.9.60)*.

Section 2.9.40 explains when an entity must prepare the initial hedge documentation, including results of the initial effectiveness assessment.

There are certain exceptions for some private companies adopting the simplified hedge accounting approach and for private companies not adopting the simplified hedge accounting approach. For further discussion of private companies, see chapter 10.
What is the level of detail needed to satisfy the hedge documentation requirements?

**Interpretive response:** The level of detail required in hedge documentation is a matter of judgment. However, the SEC staff has stated that the method used to assess hedge effectiveness 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 hedge accounting. [1999 AICPA Conf]

We believe the required documentation around the hedging relationship should also be specific enough to identify the specific hedged item or transaction and the hedging instrument. For example, if the hedged item was a note payable, all the relevant terms of the note should be documented or a reference to the note term sheet should be made.

### 2.9.20 Documenting the risk management objective and strategy

Topic 815 requires an entity to formally document, at inception of the hedge, its 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 or cash flows attributable to the designated risk.

This documentation is important because the method of assessing the effectiveness of the relationship (discussed in chapter 9) must be consistent with the originally documented objective and strategy for that particular hedging relationship. [815-20-25-80]

The components of the formal documentation requirements around an entity’s risk management objective and strategy are as follows.

<table>
<thead>
<tr>
<th>Hedging instrument</th>
<th>Identify the derivative hedging instrument, including the proportion (i.e. all or some percentage) of the derivative instrument that is designated as the hedging instrument (see sections 2.6 and 2.7). [815-20-25-3(b)(i)]</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>If the hedging relationship involves a combination of two or more derivatives, the documentation should identify the combination.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Hedged item or transaction</th>
<th>Specifically identify the recognized asset or liability, firm commitment, cash flows or forecasted transaction (see section 2.2.10). If applicable, this includes the specific portion of the hedged item or transaction, or the portfolio or group of hedged items or transactions. [815-20-25-3(b)(ii)]</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>— If the fair value hedging relationship involves a portfolio of similar assets and liabilities, see section 3.3.40 for further discussion of hedge accounting qualifying criteria.</td>
</tr>
</tbody>
</table>
2. General hedging requirements

If the cash flow hedging relationship involves a group of similar forecasted transactions, see section 5.3.60 for further discussion of hedge accounting qualifying criteria.

Document how the change in the fair value or cash flows on the hedged item or transaction attributable to the risk being hedged will be determined; this affects the assessment of effectiveness.

Section 2.9.50 discusses incremental documentation requirements for fair value hedges related to:
— firm commitments; and
— last-of-layer method.

Section 2.9.60 discusses incremental documentation requirements for cash flow hedges, including specific identification of the timing, nature and amount of a hedged forecasted transaction.

**Nature of the risk being hedged**

Identify the risk(s) being hedged – e.g. interest rate risk, credit risk, price risk and/or foreign exchange risk (see sections 2.3 and 2.4).

For hedges of interest rate risk, identify the benchmark interest rate (see section 2.3.30) or the contractually specified interest rate (see section 2.3.40).

Section 2.9.60 discusses incremental documentation requirements for cash flow hedges related to certain hedged risks – e.g. specifying contractually specified components.

**Assessment of hedge effectiveness**

See section 2.9.30.

Documentation of the hedged item or transaction and the risk being hedged cannot be ambiguous. This will avoid circumstances that could call into question which item, transaction or designated risk is part of a hedging relationship.

For example, an entity may hedge more than one risk at a time, as long as each designated risk is accounted for separately; for guidance on accounting for simultaneous hedges, see section 2.3.80. If a hedged item or transaction is already subject to another hedging relationship, it is critical to specify and document which item or forecasted transaction and its associated risk are being hedged.

Examples 2.9.30 and 2.9.40 illustrate the documentation requirements for fair value hedges and cash flow hedges, respectively.

### 2.9.30 Documenting assessment of hedge effectiveness

**Excerpt from ASC 815-20**

> **Formal Designation and Documentation at Hedge Inception**

25-3(b)(2) The entity’s risk management objective and strategy for undertaking the hedge, including identification of all of the following: …

iv. The method that will be used to retrospectively and prospectively assess the hedging instrument’s effectiveness in offsetting the exposure to
changes in the hedged item’s **fair value** (if a fair value hedge) or hedged transaction’s variability in cash flows (if a cash flow hedge) attributable to the hedged risk. There shall be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness.

01. An entity shall perform an initial prospective assessment of hedge effectiveness on a quantitative basis (using either a dollar-offset test or a statistical method such as regression analysis) unless one of the following applies:
   A. In a cash flow or fair value hedge, the entity applies the shortcut method in accordance with paragraphs 815-20-25-102 through 25-117.
   B. In a cash flow or fair value hedge, the entity determines that the critical terms of the hedging instrument and the hedged item match in accordance with paragraphs 815-20-25-84 through 25-85.
   C. In a cash flow hedge, the hedging instrument is an option, and the conditions in paragraphs 815-20-25-126 and 815-20-25-129 through 25-129A are met.
   D. In a cash flow hedge, a **private company** that is not a financial institution as described in paragraph 942-320-50-1 applies the simplified hedge accounting approach in paragraphs 815-20-25-133 through 25-138.
   E. In a cash flow hedge, the entity assesses hedge effectiveness under the change in variable cash flows method in accordance with paragraphs 815-30-35-16 through 35-24, and all of the conditions in paragraph 815-30-35-22 are met.
   F. In a cash flow hedge, the entity assesses hedge effectiveness under the hypothetical derivative method in accordance with paragraphs 815-30-35-25 through 35-29, and all of the critical terms of the hypothetical derivative and hedging instrument are the same.
   G. In a net investment hedge, the entity assesses hedge effectiveness using a method based on changes in spot exchange rates, and the conditions in paragraph 815-35-35-5 (for derivative instruments) or 815-35-35-12 (for nonderivative instruments) are met.
   H. In a net investment hedge, the entity assesses hedge effectiveness using a method based on changes in forward exchange rates, and the conditions in paragraph 815-35-35-17A are met.

02. The initial prospective quantitative hedge effectiveness assessment using information applicable as of the date of hedge inception is considered to be performed concurrently at hedge inception if it is completed by the earliest of the following:
   A. The first quarterly hedge effectiveness assessment date
   B. The date that financial statements that include the hedged transaction are available to be issued
   C. The date that any criterion in Section 815-20-25 no longer is met
   D. The date of expiration, sale, termination, or exercise of the hedging instrument
   E. The date of dedesignation of the hedging relationship
F. For a cash flow hedge of a forecasted transaction (in accordance with paragraph 815-20-25-13(b)), the date that the forecasted transaction occurs.

03. An entity also shall document at hedge inception whether it elects to perform subsequent retrospective and prospective hedge effectiveness assessments on a qualitative basis and how it intends to carry out that qualitative assessment. See paragraphs 815-20-35-2A through 35-2F for additional guidance on qualitative assessments of effectiveness. In addition, the entity shall document which quantitative method it will use if facts and circumstances of the hedging relationship change and the entity must quantitatively assess hedge effectiveness in accordance with paragraph 815-20-35-2D. An entity must document that it will perform the same quantitative assessment method for both initial and subsequent prospective hedge effectiveness assessments. The guidance in paragraphs 815-20-55-55 through 55-56 applies if the entity wants to change its quantitative method of assessing effectiveness after the initial quantitative effectiveness assessment.

04. An entity that applies the shortcut method in paragraphs 815-20-25-102 through 25-117 may elect to document at hedge inception a quantitative method to assess hedge effectiveness and measure hedge results if the entity determines at some point during the term of the hedging relationship that the use of the shortcut method was not or no longer is appropriate. See paragraphs 815-20-25-117A through 25-117D.

v. Subparagraph superseded by Accounting Standards Update No. 2017-12.

vi. If the entity is hedging foreign currency risk on an after-tax basis, that the assessment of effectiveness will be on an after-tax basis (rather than on a pretax basis).

Topic 815 requires an entity to document its assessment of hedge effectiveness at inception of a hedging relationship and on an ongoing basis. That is, an entity must provide documentation supporting why and how it expects changes in the fair value or cash flows of the derivative hedging instrument to offset changes in the fair value or cash flows of the hedged item or transaction 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 value or cash flows (hedge effectiveness testing – see chapter 9). [815-20-25-3(b)(2)(iv)]

The following table summarizes documentation requirements for hedge effectiveness at inception of the hedging relationship and on an ongoing basis.

| Documentation at hedge inception | — Document analysis and results of initial (prospective) effectiveness assessment. Unless the hedging relationship is one of eight specified situations, an entity is required to perform this assessment on a quantitative basis [see sections 9.2.20 and 9.6]. [815-20-25-3(b)(2)(iv)(01-02)] |
| — Document method(s) that will be used to perform subsequent (retrospective and prospective) effectiveness assessments. [815-20-25-3(b)(2)(iv)] |
2. General hedging requirements

- **Shortcut method.** Under the shortcut method, an entity may elect to document at hedge inception a quantitative method to assess hedge effectiveness if it is determined at a later date that the shortcut method was not or is no longer appropriate (see section 9.3).

- **Critical terms match method and simplified hedge accounting approach.** If one of these methods is applied, the entity follows the applicable guidance for subsequent assessments (see sections 9.4 and 10.2, respectively).

- **Qualitative.** If subsequent effectiveness assessments will be performed on a qualitative basis, document how those assessments will be performed. Additionally, document which quantitative method will be used if facts and circumstances change and the entity must quantitatively assess hedge effectiveness; this method is required to be the same as that used to support the entity’s initial prospective hedge effectiveness assessment. For guidance on electing qualitative effectiveness assessments, see section 9.5.10.

- **Quantitative.** Document selected quantitative approach – i.e. dollar-offset or statistical analysis (see section 9.6).

**Documentation during the hedging relationship**

- Document analysis and results of subsequent prospective and retrospective effectiveness assessments.
- For critical terms match method, continued documentation of matching of critical terms at each effectiveness period. See section 9.4.40 for further documentation criteria. [815-20-35-9]

See chapter 9 for comprehensive guidance on assessing hedge effectiveness, both at inception and during the hedging relationship.

**FASB Example: Documentation when critical terms of the hedging instrument and hedged forecasted transaction match**

While section 9.4 elaborates on the assessment of the critical terms match method of a forecasted transaction, the following example illustrates the documentation requirements of paragraph 815-20-25-3 for such a hedging relationship.

**Excerpt from ASC 815-20**

**>> Example 1A: Documentation When the Critical Terms of the Hedging Instrument and Hedged Forecasted Transaction Match**

**55-80A** This Example illustrates the documentation requirements in paragraph 815-20-25-3 when the critical terms of the hedging instrument and hedged forecasted transaction match in accordance with paragraphs 815-20-25-84 through 25-85. On January 1, 20X1, Entity A, a U.S. dollar (USD) functional currency entity, executes a forward contract to hedge a portion of its
exposure to Canadian Dollar- (CAD-) denominated forecasted sales expected to occur in December 20X1. Entity A determines that all the critical terms of the hedging instrument and hedged forecasted transaction match. It documents the hedging relationship concurrently with the execution of the forward contract in accordance with paragraph 815-20-25-3 as follows:

a. Risk management objective: To hedge against movements in the USD/CAD exchange rate that will affect the USD value of future CAD sales.

b. Hedged forecasted transaction: The first CAD 500,000 sales in December 20X1.

c. Hedging instrument: Foreign exchange forward contract to sell CAD 500,000 and receive USD 400,000 on December 31, 20X1. The fair value of the forward contract at hedge inception is zero.

d. Method of assessing hedge effectiveness: Entity A will assess the effectiveness on a qualitative basis at hedge inception. The critical terms of the hedging instrument and hedged forecasted transaction can be considered to match because the notional amounts and underlyings of the hedging instrument and hedged forecasted transaction are the same and the forecasted sales are expected to occur in the same fiscal month as the maturity date of the hedging instrument. Therefore, the hedge is expected to be perfectly effective. Subsequent assessments of effectiveness will be performed by verifying and documenting whether the critical terms of the hedging instrument and hedged forecasted transaction have changed during the period in review and whether it remains probable that the counterparty to the hedged item and hedged forecasted transactions will not default. If there are no such changes in critical terms or counterparty credit risk, Entity A will continue to conclude that the hedging relationship is perfectly effective.

2.9.40 Timing of initial hedge documentation, including initial effectiveness assessment

Excerpt from ASC 815-20

>>> Timing of Initial Quantitative Prospective Effectiveness Assessment

55-79C The following scenarios illustrate the application of paragraph 815-20-25-3(b)(2)(iv)(02). Entity A documents all hedges in accordance with paragraph 815-20-25-3, including designating the hedging instrument, hedged item, and method of assessing hedge effectiveness. It performs subsequent prospective and retrospective hedge effectiveness assessments every three months on the last day of the quarter in accordance with paragraph 815-20-25-79(a) through (b). In the following scenarios, assume that the next quarterly effectiveness assessment date is March 31, 20X1. Entity A also does not redesignate the hedging relationships in the following scenarios.
2. General hedging requirements

>>> Scenario A

55-79D Entity A enters into a cash flow hedging relationship on January 15, 20X1, in which the hedged item is a forecasted transaction expected to occur in one year. Because the hedged item and hedging instrument do not expire, are not sold, or do not terminate before the quarterly effectiveness testing date, Entity A may perform the initial prospective quantitative effectiveness assessment at any time after hedge designation but no later than March 31, 20X1.

>>> Scenario B

55-79E Entity A enters into a cash flow hedging relationship on March 28, 20X1, in which the hedged item is a forecasted transaction expected to occur in one year. Entity A must perform the initial prospective quantitative effectiveness assessment no later than March 31, 20X1.

>>> Scenario C

55-79F On January 15, 20X1, Entity A enters into a cash flow hedging relationship in which the hedged forecasted purchase of a nonfinancial asset is expected to occur in two months. The purchase occurs as forecasted on March 15, 20X1. Entity A must complete the initial prospective effectiveness assessment at any time after hedge designation but no later than March 15, 20X1, when the forecasted purchase occurs.

The following table summarizes the required timing of the elements of initial hedge documentation, including initial hedge effectiveness assessment, for all entities other than certain private companies. See chapter 10 for requirements for certain private companies and certain not-for-profit entities.

<table>
<thead>
<tr>
<th>Element of hedge documentation</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>All entities other than certain private companies and certain not-for-profit entities</td>
<td></td>
</tr>
<tr>
<td>Initial prospective assessment of hedge effectiveness (if quantitative testing is required). [815-20-25-3(b)(2)(iv)]</td>
<td>Earliest of the following: [815-20-25-3(b)(2)(iv)(02)]</td>
</tr>
<tr>
<td></td>
<td>— first quarterly hedge effectiveness assessment date;</td>
</tr>
<tr>
<td></td>
<td>— date the financial statements that include the hedged transaction are available to be issued;</td>
</tr>
<tr>
<td></td>
<td>— date any hedge accounting criterion is no longer met;</td>
</tr>
<tr>
<td></td>
<td>— date the hedging instrument expires or is sold, terminated or exercised;</td>
</tr>
<tr>
<td></td>
<td>— date the hedging relationship is dedesignated; or</td>
</tr>
<tr>
<td></td>
<td>— for a cash flow hedge of a forecasted transaction (in accordance with paragraph 815-20-25-13(b)), date the forecasted transaction occurs.</td>
</tr>
<tr>
<td>All other elements of hedge documentation. [815-20-25-3]</td>
<td>Concurrent with hedge designation. [815-20-25-3]</td>
</tr>
</tbody>
</table>
As noted in the table above, certain elements of the hedging relationship must be documented at the designation of the hedging relationship, including the identification of the hedging instrument, the nature of the risk, and the hedged item or transaction. The hedging relationship cannot be designated retroactively, as an entity would then have the benefit of hindsight and could use that to designate hedging relationships that would provide a desired financial result.

Example 2.9.10

Importance of timing of formal documentation of the hedge

ABC Corp. purchased an option on January 1, Year 1. ABC intends to use the option to hedge a qualifying forecasted purchase that it expects to occur in nine months on September 1, Year 1.

On March 31, Year 1, ABC wishes to designate and document the hedge of its exposure to variability in cash flows related to the forecasted transaction. It cannot document and designate the hedging relationship such that hedge accounting could be applied retrospectively from the date the option was purchased (on January 1, Year 1).

However, ABC may formally document the existence of a qualifying hedge on March 31, Year 1 and apply hedge accounting prospectively.

ABC will treat the option as a trading derivative for the three months to March 31, Year 1 with changes in its fair value recognized immediately in earnings.

Example 2.9.20

Timing requirements for initial hedge documentation

The following example is adapted in part from scenarios A to C in paragraphs 815-20-55-79C to 55-79F.

The following scenarios demonstrate the required timing for preparing initial hedge documentation for a hedging relationship that is not eligible for the simplified hedge accounting approach (see Question 10.2.10) or documentation relief for certain private companies and certain not-for-profit entities (see Question 10.3.10).

The scenarios compare two different types of entities. This example does not demonstrate the timing of performing quarterly hedge effectiveness assessments, which is discussed in section 9.2.20.

Entities

The following two types of entities are compared in each scenario.

- **Bank** is a private financial institution. Because Bank is a financial institution, it does not qualify for the special guidance applicable to certain private companies that is described in chapter 10.
— PublicCo is an SEC registrant.

Both entities are required to document at hedge inception all elements of the hedging relationship except the initial prospective effectiveness assessment.

The following assumptions are relevant to all scenarios.
— Bank and PublicCo are required to perform the initial prospective effectiveness assessment quantitatively.
— Bank and PublicCo perform retrospective quarterly hedge effectiveness assessments every three months on the last day of the quarter, with the first date being March 31, Year 1.
— In no scenario does Bank or PublicCo dedesignate the hedging relationship before the end of the hedged term. Additionally, before the date of the forecasted transaction, the hedged transaction and hedging instrument do not expire, are not sold and do not terminate.
— The forecasted transaction occurs as expected.

Scenario 1: Hedging relationship begins earlier in the quarterly period

Bank and PublicCo each enter into a cash flow hedging relationship on March 15, Year 1, in which the hedged transaction is a forecasted transaction expected to occur in one year.

**Scenario 2: Hedging relationship begins later in the quarterly period**

Bank and PublicCo each enter into a cash flow hedging relationship on March 15, Year 1, in which the hedged transaction is a forecasted transaction expected to occur in one year.
Scenario 3: Hedging relationship has a shorter duration

Bank and PublicCo each enter into a cash flow hedging relationship on January 15, Year 1, in which the hedged transaction is a forecasted transaction expected to occur in two months.

A
Bank and PublicCo: On this date, the initial hedge documentation is required to include all elements except the initial prospective quantitative effectiveness assessment.

B
Bank and PublicCo: By this date, the initial prospective quantitative effectiveness assessment must be performed.
Observation

Some entities may not benefit from the ability to delay initial quantitative prospective effectiveness assessments

The FASB acknowledged that the ability to complete the initial quantitative prospective effectiveness assessment after hedge designation may not provide relief for entities that either have a significant volume of hedging relationships or that frequently redesignate and redesignate hedging relationships. However, those entities usually have systems and processes in place that are capable of performing those assessments concurrently with hedge designation. [ASU 2017-12:BC177]

2.9.50 Documentation requirements for fair value hedges

Excerpt from ASC 815-20

> Formal Designation and Documentation at Hedge Inception

25-3(c) Documentation requirement applicable to fair value hedges only:

1. For a fair value hedge of a firm commitment, a reasonable method for recognizing in earnings the asset or liability representing the gain or loss on the hedged firm commitment.
2. For a hedging relationship designated under the last-of-layer method, an analysis to support the entity’s expectation that the hedged item is anticipated to be outstanding as of the hedged item’s assumed maturity date (see paragraph 815-20-25-12A(a) for additional guidance).

In addition to the general documentation requirements discussed above at section 2.9.10, there are incremental documentation requirements specific to fair value hedges relating to firm commitments and hedging relationships designated under the last-of-layer method.

| Firm commitments (section 3.3.20) | Documentation includes a reasonable method for recognizing in earnings the asset or liability that represents the gain or loss on the hedged firm commitment. [815-20-25-3(c)(1)]
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Question 4.4.10 contains guidance on subsequent accounting for assets or liabilities recognized as a result of applying fair value hedge accounting to an unrecognized firm commitment.</td>
<td></td>
</tr>
</tbody>
</table>
| Last-of-layer (section 3.3.100) | Analysis to support the entity’s expectation that the hedged item (e.g. last-of-layer) will be outstanding at the hedged item’s assumed maturity date. [815-20-25-3(c)(2)]
| Question 3.3.320 contains guidance on what is needed to support the entity’s expectation that the last-of-layer will remain outstanding at the end of the hedge term. |
The following is an example of the formal documentation expected for a fair value hedge of a firm commitment.

Example 2.9.30
Formal documentation for a fair value hedge of a firm commitment

ABC Corp. is a US dollar functional currency entity. On January 1, Year 1, ABC enters into a firm commitment to purchase a machine from a British manufacturer for 10,000 pounds sterling (£) in 12 months.

ABC chooses to hedge its exposure to changes in fair value of the firm commitment attributable to foreign currency exchange rates. It enters into a 12-month forward contract with Euro Bank to exchange a fixed amount of US dollars for a fixed amount of euros (€) because it has determined that changes in the exchange rate for $/€ correlate with changes in the exchange rate for $/£. Except for the currency in which the forward contract will be settled (¬ rather than £), the terms of the forward contract match those of the firm commitment.

ABC prepares the following documentation on January 1, Year 1.

Hedging relationship and risk management objective and strategy

On January 1, Year 1, ABC entered into a firm commitment to purchase a machine from a British manufacturer for £10,000 in 12 months. As a result, ABC is exposed to changes in the fair value of this commitment during the next 12 months due to changes in the exchange rate for $/£.

ABC’s risk management objective is to lock in the fair value (cost) of the firm commitment in its functional currency. ABC meets this objective by entering into a 12-month forward contract to exchange a fixed amount of US dollars for a fixed amount of euros. It expects that the amount of euros received under the contract will be sufficient to satisfy the pounds sterling obligation inherent in the firm commitment. That is, changes in the fair value of the forward contract caused by fluctuations in the exchange rate for $/€ are expected to be highly effective in offsetting changes in the fair value of the firm commitment caused by fluctuations in the exchange rate for $/£.

ABC designates the forward contract (the hedging instrument) as a hedge of its exposure to changes in fair value attributable to changes in the foreign currency exchange rates for $/€ related to the firm commitment.

Hedging instrument

ABC identifies the following forward contract as the derivative hedging instrument.

— Date of forward contract = January 1, Year 1
— Notional amount = €10,000 for equivalent US dollars
— Rate: Forward exchange rate for $/€ at inception of contract
— Term = 12 months
— Settlement = net cash due on December 31, Year 1
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 for $/£. 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 for $/£.

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, Year 1), the firm commitment asset or liability balance will be reclassified as an addition to, or subtraction from, the carrying amount of the machine. This carrying amount will be recognized in earnings in accordance with ABC’s normal depreciation policy.

Hedge effectiveness at inception

| Prospectively | During the 12 months before inception of the forward contract, the fluctuations in the 12-month forward exchange rate for $/€ were very similar to fluctuations in the 12-month forward exchange rate for $/£. ABC’s cumulative dollar-offset method documented that a comparison of the fluctuations in the two forward exchange rates ranged from 90%–110% over the past 12 months. Based on these findings, it is expected that such a relationship will continue during the next 12 months, which is the period that the hedging relationship between the forward contract and the firm commitment will be in place. |

Hedge effectiveness testing method – documented at inception of the hedging relationship
On a quarterly basis, ABC will assess effectiveness by updating the analysis performed coincident with the hedge designation to reflect the quarter’s fluctuations in the two exchange rates. It will consider the risk of default by the counterparty to the forward contract and its own nonperformance risk in this assessment.

| Retrospectively | ABC 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 for $/€ 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, ABC will determine whether it expects the hedging relationship to continue to be highly effective based on the updated analysis. |

If certain criteria are met, ABC may elect to perform the quarterly effectiveness testing on a qualitative basis. For further guidance on performing effectiveness testing on a qualitative basis, see section 9.5.
2.9.60 Documentation requirements for cash flow hedges

Excerpt from ASC 815-20

> Formal Designation and Documentation at Hedge Inception

25-3 Concurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged transaction, or a method of assessing effectiveness to achieve a desired accounting result. To qualify for hedge accounting, there shall be, at inception of the hedge, formal documentation of all of the following: …

d. Documentation requirement applicable to cash flow hedges only:
   1. For a cash flow hedge of a forecasted transaction, documentation shall include all relevant details, including all of the following:
      i. The date on or period within which the forecasted transaction is expected to occur.
      ii. The specific nature of asset or liability involved (if any).
      iii. Either of the following:
         01. The expected currency amount for hedges of foreign currency exchange risk; that is, specification of the exact amount of foreign currency being hedged
         02. The quantity of the forecasted transaction for hedges of other risks; that is, specification of the physical quantity (that is, the number of items or units of measure) encompassed by the hedged forecasted transaction.
      iv. If a forecasted sale or purchase is being hedged for price risk, the hedged transaction shall not be specified in either of the following ways:
         01. Solely in terms of expected currency amounts
         02. As a percentage of sales or purchases during a period.
      v. The current price of a forecasted transaction shall be identified to satisfy the criterion in paragraph 815-20-25-75(b) for offsetting cash flows.
      vi. 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, a 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 product sold during a 3-month period (because the last 15,000 units cannot be identified when they occur, but only when the period has ended).
      vii. If the hedged risk is the variability in cash flows attributable to changes in a contractually specified component in a forecasted purchase or sale of a nonfinancial asset, identification of the contractually specified component.
      viii. If the hedged risk is the variability in cash flows attributable to changes in a contractually specified interest rate for forecasted
interest receipts or payments on a variable-rate financial asset or liability, identification of the contractually specified interest rate.

In addition to the general documentation requirements discussed in section 2.9.10, there are incremental documentation requirements specific to cash flow hedges. These primarily relate to documentation around the specific identification of a forecasted transaction.

As discussed in section 5.3.30, a forecasted transaction needs to be described with sufficient specificity such that when the transaction occurs, it is clear whether that transaction is or is not the hedged transaction. Topic 815 requires an entity to formally document certain details around the specific identification of the forecasted transaction, including:

| **Timing** | Timing of when the forecasted transaction is expected to occur (e.g. specific date or period). \([815-20-25-3(d)(1)(i)]\)  
If a forecasted transaction is expected to occur within a timeframe, but the date within that timeframe is uncertain, an entity may document a range of time to comply with this requirement. For guidance around uncertainty of timing within a range, see section 5.3.40. |
|---|---|
| **Nature** | Specific nature of the asset or liability involved, or first cash flows received or paid to a specific amount in a particular period (without reference to the specific asset or liability). \([815-20-25-3(d)(1)(ii)]\)  
For guidance around specifically identifying the single forecasted transaction (or group of forecasted transactions), see section 5.3.30. |
| **Quantity** | The hedged quantity (e.g. specific number of items or units of measure) for hedges of price risk, interest rate risk and/or credit risk. \([815-20-25-3(d)(1)(ii)(02)]\) |
| **Current market price** | The current market price of the forecasted transaction, both at inception of the hedge and subsequently. \([815-20-25-3(d)(1)(vi)]\)  
This information is necessary to determine the change in expected cash flows.  
An entity should also 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 the assessment of effectiveness. |
| **Foreign currency amount** | The expected currency amount for hedges of foreign currency risk. \([815-20-25-3(d)(1)(iii)(01)]\) |
| **Contractually specified component** | The contractually specified component for hedges of exposure to changes in a contractually specified component related to forecasted transactions of nonfinancial assets or liabilities (see section 5.4.10). \([815-20-25-3(d)(1)(vi)]\) |
| **Contractually specified interest rate** | The contractually specified interest rate for hedges of exposure to changes in a contractually specified interest rate related to forecasted transactions of financial assets or liabilities (see section 2.3.40). \([815-20-25-3(d)(1)(viii)]\) |
Price risk
For hedges of price risk, the hedged transaction should not be specified: 
- solely in terms of expected currency amounts; or 
- as a percentage of sales or purchases during a period.

Examples
The examples in this section demonstrate the formal documentation for certain cash flow hedging relationships, for entities not applying guidance specific to certain private companies or not-for-profit entities.

- Formal documentation for a cash flow hedge of a forecasted transaction (Example 2.9.40).
- Formal documentation for forecasted purchases of fuel when hedging price risk (Example 2.9.50).

Formal documentation required by certain private companies and not-for-profit entities is discussed in chapter 10.

Example 2.9.40
Formal documentation for a cash flow hedge of a forecasted transaction

On January 1, Year 1, ABC Corp. issues a five-year, $100,000,000 debt obligation. The interest rate on the debt obligation is variable at the six-month LIBOR plus 1.5%.

ABC 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, Year 1. 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.

ABC prepares the following documentation on January 15, Year 1.

Hedging relationship and risk management objective and strategy

On January 1, Year 1, ABC 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, ABC is exposed to variability in cash flows related to changes in its forecasted interest payments as six-month LIBOR (the benchmark interest rate) changes.

ABC’s risk management objective is to lock in the interest cash outflows on this debt obligation. ABC 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%. ABC 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).
Hedging instrument

ABC identifies the following interest rate swap as the derivative hedging instrument.

- Date of Swap = January 15, Year 1
- Notional amount = $100,000,000
- Premium paid = $0
- Term = Five years maturing on January 14, Year 6
- Fixed leg = 8.5% per annum
- Fixed leg payer = ABC
- 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.

Hedged forecasted transaction

Forecasted interest payments are to be made on July 1 and January 1 of each year on its five-year $100,000,000 debt obligation issued January 1, Year 1 and maturing on December 31, Year 6. 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.

Hedge effectiveness at inception

Prospectively

| | 
|---|---|
| ABC has designated the risk of changes in its interest cash flows on its five-year, $100,000,000 debt obligation issued January 1, Year 1 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 ABC is hedging interest rate risk, ABC cannot automatically conclude that the hedging relationship would have been highly effective over the period equivalent to the designated hedging relationship. This is 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. ABC 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, ABC 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, ABC concluded that the hedging relationship would have been highly effective historically for the equivalent of at least four hedging periods. |
Based on the regression analysis completed, it is expected that on an ongoing basis the hedging relationship will remain effective throughout the hedging relationship.

**Hedge effectiveness testing method – documented at the inception of the hedging relationship**

On a quarterly basis, ABC will assess effectiveness by updating the analysis performed coincident with the hedge designation (to reflect the most recent change in interest rates). It will consider the risk of default by the counterparty to the swap contract and its own nonperformance risk in this assessment.

<table>
<thead>
<tr>
<th>Method</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retrospectively</td>
<td>ABC 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, ABC 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.</td>
</tr>
<tr>
<td>Prospectively</td>
<td>On a quarterly basis, ABC will determine whether it expects the hedging relationship to continue to be highly effective based on the updated analysis.</td>
</tr>
</tbody>
</table>

If certain criteria are met, ABC may elect to perform the quarterly effectiveness testing on a qualitative analysis basis. For further guidance on performing effectiveness testing on a qualitative basis, see section 9.5.

**Example 2.9.50**

**Formal documentation of forecasted purchases of fuel when hedging price risk**

This example illustrates the documentation of a hedging strategy for a group of similar forecasted purchases. In addition to documenting the overall hedging strategy, an entity needs to formally document (at inception) each individual hedging relationship that is designated using the hedging strategy. This could be a supplement to the documentation of the overall hedging strategy.

**Risk management objective and strategy**

Freight Co. (Freight) purchases fuel at various locations (e.g. New York Harbor, US Gulf Coast, Singapore) on an ongoing basis. Because its transport operations involve both air and ground transport, Freight regularly purchases both jet and diesel fuel.

Fuel costs make up a substantial part of Freight’s total operating expenses. This exposes the overall profitability and operating cash flows to the variability in the market price for fuel. Freight’s objective is to hedge this variability, which is limited to changes in prices at various locations. This is because fixed delivery costs from the locations have been negotiated.

Freight’s strategy for achieving this objective is to use futures and purchased options with notional amounts and underlying indices that 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 (i.e., price risk) for the purchase of fuel. Freight’s exposure to changes in the overall price of fuel will be affected by both the type of fuel expected to be purchased (e.g., jet fuel or diesel fuel) and the location.

As discussed above, the variability in the overall cash outflows for the purchase of fuel is limited to changes in spot prices at various locations because delivery costs are fixed. The hedge period for individual relationships is typically three months.

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 groups 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 on both the type and location of fuel expected to be purchased.

The hedging instruments will be futures or purchased options indexed to either:

- the NYMEX Heating Oil or 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).

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 Freight is able to demonstrate high effectiveness.

A new hedging relationship will be designated each time a derivative is linked to a specified group of similar 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 first day of the month in which the derivative contract matures/settles that:

1. in aggregate represent the number of gallons (or equivalent barrels) equal to the notional amount of the hedging instrument; and
2. 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 group of similar forecasted purchases.

Only those individual forecasted purchases that are considered to be similar with respect to the risk being hedged are included within the same hedging group of forecasted transactions.
Because the overall price of a gallon of fuel is significantly affected by both the type of fuel and the location of the purchase, Freight will identify groups of hedged forecasted transactions first by type and then more specifically by location. For example, each forecasted purchase within a particular group will be for the same type, either jet fuel or diesel fuel. However, there may be multiple groups of forecasted jet fuel purchases based on the location at which the jet fuel is expected to be purchased.

**Similarity assessment**

To demonstrate that each group is similar, Freight will perform a regression analysis to show that the changes in expected prices for the purchases of fuel at each location within the group are highly correlated with each other. **Example 5.3.30** continues this example, illustrating the similarity assessment.

**Hedge effectiveness**

For the forecasted transactions to qualify for hedge accounting, Freight needs to demonstrate that the hedging instrument is highly effective at hedging the overall price risk for each individual group. **Example 9.6.20** continues this example, illustrating regression analysis to quantitatively assess effectiveness for a cash flow hedge of total price risk for a group of similar transactions.

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**2.10 Discontinuing hedge accounting – general guidance**

**2.10.10 Overview**

| Excerpt from ASC 815-20 |

55-56 This Subtopic permits a hedging relationship to be dedesignated (that is, discontinued) at any time. (See paragraphs 815-25-40-1(c) and 815-30-40-1(c).) If an entity wishes to change any of the critical terms of the hedging relationship (including the method designated for use in assessing hedge effectiveness), as documented at inception, the mechanism provided in this Subtopic to accomplish that change is the dedesignation of the original hedging relationship and the designation of a new hedging relationship that incorporates the desired changes. However, as discussed in paragraph 815-30-35-37A, a change to the hedged risk in a cash flow hedge of a forecasted transaction does not result in an automatic dedesignation of the hedging relationship if the hedging instrument continues to be highly effective at achieving offsetting cash flows associated with the hedged item attributable to the revised hedged risk. The dedesignation of an original hedging relationship and the designation of a new hedging relationship represents the application of this Subtopic and is not a change in accounting principle under Topic 250, even though the new hedging relationship may differ from the original hedging relationship only with respect to the method designated for use in assessing the hedge effectiveness of that hedging relationship. Although paragraph 815-20-35-19 refers to discontinuing an existing hedging relationship and then designating and documenting a new hedging relationship using an improved
method for assessing effectiveness, that reference was not meant to imply that the perceived improved method had to be justified as a preferable method of applying an accounting principle under Topic 250.

Excerpt from ASC 815-25

> Discontinuing Hedge Accounting

**40-1** An entity shall discontinue prospectively the accounting specified in paragraphs 815-25-35-1 through 35-6 for an existing hedge if any one of the following occurs:

a. Any criterion in Section 815-20-25 is no longer met.

b. The **derivative instrument** expires or is sold, terminated, or exercised.

c. The entity removes the designation of the **fair value hedge**.

Excerpt from ASC 815-30

> Discontinuing Hedge Accounting

**40-1** An entity shall discontinue prospectively the accounting specified in paragraphs 815-30-35-3 and 815-30-35-38 through 35-41 for an existing hedge if any one of the following occurs:

a. Any criterion in Section 815-30-25 is no longer met.

b. The **derivative instrument** expires or is sold, terminated, or exercised.

c. The entity removes the designation of the **cash flow hedge**.

Hedge accounting is elective and is permitted only for hedging relationships that meet all of the qualifying criteria. Therefore, if any eligibility criteria cease to be met the hedging relationship must be discontinued – i.e. hedge dedesignation.

An entity may also be required to dedesignate the hedging relationship if it decides to change any of the critical terms of the originally documented hedging relationship. As a result, it is important for an entity to properly document the hedging relationship at its inception, including documentation around the methods for assessing effectiveness (see formal documentation requirements in section 2.9).

The following table provides an overview of circumstances that would require an entity to discontinue or partially dedesignate a hedging relationship:

<table>
<thead>
<tr>
<th>Change in eligibility or critical terms of hedged items or transactions (section 2.10.20)</th>
<th>Hedged item or transaction no longer meets the eligibility criteria. [815-25-40-1(a), 815-30-40-1(a)]</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Modification of hedged item or transaction such that critical terms of the original hedging relationship have changed. [815-20-55-56]</td>
</tr>
</tbody>
</table>
Hedging

2. General hedging requirements

2.10.20 Change in eligibility or critical terms of hedged items or transactions

Hedge accounting must be discontinued when the hedged item or transaction no longer meets the qualifying criteria outlined in section 2.2.

— **Fair value hedge.** The hedged item must be specifically identified as either a specific portion of a single recognized asset or liability, a firm commitment or a portfolio of similar assets or liabilities. Therefore, any unanticipated changes to the hedged item (or portfolio) impacting the originally documented hedging relationship would require full dedesignation or partial dedesignation.

— **Cash flow hedge.** Forecasted cash flows relating to existing or forecasted assets or liabilities are the hedged transactions in a cash flow hedge. A
Hedging

2. General hedging requirements

A cash flow hedge should be discontinued when the forecasted transaction is no longer probable as described in the original hedge documentation.

— **Net investment hedges.** Net investment hedges of foreign operations include investments in incorporated and unincorporated foreign operations. Therefore, changes in ownership or changes in the net investment balance may require dedesignation.

The following table illustrates changes in the eligibility or critical terms of hedged items or transactions that would require full dedesignation or partial dedesignation.

<table>
<thead>
<tr>
<th>Fair value hedge</th>
<th>Cash flow hedge</th>
<th>Net investment hedge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedged item (or portions thereof) is sold or extinguished.</td>
<td>Forecasted transaction is no longer probable (Question 2.10.10 and section 6.5.20).</td>
<td>Complete sale or substantial liquidation of foreign operation (section 8.5.20).</td>
</tr>
<tr>
<td>Adding to or deleting from a portion of a hedged item or portfolio of hedged items (Question 2.10.20).</td>
<td>Existing recognized asset or liability is sold or extinguished.</td>
<td>Other events leading to a loss of control of the investment in foreign entity (section 8.5.20).</td>
</tr>
<tr>
<td>Items in a hedged portfolio no longer pass the similarity test (section 3.3.40).</td>
<td>Entity is no longer exposed to variability in cash flows (i.e. forecasted transaction becomes a firm commitment) (Example 6.5.30).</td>
<td>Partial sale of investment in foreign operation (section 8.5.20).</td>
</tr>
<tr>
<td>Hedged firm commitments are modified such that they no longer meet the definition of a firm commitment (Question 2.10.50).</td>
<td>Adding to or deleting from a portion of a forecasted transaction or group of hedged transactions (Question 2.10.20).</td>
<td>Changes in the net investment balance should be monitored to determine whether the hedging relationship should be redesignated to reflect a revised balance (section 8.2.20).</td>
</tr>
<tr>
<td>For last-of-layer hedges, Question 2.10.40.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Future developments

At a March 2018 meeting, the FASB discussed potential Codification improvements that may extend an entity’s ability to change the hedged risk and/or the hedged forecasted transaction (see Question 5.4.90). This will include clarification related to how broadly or narrowly the hedged transaction is defined and whether a change in the hedged risk constitutes a change in the hedged transaction. [FASB meeting 03-18]
Example 2.10.10

Discontinuance of hedging relationship when an unrelated party is acquired

Cash flow hedges

ABC Corp. applies hedge accounting to a forecasted transaction to purchase a nonfinancial asset from XYZ (a third party) for its exposure to price risk.

Later, ABC acquires a controlling interest in XYZ. Because XYZ is no longer a ‘party external to the reporting entity’, the forecasted transaction is not eligible for designation as a hedged transaction (see section 5.3.50).

Furthermore, intercompany transactions are not eligible for hedge accounting unless the hedged risk is variability due to changes in foreign currency exchange rates (see section 2.5.50).

Therefore, ABC is required to discontinue the hedging relationship.

Fair value hedges

Similarly, ABC would be required to discontinue a hedging relationship involving a firm commitment to purchase a nonfinancial asset from XYZ. To be eligible for hedge accounting, a firm commitment must be between two unrelated parties (see section 3.3.20).

Question 2.10.10

If an entity concludes that some (but not all) forecasted transactions are no longer probable, is it required to discontinue a cash flow hedging relationship?

Interpretive response: Yes. We believe the entity must discontinue cash flow hedge accounting for the specific forecasted transactions that are no longer probable, even if the entire hedging relationship is highly effective. If the conditions for a partial dedesignation are met (see Questions 2.10.100 and 2.10.110), the entity may choose to partially dedesignate the hedging relationship. Otherwise, we would generally expect the entity to fully dedesignate the hedging relationship, however there may be other acceptable approaches based on the specific facts and circumstances.

Scenario 1 of Example 2.10.40 illustrates a partial dedesignation when an entity concludes that some forecasted transactions in a group or series of forecasted transactions are no longer probable. In that example, the hedging instrument is a forward contract. We believe the same general concepts in that example would apply when the hedging instrument is an option or an interest rate swap, although there may be additional complexities in those situations.
Question 2.10.20

Does adding to or deleting from a portion of a hedged item or transaction (or portfolio or group of hedged items or transactions) require dedesignation of the hedging relationship?

Interpretive response:

**Fair value hedges**

It depends. The following table summarizes when fair value hedging relationships should be dedesignated because of additions or deletions.

<table>
<thead>
<tr>
<th>Change</th>
<th>Is dedesignation required?</th>
</tr>
</thead>
</table>
| **Increase in hedged item or addition to a hedged portfolio** | Yes. We would consider an increase to the portion of a hedged item or the addition of new items to a portfolio of hedged items as a change in the critical terms of the hedging relationship. This requires discontinuation of the hedging relationship.  
We believe reselling (reissuing) a portion of an entity’s own debt is not considered an addition in this context (see Question 2.10.30). |
| **Decrease in hedged item or deletion from a hedged portfolio** | Yes. If there is a reduction in the balance of a hedged item or portfolio of hedged items, we believe this is a change to the critical terms of the original hedging relationship and would require full or partial dedesignation of the hedging relationship.  
We believe that scheduled loan amortizations of principal, prepayments or writeoffs are not considered deletions in this context. In addition, we believe repurchasing a portion of an entity’s own debt is not a deletion in this context (see Question 2.10.30). |

This response does not apply to hedges using the last-of-layer method (see Question 2.10.40).

**Cash flow hedges**

It depends on the method used to specifically identify the transaction (or group of transactions) in the original hedging relationship. The following table summarizes when cash flow hedging relationships should be dedesignated because of additions to or deletions from a portion of a hedged transaction or group of transactions.

<table>
<thead>
<tr>
<th>Change / hedged transaction</th>
<th>Is dedesignation required?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Increase in hedged transaction or addition to a group of transactions</strong></td>
<td>Yes. We believe that adding transactions to a specific item or group of items represents a change in a critical term of the original hedging relationship, which requires dedesignation of the original hedging relationship.</td>
</tr>
<tr>
<td>Hedged transaction identified as relating to a specific individual asset or liability (or group thereof)</td>
<td>It depends. We believe an entity may continue the hedging relationship as long as it is probable that it will continue to</td>
</tr>
</tbody>
</table>
### Change / hedged transaction

<table>
<thead>
<tr>
<th>Change / hedged transaction</th>
<th>Is dedesignation required?</th>
</tr>
</thead>
<tbody>
<tr>
<td>cash flows received or paid up to a specific amount in a particular period (without reference to the specific asset or liability)</td>
<td>receive (or pay) the specified cash flows. In other words, any changes to the composition of existing assets or liabilities generating the cash flows would not affect the designated hedging relationship. This assumes the total dollar amount of the forecasted transaction(s) has not changed.</td>
</tr>
</tbody>
</table>

### Decrease in hedged transaction or deletion from a group of transactions

| Hedged transaction identified as relating to a specific individual asset or liability (or group thereof) | Yes. We believe that reducing a portion of a specific item or deleting from the composition of a specific group represents a change in the probability of the identified hedged forecasted transactions for the hedging relationships related to the reduced balance of an item or the individual item(s) removed from the group. Consequently, the hedging relationships for the forecasted transactions that are no longer probable must be discontinued. [815-20-55-99] |
| Hedged transaction identified as first cash flows received or paid up to a specific amount in a particular period (without reference to the specific asset or liability) | It depends. Any reductions to related assets or liabilities might not affect the designated hedging relationship. As long as an entity determines it is probable that it will continue to receive (or pay) the originally designated cash flows (e.g. first LIBOR-based interest payments received), the original hedging relationship can continue if it remains highly effective. [815-20-55-95] If an entity concludes it is not probable that it will receive (or pay) some of the originally designated cash flows, the entity must discontinue the hedging relationship for those forecasted transactions that are no longer probable. We believe that in certain circumstances an entity would have the option of partially dedesignating a proportion of the hedging instrument if certain criteria are met (see section 2.10.60). Otherwise, we would generally expect the entity to fully dedesignate the hedging relationship, however there may be other acceptable approaches based on the specific facts and circumstances. |

**Missed forecast.** If it is probable that a portion of the forecasted transaction will *not* occur, we believe an entity must immediately reclassify into earnings related amounts in AOCI (unless the purchase will occur within an additional two-month period or extenuating circumstances apply) and also consider this missed forecast when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions. See section 6.5.20, including Question 6.5.110.
<table>
<thead>
<tr>
<th>Change / hedged transaction</th>
<th>Is dedesignation required?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Missed forecast.</strong> If it is probable that a portion of the forecasted transaction will not occur, we believe an entity must immediately reclassify into earnings related amounts in AOCI (unless the purchase will occur within an additional two-month period or extenuating circumstances apply) and also consider this missed forecast when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions. See section 6.5.20, including Question 6.5.110.</td>
<td></td>
</tr>
</tbody>
</table>

The FASB has discussed updates that may extend an entity’s ability to change the hedged risk to the hedged forecasted transaction (see Question 5.4.90). As a result, revisions to this interpretive response may be provided in a future edition.

**Question 2.10.30**

**Is a fair value hedging relationship required to be discontinued if an entity repurchases and subsequently resells (reissues) some of its own debt?**

**Background:** In certain situations, an entity issues public debt and also acts as a market-maker for that debt. As a market-maker, the entity is expected to acquire and subsequently resell (reissue) some of the debt.

**Interpretive response:** It depends on whether the hedging relationship remains highly effective. We believe the entire debt issuance may be designated as the hedged item, rather than designating the individual debt certificates as a portfolio of hedged items.

This is consistent with:

- paragraph 470-60-15-4 regarding troubled debt restructurings, which states that a bond constitutes one payable even though there are many bondholders.

- paragraph 320-10-35-20 regarding investment securities, 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.

When the hedged item is designated as an individual debt issuance, acquisitions and resales (reissues) of a portion of the debt issuance result in the outstanding principal balance of the designated hedged item fluctuating. In this instance, the balance of the designated hedged item is merely fluctuating and therefore this is not considered an additional item designated as the hedged item or portfolio in the context of Question 2.10.20 or a partial dedesignation (see section 2.10.60). In other words, it is not considered to be a change in the critical terms of the hedging relationship. These fluctuations will result in the hedging relationship not being perfectly effective.
This lack of perfect effectiveness will occur even if the hedged item is designated as a portion of the entire debt issuance (e.g. 90% of the entire issuance). In that situation, 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 is required to consider the effect of the market making activities. This may result in the entity concluding that the relationship will not be or has not been highly effective, which would require the hedging relationship to be fully or partially redesignated.

**Question 2.10.40**

How does a decrease in the balance of the last of layer expected to remain outstanding at the end of the hedge term affect a last-of-layer hedging relationship?

**Background:** Topic 815 permits an entity to designate a fixed amount of a closed portfolio of prepayable financial assets as the hedged item in a fair value hedge of interest rate risk if the entity expects that the designated amount will remain outstanding at the end of the hedge term – i.e. last of layer (see section 3.3.100). [815-20-25-12(b)(2), 25-12A]

An entity is required to support its expectation that the last of layer will remain outstanding at the end of the hedge term. In this analysis, the entity assumes that as prepayments, defaults and other events affecting the timing and amount of cash flows occur, they will first be applied to the portion of the closed portfolio that is not part of the designated last of layer (see Question 3.3.320). [815-20-25-12A]

**Excerpt from ASC 815-25**

**40-8** For a hedging relationship designated under the last-of-layer method in accordance with paragraph 815-20-25-12A, an entity shall discontinue (or partially discontinue) hedge accounting in either of the following circumstances:

a. If the entity cannot support on a subsequent testing date that the hedged item (that is, the designated last of layer) is anticipated to be outstanding in accordance with paragraph 815-25-35-7A, it shall at a minimum discontinue hedge accounting for the portion of the hedged item no longer expected to be outstanding at the hedged item’s assumed maturity date.

b. If on a subsequent testing date the outstanding amount of the closed portfolio of prepayable financial assets or one or more beneficial interests is less than the hedged item, the entity shall discontinue hedge accounting.
Interpretive response: There are two situations in which a hedging relationship designated using the last-of-layer method in a closed portfolio of prepayable financial assets is discontinued, as illustrated in the following diagram.

<table>
<thead>
<tr>
<th>Occurs when:</th>
<th>Scenario 1: Partial discontinuation</th>
<th>Scenario 2: Full discontinuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount outstanding in portfolio on testing date exceeds last of layer (i.e. hedged item) but last of layer not expected to remain outstanding at end of hedge term</td>
<td>The portion of the last of layer no longer expected to remain outstanding at end of hedge term</td>
<td>The entire hedging relationship</td>
</tr>
<tr>
<td>Hedge accounting is discontinued for:</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

By allowing partial dedesignation of a last-of-layer hedging relationship, an entity can reduce the amount of the hedged item based on updated estimates of the balance expected to remain outstanding at the end of the hedge term, assuming it is not less than the current balance of the portfolio.

The FASB acknowledged that estimating the balance expected to remain at the hedged item’s assumed maturity date resembles a cash flow hedging concept. However, the tainting threshold for cash flow hedges in paragraph 815-30-40-5 should not be applied to the last-of-layer method. This means that a pattern of partially dedesignating a last-of-layer hedging relationship would not call into question an entity’s ability to accurately predict the balance remaining at the end of the hedge term or the propriety of using the last-of-layer method in the future. [ASU 2017-12.BC119]

For guidance on partially and fully discontinuing hedge accounting for a last-of-layer hedge, see section 4.5.30.

Question 2.10.50

How is hedge accounting discontinued for a hedged item that no longer meets the definition of a firm commitment?

Excerpt from ASC 815-25

>> Hedged Item No Longer Meets Definition of Firm Commitment

40-5 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 do both of the following:
2. General hedging requirements

a. Derecognize any asset or liability previously recognized pursuant to paragraph 815-25-35-1(b) (because of an adjustment to the carrying amount for the firm commitment)
b. Recognize a corresponding loss or gain currently in earnings.

40-6 A pattern of discontinuing hedge accounting and derecognizing firm commitments would call into question the firmness of future hedged firm commitments and the entity’s accounting for future hedges of firm commitments.

If the hedged item in a fair value hedge is a firm commitment that later ceases to meet the definition of a firm commitment (e.g. because the counterparty terminated the agreement), the asset or liability previously recognized is recognized in earnings immediately. This is because the firm commitment no longer exists. [815-25-40-5]

Situations in which this occurs are expected to be rare. A pattern of discontinuing hedge accounting of firm commitments because the contracts ceased to meet the definition of a firm commitment may call into question whether future arrangements represent firm commitments and (as a result) the ability to apply hedge accounting for future firm commitments. [815-25-40-6]

2.10.30 Change in eligibility or critical terms of hedging instrument

Hedge accounting must be discontinued when the hedging instrument no longer meets the qualifying criteria outlined in section 2.6.

The following are examples of changes in the eligibility or critical terms of a hedging instrument that would require dedesignation:

—— hedging instrument expires or is sold, terminated or exercised;
—— hedging instrument is no longer highly effective at offsetting changes in fair value or cash flows of the hedged item or transaction (see section 2.10.50);
—— a change in the creditworthiness of the counterparty or an entity’s own nonperformance risk that causes the hedge to no longer be highly effective (see section 9.2.60);
—— rebalancing a combination of hedging instruments (see Question 2.10.60);
—— hedging instrument is dedesignated in its entirety; and
—— changes to contractual terms (e.g. strike price, maturity dates, or embedded put or call options).

An entity may also elect to partially dedesignate a hedging relationship by partially dedesignating the hedging instrument (see section 2.10.60).
Question 2.10.60

Is a hedging relationship required to be discontinued if the hedging instrument is a combination of derivatives and the combination is rebalanced?

Background: Some entities hedge portfolios of similar assets or liabilities using a combination of derivatives as hedging instruments. Additions or deletions (a rebalancing) to either the portfolio of derivatives or hedged items may be needed to achieve high effectiveness, such as in a delta-neutral dynamic hedging strategy or a dynamic hedging relationship involving a tailing strategy (see section 9.2.50). For guidance on designating a combination of derivatives as the hedging instrument, see section 2.6.40.

Interpretive response: Yes. Rebalancing a portfolio of derivatives changes the composition of the derivative hedging instruments specified in the original hedge documentation and therefore represents a change in the hedging relationship. As a result, an entity would be required to dedesignate the current hedging relationship and could redesignate a new hedging relationship.

Fair value hedges. For guidance on amortization of the basis adjustment when a portfolio of hedged items that is hedged by a combination of hedging instruments is rebalanced, see Question 4.5.10.

Question 2.10.70

Does modification of a hedging instrument’s collateral requirements require a hedge to be discontinued?

Interpretive response: No. We believe that neither the modification of collateral requirements nor the addition of a new guarantor results in the existing derivative being viewed as terminated. This is because the substantive terms of the derivative (e.g. strike price or maturity date) did not change. As a result, we do not believe these changes cause discontinuation of any associated hedging relationship.

However, the fair value of the derivative instrument may be affected by these changes, which may affect hedge effectiveness.

Derivative novation

Excerpt from ASC 815-20

55-56A For the purposes of applying the guidance in paragraph 815-20-55-56, a change in the counterparty to a derivative instrument that has been designated as the hedging instrument in an existing hedging relationship would not, in and of itself, be considered a change in a critical term of the hedging relationship.
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. In some situations, the derivative instrument that is the subject of the novation might be designated as the hedging instrument in a hedging relationship.

A novation is not considered a termination of the hedging instrument, but rather is a change in the counterparty to a derivative instrument. Therefore, when a novation occurs an entity is typically not required to discontinue the hedging relationship.

However, if a derivative instrument novation involves a new counterparty with creditworthiness different from that of the old counterparty, the entity should consider that change in creditworthiness in determining whether the hedging relationship continues to be highly effective and qualifies for hedge accounting. Similarly, if a novation leads to changes in security or cash collateral posting requirements, those changes should also be incorporated into an entity’s assessment of hedge effectiveness.

**Question 2.10.80**

**Why would a derivative novation occur?**

**Interpretive response:** 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 over-the-counter (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.

2.10.40 Change in hedged risk

Topic 815 requires an entity to discontinue hedge accounting when the critical terms of the original hedging relationship have changed, with the exception of changes to hedged risk when hedging forecasted transactions. [815-20-55-56]

— **Fair value hedges.** If there is a change to the hedged risk in a fair value hedge, this would be considered a change in the critical terms of the hedging relationship and an entity is required to dedesignate the hedging relationship.

— **Cash flow hedges.** If there is a change to the hedged risk in a cash flow hedge for a forecasted transaction, an entity is not required to automatically dedesignate the hedging relationship if the hedging relationship continues to be highly effective. See section 5.4.60 for guidance on changing the hedged risk when hedging forecasted transactions. [815-30-35-37A]

— **Net investment hedges.** A net investment hedge is a hedge of the exposure to foreign currency risk of a net investment in a foreign operation. If there is a change to the functional currency of the hedged net investment, an entity is required to dedesignate the hedging relationship. See paragraphs 4.021 to 4.033 in KPMG’s Handbook, *Foreign Currency*, for additional guidance on changing the functional currency of an entity.

2.10.50 Change in hedge effectiveness

Hedge accounting must be discontinued when the hedging relationship is no longer highly effective. The date at which hedge accounting must be discontinued depends on whether the hedging relationship failed the prospective effectiveness test or the retrospective effectiveness test.

<table>
<thead>
<tr>
<th>Failure to meet...</th>
<th>Discontinuance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Prospective effectiveness assessment</strong></td>
<td>— Discontinue hedge accounting prospectively.</td>
</tr>
</tbody>
</table>
Failure to meet... | Discontinuance
---|---
Retrospective effectiveness assessment | — Discontinue hedge accounting as of the last date on which effectiveness testing indicated relationship was highly effective, or date of a specific event or change in circumstance. [815-25-40-3 – 40-4]
| — Hedging relationship not eligible for partial dedesignation (see Question 2.10.100).

For additional guidance on hedging relationships that are no longer highly effective, see the following.

— **Fair value hedges.** For guidance on identifying the date hedge accounting should be discontinued, see section 4.5.20.

— **Cash flow hedges.** For guidance on identifying the date hedge accounting should be discontinued, including circumstances when a change in creditworthiness causes a hedge to cease being highly effective, see Questions 6.5.30 and 6.5.40.

— **Net investment hedges.** For guidance on discontinuing a hedging relationship that is no longer effective as an economic hedge, see section 8.5.40.

**Changing quantitative methods for assessing effectiveness.** A change in the quantitative method for assessing effectiveness – including whether a component of the hedging instrument is excluded from the assessment of effectiveness – is considered a change in the hedging relationship that requires an entity to dedesignate and redesignate the hedging relationship. For guidance on requirements when an entity changes its quantitative method for assessing effectiveness, see section 9.6.40.

**Question 2.10.90**

If a hedging relationship has not been highly effective retrospectively, but is expected to be prospectively, is hedge accounting required to be discontinued prospectively?

**Interpretive response:** Not necessarily. Generally, if an entity determines that a hedging relationship has not been retrospectively highly effective at the current assessment date, it does not apply hedge accounting for the period between the previous assessment date and the current assessment date. This means that the change in fair value of the hedged item (for fair value hedges) is not recognized as a basis adjustment or the change in fair value of the hedging instrument (for cash flow hedges) is recognized in earnings (rather than OCI) for the assessment period. The entity may discontinue the current hedging relationship and designate the derivative in a new hedging relationship (see section 2.10.70).

However, if the hedging relationship is expected to be prospectively highly effective, the hedging relationship is not required to be discontinued prospectively. We believe these circumstances should be limited. For example,
if an entity can provide sufficient evidence to support its conclusion that the hedging relationship was not highly effective in a previous effectiveness assessment period due to an unusual, discrete event that is not expected to occur in future effectiveness assessment periods, we believe the hedging relationship is not required to be discontinued prospectively.

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Example 2.10.20

**Hedge discontinuation because the hedging relationship is no longer highly effective**

ABC has 20,000 barrels of West Texas Grade A crude oil in its inventory. To hedge the fair value of this oil, ABC enters into a six-month futures contract on 20,000 barrels of West Texas Grade B crude oil.

ABC has entered into a futures contract on West Texas Grade B (rather than Grade A) 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, ABC determined that the hedging relationship was highly effective. However, at the end of the fourth month, ABC’s management determined that the hedging relationship is no longer highly effective on a prospective basis; this is because 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.

ABC is required to stop applying hedge accounting as of the latest date that it can be demonstrated that the hedging relationship was highly effective, which would be the date of the fire. For guidance on applying hedge accounting through the date that an event or change in circumstance resulted in the hedge no longer being highly effective, see section 4.5.20 (fair value hedges) and Question 6.5.30 (cash flow hedges).

However, ABC could later redesignate the futures contract in a fair value hedging relationship with its West Texas Grade A crude oil inventory (i.e. a new hedging relationship) if it concluded that the hedging relationship was expected to be effective in the future and all the other hedge criteria are met.

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**2.10.60 Partially dedesignating a hedging relationship**

<table>
<thead>
<tr>
<th>Question 2.10.100</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Under what conditions may an entity partially dedesignate a hedging relationship?</strong></td>
</tr>
</tbody>
</table>

**Background:** We believe an entity may partially dedesignate a hedging relationship for a variety of reasons, including but not limited to:

- a decrease in the balance of a hedged item or deletion from a hedged portfolio (see Question 2.10.20);
— a portion of the forecasted transaction or group of transactions is no longer probable (see Questions 2.10.10 and 2.10.20); or
— the entity elects to partially dedesignate the hedging relationship.

**Interpretive response:** We believe an entity may partially dedesignate a hedging relationship if all of the following conditions are met:

— **The entity concurrently modifies the original hedge documentation** to reflect updated proportions of the hedging instrument and/or hedged item or forecasted transaction. This is based on the requirement for an entity to prepare hedge documentation concurrent with the hedge designation (see section 2.9.40). [815-20-25-3]

— **The original hedging relationship has been highly effective on a retrospective basis.** This assessment is based on the hedged item(s) or forecasted transaction(s) as designated in the original formal hedge documentation (as opposed to the formal hedge documentation as updated to reflect the partial dedesignation). Changes to the hedged items or transactions subsequent to hedge inception would be factored into the assessment – i.e. specific forecasted transactions that are not probable would be excluded from the effectiveness assessment for a cash flow hedge.

— **The partially dedesignated hedging instrument is expected to be prospectively highly effective** at offsetting changes in the fair value or cash flows of the hedged item or transaction. This assessment is based on the hedged item(s) or forecasted transaction(s) as designated in the formal hedge documentation after it had been updated to reflect the partial designation.

— **Hedge ratio.** When partially dedesignating a hedging relationship, we believe the same hedge ratio – i.e. the ratio of the amount of the hedged item or transaction to the notional amount of the hedging instrument – that was included in the original hedging relationship needs to be maintained in the partially dedesignated hedging relationship.

This response does not apply to **fair value hedges** using the last-of-layer method (see Question 2.10.40).

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**Question 2.10.110**

**How does an entity partially dedesignate a hedging instrument?**

**Interpretive response:** If the criteria to partially designate the hedging relationship are met (see Question 2.10.100), we believe a decrease to the notional amount of a derivative designated as the hedging instrument can be achieved in either of the following ways.

— **Decreasing the proportion of the derivative designated as the hedging instrument.** An entity can modify the hedge documentation to reduce the proportion of the derivative instrument designated in the hedging relationship. The proportion of the derivative instrument no longer designated as part of the hedging relationship is eligible to be designated in
a new hedging relationship. This is illustrated in Examples 2.10.30 (fair value hedge) and 2.10.40 (cash flow hedge).

— Partially terminating the derivative hedging instrument. We believe the hedging instrument can be partially terminated such that the notional of the hedging instrument is decreased. In this situation, the originally documented proportion of the hedging instrument continues to be the designated proportion, although of a smaller notional amount. To partially terminate a hedging instrument without dedesignating and redesignating the entire hedging relationship, the only change in the terms of the hedging instrument should relate to the reduction in the notional amount. There can be no other changes to the critical terms of the original agreement. This is illustrated in Example 2.10.50.

Example 2.10.30
Partial decrease of hedged item in a fair value hedge

ABC entered into an interest rate swap to hedge exposure to interest rate risk on $60 million of $100 million outstanding debt. ABC documents the hedged item as 60% of the principal amount of $100 million.

The original hedging relationship includes the following.
— Principal amount of debt: 60% of the outstanding debt balance (the initial hedged item is therefore $60 million)
— Swap notional amount: 100% of the interest rate swap notional amount

Because both amounts are initially $60 million, the initial hedge ratio is 1:1.

Scenario 1: Partial repayment of principal and partial dedesignation

ABC subsequently repays $10 million principal of the outstanding debt (i.e. 10%). This is not a scheduled principal payment. Since the hedged item is 60% of the outstanding debt balance, and the outstanding debt has been reduced to $90 million, the hedged item is reduced to $54 million.

ABC wishes to partially dedesignate 10% (or $6 million) of the notional amount of the interest rate swap to align it with the remaining amount of the hedged item.

ABC performs retrospective and prospective hedge effectiveness assessments.

<table>
<thead>
<tr>
<th>Retrospective – original hedging relationship</th>
<th>100% of the interest rate swap ($60 million notional) is determined to be highly effective retrospectively at hedging exposure to interest rate risk on the remaining amount of the hedged item ($90 million principal outstanding × 60% = $54 million principal).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prospective – original hedging relationship</td>
<td>90% of the interest rate swap ($60 million notional × 90% = $54 million notional) is determined to be highly effective prospectively at hedging exposure to interest rate risk on the remaining amount of the hedged item ($90 million principal outstanding × 60% = $54 million principal).</td>
</tr>
</tbody>
</table>
In addition, the hedge ratio of the partially dedesignated hedging relationship remains 1:1 – i.e. $54 million remaining amount of hedged item to $54 million notional amount of the hedging instrument.

Therefore, ABC may partially dedesignate the hedging relationship.

ABC elects to partially dedesignate 10% (or $6 million) of the notional amount of the interest rate swap. Concurrently, ABC modifies the hedge documentation to reflect the reduced amounts of the hedged item and hedging instrument.

### Updated hedging relationship

<table>
<thead>
<tr>
<th>60% designated portion of outstanding portion of debt balance: $54 million principal</th>
<th>90% designated proportion of swap: $54 million notional</th>
</tr>
</thead>
</table>

| Accounting considerations |
| Subsequent changes in the fair value of the proportion of the swap no longer designated as part of the hedging relationship (i.e. $6 million notional) are recognized in earnings. This proportion of the hedging instrument is eligible to be designated in a new hedging relationship. [815-25-40-2] |
| The cumulative basis adjustment recognized at the date of prepayment is part of the amortized cost basis used to determine the gain or loss related to the prepayment. |
| For additional guidance on partially discontinuing fair value hedge accounting, see Question 4.5.20. |

### Notes:

1. $90 million principal outstanding × 60% = $54 million principal.  
2. $60 million total notional of the swap × 90% = $54 million notional.

Alternatively, ABC could partially dedesignate the hedging relationship by terminating a proportion of the interest rate swap (see Example 2.10.50).

### Scenario 2: Partial repayment of principal and full dedesignation

ABC subsequently repurchases $25 million on its outstanding debt (i.e. 25%). This is not a scheduled principal payment.

ABC wishes to partially dedesignate 25% (or $15 million) of the notional amount of the interest rate swap to align it with the remaining amount of the hedged item.

ABC performs a retrospective effectiveness assessment.

### Retrospective – original hedging relationship

| 100% of the interest rate swap ($60 million notional) is determined to be not highly effective retrospectively at hedging exposure to interest rate risk on the remaining amount of the hedged item ($75 million principal outstanding × 60% = $45 million principal). |

Because the original hedging relationship is not highly effective retrospectively, ABC cannot partially dedesignate the hedging relationship. Instead, ABC must fully dedesignate the hedging relationship.
Example 2.10.40
Partial reduction of items in a group of hedged forecasted transactions (cash flow hedge)

ABC Corp. is a car manufacturer. On January 1, Year 1, ABC forecasts it will purchase 100,000 tons of steel on December 31, Year 1. ABC’s contracts to purchase steel are typically at a price based on the NYSE American Steel Index.

ABC enters into a forward derivative contract indexed to the NYSE American Steel Index to purchase 100,000 tons of steel that will mature on December 31, Year 1.

ABC documents as the hedged risk the variability in cash flows attributable to changes in the contractually specified NYSE American Steel Index in the not-yet-existing purchase contract. Assume all criteria are met to qualify for hedge accounting.

The hedge ratio is 1:1 – i.e. forecasted purchase of 100,000 tons to a hedging instrument with a notional of 100,000 tons.

Scenario 1: It is probable that 10% of the original forecasted transaction will not occur

On July 1, Year 1, ABC determines it is probable that the purchase of 10,000 tons of steel will not occur. ABC concludes it is probable that it will continue to purchase 90,000 tons of steel on December 31, Year 1.

ABC wishes to partially dedesignate 10% (or 10,000 tons) of the notional amount of the forward contract to align it with the amount of steel purchases that remain probable (i.e. 90,000 tons).

ABC performs retrospective and prospective hedge effectiveness assessments.

<table>
<thead>
<tr>
<th>Retrospective – original hedging relationship</th>
<th>100% of the forward contract (100,000 tons notional) is determined to be highly effective retrospectively at hedging exposure to the contractually specified NYSE American Steel Index on the remaining amount of the hedged forecasted transaction (90,000 tons).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prospective – original hedging relationship</td>
<td>90% of the forward contract (100,000 tons notional x 90% = 90,000 tons) is highly effective prospectively at hedging exposure to the contractually specified NYSE American Steel Index on the remaining amount of the hedged forecasted transaction (90,000 tons).</td>
</tr>
</tbody>
</table>

In addition, the hedge ratio of the partially dedesignated hedging relationship remains 1:1 – i.e. forecasted purchase of 90,000 tons to a hedging instrument with a notional of 90,000 tons.

Therefore, ABC may partially dedesignate the hedging relationship.

ABC partially dedesignates 10,000 tons of the notional amount of the forward contract. Concurrently, ABC modifies the hedge documentation to reflect the reduced amounts of the hedged transaction and hedging instrument.
### 2. General hedging requirements

**Updated hedging relationship**

<table>
<thead>
<tr>
<th>Forecasted transaction: 90,000 tons of steel</th>
<th>Accounting considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>90% designated proportion of forward contract: 90,000 tons of steel</td>
<td>Subsequent changes in the fair value of the proportion of the forward contract no longer designated as part of the hedging relationship (i.e. 10,000 tons of notional) are recognized in earnings, rather than AOCI. This proportion of the hedging instrument is eligible to be designated in a new hedging relationship. Amounts in AOCI at the date of partial dedesignation are allocated between the forecasted transactions that remain in the hedging relationship and those that were dedesignated. Because it is probable that the purchase of 10,000 tons will not occur, the amount of AOCI allocated to the purchase of 10,000 tons is immediately reclassified into earnings unless the purchase will occur within an additional two-month period or extenuating circumstances apply. For additional guidance on partially discontinuing cash flow hedge accounting, see Question 6.5.20.</td>
</tr>
</tbody>
</table>

**Note:**

1. Total notional amount of forward contract (i.e. 100,000 tons of steel) × 90% = 90,000 tons of steel.

Because it is probable that a portion of the originally forecasted transactions will not occur, ABC is required to consider this as a missed forecast when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions (see Question 6.5.110).

**Scenario 2: Probable 25% of the forecasted transaction will not occur and full dedesignation**

On July 1, Year 1, ABC determines it is probable that the purchase of 25,000 tons of steel will not occur. ABC concludes it is probable that it will continue to purchase 75,000 tons of steel on December 31, Year 1.

ABC wishes to partially dedesignate 25% (or 25,000 tons) of the notional amount of the forward contract to align it with the amount of steel purchases that remain probable (i.e. 75,000 tons).

ABC performs a retrospective hedge effectiveness assessment.

| Retrospective – original hedging relationship | 100% of the forward contract (100,000 tons notional) is not highly effective retrospectively at hedging exposure to the contractually specified NYSE American Steel Index on the remaining amount of the hedged forecasted transaction (75,000 tons). |

Because the original hedging relationship is not highly effective retrospectively, ABC cannot partially dedesignate the hedging relationship. Instead, ABC must fully dedesignate the hedging relationship.

Because it is probable that the purchase of 25,000 tons of steel will not occur, ABC is required to immediately reclassify related amounts from AOCI into earnings unless the purchase will occur within an additional two-month period or extenuating circumstances apply (see section 6.5.20). Additionally, ABC is required to consider this as a missed forecast when evaluating whether it has a
pattern of missing forecasts that calls into question its ability to predict future transactions (see Question 6.5.110).

Example 2.10.50
Partial termination of a hedging instrument

Assume the same facts and circumstances as in Example 2.10.30 (Scenario 1: Partial repayment of principal and partial dedesignation), except that ABC partially terminates the interest rate swap.

After paying down $10 million on its outstanding debt balance (originally $60 million principal), ABC negotiates with the counterparty of the interest rate swap to reduce the notional amount from $60 million to $54 million. ABC settles the fair value of the interest rate swap related to the $6 million reduced notional with the counterparty. The swap agreement is amended to reflect the reduced notional amount of $54 million. No other critical terms or conditions are changed.

The hedge ratio of the partially dedesignated hedging relationship remains 1:1 – i.e. $54 million hedged item to $54 million hedging instrument. Hedge accounting continues to be applied to the reduced notional amount of the interest rate swap. Concurrently, ABC modifies the hedge documentation to reflect the reduced amounts of the hedged transaction and hedging instrument.

2.10.70 Redesignating a hedging relationship

Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15A This Topic places no limitations on an entity’s ability to prospectively designate, dedesignate, and redesignate a qualifying hedge of the same forecasted transaction.

Excerpt from ASC 815-25

> Discontinuing Hedge Accounting

40-2 In the circumstances discussed in paragraph 815-25-40-1, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in (a) and (c) in paragraph 815-25-40-1, a different hedged item or a hedged transaction if the hedging relationship meets the criteria specified in Section 815-20-25 for a fair value hedge or a cash flow hedge.
> **Discontinuing Hedge Accounting**

**40-3** Furthermore, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in paragraph 815-30-40-1(a) and 815-30-40-1(c), a different hedged **transaction** or a hedged item if the hedging relationship meets the applicable criteria for a cash flow hedge or a **fair value hedge**.

An entity may redesignate a new hedging relationship that involves either: [815-25-40-2, 815-30-40-3]

— the same hedged item or transaction and a different (or modified) hedging instrument;
— the same hedging instrument with a different (or modified) hedged item or transaction; or
— the same hedged item or transaction and the same hedging instrument.

The redesignated hedging relationship must meet all of the qualifying criteria and be formally documented.

The dedesignation and redesignation of a new hedging relationship is not a change in accounting principle under Topic 250 (accounting changes and errors). Hedge accounting is applied prospectively at inception of the redesignated hedging relationship. [815-20-55-56, 815-25-40-2, 815-30-40-3]

**Net investment hedges.** Entities are required to periodically assess whether a net investment hedge needs to be dedesignated and redesignated based on changes in the net investment balance. For further discussion, see section 8.2.20.

### Question 2.10.120

**What should an entity consider when redesignating an existing derivative instrument?**

**Background:** If an entity redesignates an existing derivative instrument in a new hedging relationship, the derivative will typically have a fair value other than zero because of changes in market conditions since inception of the hedging instrument. In other words, the derivative will be off-market at redesignation.

**Interpretive response:** These off-market terms should be considered when determining whether the new relationship is expected to be highly effective and can qualify for hedge accounting.

There are additional considerations for the following.

— **Cash flow hedges** involving derivative hedging instruments with multiple cash flows or periodic cash settlements (e.g. interest rate swaps). For these hedging relationships, amounts in AOCI that are related to the initial fair value are required to be reclassified into earnings on a systematic and
rational basis over the periods during which the hedged forecasted transactions affect earnings (see section 6.3.20). [815-30-35-41A]

— **Net investment hedges.** When an entity changes from the forward to the spot method for assessing effectiveness of a net investment hedge, a non-zero fair value of the derivative instrument creates some complexity when determining the value of the excluded component at the time of redesignation. In a February 2018 FASB meeting, the Board discussed methodologies for amortizing the excluded component, including the off-market element of a derivative instrument that could occur at the time of redesignation. For further discussion, see Question 8.4.100.

**Question 2.10.130**

Is there a limit on the frequency of dedesignating and redesignating a hedging relationship?

**Interpretive response:** No. Topic 815 does not limit the frequency of dedesignating and redesignating hedging relationships. There are hedging strategies that require frequent dedesignation and redesignation – i.e. dynamic hedging strategies (see Question 2.10.60 and section 9.2.50).

However, a pattern of dedesignating hedging relationships in certain circumstances may limit an entity’s ability to designate similar hedging relationships in the future:

— **Cash flow hedges.** A pattern of dedesignating hedging relationships when it is probable that a forecasted transaction will not occur calls into question an entity’s ability to accurately predict forecasted transactions and use hedge accounting in the future for similar forecasted transactions. See Question 6.5.110 regarding factors that are considered when evaluating whether missed forecasts represent a pattern. [815-30-40-5]

— **Fair value hedges.** A pattern of dedesignating hedging relationships because a contract no longer meets the definition of a firm commitment calls into question whether contracts entered into in the future are firm commitments that are eligible for hedge accounting (see Question 2.10.50). [815-25-40-6]
3. Qualifying criteria for fair value hedges

Detailed contents

3.1 How the standard works
3.2 Objective of a fair value hedge
3.3 Eligibility of hedged items
   3.3.10 Basic requirements
   3.3.20 Firm commitments: Definition and identification
   3.3.30 Firm commitments: Limitation on contracts that meet the definition of a derivative
   3.3.40 Portfolio of similar assets or liabilities
   3.3.50 Hedging portfolios: Assessing similar risks for a portfolio of loans
   3.3.60 Portion (or percentage) of a hedged item
   3.3.70 Hedging portions of financial items: Benchmark interest rate component
   3.3.80 Hedging portions of prepayable financial instruments: Partial-term hedges of interest rate risk
   3.3.90 Hedging portions of items: Embedded put or call options
   3.3.100 Last-of-layer method

Questions

3.3.10 Can unrecognized assets or liabilities ever be hedged items in a fair value hedge?
3.3.20 When hedging an unrecognized firm commitment, is the risk related to changes in forward or spot prices?
3.3.30 Do loan commitments or interest rate locks meet the definition of a firm commitment?
3.3.40 Can a price that varies with the market price of a fixed quantity of an item qualify as a fixed price?
3.3.50 Can a price specified in a foreign currency be a fixed price?
3.3.60 Is there a requirement for the economic disincentive to be explicitly stated in a contract?
3.3.70 Can the disincentive for nonperformance be in the form of opportunity cost?
3.3.80 Can the disincentive for nonperformance be in the form of a potential writeoff?
3.3.90 Can a firm commitment that is accounted for as a derivative ever qualify as a hedging instrument?

3.3.100 Are there acceptable ranges when evaluating shared risk exposure?

3.3.110 How often should the evaluation of the similarity of items hedged in a portfolio be performed?

3.3.120 Are periodic similarity tests required to be performed on a quantitative basis?

3.3.130 Should the similarity assessment for servicing rights use the same risk characteristics as those used in the impairment assessment under Topic 860?

3.3.140 Can a first cash flows received (paid) approach be used in a fair value hedge?

3.3.150 Which key characteristics of a loan are considered when evaluating whether individual loans share similar risk exposure?

3.3.160 Can an entity designate a portion or percentage of a nonfinancial item as the hedged item?

3.3.170 Which benchmark interest rate may be used for measurement purposes when hedging only the benchmark rate component?

3.3.180 May an entity separately designate the fixed rate subject to inflation adjustments as a benchmark rate component?

3.3.190 Why would an entity designate only the benchmark rate component?

3.3.200 If an entity uses the benchmark rate component to measure the change in fair value of a hedged item, must it do so for all similar hedging relationships?

3.3.210 When will a partial-term hedge improve effectiveness?

3.3.220 Can an entity designate a partial-term hedge using an assumed term that ends on or before the initial date a financial instrument can be prepaid?

3.3.230 Can the partial-term hedge guidance and the guidance for hedging only the benchmark rate component be applied to the same hedging relationship?

3.3.240 Must specific conditions be met to apply partial-term hedging in a fair value hedge of interest rate risk?

3.3.250 Can an entity apply hedge accounting to more than one partial term of a single instrument?

3.3.260 When multiple partial terms are hedged in separate hedging relationships, do the terms need to be consecutive?

3.3.270 Can an entity hedge multiple risks when applying partial-term hedging guidance?
3. Qualifying criteria for fair value hedges

3.3.280 Is an entity permitted to hedge the risk of changes in the fair value of an embedded call option in an HTM security that is prepayable?

3.3.290 Can an entity hedge the fair value exposure of options embedded in contracts that qualify as firm commitments?

3.3.300 What is a ‘closed portfolio’?

3.3.310 What conditions must be met for a last-of-layer hedge to pass the similarity test qualitatively?

3.3.320 What is needed to support the entity’s expectation that the last of layer will remain outstanding at the end of the hedge term?

3.3.330 Must an entity assert it is ‘probable’ that the balance of the last of layer will remain outstanding at the end of the hedge term?

3.3.340 What financial instruments can be included in the portfolio under the last-of-layer method?

3.3.350 Can the last-of-layer method be applied to a portfolio of financial liabilities?

3.3.360 Can an entity hedge multiple layers under the last-of-layer method?

**Examples**

3.3.10 Letter of intent to purchase steel

3.3.20 Contract based on fair value at future date

3.3.30 Contract with fixed price specified in a currency other than the entity’s functional currency

3.3.40 Payments made pursuant to royalty agreements

3.3.50 Firm commitment to purchase silver with a forward contract

3.3.60 Specific portion of a foreign currency denominated firm commitment

3.3.70 Designating a fair value hedge of interest rate risk using the partial-term approach

3.3.80 Hedging interest rate risk and foreign currency risk in a partial-term hedge

### 3.4 Eligibility of hedged risks

3.4.10 Interest rate risk hedges of prepayable financial instruments

3.4.20 Limitations on price risk for nonfinancial items

**Questions**

3.4.10 Why would an entity elect to consider only the effect of changes in the benchmark interest rate on the decision to prepay the financial instrument?
3.4.20 Is an entity required to consider only how changes in the benchmark interest rate affect the decision to prepay?

3.4.30 What instruments are considered prepayable under paragraph 815-20-25-6B?

3.4.40 How does paragraph 815-20-25-6B apply to nonconvertible debt with an embedded contingent call or put option?

3.4.50 Does paragraph 815-20-25-6B apply to interest rate risk hedges related to debt conversion options?

3.4.60 Does the election to consider only how changes in the benchmark interest rate affect the decision to prepay a debt instrument have to be applied to all prepayable hedged items?

**Examples**

3.4.10 Applying paragraph 815-20-25-6B to a callable bond

3.4.20 Applying paragraph 815-20-25-6B to a nonconvertible bond with an embedded contingent put

3.4.30 Fair value hedge of gold watch inventory with a gold futures contract

### 3.5 Hedging instruments in fair value hedges

3.5.10 Overview
3.1 How the standard works

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 item due to its fixed price or rate.

Topic 815 requires that certain criteria be met for a hedging relationship to qualify for fair value hedge accounting.

<table>
<thead>
<tr>
<th>Criterion 1</th>
<th>Criterion 2</th>
<th>Criterion 3</th>
<th>Criterion 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligibility of hedged items or transactions</td>
<td>Eligibility of hedged risk(s)</td>
<td>Eligibility of hedging instruments</td>
<td>Hedge effectiveness</td>
</tr>
<tr>
<td><strong>Criterion 5: Formal documentation</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Topic 815 specifies certain items that are eligible for designation as a hedged item in a fair value hedge.

**Criterion 1: Items eligible for fair value hedges (section 3.3)**

- Individual recognized assets and liabilities *(section 3.3.10)*
- Firm commitments *(section 3.3.20)*
- Portfolio of similar assets and liabilities *(section 3.3.40)*
- Portion (or percentage) of hedged item *(section 3.3.60)*
  - Hedging only benchmark interest rate component *(section 3.3.70)*
  - Partial-term hedge of interest rate risk *(section 3.3.80)*
  - Embedded put or call options *(section 3.3.90)*
  - Last-of-layer method *(section 3.3.100)*
  - Residual value in a lease *(section 3.3.101)*

Note:

Additionally, the risk(s) associated with the hedged item needs to qualify for hedge accounting. The risks eligible to be designated in a fair value hedge are different for financial and nonfinancial items.
Criterion 2: Risks eligible for fair value hedges

<table>
<thead>
<tr>
<th>Financial items (section 2.3)</th>
<th>Nonfinancial items (section 2.4)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Interest rate risk</strong></td>
<td></td>
</tr>
<tr>
<td>Changes in the benchmark interest rate for recognized fixed-rate financial instruments.</td>
<td>Not applicable.</td>
</tr>
<tr>
<td><strong>Credit risk</strong></td>
<td></td>
</tr>
<tr>
<td>Includes:</td>
<td></td>
</tr>
<tr>
<td>— changes in the obligor’s creditworthiness; and</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>— changes in the credit spread over the benchmark interest rate.</td>
<td></td>
</tr>
<tr>
<td><strong>Foreign currency risk</strong></td>
<td></td>
</tr>
<tr>
<td>Changes in the related foreign currency exchange rates.</td>
<td>Changes in the related foreign currency exchange rates if the firm commitment is denominated in a foreign currency.</td>
</tr>
<tr>
<td><strong>Price risk</strong></td>
<td></td>
</tr>
<tr>
<td>Total change in the fair value.</td>
<td>Total change in the fair value.</td>
</tr>
</tbody>
</table>

Section 3.4 provides detail around the eligibility criteria for hedged risks that are specific to fair value hedges, including:

— interest rate risk on prepayable financial instruments; and
— limitations on price risk for nonfinancial items.

**Foreign currency risk.** For further guidance on hedging foreign currency risk, see chapter 7.

Criterion 3: Hedging instruments eligible for fair value hedges

<table>
<thead>
<tr>
<th>General criteria for all hedging instruments (section 2.6)</th>
<th>General limitations on all hedging instruments (section 2.7)</th>
</tr>
</thead>
</table>

Chapter 2 discusses the general criteria and limitations on hedging instruments for all hedges. There are no additional eligibility criteria or limitations specific to fair value hedges, other than fair value hedges involving foreign currency risk (see section 7.6.20).

Criterion 4: Hedge effectiveness (chapter 9)

A derivative hedging instrument can qualify as a hedging instrument only if the entity expects the changes in fair value of the instrument to be — and the...
changes in fair value of the instrument actually are—effective at offsetting changes in fair value of the hedged item.

<table>
<thead>
<tr>
<th>Criterion 5: Formal documentation for fair value hedges</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Formal documentation requirements</strong></td>
</tr>
<tr>
<td>for all hedges</td>
</tr>
<tr>
<td><em>(section 2.9)</em></td>
</tr>
<tr>
<td><strong>Formal documentation requirements</strong></td>
</tr>
<tr>
<td>specific to fair value hedges</td>
</tr>
<tr>
<td><em>(section 2.9.50)</em></td>
</tr>
</tbody>
</table>
3.2 Objective of a fair value hedge

Fair value hedges are structured to reduce or eliminate the exposure resulting from a hedged item's fixed price or rate. Common examples of transactions that create such exposure are:

— 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.

Such transactions expose an entity to changes in the fair value of the item. For example, when an entity holds a fixed-rate security, the entity bears the risk of a change in the market price of the security through the date on which it matures or is sold.

The following table includes common examples of fair value exposures and hedging strategies.

<table>
<thead>
<tr>
<th>Hedged item</th>
<th>Fair value exposure</th>
<th>Hedging strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognized assets and liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed-rate assets</td>
<td>Interest rate risk</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.</td>
</tr>
<tr>
<td></td>
<td>Price risk</td>
<td>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</td>
<td>Interest rate risk</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.</td>
</tr>
<tr>
<td></td>
<td>Price risk</td>
<td>Lock in a maximum value by purchasing an interest rate floor option.</td>
</tr>
<tr>
<td>Firm commitments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commitment to issue a fixed-rate debt obligation</td>
<td>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 US Treasury securities.</td>
</tr>
<tr>
<td>Commitment to purchase inventory</td>
<td>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</td>
<td>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>
3.3 Eligibility of hedged items

Criterion 1: Eligibility of hedged items or transactions
Criterion 2: Eligibility of hedged risk(s)
Criterion 3: Eligibility of hedging instruments
Criterion 4: Hedge effectiveness
Criterion 5: Formal documentation

Section 3.3 discusses the criteria that must be met for items to be eligible for fair value hedge accounting. Topic 815 also prohibits certain items from hedge accounting, which are discussed in section 2.5.

Foreign currency risk. For guidance on the eligibility of hedged items in a fair value hedge of foreign currency risk, see section 7.4.10.

3.3.10 Basic requirements

Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-11 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 if all applicable criteria in this Section are met.

25-12 An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following additional 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.

Only recognized assets or liabilities, or unrecognized firm commitments, are eligible to be designated as the hedged item in a fair value hedge. [815-20-25-12]

Question 3.3.10

Can unrecognized assets or liabilities ever be hedged items in a fair value hedge?

Interpretive response: Yes, but only if they embody a firm commitment. The FASB decided that an unrecognized asset or liability that does not embody a firm commitment should not be eligible for designation as a hedged item. This is because fair value hedge accounting for an unrecognized asset or liability (e.g. an internally developed core deposit intangible) would result in recognizing a portion of it. [FAS 133.BC437]
For example, a contingent liability should only be recorded if the contingency is probable and the amount of the liability can be reasonably estimated under Topic 450 (contingencies). It should not be recognized earlier through the application of hedge accounting.

However, an entity is permitted to designate unrecognized firm commitments, including one that is embodied in an unrecognized asset or liability (e.g. mortgage servicing rights), as the hedged item in a fair value hedge. [815-20-55-11]

**Question 3.3.20**

When hedging an unrecognized firm commitment, is the risk related to changes in forward or spot prices?

**Interpretive response:** Either. 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 hedged item 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.

Therefore, when hedging changes in the fair value of a firm commitment attributable to changes in prices (i.e. price risk or foreign currency risk), entities may designate the risk being hedged as either changes in forward prices or changes in spot prices.

### 3.3.20 Firm commitments: Definition and identification

**Excerpt from ASC 815-20**

20 Glossary

**Firm Commitment** – 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. The binding provisions of an agreement are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject. 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, a price that is specified in terms of ounces of gold would not be a fixed price if the market price of the item to be purchased or sold under the firm commitment varied with the price of gold.
b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory 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 nonperformance to make performance probable for purposes of applying the definition of a firm commitment.

>>> Application of the Definition of a Firm Commitment

55-10 This implementation guidance discusses whether certain items meet the definition of a firm commitment for purposes of paragraph 815-20-25-12.

55-11 A firm commitment that represents an asset or liability that a specific accounting standard prohibits recognizing (such as a lessor’s noncancellable operating lease or an unrecognized mortgage servicing right) may nevertheless be designated as the hedged item in a fair value hedge.

55-12 A mortgage banker’s unrecognized interest rate lock commitment 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 derivative instruments 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.)

The hedged item in a fair value hedging relationship can be an unrecognized firm commitment. Topic 815 defines a firm commitment by specifying certain characteristics that must be present, which are summarized below. [815-20 Glossary]

---

### Does the agreement meet the definition of a firm commitment? (all characteristics must be included)

- Agreement is between two unrelated parties

- Agreement is binding or (legally) enforceable on both parties

- Agreement contains all of the following characteristics:
  - Contract specifies all significant terms (e.g. quantity, fixed price and timing)
  - Fixed price must be a specified amount or specified interest rate (or effective yield)
  - Includes a disincentive for nonperformance that is sufficiently large to make performance probable

---
Examples of firm commitments that could be eligible for designation as hedged items include:

- an agreement to purchase a specified quantity of assets at a specified price and date;
- an agreement to purchase a particular machine in one year at a specified price; and
- 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.

**Agreement is between two unrelated parties**

A firm commitment must be between two unrelated parties. As a result, transactions with parties such as equity method investees, affiliates, unconsolidated joint ventures, consolidated entities, shareholders and directors are excluded from being firm commitments.

**Agreement is binding or (legally) enforceable on both parties**

To meet the definition of a firm commitment, the agreement must be binding on both parties.

The FASB noted that an agreement that is binding on one party but not the other is an option rather than a firm commitment. They believe the fundamental nature of a financial instrument should not be ignored. [FAS 133.BC441]

Firm commitments that meet the definition of a derivative (e.g. options) are not eligible to be designated in a fair value hedge. See discussion of this limitation in section 3.3.30.

**Example 3.3.10**

**Letter of intent to purchase steel**

ABC Corp. is a manufacturing entity. A major component of ABC’s manufacturing (steel) is purchased from Metal Inc., an unrelated supplier. Steel is readily available from a number of suppliers and there is little cost associated with switching suppliers.

To ensure availability of steel, ABC has signed a letter of intent with Metal that specifies the likely requirements. The letter of intent is not legally binding and includes a fixed price. ABC is not required to pay a penalty if the letter of intent is cancelled.

**Does the letter of intent with Metal meet the definition of a firm commitment?**

No. The definition of a firm commitment requires a legally binding agreement.

Among other things, this agreement also lacks a sufficiently large economic disincentive restricting ABC from changing suppliers. ABC is not required to pay...
a penalty for cancelling the contract, steel is readily available from other suppliers and there is little cost to ABC for switching suppliers.

**Question 3.3.30**

**Do loan commitments or interest rate locks meet the definition of a firm commitment?**

**Background:** Loan commitments and interest rate lock commitments are legally binding commitments to extend credit to a counterparty under certain pre-specified terms and conditions, with the interest rate and the maximum loan amounts set before funding. [815-10 Glossary]

**Interpretive response:** Neither a commitment to originate a loan nor an interest rate lock commitment obligate the potential borrower. Therefore, they do not meet the definition of a firm commitment and cannot be the hedged item in a fair value hedge. [815-20-55-12]

**Characteristics of significant terms (including fixed price and disincentive for nonperformance)**

The significant terms an agreement needs to specify include:

— the quantity to be exchanged;
— the fixed price; and
— the timing of the transaction.

The definition of a firm commitment requires that the fixed price be specified in terms of a currency (or an interest rate) rather than an index, or in terms of the price or a number of units of an asset other than a currency (e.g. ounces of gold).

In addition, the agreement must include a disincentive for nonperformance that is sufficiently large to make performance probable. The determination of whether a sufficiently large disincentive for nonperformance exists requires judgment based on the facts and circumstances of each contract.

**Question 3.3.40**

**Can a price that varies with the market price of a fixed quantity of an item qualify as a fixed price?**

**Interpretive response:** No. The definition of a firm commitment explicitly states that a price that varies with the market price of an 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 based on a fixed quantity of gold. This is 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, a contract with a price that varies with the market price of an item may qualify as a hedged item in a **cash flow hedge** of a forecasted transaction.
3. Qualifying criteria for fair value hedges

Example 3.3.20

Contract based on fair value at future date

ABC Corp. enters into a contract to sell in one month 100,000 bushels of wheat to XYZ at the then fair value. If ABC cancels this contract, it will be required to pay a $50,000 penalty to XYZ.

Does the contract meet the definition of a firm commitment?

No. Because this contract provides for the sale of wheat to XYZ at fair value as opposed to a fixed price, it does not qualify as a firm commitment.

Question 3.3.50

Can a price specified in a foreign currency be a fixed price?

Interpretive response: Yes. A fixed price may be expressed as a specific amount of an entity’s functional currency or of a foreign currency.

The price of a foreign currency denominated firm commitment is not fixed in terms of the entity’s functional currency. However, Topic 815 explicitly allows foreign currency denominated firm commitments to be designated in fair value hedges of foreign currency risk (see section 7.4.50).

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 foreign currency exchange rates. Therefore, such commitments are also eligible to be designated in cash flow hedges of foreign currency risk (see section 7.6.40).

Example 3.3.30

Contract with fixed price specified in a currency other than the entity’s functional currency

ABC Corp. is a manufacturing entity with a functional currency of the US 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 ABC’s specifications.

To ensure CPU availability, ABC enters into a contract with Asia 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.

Does the contract meet the definition of a firm commitment?

Yes. The definition of a firm commitment requires 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. ABC’s commitment has all of these features.

The fixed price may be expressed as a specific amount of an entity’s functional currency or of a foreign currency (see Question 3.3.50). The fixed price has been specified in yen, a currency other than ABC’s functional currency.
Therefore, this foreign currency denominated firm commitment is eligible for designation in a fair value foreign currency hedge if all other criteria are met (see sections 7.3 and 7.4).

Example 3.3.60 continues this example, illustrating the designation of a specific portion of a foreign currency denominated firm commitment as the hedged item.

**Cash flow hedges.** Because this foreign currency denominated firm commitment also exposes ABC to variability in cash flows due to changes in currency rates, it is also eligible to be a hedged transaction in a cash flow hedge of foreign currency risk (see sections 7.3 and 7.6).

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**Example 3.3.40**

**Payments made pursuant to royalty agreements**

ABC Corp. pays royalties on each of the two products it sells. ABC’s functional currency is the US Dollar.

For one of its products, ABC pays King Corp. royalties of 10% of its revenue on all US sales. The royalty payments are made on January 15 and July 15 each year in US Dollars. ABC has a very stable sales history and has consistently achieved its stated budgets. It expects to make royalty payments of $5,000,000 on each of January 15 and July 15.

For its second product, ABC pays Queen PLC royalties on all sales in the UK of a product licensed from Queen. The royalties are paid in pounds sterling (£) and equal to £200,000 per quarter plus 2% of the quarterly revenue in excess of £5,000,000. The royalties are due 10 business days after the quarter-end. ABC expects to pay Queen £300,000 per quarter.

In both instances, ABC 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.

**Does the agreement with King meet the definition of a firm commitment?**

No. The definition of a firm commitment requires that the commitment have 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.

**Cash flow hedges.** However, this contract may qualify as a hedged transaction in a cash flow hedge because the anticipated payments due under the contract may qualify as forecasted transactions.

**Does the agreement with Queen meet the definition of a firm commitment?**

Yes, because there is a £200,000 minimum contractual payment. That amount is not variable and is due to Queen regardless of revenue. The remaining amounts (i.e. any royalty payable over £200,000) should be considered in the same manner as the agreement with King.
Therefore, this foreign currency denominated firm commitment is eligible for designation in a fair value foreign currency hedge if all other criteria are met (see sections 7.3 and 7.4).

Question 3.3.60
Is there a requirement for the economic disincentive to be explicitly stated in a contract?

Excerpt from ASC 815-25

55-84 This Example illustrates a circumstance in which statutory remedies for default constitute a disincentive for nonperformance in applying the definition of a firm commitment. Entity A enters into an agreement to purchase 4,000 barrels of a common solvent from a chemical entity at $200 per barrel on June 1, 2000. The provisions of the agreement do not include a specific disincentive for nonperformance that is sufficiently large to make performance probable. However, the laws of the legal jurisdiction to which the agreement is subject provide a disincentive for nonperformance if Entity A does not take delivery of the barrels pursuant to the agreement. The solvent is not readily convertible to cash. Therefore, because the governing legal jurisdiction provides statutory rights to pursue remedies for default equivalent to the damages suffered, the agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable for purposes of applying the definition of a firm commitment.

Interpretive response: A sufficiently large disincentive for nonperformance is required for a contract to be a firm commitment. This penalty does not need to be explicitly contained in the contract.

This requirement would be met if the legal jurisdiction that governs the agreement provides statutory remedies for default equivalent to the damages suffered by the non-defaulting party, even though the agreement itself does not include an explicit monetary penalty for nonperformance. [815-20-55-84]

In other words, the sufficiently large disincentive for nonperformance criterion can be met if the counterparty to a transaction may initiate legal remedies that constitute a sufficiently large disincentive. [815-20 Glossary]

This is illustrated in Subtopic 815-25’s FASB Example 13 above.
3.3.70 Can the disincentive for nonperformance be in the form of opportunity cost?

**Background:** A manufacturer enters into a commitment to purchase certain raw materials from one supplier. The transaction is considered probable because to purchase the same raw materials from other suppliers would be significantly more expensive.

**Interpretive response:** A disincentive for nonperformance cannot be in the form of opportunity costs. Such a disincentive is not included in an agreement, nor is it part of the legal rights or obligations codified in the laws to which such agreements are subject. Therefore, an agreement with a disincentive based solely on opportunity cost does not qualify as a firm commitment.

3.3.80 Can the disincentive for nonperformance be in the form of a potential writeoff?

**Background:** 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.

**Interpretive response:** A disincentive for nonperformance cannot be in the form of a potential writeoff. Such a disincentive is not included in an agreement, nor is it part of the legal rights or obligations codified in the laws to which such agreements are subject. Therefore, an agreement with a disincentive based solely on a potential write-off does not qualify as a firm commitment.

### 3.3.30 Firm commitments: Limitation on contracts that meet the definition of a derivative

**Excerpt from ASC 815-20**

>>> Normal Purchases and Normal Sales as Hedged Items or Transactions

25-7 A contract that is not subject to the requirements of Subtopic 815-10 because it qualifies for the normal purchases and normal sales scope exception may be designated as a hedged item in a fair value hedge, if the provisions of this Section are met. As the hedged item, the contract would be accounted for under fair value hedge accounting. Similarly, the purchase under that contract may be the hedged transaction in a cash flow hedge, if the provisions of paragraph 815-20-25-15 are met. For cash flow hedges, the special accounting applies to the hedging instrument, not to the purchase contract that is related to the hedged forecasted transaction.
25-8 In emphasizing the conditions in the definition of a derivative instrument in paragraphs 815-10-15-83 through 15-139, paragraphs 815-10-15-13 through 15-82 essentially exempt contracts that meet the definition of a derivative instrument from the requirements of Subtopic 815-10 applicable to derivative instruments. However, paragraphs 815-10-15-13 through 15-82 are not intended to preclude such contracts from being subject to the requirements of Subtopic 815-10 applicable to the hedged item in a fair value hedge.

25-9 A contract that qualifies for the normal purchases and normal sales exception will typically satisfy the criteria for a firm commitment and will not be recognized on an entity’s financial statements because of the exclusion from recognition under Subtopic 815-10 or other Topics. The transaction under a contract that qualifies for the normal purchases and normal sales exception but does not satisfy the criteria for a firm commitment because the contract does not contain a fixed price may be the hedged transaction in a cash flow hedge.

If a firm commitment is also a derivative instrument in the scope of Subtopic 815-10, it cannot be designated as a hedged item in a fair value hedge. Rather, it is accounted for as a derivative instrument.

A firm commitment is not in the scope of Topic 815 if it meets the normal purchases and normal sales scope exception in Subtopic 815-10 (or any other scope exception in that Subtopic). Therefore, a firm commitment that is a derivative instrument but that qualifies for this exception and is not accounted for as a derivative can be a hedged item in a fair value hedge. [815-20-25-7]

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 entity over a reasonable period in the normal course of business. [815-10-15-22]

Although the requirements for a derivative instrument to qualify for this exception are beyond the scope of this publication, an instrument will not qualify for the exception unless it meets these minimum requirements. [815-10-15-25]

— the asset under the contract is delivered in quantities expected to be used or sold by the entity over a reasonable period in the normal course of business;
— 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 Question 5.4.50 for the requirements to meet this criterion); and
— the entity documents the designation of the contract as a normal purchase or a normal sale.

The following decision tree provides an overview of the considerations to determine whether a firm commitment is eligible to be designated as a hedged item in a fair value, cash flow or foreign currency hedge.
3. Qualifying criteria for fair value hedges

Does contract meet the definition of a firm commitment?
Yes → Forecasts transaction may be eligible for designation as a transaction in a cash flow hedge if certain criteria are met.
No → Contract is eligible to be designated in a fair value hedge.

Does contract meet the definition of a derivative under Subtopic 815-10?
Yes → If the contract has a fixed price denominated in a currency other than an entity's functional currency, it may qualify as a hedged item in a cash flow hedge of foreign currency risk.
No → Do any of the exemptions in paragraph 815-10-15-13 apply (e.g. normal purchases and normal sales)?
Yes → Contract may qualify as a hedging instrument in an all-in-one cash flow hedge.
No → No

Question 3.3.90
Can a firm commitment that is accounted for as a derivative ever qualify as a hedging instrument?

Interpretive response: Yes. If a firm commitment does not meet any of the scope exceptions in paragraph 815-10-15-13 (e.g. normal purchases and normal sales scope exception), it is treated as a derivative and may be used as the hedging instrument in a hedging relationship. For example, it may qualify as a hedging instrument for the forecasted purchase or sale that will result from the firm commitment. This is referred to as an 'all-in-one' cash flow hedge (see section 5.3.90).

Example 3.3.50
Firm commitment to purchase silver with a forward contract
ABC Corp. 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 at the date of sale. ABC has a contract to purchase 100,000 ounces of silver from DEF at $4.99 per ounce on December 31, Year 1.
If ABC does not purchase the silver from DEF, it will be required to pay DEF a substantial penalty of $300,000. ABC is not required to make an up-front cash payment. There is no net settlement provision in the contract. Further, the quantities of silver delivered under the contract are expected to be used by ABC over a reasonable period in the normal course of business.

ABC is concerned about fluctuations in the price of silver during the commitment period. This would cause the inventory to be recorded at prices other than the market price at the date of purchase. Therefore, ABC wishes to enter into a transaction to hedge the risk of changes in the fair value of the forward contract due to changes in the market price of silver.

**Does the forward contract meet the definition of a firm commitment?**

Yes. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price and the timing of the transaction. The agreement also includes a disincentive for nonperformance that is sufficiently large to make performance probable. Therefore, the forward contract meets the definition of a firm commitment.

**Does the contract meet the definition of a derivative under Subtopic 815-10?**

Yes. The contract meets the definition of a derivative under Subtopic 815-10 because:

- it has an underlying and a notional amount – i.e. price of silver, and 100,000 ounces of silver;
- no initial investment is required; and
- the contract provides for delivery of an asset (i.e. silver) that is readily convertible to cash.

**Do any of the exemptions in paragraph 815-10-15-13 apply (e.g. normal purchases and normal sales)?**

Yes. Although the contract meets the definition of a derivative, it qualifies for the normal purchases and sales scope exception based on the following.

- The quantities of silver delivered under the contract are expected to be used over a reasonable period in the normal course of business. [815-10-15-27]
- The contract does not include a price adjustment. Therefore, ABC is not required to assess whether the underlying is clearly and closely related to the asset being purchased. [815-10-15-30]
- ABC documents the designation of the contract as a normal purchase or a normal sale.

**Does the forward contract qualify to be designated as a hedged item?**

Yes. The forward contract may present an earnings exposure to ABC because as the market price of silver changes, the amount at which ABC can sell the silver platters will also change. As a result, ABC can hedge the exposure related to the forward contract assuming all other eligibility criteria are met.

Example 4.3.40 continues this example, illustrating the accounting for a fair value hedge of a firm commitment to purchase silver with a forward contract.
3.3.40 Portfolio of similar assets or liabilities

Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-12(b)(1) If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities shall 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 shall 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. See the discussion beginning in paragraph 815-20-55-14 for related implementation guidance. An entity may use different stratification criteria for the purposes of impairment testing and for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge.

>>>>> Determining Whether Risk Exposure is Shared within a Portfolio

55-14 This implementation guidance discusses the application of the guidance in paragraph 815-20-25-12(b)(1) that the individual assets or individual liabilities within a portfolio hedged in a fair value hedge shall share the risk exposure for which they are designated as being hedged. If the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent 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 percent to 11 percent. 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 percent to 13 percent would be inconsistent with the requirement in that paragraph.

For assets or liabilities to be aggregated and hedged as a portfolio, at the inception of the hedging relationship and on an ongoing basis, each asset or liability individually needs to:
— 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 attributable to the hedged risk.

Question 3.3.100

Are there acceptable ranges when evaluating shared risk exposure?

Interpretive response: Topic 815 provides an example illustrating an acceptable range of changes in fair value.

If the change in the fair value of a hedged portfolio attributable to the hedged risk were 10%, then the change in fair values attributable to the hedged risk for each item in the portfolio should be within a relatively narrow range, such as 9%–11% (i.e. 90%–110% of the change in fair value of the hedged portfolio attributable to the hedged risk of 10%). The example further illustrates that a
range of 7%–13% (i.e. 70%–130% of the change in fair value of the hedged portfolio attributable to the hedged risk of 10%) would indicate the items are not similar. [815-20-55-14]

Based on this example, we believe that items in a portfolio are similar if the change in 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%–120% of the percentage change in the fair value of the aggregate hedged portfolio attributable to the hedged risk.

Therefore, if the change in the fair value of a hedged portfolio is 5%, the acceptable range for each individual item in the portfolio would be 4%–6% – i.e. 80%–120% of the 5% change in total fair value of portfolio.

However, in certain circumstances we believe an entity could perform a qualitative assessment when evaluating shared risk exposure. See Questions 3.3.120 and 3.3.150.

**Question 3.3.110**

How often should the evaluation of the similarity of items hedged in a portfolio be performed?

**Interpretive response:** To continue applying hedge accounting, hedged items in the portfolio must continue to be similar. Therefore, the similarity test should be performed prospectively on a recurring basis. We believe the evaluation of ‘similar’ should be performed each period that hedge effectiveness is assessed.

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 changes in market factors, an entity cannot continue applying hedge accounting.

However, there is an exception for hedges applying the last-of-layer method, whereby an entity is permitted to perform this assessment only at hedge inception (see Question 3.3.310).

**Question 3.3.120**

Are periodic similarity tests required to be performed on a quantitative basis?

**Interpretive response:** Not necessarily. Instead of performing a quantitative assessment each period, we believe an entity could perform a qualitative assessment in certain circumstances. This will require judgment and should be based on a variety of factors, including the extent of the quantitative analysis performed at inception of the hedge and the nature of the items being hedged.

For example, an entity could perform detailed stress testing around changes in market factors to develop a range based on impact to the similarity of items in a portfolio. In other words, whether changes in market factors would cause items to be outside the acceptable range for concluding that each individual item shares similar risk exposure. Any subsequent similarity assessments could be
limited to monitoring whether hedged items are trending within the range original expected and confirming that market factors did not change in a way that wasn’t originally considered in the stress testing.

If facts and circumstances regarding the portfolio change, or changes are not within the range originally expected, the entity should perform a quantitative assessment to determine whether the items continue to be similar.

**Question 3.3.130**

Should the similarity assessment for servicing rights use the same risk characteristics as those used in the impairment assessment under Topic 860?

**Excerpt from ASC 815-20**

>>> Servicing Rights as a Hedged Item

**55-16** Paragraph 815-20-25-12(b)(1) provides criteria under which similar assets or similar liabilities may be aggregated and hedged as a portfolio under a fair value hedge, requiring, in part, that the individual assets or individual liabilities share the risk exposure for which they are designated as being hedged. Servicers of financial assets that designate a hedged portfolio by aggregating servicing rights within one or more risk strata used under paragraph 860-50-35-9 would not necessarily comply with the requirement in paragraph 815-20-25-12(b)(1) for portfolios of similar assets because the risk strata under paragraph 860-50-35-9 can be based on any predominant risk characteristic, including date of origination or geographic location.

**Interpretive response:** An entity is required by Topic 860 (transfers and servicing) to aggregate servicing rights for purposes of assessing impairment. This includes stratifying servicing assets within a class based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type, size, interest rate, date of origination, term and geographic location. For mortgage loans, financial asset type refers to the various conventional or government guaranteed or insured mortgage loans and adjustable-rate or fixed-rate mortgage loans. [860-50-35-9]

When considering the similarity of the individual items to determine whether they can be hedged as a portfolio, an entity is not required to aggregate servicing rights in the same manner as when assessing impairment. That is because the risk strata used for impairment testing may not be sufficient to satisfy the similarity requirements for portfolio hedging. [815-20-55-16]
3. Qualifying criteria for fair value hedges

Question 3.3.140
Can a first cash flows received (paid) approach be used in a fair value hedge?

Background: For a cash flow hedge, the hedged transaction can be identified as the first cash flows received or paid to a specific amount in a particular period (without reference to the specific asset or liability) when hedging a group of transactions (see section 5.3.30).

Interpretive response: No. A first cash flows received (paid) approach does not require an entity to specifically identify the asset or liability for which the forecasted transaction relates. In general, Topic 815 requires fair value hedge accounting to be applied to individual assets or liabilities or portions of individual assets or liabilities, including those hedged in a portfolio (see section 4.3.30 for guidance on portfolio-level basis adjustments). Therefore, we believe an entity needs to specifically identify the individual assets or liabilities (or portions thereof) within the portfolio as the hedged item, with the exception of the last-of-layer method. [FAS 133.432, ASU-2017.BC109]

Under the last-of-layer method, the hedged item can be designated as a stated amount remaining in a closed portfolio of prepayable assets (see section 3.3.100). The designation of the hedged item under this method is effectively the inverse of how the hedged item is designated when a first cash flows received (or paid) approach is used for a cash flow hedge. [815-20-25-12A, ASU2017.BC109-BC110]

3.50 Hedging portfolios: Assessing similar risks for a portfolio of loans

Excerpt from ASC 815-20

Determining Whether Risk Exposure is Shared within a Portfolio

55-15 In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate:

a. Loan type
b. Loan size
c. Nature and location of collateral
d. Interest rate type (fixed or variable)
e. Coupon interest rate or the benchmark rate component of the contractual coupon cash flows (if fixed)
f. Scheduled maturity or the assumed maturity if the hedged item is measured in accordance with paragraph 815-25-35-13B
g. Prepayment history of the loans (if seasoned)
h. Expected prepayment performance in varying interest rate scenarios.

Topic 815 provides characteristics to be considered when assessing similarity in a portfolio of loans, including the type of loan and its scheduled maturity. [815-20-55-15]
For individual loans to be considered similar and aggregated in a portfolio, there must be an expectation 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, which may also require consideration of prepayment risk.

Question 3.3.150
Which key characteristics of a loan are considered when evaluating whether individual loans share similar risk exposure?

Interpretive response: It depends. By defining the portfolio of loans in a restrictive manner (e.g. similar settlement terms, collateralized by property in the same geographic region, similar scheduled maturities and similar interest rates), each loan in a portfolio may be expected to meet the similarity test. That is, each loan may be considered to have the same exposure to prepayment risk since each loan has a similar prepayment option. [815-20-55-176]

However, there are some fair value hedging strategies that provide opportunities for an entity to designate the hedged components of financial instruments within a portfolio in a manner that will result in those items sharing the same maturity and/or coupon rate (solely for hedge accounting purposes).

<table>
<thead>
<tr>
<th>Benchmark rate component (section 3.3.70)</th>
<th>Fixed-rate financial instruments can have the same benchmark rate component designated as the hedged item.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partial-term hedges (section 3.3.80)</td>
<td>Maturities of financial instruments can be defined as the same partial term.</td>
</tr>
<tr>
<td>Last-of-layer method (section 3.3.100)</td>
<td>Assumes all prepayable financial assets in a closed portfolio have the same maturity and benchmark coupon rate.</td>
</tr>
</tbody>
</table>

An entity may designate the hedged item and the benchmark rate component (e.g. LIBOR) to be the same.

For example, assume an entity wants to aggregate and hedge a portfolio of five loans.

<table>
<thead>
<tr>
<th>Contractual terms of loans</th>
<th>Hedge using partial-term and benchmark rate components</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Remaining maturity</td>
</tr>
<tr>
<td>Loan 1</td>
<td>24 months</td>
</tr>
<tr>
<td>Loan 2</td>
<td>17 months</td>
</tr>
<tr>
<td>Loan 3</td>
<td>21 months</td>
</tr>
<tr>
<td>Loan 4</td>
<td>26 months</td>
</tr>
<tr>
<td>Loan 5</td>
<td>28 months</td>
</tr>
</tbody>
</table>
If the entity hedges the portfolio using the benchmark interest rate component and/or the partial-term guidance, it may be more likely that it could assess similarity qualitatively (see Question 3.3.120). In the example above, applying these approaches in combination would allow the entity to assume all five loans have the identical coupon rate (i.e. the LIBOR component of the fixed interest coupons) and mature on the identical date (i.e. in 17 months).

However, depending on the type of hedge, an entity may still need to consider items such as loan type, collateral, prepayment expectations, etc. For example, a more complex similarity test is required if the entity aggregates loans based on contractual terms. This is illustrated in Subtopic 815-20’s Example 19 below.

**FASB Example: Hedging a Portfolio of Fixed-Rate Financial Assets**

This Example illustrates the application of paragraphs 815-20-25-12(b)(1) and 815-20-25-75 to a hedge of a portfolio of fixed-rate financial assets.

Entity A has a portfolio of seasoned, one to four family, fixed-rate mortgages that it wishes to designate as the hedged item in a fair value hedge of the benchmark interest rate (LIBOR). Each loan within the portfolio has similar settlement terms, is collateralized by property in the same geographic region, and has similar scheduled maturities. The loans are all within a specified interest rate band and are prepayable at par; each of the loans contained in the portfolio is expected to react in a generally proportionate manner to changes in the benchmark interest rate based on calculations performed by Entity A.

Entity A enters into a pay-fixed, receive-LIBOR interest rate swap with a fair value of zero at the inception of the hedging relationship. The stated maturity of the interest rate swap is consistent with the stated maturities of the loans. The notional amount of the interest rate swap amortizes based on a schedule that is expected to approximate the principal repayments of the loans (excluding prepayments). There is no optionality included in the interest rate swap. As part of its documented risk management strategy associated with this hedging relationship, on a quarterly basis, Entity A intends to do both of the following:

a. Assess effectiveness of the existing hedging relationship on a quantitative basis for the past three-month period
b. Consider possible changes in value of the hedging derivative and the hedged item over the next three months in deciding whether it has an expectation that the hedging relationship will continue to be highly effective at achieving offsetting changes in fair value.

Entity A’s portfolio of loans satisfies the requirements of paragraph 815-20-25-12(b)(1) regarding the grouping of similar assets because the portfolio of loans has been defined in a restrictive manner and Entity A
determined, by calculation, that each of the loans contained in the portfolio is expected to react in a generally proportionate manner to changes in the benchmark interest rate. Even though certain of the loans may prepay, each loan still may be considered to have the same exposure to prepayment risk because each loan has a similar prepayment option. When aggregating loans in a portfolio, an entity is permitted to consider among other things prepayment history of the loans (if seasoned) and expected prepayment performance in varying interest rate scenarios.

55-177 Entity A’s documented hedging strategy meets the requirements of paragraph 815-20-25-75 for a prospective assessment of effectiveness provided the entity established 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.

55-178 Paragraph 815-20-25-79(a) explains that a probable future change in fair value will be more heavily weighted than a reasonably possible future change. For example, Entity A could assign a probability weighting to each possible future change in value of the hedged portfolio. Depending on the level of market interest rates and the expected prepayment rates for the types of loans in the hedged portfolio, Entity A may reach a conclusion that the change in fair value of the swap will be highly effective at offsetting the change in the value of the portfolio of loans, inclusive of the prepayment option. As a result of this analysis, management would conclude that hedge accounting is permitted for the hedging relationship for the next three-month period. Management is required to assess the effectiveness of the existing hedging relationship for the past three-month period. If necessary, the notional amount of the swap in excess of the portfolio balance at the end of each three-month period must be redesignated to allow high effectiveness to continue in the future.

### 3.3.60 Portion (or percentage) of a hedged item

**Excerpt from ASC 815-20**

**>> Hedged Item Criteria Applicable for Fair Value Hedges Only**

25-12(b)(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:

i. A percentage of the entire asset or liability (or of the entire portfolio). An entity shall not express the hedged item as multiple percentages of a recognized asset or liability and then retroactively determine the hedged item based on an independent matrix of those multiple percentages and the actual scenario that occurred during the period for which hedge effectiveness is being assessed.

ii. One or more selected contractual cash flows, including one or more individual interest payments during a selected portion of the term of a debt instrument (such as the portion of the asset or liability representing the present value of the interest payments in any consecutive two years
iii. A put option or call option (including an interest rate cap or price cap or an interest rate floor or price floor) embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 815-15-25-1.

iv. The residual value in a lessor’s net investment in a direct financing or sales-type lease.

**Example 2: Portions and Portfolios of Individual Items as Hedged Item**

55-81 This Example illustrates the application of paragraph 815-20-25-12.

55-82 An entity that issues $100 million of fixed-rate debt may wish to hedge 50 percent of its fair value exposure to interest rate risk, as permitted by paragraph 815-20-25-12(b)(2). To accomplish that, the entity could enter into an interest rate swap with a notional amount of $50 million. The paragraph 815-20-25-104(a) criterion is satisfied because the entity has designated as a fair value hedge 50 percent of the contractual principal amount as the hedged item and has entered into an interest rate swap with a notional amount that matches the hedged principal amount.

55-83 If $100 million of fixed-rate debt were issued in increments of $1,000 individual bonds, the entity could aggregate 50,000 of those individual bonds as a portfolio to equal the notional amount of the swap, as permitted by paragraph 815-20-25-12(b)(1) (for the purposes of this Example, it is assumed that the hedge satisfies the portfolio requirements of that paragraph).

An entity can hedge a portion or percentage of an asset, liability or firm commitment. However, the specific portion (or percentage) must be identified.

For example, an entity could hedge 70% of its exposure to interest rate risk related to a specified debt obligation by designating 70% of the principal amount of the debt as the hedged item, and entering into an interest rate swap with a notional amount equal to the portion of the debt designated as the hedged item.

**Interest rate risk.** Topic 815 also provides an entity with additional choices when designating the hedged item in a fair value hedge of interest rate risk, which include both of the following.

<table>
<thead>
<tr>
<th>Benchmark rate component (section 3.3.70)</th>
<th>Benchmark rate component of fixed-coupon interest cash flows.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partial-term hedges (section 3.3.80)</td>
<td>Selected contractual cash flows, including one or more selected consecutive interest payments, for part of the financial instrument’s remaining term.</td>
</tr>
</tbody>
</table>
Question 3.3.160

Can an entity designate a portion or percentage of a nonfinancial item as the hedged item?

Interpretive response: It depends. 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 (i.e. price risk). [815-20-25-12(e)]

Therefore, an entity is unable to designate only a portion or percentage of the nonfinancial asset or liability as the hedged item. For guidance on limitations when hedging price risk for nonfinancial assets and liabilities in a fair value hedge, see section 3.4.20.

Foreign currency risk. However, if the hedged item is a foreign currency denominated firm commitment to purchase a nonfinancial asset in a fair value hedge of foreign currency risk, we believe an entity can designate a specific portion as the hedged item when hedging foreign currency risk. For guidance on hedging foreign currency denominated firm commitments, see section 7.4.50.

Cash flow hedges. The restriction on hedging a specific component of a nonfinancial item differs from guidance for cash flow hedges, which allows an entity to hedge a contractually specified component.

Example 3.3.60

Specific portion of a foreign currency denominated firm commitment

This example uses the same facts and circumstances as Example 3.3.30. For ease of reference, they are summarized below.

ABC Corp. is a manufacturing entity with a functional currency of the US 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 ABC’s specifications. To ensure CPU availability, ABC enters into a contract with Asia 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.

Assume the contract meets the definition of a firm commitment and all other eligibility criteria are met.

Foreign currency risk

ABC wishes to hedge foreign currency risk associated with the first 500 units being acquired each month. In this instance, ABC has identified a specific portion of the firm commitment because there is no uncertainty as to which units are being hedged. Therefore, the first 500 units being acquired each month can be designated as the hedged item. For guidance on fair value hedges of foreign currency risk, see section 7.4.
However, ABC cannot designate the hedged item as being the foreign currency exposure associated with any 500 units being acquired each month. Because the hedged item could be any 500 units acquired during the month, ABC has not identified a specific portion as the hedged item. This portion of the firm commitment would not be eligible for hedge accounting.

**Price risk**

ABC cannot hedge price risk associated with a portion of the firm commitment to purchase CPUs. For limitations on price risk for nonfinancial items, see section 3.4.20.

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**Prohibition of preset hedge coverage ratios for servicing right assets**

Excerpt from ASC 815-20

>>> Prohibition of Preset Hedge Coverage Ratios

55-63 Subtopic 860-50 requires that if an entity subsequently measures servicing assets and servicing liabilities using the amortization method, any impairment of servicing assets, which is the amount by which the carrying amount of the servicing assets for an individual stratum exceeds their fair value, be recognized in current earnings. However, an increase in the fair value above the carrying amount of servicing assets for an individual stratum may not be recognized in current earnings.

55-64 Entities that service certain types of financial assets may wish to designate as the hedged item in a fair value hedge a prespecified percentage of the total change in fair value of those servicing rights (attributable to the hedged risk) that varies based on changes in a specified independent variable. Because the prespecified percentage for each specified independent variable can be presented in a rectangular array, that method of determining the hedged item retroactively based on the actual independent variable is sometimes referred to as the matrix method. Under that approach, at the end of the hedge assessment period, the entity would determine the hedged item and assess hedge effectiveness by determining retrospectively which hedge coverage ratio would be applied to the servicing right asset to identify the hedged item for that period. That approach is in contrast to designating the hedged item at the inception of the hedge by specifying a single percentage of that recognized servicing right asset as the hedged item.

55-65 In a fair value hedge of a portion of a recognized servicing right asset subsequently measured using the amortization method and its related impairment analysis, an entity may not designate the hedged item at the inception of the hedge by initially specifying a series of possible percentages of the servicing right asset (that is, preset hedge coverage ratios) and then determining at the end of the assessment period what specific percentage of the servicing right asset is the actual hedged item for that period based on the change in a specified independent variable during that period. Such a matrix method would not be a valid application of the provisions of this Subtopic.
Paragraph 815-20-25-12(b)(2)(i) precludes an entity from expressing the hedged item as multiple percentages of a recognized asset or liability and then retroactively determining the hedged item based on an independent matrix of those multiple percentages and the actual scenario that occurred during the period for which hedge effectiveness is being assessed.

There is a limited exception under paragraph 815-20-25-10 in which a collar that is comprised of one purchased option and one written option that have different notional amounts is designated as the hedging instrument, and the hedged item is specified as two different proportions of the same asset based on the upper and lower rate or price range of the asset referenced in those two options.

An entity may designate a specific percentage of a recognized servicing asset as the hedged item at inception. However, an entity may not designate 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). [815-20-55-65]

Under this approach, at the end of the hedge assessment period, an entity would determine the hedged item and measure hedge effectiveness by determining retrospectively which hedge coverage ratio would be applied when designating the hedged item for that period. In other words, the percentage of assets being hedged changes after hedge inception and is not determinable until the end of the hedge period.

This is different from designating a specific percentage of the recognized servicing right asset as the hedged item at inception.

There is one exception to the general concept that a single percentage of the entire asset or liability (or portfolio) must be designated at inception of the hedge as the hedged item. This strategy incorporates a collar that has different notional amounts for the purchased and written option components (see Question 9.2.290).

3.3.70 Hedging portions of financial items: Benchmark interest rate component

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-12 An asset or liability is eligible for designation as a hedged item in a fair value hedge if all of the following additional criteria are met: …

f. 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 any of the following: …

2. The risk of changes in its fair value attributable to changes in the designated benchmark interest rate (referred to as interest rate risk)
Excerpt from ASC 815-25

>> Changes Involving Interest Rate Risk

35-13 In calculating the change in the hedged item’s fair value attributable to changes in the benchmark interest rate (see paragraph 815-20-25-12(f)(2)), the estimated coupon cash flows used in calculating fair value shall be based on either the full contractual coupon cash flows or the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception.

Interest rate risk. Topic 815 provides an entity with a choice of measuring the change in a hedged item’s fair value attributable to the changes in the benchmark interest rate based on either the hedged item’s: [815-25-35-13]

— entire contractual coupon cash flows; or
— the benchmark rate component of the contractual coupon cash flows determined at inception of the hedging relationship.

This election affects an entity’s assessment of hedge effectiveness and fair value hedge accounting because of its effect on the measurement of the hedged item. [815-25-35-13A]

Section 4.3.20 provides detailed guidance on using either the hedged item’s entire contractual coupon cash flows or using the benchmark rate component of the contractual coupon cash flows to measure the change in the hedged item’s fair value.

Question 3.3.170

Which benchmark interest rate may be used for measurement purposes when hedging only the benchmark rate component?

Interpretive response: Topic 815 uses the term ‘benchmark rate’ component of the contractual coupon cash flows. We believe ‘benchmark rate’ refers to the Benchmark Interest Rate as defined in the Master Glossary.

An entity may use any rate that meets the Master Glossary definition of a Benchmark Interest Rate to measure the change in the hedged item’s fair value attributable to interest rate risk. In the United States, the interest rates on direct Treasury obligations of the US government, the LIBOR swap rate, the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate) and the SIFMA Municipal Swap Rate are considered to be benchmark interest rates. For more information on benchmark interest rates, see section 2.3.30. [815-20-25-6A, 815-20 Glossary]
Question 3.3.180
May an entity separately designate the fixed rate subject to inflation adjustments as a benchmark rate component?

Interpretive response: No. At a September 2018 Board meeting, the FASB noted an entity could not separately designate the benchmark interest rate component of an otherwise fixed interest rate as the hedged item in a fair value hedge if the fixed interest rate was subject to inflation adjustments. This is because the overall rate is considered to be a variable rate, as opposed to a fixed rate, and interest rate components of variable rate instruments can only be the hedged risk when they are contractually specified. [FASB meeting 09-18]

For example, an entity owns fixed-rate debt instruments with an inflation-adjusted principal that fluctuates based on an inflation index. Interest payments are calculated based on the fixed rate and the inflation-adjusted principal balance. Because of the inflation adjustment, the rate is not considered to be a fixed-rate. As a result, the entity would not be able to hedge a benchmark component in a fair value hedge.

Because these are considered variable-rate instruments, the entity may hedge the variability in cash flows using a cash flow hedge.

Question 3.3.190
Why would an entity designate only the benchmark rate component?

Interpretive response: For hedge accounting purposes, using only the benchmark rate component of the contractual coupon cash flows of a financial instrument can provide a better offset between the changes in the fair values of the hedging instrument (e.g. an interest rate swap) and hedged item attributable to interest rate risk. Therefore, we expect that many entities will use the benchmark rate component.

Certain hedging relationships could even be perfectly effective; see Case B of Subtopic 815-25’s Example 9 in section 4.3.20. [815-25-55-61C]

In addition, using the benchmark rate component for hedge accounting may better reflect how entities manage interest rate risk. For example, assume a bond has a 5% interest coupon. If the benchmark rate component is 3%, the additional 2% could be viewed as a reflection of credit risk.
Using the entire contractual coupon cash flows to assess hedge effectiveness incorporates credit risk into the hedge effectiveness assessment. If an entity’s risk management strategy is to hedge only the changes in the benchmark interest rate without hedging credit spreads, applying hedge accounting to the total contractual coupon results in misalignment between the risk management strategy and hedge accounting.

**Question 3.3.200**

If an entity uses the benchmark rate component to measure the change in fair value of a hedged item, must it do so for all similar hedging relationships?

**Interpretive response:** No. For fair value hedges, the election to use either the entire contractual coupon or the benchmark rate component cash flows to measure the change in the hedged item’s fair value attributable to interest rate risk is made on a hedge-by-hedge basis. [ASU 2017-12.BC129]

**3.3.80 Hedging portions of prepayable financial instruments: Partial-term hedges of interest rate risk**

**Excerpt from ASC 815-25**

**>>> Partial-Term Hedges of Interest Rate Risk**

35-13B For a fair value hedge of interest rate risk in which the hedged item is designated as selected contractual cash flows in accordance with paragraph 815-20-25-12(b)(2)(ii), an entity may measure the change in the fair value of the hedged item attributable to interest rate risk using an assumed term that begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable. The assumed maturity of the hedged item occurs on the date in which the last hedged cash flow is due and payable.

[815-20-25-12(b)(2)(ii)]

Topic 815 provides an entity with a choice of designating the hedged item in a fair value hedge of **interest rate risk** as either: [815-20-25-12(b)(2)(ii)]

— the entire financial instrument (or a percentage of it) for its entire remaining term; or
— selected consecutive interest payments with the assumption that the principal payment occurs at the end of the hedge term (partial-term hedge).

For example, an entity issues a noncallable, five-year fixed-rate debt instrument. The entity could designate a fair value hedge of interest rate risk for the entire term or designate a partial-term hedge for the first two years of its term (see Example 3.3.70). [815-25-55-95]
The following illustrates a partial-term hedge.

For partial-term hedges, an entity measures the change in the hedged item’s fair value attributable to interest rate risk using an assumed term that reflects only the designated cash flows and assumes that the principal payment occurs at the end of the hedge term. [815-25-35-13B]

**Question 3.3.210**

*When will a partial-term hedge improve effectiveness?*

**Interpretive response:** A partial-term hedge may enable an entity to better align hedge accounting with its interest rate risk management strategies.

Assume an entity uses a two-year interest rate swap to hedge the first two years of fixed-rate interest payments on a noncallable, five-year fixed-rate bond. The entity could consider the bond’s entire contractual term when assessing hedge effectiveness and measuring the change in the bond’s fair value attributable to interest rate risk. However, the changes in the fair value of a two-year interest rate swap would generally not be expected to offset the changes in the fair value of a noncallable, five-year fixed-rate bond. Therefore, the entity would likely be unable to conclude that the hedging relationship would be highly effective.

Instead, an entity may designate a partial-term hedge. In this case, the principal repayment of the hedged item is assumed to occur at the end of the hedge term. This results in more favorable assessment of hedge effectiveness and measurement of the hedged item. [815-25-35-13B]

**Question 3.3.220**

*Can an entity designate a partial-term hedge using an assumed term that ends on or before the initial date a financial instrument can be prepaid?*

**Interpretive response:** Yes. An entity could designate the partial term such that it ends before (or on) the initial date on which a financial instrument can be prepaid – e.g., the first day a bond can be called. Therefore, the hedged item is not prepayable during the hedge term. In such cases, an entity does not consider prepayment risk when assessing hedge effectiveness and measuring the change in the hedged item’s fair value attributable to interest rate risk. [ASU 2017-12.BC106]
For further discussion of hedging prepayable financial instruments, see sections 3.4.10 and 3.3.100 (last-of-layer method).

**Question 3.3.230**

Can the partial-term hedge guidance and the guidance for hedging only the benchmark rate component be applied to the same hedging relationship?

**Interpretive response**: Yes. An entity may:

- designate only part of the remaining term of a financial instrument as the hedged item in a fair value hedge of interest rate risk; and [815-25-35-13B]
- elect to measure the change in the hedged item’s fair value using only the benchmark rate component of the contractual coupon cash flows. [815-25-35-13]

**Question 3.3.240**

Must specific conditions be met to apply partial-term hedging in a fair value hedge of interest rate risk?

**Interpretive response**: Yes. The interest payments being hedged must be consecutive interest payments. For example, an entity may designate the first five years of interest payments of a 10-year bond as a hedged item. [815-20-25-12(b)(2)(i), 815-25-35-13B]

The partial term may begin after inception of the financial instrument. For example, an entity may designate the interest payments in Years 4–6 of the bond as the hedged item, along with an appropriate hedging instrument (e.g. a forward-starting three-year interest rate swap) as a fair value hedge.

**Question 3.3.250**

Can an entity apply hedge accounting to more than one partial term of a single instrument?

**Background**: An entity may wish to designate two or more partial terms from a single financial instrument as separate hedged items in separate hedging relationships. For example, the first five years of interest payments of a bond as a hedged item in a fair value hedge, and the next five years of interest payments of the same bond as a hedged item in a separate fair value hedge.

**Interpretive response**: At a March 2018 Board meeting, the FASB noted that the partial-term hedging guidance can be applied simultaneously to multiple partial-term hedging relationships for a single debt instrument. In other words, an entity is permitted to designate more than one partial term of a financial instrument as separate hedged items. [FASB meeting 03-18]
Question 3.3.260

When multiple partial terms are hedged in separate hedging relationships, do the terms need to be consecutive?

**Interpretive response:** No. At a March 2018 meeting, the FASB noted an example of simultaneous partial-term hedges where an entity designates consecutive interest cash flows in Years 1–3 and consecutive interest cash flows in Years 5–7 of a 10-year bond. [FASB meeting 03-18](#)

Therefore, we believe there is no requirement for the terms of multiple partial-term hedges to be consecutive.

Example 3.3.70

**Designating a fair value hedge of interest rate risk using the partial-term approach**

The following example is adapted from the facts outlined in the Example 15 in Subtopic 815-25 (reproduced in section 4.3.20).

On January 1, Year 1, ABC Corp. issues a noncallable, five-year, $100 million debt instrument with a 3% semiannual interest coupon. On the same date, ABC also enters into a two-year interest rate swap with a notional amount of $100 million.

ABC elects to apply partial-term hedging guidance by:

— designating the cash flows associated with the first two years of the debt issuance as the hedged item; and
— identifying interest rate risk as the hedged risk.

The assumed term of the hedged item is two years – i.e. the same term as the interest rate swap.

**Partial-term begins after inception**

The partial term may begin after inception of the financial instrument. For example, ABC could designate the cash flows associated with Years 2–4 as the hedged item. The hedging instrument would be a forward-starting three-year interest rate swap.

**Multiple partial-term hedges**

ABC could designate multiple partial-term hedges. For example, in addition to designating the cash flows associated with Years 1–2 of the issued debt, ABC could also designate cash flows associated with Years 4–5.

The hedging instruments would be two interest rate swaps: one associated with the first two years of the debt instrument, and the second a forward-starting two-year interest rate swap that aligns with the cash flows for Years 4–5.
Question 3.3.270

Can an entity hedge multiple risks when applying partial-term hedging guidance?

Interpretive response: The guidance for partial-term hedges focuses solely on fair value hedges of interest rate risk. However, at a September 2018 Board meeting the FASB noted that this guidance could also be applied to a single fair value hedge of both interest rate risk and foreign currency risk. Therefore, we believe the partial-term guidance cannot be applied to:

— hedges of only foreign currency risk.

— hedges that include credit risk or price risk.

Example 3.3.80

Hedging interest rate risk and foreign currency risk in a partial-term hedge

On January 1, Year 1, ABC Corp. issues a noncallable, five-year, €100 million debt instrument with a 3% semiannual interest coupon denominated in euros. ABC’s functional currency is the US Dollar.

On the same date, ABC also enters into a two-year cross-currency interest rate swap with a notional amount of €100 million.

ABC may elect to apply partial-term hedging guidance by:

— designating the cash flows associated with the first two years of the euro-denominated debt issuance as the hedged item; and

— identifying both the interest rate risk and foreign currency risk as the hedged risks.

The assumed term of the hedged item would be two years – i.e. the same term as the cross-currency interest rate swap.

Hedge effectiveness. Topic 815 allows an entity to exclude the portion of the change in fair value of a currency swap attributable to the cross-currency basis spread (see section 9.2.70). This may result in a more highly effective hedge when designating a cross-currency interest rate swap in a fair value hedge of interest rate risk and foreign currency risk.

For guidance on hedging a combination of foreign currency risk and other risks, see section 7.3.40 (hedging multiple risks).
3.3.90 Hedging portions of items: Embedded put or call options

Excerpts from ASC 815-20

>> Hedged Item Criteria Applicable for Fair Value Hedges Only

25-12(b)(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: …

iii. A put option or call option (including an interest rate cap or price cap or an interest rate floor or price floor) embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 815-15-25-1.

> Items Specifically Ineligible for Designation as a Hedged Item or Transaction

25-43 Besides those hedged items and transactions that fail to meet the specified eligibility criteria, none of the following shall be designated as a hedged item or transaction in the respective hedges: …

c. With respect to fair value hedges only:
   1. If the entire asset or liability is an instrument with variable cash flows, an implicit fixed-to-variable swap (or similar instrument) perceived to be embedded in a host contract with fixed cash flows.

   …

   7. A component of an embedded derivative in a hybrid instrument—for example, embedded options in a hybrid instrument that are required to be considered a single forward contract under paragraph 815-10-25-10 cannot be designated as items hedged individually in a fair value hedge in which the hedging instrument is a separate, unrelated freestanding option.

On a stand-alone basis, derivatives cannot be designated as hedged items. However, Topic 815 specifically allows embedded put or call options that are not separated to be hedged items in a fair value hedge, with some limitations. [815-20-25-12(b)(2)(iii)]

The following table summarizes the embedded put or call options that are explicitly prohibited from being designated as the hedged item.
3. Qualifying criteria for fair value hedges

<table>
<thead>
<tr>
<th>Re-characterization of a financial instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity is prohibited from re-characterizing a variable-rate financial instrument as a fixed-rate financial instrument with an embedded interest rate swap in an effort to achieve fair value hedging. The FASB did not intend for an entity to be able to hedge a contractual provision that creates variability in future cash flows as a fair value hedge rather than a cash flow hedge. [815-20-25-43(c)(1), FAS 133.BC435]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Component of an embedded derivative</th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity is prohibited from hedging a component of an embedded derivative in a hybrid instrument. For example, assume the combination of two embedded options (e.g. a purchased put option and a written put option) in a single hybrid instrument is viewed as a single forward contract. An entity cannot separately designate either the purchased put option or the written put option as the hedged item. [815-10-25-10, 815-20-25-43(c)(7)]</td>
</tr>
</tbody>
</table>

If an entity does not separately identify an embedded derivative as the hedged item in a fair value hedge of interest rate risk, and the hedge is not designated using the last-of-layer method, it must consider the effect of the embedded derivative of the same risk class when designating a hedge of an individual risk, if that embedded derivative is exercisable during the hedge period. For example, the effect of an embedded prepayment option must be considered in designating a hedge of interest rate risk (see section 3.4.10). [815-20-25-6]

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**Question 3.3.280**

Is an entity permitted to hedge the risk of changes in the fair value of an embedded call option in an HTM security that is prepayable?

**Interpretive response:** Yes. Interest rate risk and price risk are not eligible to be designated as hedged risks for a debt security that is classified as HTM. However, Topic 815 allows an entity to hedge the risk of changes in the fair value of an embedded call option in a HTM debt security that is prepayable. [815-20-25-12(d)]

For example, an entity purchased a five-year callable debt security and classified it as HTM. The callable feature of the security represents a call option held by the issuer of the security. The entity may purchase a put option to hedge the written call option component (i.e. prepayment feature) of the HTM debt security and designate it as a hedge of the changes in fair value of the call option.
Can an entity hedge the fair value exposure of options embedded in contracts that qualify as firm commitments?

Excerpt from ASC 815-20

Application of the Definition of Firm Commitment

55-13 A supply contract for which the contract price is fixed only in certain circumstances (such as if 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 815-15-25-1, either party to the supply contract can hedge the fair value exposure arising from the cap or floor.

Background: The term ‘fixed price’ as it relates to a firm commitment encompasses:

- situations in which the price is always fixed; and
- situations in which the price is fixed through the existence of an embedded option that is not separated from the host contract – e.g. price caps or floors in a long-term supply or purchase contract.

Interpretive response: The fair value exposure of the cap or the floor in supply contracts is eligible for fair value hedge accounting. The embedded caps and floors typically are not required to be separated from the host contracts because their economic characteristics and risks are clearly and closely related to the economic characteristics and risks of the host contract. [815-20-55-13]

For example, 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). [815-20-55-85]

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. It could then 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. [815-20-55-87]

An option embedded in a nonderivative contract may be a purchased option that an entity hedges with a written option in an effort to monetize the value of the purchased option (see Example 3 in Subtopic 815-20 below).
**FASB Example: Firm commitment with embedded price caps or floors**

**Excerpt from ASC 815-20**

>> Example 3: Firm Commitment as Hedged Item in Relation to Long-Term Supply Contracts with Embedded Price Caps or Floors

55-84 This Example illustrates the application of paragraph 815-20-25-12 and the definition of firm commitment in relation to long-term supply contracts with embedded price caps or floors.

55-85 Entity A enters into a long-term supply contract with a customer to sell a specified amount of a certain material. The selling price is the 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. The customer is not required to make an up-front cash payment for the written option (that is, the price cap) in the supply contract. Consequently, the supply contract is neither a recognized asset nor a recognized liability at inception.

55-86 The supply contract in its entirety does not meet the definition of a derivative instrument due to the absence of a net settlement characteristic—that is, the contract does not permit or require net settlement (see guidance beginning in paragraph 815-10-15-100), there is no market mechanism (see guidance beginning in paragraph 815-10-15-110), and it does not require delivery of an asset that is readily convertible to cash (see guidance beginning in paragraph 815-10-15-119). Pursuant to the guidance in paragraph 815-15-25-19, the embedded cap on the selling price is an option that does not warrant separate accounting under Subtopic 815-15 because it is clearly and closely related to the host supply contract. In addition, because the supply contract is not remeasured with changes in fair value reported currently in earnings, it meets the criteria in paragraph 815-20-25-43(c)(3) to qualify as a hedged item in a fair value hedge.

55-87 Entity A wishes to enter into a transaction to hedge the risk of changes in the fair value of the embedded written price cap in the supply contract. Accordingly, it purchases 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. In accordance with the guidance in paragraph 815-20-25-12, a supply contract for which the contract price is fixed only under certain circumstances (such as when market prices are above an embedded price cap) meets the definition of a firm commitment for purposes of designating the hedged item in a fair value hedge. Therefore, if the selling price in a supply contract is subject to a cap, a floor, or both, either party to the contract is eligible to apply fair value hedge accounting in a hedging relationship to hedge the fair value exposure of the cap or floor. For the range of monthly average list prices above $15 per pound, the contract has a fixed $15 per pound price. Thus, Entity A may designate the written cap embedded in the supply contract...
as the hedged item in a fair value hedging relationship provided the other criteria for a fair value hedge are met. The embedded written cap in this Example is a specific portion of the contract that is subject to the risk of changes in fair value due to changes in the list price of the underlying materials. Because it is not accounted for separately from the supply contract, the embedded written cap may be designated as the hedged item in a fair value hedge. Paragraph 815-20-25-12 allows a nonbifurcated call option that is embedded in a supply contract to be the hedged item in a fair value hedge regardless of whether that supply contract is a recognized asset or liability or an unrecognized firm commitment.

3.3.100 Last-of-layer method

Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-12A For a closed portfolio of prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments, an entity may designate as the hedged item a stated amount of the asset or assets that are not expected to be affected by prepayments, defaults, and other factors affecting the timing and amount of cash flows if the designation is made in conjunction with the partial-term hedging election in paragraph 815-20-25-12(b)(2)(ii) (this designation is referred to throughout Topic 815 as the “last-of-layer method”).

a. As part of the initial hedge documentation, an analysis shall be completed and documented to support the entity’s expectation that the hedged item (that is, the designated last of layer) is anticipated to be outstanding as of the hedged item’s assumed maturity date in accordance with the entity’s partial-term hedge election. That analysis shall incorporate the entity’s current expectations of prepayments, defaults, and other events affecting the timing and amount of cash flows associated with the closed portfolio of prepayable financial assets or beneficial interest(s) secured by a portfolio of prepayable financial instruments.

b. For purposes of its analysis, the entity may assume that as prepayments, defaults, and other events affecting the timing and amount of cash flows occur, they first will be applied to the portion of the closed portfolio of prepayable financial assets or one or more beneficial interests that is not part of the hedged item (that is, the designated last of layer).

>>>> Determining Whether Risk Exposure Is Shared Within a Portfolio

55-14 This implementation guidance discusses the application of the guidance in paragraph 815-20-25-12(b)(1) that the individual assets or individual liabilities within a portfolio hedged in a fair value hedge shall share the risk exposure for which they are designated as being hedged. If the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent 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 percent to 11 percent. In contrast, an expectation that
3. Qualifying criteria for fair value hedges

the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7 percent to 13 percent would be inconsistent with the requirement in that paragraph.

55-14A If both of the following conditions exist, the quantitative test described in paragraph 815-20-55-14 may be performed qualitatively and only at hedge inception:

a. The hedged item is a closed portfolio of prepayable financial assets or one or more beneficial interests designated in accordance with paragraph 815-20-25-12A.

b. An entity measures the change in fair value of the hedged item based on the benchmark rate component of the contractual coupon cash flows in accordance with paragraph 815-25-35-13.

Using the benchmark rate component of the contractual coupon cash flows when all assets have the same assumed maturity date and prepayment risk does not affect the measurement of the hedged item results in all hedged items having the same benchmark rate component coupon cash flows.

>>> Consideration of Prepayment Risk Using the Last-of-Layer Method

25-118A In a fair value hedge of interest rate risk designated under the last-of-layer method in accordance with paragraph 815-20-25-12A, an entity may exclude prepayment risk when measuring the change in fair value of the hedged item attributable to interest rate risk.

Excerpt from ASC 815-25

> Estimating the Remaining Balance under the Last-of-Layer Method

35-7A When the hedged item is designated and accounted for under the last-of-layer method in accordance with paragraph 815-20-25-12A, an entity shall perform and document at each effectiveness assessment date an analysis that supports the entity’s expectation that the hedged item (that is, the designated last of layer) is still anticipated to be outstanding as of the hedged item’s assumed maturity date. That analysis shall incorporate the entity’s current expectations of prepayments, defaults, and other events affecting the timing and amount of cash flows using a method consistent with the method used to perform the analysis in paragraph 815-20-25-12A(a).

Topic 815 permits an entity to designate a fixed amount of a closed portfolio of prepayable financial assets as the hedged item in a fair value hedge of interest rate risk if the entity expects that the designated amount will remain outstanding at the end of the hedge term (i.e. last of layer). One or more beneficial interests secured by a portfolio of prepayable financial instruments may also be designated as a last of layer. [815-20-25-12A]

If an entity uses the last-of-layer method, it does not consider prepayment risk for assessing hedge effectiveness and measuring the change in fair value of the hedged item attributable to interest rate risk. For example, an entity has a $1 billion closed portfolio of 15-year prepayable mortgage loans. It expects that
$300 million will remain outstanding at the end of 10 years. The entity may designate the $300 million portion of the mortgage portfolio as the hedged item in a fair value hedge of interest rate risk for 10 years. [815-20-12(b)(2), 25-12A, 25-118A, ASU 2017-12.BC113]

This example is illustrated below.

The entity then treats the last of layer as a nonprepayable item for hedge effectiveness assessment and measurement purposes. Consequently, it can designate a 10-year $300 million plain vanilla interest rate swap as the hedging instrument. [815-20-25-118A, ASU 2017-12.BC113]

To apply the last-of-layer method to a portfolio of prepayable financial assets, certain conditions must be met.

**Formal documentation.** There are additional requirements related to the initial hedge documentation. Specifically, an entity needs to document its analysis supporting its expectation that the designated last of layer (i.e. the hedged item) will remain outstanding at the end of the hedge term. This analysis must be performed and documented at each effectiveness assessment date. [815-20-25-3(c)(2)]
Question 3.3.300
What is a ‘closed portfolio’?

Interpretive response: To apply the last-of-layer method, the portfolio must be a closed portfolio. That is, a portfolio of financial assets to which no other financial assets will be added during the hedge term and for which the assets are not designated in any other interest rate hedging relationship. [815-20-25-12A]

Current guidance is not clear as to whether an entity would be able to remove assets from a closed portfolio on a discretionary basis. At a September 2018 meeting, the FASB clarified that financial assets could be sold or voluntarily transferred from the closed portfolio, but cannot be added or replaced. [FASB meeting 09-18]

This means that an entity can remove financial assets from the closed portfolio in a last-of-layer hedge without redesignating the hedging relationship. This is because the hedged item, which is only the last-of-layer portion of the portfolio, was not changed.

Question 3.3.310
What conditions must be met for a last-of-layer hedge to pass the similarity test qualitatively?

Interpretive response: To apply the last-of-layer method, the prepayable financial assets in the closed portfolio should share the same risk exposure for the risk being hedged – i.e. the same benchmark interest rate risk. In other words, they must pass the similarity test. [815-20-25-12A, 55-14]

An entity is permitted to assess similarity qualitatively, and is permitted to perform this assessment only at hedge inception, only when it: [815-20-25-12A, 55-14A, ASU 2017-12.BC112]

— applies the partial-term hedge guidance (see section 3.3.80); and
— elects to hedge only the benchmark rate component of the contractual coupon cash flows (see section 3.3.70).

When an entity applies the partial-term hedge guidance, it assumes that the maturities of all assets in the closed portfolio are identical. [ASU 2017-12.BC112]

Further, using the benchmark rate component when all assets have the same assumed maturity (partial-term) has the same effect as all of the assets in the closed portfolio having the same benchmark rate coupon. [ASU 2017-12.BC112]

The assets that comprise the closed portfolio will likely have different coupon payment dates. We believe an entity is not required to consider differences in coupon payment dates when performing its qualitative assessment because coupon payment dates are not one of the criteria in performing the similarity test qualitatively. [815-20-55-14A, ASU 2017-12.BC112]
Question 3.3.320

What is needed to support the entity’s expectation that the last of layer will remain outstanding at the end of the hedge term?

Interpretive response: An entity is required to perform and document an analysis supporting its expectation that the last of layer (i.e. the hedged item) will remain outstanding at the end of the hedge term. This is done as part of the initial hedge documentation and on each effectiveness assessment date. [815-20-25-12A, 815-25-35-7A, ASU 2017-12.BC113]

The analysis should incorporate the entity’s current expectations of prepayments, defaults and other events affecting the timing and amount of cash flows associated with the closed portfolio of prepayable financial assets (or beneficial interests secured by a portfolio of prepayable financial assets). We believe these expectations should be consistent with the entity’s expectations and estimates prepared for other purposes (e.g. the allowance for credit losses). [815-20-25-12A, 815-25-35-7A, ASU 2017-12.BC113]

In this analysis, the entity assumes that as prepayments, defaults and other events affecting the timing and amount of cash flows occur, they will first be applied to the portion of the closed portfolio (or one or more beneficial interests) that is not part of the designated last of layer. [815-20-25-12A]

Question 3.3.330

Must an entity assert it is ‘probable’ that the balance of the last of layer will remain outstanding at the end of the hedge term?

Interpretive response: No. An entity need not assert that it is ‘probable’ that the last of layer (i.e. the hedged item) will remain outstanding at the end of the hedge term. [ASU 2017-12.BC115]

Instead, the entity only needs to have an expectation that the last of layer will remain outstanding at the end of the hedge term and should support that expectation (see Question 3.3.320). We believe the FASB intended this to be a lower threshold than probable.

Question 3.3.340

What financial instruments can be included in the portfolio under the last-of-layer method?

Interpretive response: The financial instruments in the portfolio from which the last of layer is derived are comprised solely of assets that are prepayable (e.g. mortgage loans) during the hedge term and that would be eligible as a hedged item in a fair value hedge. At its February 2018 Board meeting, the FASB clarified that financial instruments considered prepayable for the purpose of applying paragraph 815-20-25-6B would also be considered to be prepayable for the purpose of applying the last-of-layer method. [Staff interpretation]
For a discussion of what is considered prepayable for the purpose of applying paragraph 815-20-25-6B, see Question 3.4.30.

The last-of-layer method can also be applied to a beneficial interest, or a portfolio of beneficial interests collateralized by prepayable financial instruments. The FASB decided to allow the last-of-layer method to be applied to these types of beneficial interests because their cash flows are generated from a portfolio of prepayable financial instruments. Therefore, the economic substance of their cash flows is the same as that of a portfolio of prepayable financial assets. [ASU 2017-12.BC124]

**Question 3.3.350**

**Can the last-of-layer method be applied to a portfolio of financial liabilities?**

**Interpretive response:** No. The FASB did not extend the last-of-layer method to financial liabilities.

An important part of the FASB’s rationale for providing the last-of-layer method was the high degree of uncertainty about which individual assets would prepay. For financial assets, this uncertainty exists because the borrower controls the decision of whether to prepay the asset – not the entity looking to hedge. For financial liabilities, there is less uncertainty about prepayments because the entity looking to hedge the liability controls the decision to prepay. [ASU 2017-12.BC126]

**Question 3.3.360**

**Can an entity hedge multiple layers under the last-of-layer method?**

**Background:** An entity may wish to designate multiple layers under the last-of-layer method. For example, assume an entity has a $1 billion closed portfolio of 15-year prepayable mortgage loans. The entity may wish to designate $300 million of the portfolio expected to be outstanding at the end of ten years and $700 million of the portfolio expected to be outstanding at the end of five years.
Interpretive response: At a March 2018 meeting, the FASB stated that entities should not apply a multiple-layer hedging strategy under the last-of-layer method.

The FASB is undertaking a narrow-scope project to determine whether hedging multiple layers should be permitted. As a result, revisions to this interpretive response may be provided in a future edition.

3.4 Eligibility of hedged risks

Criterion 1: Eligibility of hedged items or transactions
Criterion 2: Eligibility of hedged risk(s)
Criterion 3: Eligibility of hedging instruments
Criterion 4: Hedge effectiveness
Criterion 5: Formal documentation

Sections 2.3 and 2.4 provide an overview of the eligible hedged risks for both financial and nonfinancial items, including limitations on certain risks for hedged items.

This section provides detail around the eligibility criteria of hedged risks that are specific to fair value hedges, including:

— interest rate risk on prepayable financial instruments (section 3.4.10); and
— limitations on price risk for nonfinancial items (section 3.4.20).

Foreign currency risk. For further guidance on foreign currency risk as it relates to fair value hedges, see chapter 7.

3.4.10 Interest rate risk hedges of prepayable financial instruments

Excerpt from ASC 815-20

>>> Hedged Items Involving Interest Rate Risk

25-6 Hedges involving a benchmark interest rate are addressed in paragraphs 815-20-25-12(f) and 815-20-25-12A (for fair value hedges) and paragraph 815-20-25-15(j) (for cash flow hedges). Hedges involving a contractually specified interest rate are addressed in paragraph 815-20-25-15(j) (for cash flow hedges). The benchmark interest rate or the contractually specified interest rate being hedged in a hedge of interest rate risk shall be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Paragraphs 815-20-25-19A through 25-19B provide guidance on the interest rate risk designation of hedges of...
3. Qualifying criteria for fair value hedges

forecasts of issuances or purchases of debt instruments. An entity shall 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 shall be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option shall be considered in designating a hedge of interest rate risk.

Fair Value Hedges of Interest Rate Risk in Which the Hedged Item Can Be Settled before Its Scheduled Maturity

An entity may designate a fair value hedge of interest rate risk in which the hedged item is a prepayable instrument in accordance with paragraph 815-20-25-6. The entity may consider only how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity (for example, an entity may consider only how changes in the benchmark interest rate affect an obligor’s decision to call a debt instrument when it has the right to do so). The entity need not consider other factors that would affect this decision (for example, credit risk) when assessing hedge effectiveness. Paragraph 815-25-35-13A discusses the measurement of the hedged item.

Excerpt from ASC 815-25

Measuring the Fair Value of a Prepayable Instrument in Hedges of Interest Rate Risk

In a hedge of interest rate risk in which the hedged item is a prepayable instrument in accordance with paragraph 815-20-25-6, the factors incorporated for the purpose of adjusting the carrying amount of the hedged item shall be the same factors that the entity incorporated for the purpose of assessing hedge effectiveness in accordance with paragraph 815-20-25-6B. For example, if an entity considers only how changes in the benchmark interest rate affect an obligor’s decision to prepay a debt instrument when assessing hedge effectiveness, it shall consider only that factor when adjusting the carrying amount of the hedged item. The election to consider only how changes in the benchmark interest rate affect an obligor’s decision to prepay a debt instrument does not affect an entity’s election to use either the full contractual coupon cash flows or the benchmark rate component of the contractual coupon cash flows determined at hedge inception for purposes of measuring the change in fair value of the hedged item in accordance with paragraph 815-25-35-13.

Interest rate risk. When the hedged risk is changes in interest rates on a financial instrument with a prepayment option, an entity considers the prepayment option when measuring the change in the hedged item’s fair value attributable to interest rate risk unless the hedged item is not prepayable during the hedge term. For example, partial-term hedges using an assumed term that
ends before (or on) the initial date a financial instrument can be prepaid (see Question 3.3.220).

Topic 815 allows an entity to consider only the effect of changes in the benchmark interest rate on the decision to prepay a financial instrument. If an entity elects this approach, it does not consider in its assessment of hedge effectiveness how other factors (e.g. credit risk) might affect the decision to prepay the financial instrument. [815-20-25-6B]

The factors that an entity uses to measure the change in the hedged item’s fair value are the same factors that it uses for assessing hedge effectiveness. [815-25-35-13A]

**Question 3.4.10**

**Why would an entity elect to consider only the effect of changes in the benchmark interest rate on the decision to prepay the financial instrument?**

**Interpretive response:** Electing this alternative will make achieving hedge accounting more likely and provide a better accounting offset between the hedging instrument and the hedged item when hedge accounting is achieved.

In a fair value hedge, an entity measures the change in the hedged item’s fair value attributable to interest rate risk. If the hedged item is or will become prepayable during the hedge term, the entity incorporates the effect of the prepayment option into this measurement. [815-20-25-6]

One way to incorporate the effect of the prepayment option is to measure the change in the hedged item’s fair value without the prepayment option, and then add the change (positive or negative) in the fair value of the prepayment option. When determining the change in the fair value of the prepayment option, an entity may elect to consider only the effect that changes in the benchmark interest rate have on the decision to prepay the hedged instrument. This approach helps align an entity’s hedge accounting and risk management activities, and it more accurately reflects the change in the fair value of the hedged item attributable to interest rate risk. [ASU 2017-12.BC99]

**Question 3.4.20**

**Is an entity required to consider only how changes in the benchmark interest rate affect the decision to prepay?**

**Interpretive response:** No. This is an election for each hedging relationship. An entity can also continue to consider all factors (e.g. credit risk, liquidity, interest rates) when measuring the change in the fair value of the option to prepay. [815-20-25-6B]
Question 3.4.30

What instruments are considered prepayable under paragraph 815-20-25-6B?

Interpretive response: The term ‘prepayable’ is defined in the Master Glossary as “able to be settled by either party before its scheduled maturity.” [815-25 Glossary]

At the February 2018 Board meeting, the FASB noted that it intended for paragraph 815-20-25-6B to apply to financial instruments that are prepayable according to the Master Glossary definition, except for instruments that are only prepayable before maturity upon the occurrence of an event related to the debtor’s credit risk. [Staff interpretation]

In addition, the FASB clarified that the following financial instruments are considered prepayable for purposes of paragraph 815-20-25-6B:

— nonconvertible debt with currently exercisable embedded non-contingent call or put options;
— nonconvertible debt with embedded options that are exercisable during the hedge term solely based on the passage of time;
— nonconvertible debt with embedded contingent call or put options; and
— debt that is convertible into the issuer’s shares during the hedge term.

However, certain instruments that are considered prepayable for purposes of paragraph 815-20-25-6B may not be considered prepayable for other purposes. For example, the following debt instruments would be considered prepayable for purposes of paragraph 815-20-25-6B, but are not considered prepayable for purposes of applying the shortcut method (see section 9.3):

— fixed-rate debt that is callable at its then fair value;
— fixed-rate debt that includes a make-whole provision; and
— debt that includes a contingent acceleration clause that permits the issuer to accelerate the debt’s maturity only upon the occurrence of a specified event that (1) is not probable at the time the debt was issued; (2) is unrelated to changes in any market variable, including benchmark interest rates; and (3) is related to regulatory or legislative actions, or other similar events that are beyond the control of the debt issuer or holder.

For the application of paragraph 815-20-25-6B to nonconvertible debt with embedded contingent call or put options and convertible debt, see Questions 3.4.40 and 3.4.50, respectively.

Example 3.4.10

Applying paragraph 815-20-25-6B to a callable bond

ABC Corp. issues a 10-year fixed-rate bond that is callable any time starting after Year 5. ABC designates the entire term of the bond as the hedged item and designates a 10-year receive-fixed, pay-variable interest rate swap as the hedging instrument in a fair value hedge of interest rate risk.

ABC elects to assess hedge effectiveness considering only changes in the benchmark interest rate when evaluating whether it will call the debt before its
scheduled maturity – i.e. it does not consider other factors that could affect the exercise of the call option.

If ABC did not make this election, it would have considered all factors (e.g. credit risk, liquidity, interest rates) that could result in calling the bond before its maturity when measuring the change in fair value of the call option – e.g. ABC would have considered changes in its own creditworthiness because such changes could affect its decision to refinance the bond.

**Question 3.4.40**

How does paragraph 815-20-25-6B apply to nonconvertible debt with an embedded contingent call or put option?

**Interpretive response:** Contingent calls and puts are options that become exercisable upon the occurrence of an event.

If the call or put option is exercisable contingent on an event that is not explicitly linked to interest rates (e.g. it is linked to a change in control or an initial public offering by the issuer) and the contingency is substantive, the entity can ignore the option until the contingent event occurs. Once the contingent event occurs, the call or put option is currently exercisable and the entity considers only how changes in the benchmark interest rate affect the decision to settle the debt instrument before its scheduled maturity.

If the call or put option is exercisable contingent on an event explicitly linked to the benchmark interest rate (e.g. callable if LIBOR exceeds 2.0%), an entity should measure the hedged item’s fair value attributable to interest rate risk considering:

- fluctuations in interest rates that would cause the occurrence of the contingent event; and
- the probability of exercise given the interest rate scenario (only considering the effect of the benchmark interest rate).

**Example 3.4.20**

**Applying paragraph 815-20-25-6B to a nonconvertible bond with an embedded contingent put**

ABC Corp. issues a nonconvertible bond. If ABC sells a substantial asset, the bond holder can put the bond back to ABC any time after the sale.

ABC designates the bond as a hedged item in a fair value hedge. Because the put option is not currently exercisable and its exercisability is contingent on an event that is not explicitly linked to interest rates, ABC does not consider the put option for purposes of assessing hedge effectiveness and measuring the change in fair value of the bond attributable to interest rate risk until ABC sells a substantial asset.
If ABC sells a substantial asset, the option would become non-contingent and ABC would then consider how changes in the designated benchmark interest rate would affect the holder’s decision to exercise the put option for assessment and measurement purposes.

**Question 3.4.50**

Does paragraph 815-20-25-6B apply to interest rate risk hedges related to debt conversion options?

**Background:** A debt instrument that is convertible into a fixed number of the issuer’s equity shares may have an interest rate significantly less than the interest rate on a similar debt instrument that is not convertible.

Therefore, changes in interest rates generally do not significantly affect the decision to exercise a call or put option embedded in a convertible debt instrument. Instead, that decision is typically based on the issuer’s or holder’s view of the current and future expectations of the:

- underlying equity instrument’s price;
- volatility of the equity instrument’s price; and
- dividend yield on the equity instrument.

**Interpretive response:** Yes. At the February 2018 Board meeting, the FASB concluded that an entity may apply the guidance in paragraph 815-20-25-6B for interest rate risk hedges related to convertible debt. Equity price changes typically have a significant effect on the conversion option’s fair value. However, if an entity applies the guidance in paragraph 815-20-25-6B, it ignores how changes in equity prices affect the holder’s decision to exercise the conversion option when assessing hedge effectiveness and measuring the change in the hedged item’s fair value attributable to interest rate risk. [Staff interpretation]

**Question 3.4.60**

Does the election to consider only how changes in the benchmark interest rate affect the decision to prepay a debt instrument have to be applied to all prepayable hedged items?

**Interpretive response:** No. For fair value hedges, the election to consider only how changes in the benchmark interest rate affect the decision to prepay the hedged item when measuring its change in fair value attributable to interest rate risk is made on a hedge-by-hedge basis. [ASU 2017-12.BC129]

**3.4.20 Limitations on price risk for nonfinancial items**

**Price risk.** Fair value hedge accounting is permitted 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 (i.e., price risk). [815-20-25-12(e)]

Therefore, an entity is prohibited from disaggregating the risk profile of a nonfinancial asset or liability and designating one component of the profile as the hedged risk. This is 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. [FAS 133.BC416]

However, an entity could hedge its exposure to total price risk and achieve results similar to hedging a component of a nonfinancial asset (or liability). Topic 815 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 derivative instrument (based on the underlying component) must be highly effective at offsetting changes in fair value of the entire asset (or liability).

**Example 3.4.30**

**Fair value hedge of gold watch inventory with a gold futures contract**

Goldco, 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, Goldco 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 (i.e., total price risk).

### 3.5 Hedging instruments in fair value hedges

Topic 815 specifies certain criteria that must be met for financial instruments to be eligible for designation as hedging instruments, the primary requirement being that the instrument meets the definition of a derivative. Topic 815 also specifically prohibits certain instruments and outlines limitations involving written options. These concepts are discussed in sections 2.6 and 2.7.
3.5.10 Overview

There is no additional guidance specific to fair value hedges regarding the eligibility of hedging instruments, other than fair value hedges involving foreign currency risk.

Foreign currency risk. For guidance on the eligibility of hedging instruments in a fair value hedge of foreign currency risk, see section 7.4.10.
4. Accounting for fair value hedges

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   4.3.50 When the hedged risk is overall changes in fair value, can any of the contractual cash flows be excluded from the basis adjustment measurement?
   4.3.60 What discount rate should be applied when calculating the change in fair value of the hedged item attributable to changes in the benchmark rate?
   4.3.70 When the hedged risk is the benchmark interest rate, are changes in sector credit spreads, issuer credit risk or...
liquidity spreads included in the measurement of the basis adjustment?

4.3.80 What is the benchmark rate component if the hedged item is a nonprepayable financial instrument?

4.3.90 What is the benchmark rate component if the hedged item is a prepayable financial instrument?

4.3.100 What is the benchmark rate component if the hedged item has a premium or discount at hedge inception?

4.3.110 Can the benchmark rate component of the contractual coupon be used if it is greater than the entire coupon?

4.3.120 Does Topic 815 prescribe a method to be used for measuring the basis adjustment when the benchmark interest rate is hedged?

4.3.130 When the last-of-layer method is used, is it necessary to allocate the basis adjustment?

4.3.140 When assets in the portfolio from which the last of layer is derived are sold during the hedge term, is the related basis adjustment allocated to individual assets?

**Examples**

4.3.10 Fair value hedge of inventory after initial recognition

4.3.20 Accounting for the hedge of long-term debt with an interest rate swap (shortcut method)

4.3.30 Accounting for a fair value hedge of the LIBOR swap rate in a fixed-rate noncallable note

4.3.40 Accounting for a hedge of a firm commitment to purchase silver with a forward contract

4.3.50 Benchmark rate component for assessment and measurement

4.3.60 Change in fair value attributable to changes in LIBOR – all contractual cash flows included

**4.4 Subsequent accounting for basis adjustments**

4.4.10 Overview

4.4.20 Interest-bearing financial instruments

4.4.30 Measuring impairment

**Questions**

4.4.10 For firm commitments, what is the subsequent accounting for assets (liabilities) recognized due to applying fair value hedge accounting?

4.4.20 When is amortization of the basis adjustment for interest-bearing financial instruments required to begin?

4.4.30 Over what period are basis adjustments of interest-bearing financial instruments amortized?
4.4.40 Do basis adjustments for interest-bearing borrowings affect the capitalization of interest?

**KPMG observation**
Measurement of credit losses on financial instruments

4.5 **Discontinuing hedge accounting**

4.5.10 Overview
4.5.20 Hedge relationship is no longer highly effective
4.5.30 Last-of-layer hedging relationships

**Questions**

4.5.10 Does amortization begin if a portfolio of hedged items that is hedged by a combination of derivatives is rebalanced?
4.5.20 What is the accounting for a partially dedesignated fair value hedging relationship?
4.5.30 How is the outstanding basis adjustment allocated to the individual items in a portfolio on a full discontinuation?

**Examples**

4.5.10 Accounting for the termination of an interest rate swap hedging fixed-rate debt
4.5.20 Identifying the date a hedging relationship ceased to be highly effective
4.5.30 Discontinuation of a last-of-layer method hedge
4.1 How the standard works

A fair value hedge is 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 a particular risk.

In general, the fair value hedge accounting model has two main elements.

<table>
<thead>
<tr>
<th>Hedging instrument</th>
<th>Hedged item</th>
</tr>
</thead>
<tbody>
<tr>
<td>A derivative hedging instrument is recognized at fair value on the balance sheet with changes in fair value recognized in earnings, other than amounts related to excluded components that are recognized through an amortization approach.</td>
<td>Changes in the fair value of the hedged item that are attributable to the hedged risk are recognized on the balance sheet as an adjustment to the amortized cost basis of the hedged item. The offsetting entry is a gain or loss that is recognized in earnings.</td>
</tr>
</tbody>
</table>

The following diagram shows the general accounting and presentation for a highly effective fair value hedge (not including excluded components).

The effect is to offset gains or losses on the hedging instrument with gains or losses on the hedged item that are attributable to the hedged risk within one line item of the income statement.

**Basis adjustments.** The adjustment to the amortized cost basis of the hedged item from applying fair value hedge accounting is referred to as a basis adjustment. Basis adjustments are accounted for in the same manner as other components of the amortized cost basis of the hedged item.
4.2 Fair value hedge accounting model

4.2.10 Overview

Excerpts from Subtopic 815-20

35-1 Paragraph 815-10-35-2 states that the accounting for subsequent changes in the fair value (that is, gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Specifically, subsequent gains and losses on derivative instruments shall be accounted for as follows:

b. Fair value hedge. 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 815-25-35-1 through 35-6. 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 paragraphs 815-20-25-58 through 25-59. The gain or loss on the hedging derivative instrument in a hedge of an available-for-sale debt security and the offsetting loss or gain on the hedged available-for-sale debt security shall be recognized currently in earnings in the same accounting period.

> Income Statement Classification

45-1A For qualifying fair value and cash flow hedges, an entity shall present both of the following in earnings in the same income statement line item that is used to present the earnings effect of the hedged item:

a. The change in the fair value of the hedging instrument that is included in the assessment of hedge effectiveness
b. Amounts excluded from the assessment of hedge effectiveness in accordance with paragraphs 815-20-25-83A through 25-83B.

See paragraphs 815-20-55-79W through 55-79AD for related implementation guidance.

45-1D While the Derivatives and Hedging Topic does not specify whether certain income statement line items are either permitted or appropriate, the other hedging-related Subtopics in this Topic do contain specific disclosure requirements for those items. See Section 815-10-50 and Subtopics 815-25, 815-30, and 815-35.

> Statement of Cash Flows

45-2 For guidance on the classification of cash receipts and payments related to hedging activities, see paragraph 230-10-45-27.

> Other Comprehensive Income

45-3 An entity shall display as a separate classification within other comprehensive income the net gain or loss on derivative instruments
designated and qualifying as fair value or cash flow hedging instruments that are reported in comprehensive income pursuant to paragraphs 815-20-25-65, 815-20-25-83A, and 815-30-35-3.

Excerpt from ASC 815-25

> Changes in Fair Value in General

35-1 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, except for amounts excluded from the assessment of effectiveness that are recognized in earnings through an amortization approach in accordance with paragraph 815-20-25-83A. All amounts recognized in earnings shall be presented in the same income statement line item as the earnings effect of the hedged item.

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.

35-4 Although a hedging relationship must comply with an entity’s established policy range of what is considered highly effective pursuant to paragraphs 815-20-25-75 through 25-85 for that relationship to qualify for hedge accounting, that compliance does not assure perfect offset between the gain or loss on the hedging instrument and the hedged item attributable to the hedged risk. Any gain or loss on the hedging instrument that does not offset the gain or loss on the hedged item attributable to the hedged risk is recognized in earnings in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

35-6 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 debt security), the adjustment of the hedged item’s carrying amount discussed in paragraph 815-25-35-1(b) shall be recognized in earnings rather than in other comprehensive income to offset the gain or loss on the hedging instrument.

> Entities That Do Not Report Earnings

35-19 An entity that does not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit entity [NFP] or a defined benefit pension plan) shall recognize the gain or loss on a hedging 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 circumstance, the provisions of paragraphs 815-20-25-66 and 815-35-35-1 through 35-2 shall be applied. Entities that do not report earnings shall recognize the changes in the carrying amount of the hedged item pursuant to paragraphs 815-25-35-1 and 815-25-35-4 in a fair value hedge as a change in net assets in the period of change.
In general, the fair value hedge accounting model has two main elements.

— **Hedging instrument.** A derivative hedging instrument is recognized at fair value on the balance sheet with changes in fair value recognized in earnings, other than amounts related to excluded components that are recognized through an amortization approach (see section 4.2.20).

— **Hedged item.** Changes in the fair value of the hedged item that are attributable to the hedged risk are recognized on the balance sheet as an adjustment to the amortized cost basis of the hedged item. The offsetting entry is a gain or loss that is recognized in the same income statement line item as the gain or loss on the hedging instrument (see section 4.3).

The effect of the fair value hedge accounting model is to offset gains or losses on the hedging instrument with gains or losses on the hedged item within one line item of the income statement. If the hedging relationship is:

— **Perfectly effective.** These amounts exactly offset each other.
— **Not perfectly effective.** The extent to which these changes do not perfectly offset is reflected in a single line item of the income statement.

When the earnings effect of the hedged item is presented in more than one line item, the change in the fair value of the hedging instrument is allocated to the different line items.

### Question 4.2.10

**Are changes in the fair value of a hedged AFS debt security recognized in earnings?**

**Interpretive response:** Yes, to the extent that the changes in fair value are attributable to the hedged risk. When the hedged item is measured at fair value with the changes in fair value reported in OCI (e.g. AFS debt securities), changes in the hedged item’s fair value attributable to the risk being hedged are recognized in earnings rather than OCI. However, the unrealized gain or loss that arose between the time the hedged item was initially recognized and the time it was designated in a hedging relationship (if any) continues to be recognized in AOCI. Additionally, changes in fair value after inception of the hedging relationship that are not attributable to the hedged risk are recognized in AOCI. See also Question 4.3.40.

### Hedged item (basis adjustments)

The adjustment to the amortized cost basis of the hedged item from applying fair value hedge accounting is referred to as a basis adjustment.

Hedged items continue to be subject to other applicable US GAAP, including for assessing impairment (see section 4.4.30). Basis adjustments are accounted for in the same manner as other components of the amortized cost basis of the hedged item. Topic 815 provides additional guidance regarding how basis adjustments are considered when applying other applicable GAAP for interest-bearing financial instruments (see section 4.4.20).
When a fair value hedge is discontinued, the basis adjustment generally is not recognized immediately in earnings. Instead, it remains part of the amortized cost basis of the hedged item and continues to be accounted for in the same manner as other components of the amortized cost basis. The basis adjustment is included in the gain or loss calculation if the hedged item is derecognized (see section 4.5.10).

**Hedging instruments**

As discussed in section 4.2.20, Topic 815 permits an entity to exclude certain components of a hedging instrument from the assessment of a fair value hedge’s effectiveness. The following table summarizes the timing and presentation for recognizing in earnings changes in a derivative hedging instrument’s fair value that arise during the hedging relationship, depending on whether the change in fair value relates to a component that is included or excluded from the effectiveness assessment.

<table>
<thead>
<tr>
<th>Component</th>
<th>Timing of earnings recognition for changes in fair value</th>
<th>Presentation in income statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changes in fair value that are included in the assessment of hedge effectiveness</td>
<td>Recognized in earnings immediately</td>
<td>Same line item as the effect of <strong>hedged item</strong></td>
</tr>
<tr>
<td>Initial value of the excluded component and the subsequent changes in its fair value</td>
<td>Depends on the approach elected (see section 4.2.20):</td>
<td>Same line item as the effect of <strong>hedged item</strong></td>
</tr>
<tr>
<td></td>
<td>— <strong>Amortization approach.</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>The initial fair value of an excluded component is</td>
<td></td>
</tr>
<tr>
<td></td>
<td>recognized in earnings using a systematic and rational</td>
<td></td>
</tr>
<tr>
<td></td>
<td>method. Any difference between the change in the</td>
<td></td>
</tr>
<tr>
<td></td>
<td>fair value of the excluded component and the amounts</td>
<td></td>
</tr>
<tr>
<td></td>
<td>recognized in income are included in OCI.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>— <strong>Mark-to-market approach.</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Changes in fair value are recognized in earnings</td>
<td></td>
</tr>
<tr>
<td></td>
<td>immediately – i.e. as the changes occur.</td>
<td></td>
</tr>
</tbody>
</table>

**Examples**

The following examples demonstrate the fair value hedge accounting model:

— Accounting for a hedge that lacks perfect offset (Example 4.2.10).
Example 4.2.10
Accounting for a hedge that lacks perfect offset

On January 1, Year 1, ABC Corp. designates a derivative as the hedging instrument in a fair value hedge of interest rate risk on a recognized fixed-rate debt obligation. On that date, ABC formally documents that the hedging relationship is expected to be highly effective – i.e. the derivative hedging instrument is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk (interest rate risk) during the period that the hedge is designated. ABC also documents that its established policy for the range of the extent of that offset that is considered highly effective is 80%–125%.

During the three months ended March 31, Year 1, changes in the fair values of the derivative hedging instrument and the hedged debt attributable to the hedged risk are as follows.

<table>
<thead>
<tr>
<th></th>
<th>Fair value increase (decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivative hedging instrument</td>
<td>$(50,000)</td>
</tr>
<tr>
<td>Hedged debt attributable to the hedged risk (interest rate risk)</td>
<td>45,000</td>
</tr>
<tr>
<td>Hedge effectiveness¹</td>
<td>111%</td>
</tr>
</tbody>
</table>

Note:
1. $50,000 ÷ $45,000.

Because the hedging relationship was highly effective during the three months ended March 31, Year 1 in achieving offsetting changes in fair value attributable to the hedged risk, ABC applies fair value hedge accounting for the period.

ABC records the following journal entry.

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Derivative hedging instrument</td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>To record change in fair value of derivative hedging instrument.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt</td>
<td></td>
<td>45,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To record change in fair value of hedged item attributable to hedged risk.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Although the hedging relationship is highly effective, ABC’s net income reflects the $5,000 loss on the derivative hedging instrument that exceeds the gain on the hedged item. This amount reflects the extent to which the hedging relationship is not perfectly effective.
Excerpts from Subtopic 815-20

>>> Income Statement Presentation of Hedging Instruments

Paragraph 815-20-45-1A requires an entity to present the change in the fair value of the hedging instrument included in the assessment of hedge effectiveness and the amount excluded from the assessment of hedge effectiveness in the same income statement line item that is used to present the earnings effect of the hedged item. The following scenarios include implementation guidance on the meaning of the phrase the same income statement line item that is used to present the earnings effect of the hedged item.

>>>> Scenario A

Entity A designates a fair value hedge of interest rate risk in which the hedged item is a portfolio of fixed-rate loans. The derivative designated as the hedging instrument is a receive-floating-rate, pay-fixed-rate interest rate swap. In this scenario, Entity A’s objective is to convert the interest cash flows on the portfolio of fixed-rate loans to floating-rate.

The interest rate swap is a highly effective hedge of the interest rate risk of the portfolio of fixed-rate loans. Therefore, the change in the fair value of the interest rate swap should be presented in the same income statement line item used to present the earnings effect of the hedged item. Before applying hedge accounting, the earnings effect of the hedged item (that is, the interest accruals) is presented in an interest income line item. Therefore, Entity A should present all changes in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same interest income line item in the income statement.

4.2.20 Excluded components

Topic 815 permits an entity to exclude certain components of a hedging instrument – for example, the time value of an option – from the assessment of hedge effectiveness (see section 9.2.70).

An entity can recognize the initial value of the excluded components in earnings using either of the following approaches. [815-20-25-83A – 25-83B]

— Amortization approach. A systematic and rational method over the life of the hedging instrument.
— Mark-to-market approach. A method that recognizes all fair value changes of the excluded components currently in earnings, consistent with legacy US GAAP.

An entity presents amounts related to excluded components that are recognized in earnings in the same income statement line item that is used to present the earnings effect of the hedged item. [815-20-45-1A]

When using the amortization approach, any difference between the change in the fair value of the excluded component and the amounts recognized in income are included in OCI each period. Net gains or losses on derivative
hedging instruments that are included in AOCI are displayed as a separate classification within AOCI. [815-20-25-83A, 45-3]

The tax effect of amounts recorded in OCI also should be charged or credited directly to OCI. See KPMG’s Handbook, Accounting for Income Taxes, including paragraphs 9.043 and 9.050, for further information.

Any amounts associated with the excluded component remaining in AOCI when a fair value hedge is discontinued are recorded in earnings in the same manner as other components of the amortized cost basis of the hedged asset or liability when the hedged item continues to exist (see section 4.5.10).

**Examples**

The following FASB example describes approaches for assessing effectiveness in a fair value hedge of a recognized asset (US Treasury bond) with a purchased option when time value is excluded – i.e. time value is an excluded component. As discussed in section 9.4.20 (and consistent with paragraph 815-20-35-16 and the discussion in section 9.2.60). We believe the critical terms match method is precluded for fair value hedging relationships in the vast majority of circumstances.

The FASB example is followed by a KPMG example that illustrates assessing effectiveness in the fair value hedge described in the FASB example when the recognized asset is classified as an available for sale security. It includes two scenarios, illustrating and comparing the mark-to-market and amortization approaches for recognizing the excluded component.

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**Excerpt from ASC 815-25**

**>> Example 5: Fair Value Hedge of U.S. Treasury Bond with Put Options**

55-23 This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value hedge of a U.S. Treasury bond with put options. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

55-24 Entity E owns a U.S. Treasury bond and wants to protect itself against the fair value exposure to declines in the price of the bond. Entity E purchases an at-the-money put option on a U.S. Treasury security with the same terms (remaining maturity, notional amount, and interest rate) as the U.S. Treasury bond held and designates the option as a hedge of the fair value exposure of the U.S. Treasury bond. Entity E plans to hold the put option until it expires.

55-25 Because Entity E plans to hold the put option (a static hedge) rather than manage the position with a delta-neutral strategy, it could assess whether it expects the hedge to be highly effective at achieving offsetting changes in fair value by calculating and comparing the changes in the intrinsic value of the option and changes in the price (fair value) of the U.S. Treasury bond for different possible market prices. In assessing the expectation of effectiveness on an ongoing basis, Entity E also must consider the actual changes in the fair value.
value of the U.S. Treasury bond and in the intrinsic value of the option during the hedge period.

55-26 However, because the pertinent critical terms of the option and the bond are the same in this Example, Entity E could expect the changes in value of the bond attributable to changes in interest rates and changes in the intrinsic value of the option to offset completely during the period that the option is in the money. That is, the hedging relationship will be perfectly effective because Entity E has chosen to exclude changes in the option’s time value from the assessment of hedge effectiveness. Entity E may elect to account for changes in the time value of the option through an amortization approach in accordance with paragraph 815-20-25-83A or through a mark-to-market approach in accordance with paragraph 815-20-25-83B. Under either of those approaches, it should present the portion of excluded components recognized in earnings in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

Example 4.2.20
Comparison of approaches to recognize excluded component (time value) for a hedge of an AFS debt security with a put option

ABC Corp. purchases at par a US Treasury bond with a face value of $15,000,000 that it classifies as AFS.

On January 1, Year 1, the fair value of the US Treasury bond is $18,500,000 and ABC wants to protect itself against the fair value exposure to declines in the price of the bond. Therefore, ABC purchases an at-the-money put option on a US Treasury security with the same terms (remaining maturity, notional amount, and interest rate) as the US Treasury bond it holds. ABC pays a premium of $200,000.

ABC designates the put option as the hedging instrument in a hedge of the changes in fair value of the US Treasury bond. ABC plans to hold the put option until it expires.

The following additional facts are relevant.

— All criteria for hedge accounting have been met.

— ABC will assess hedge effectiveness by comparing changes in the intrinsic value of the put option with changes in the fair value of the US Treasury bond. 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 is expected to be perfectly effective.

  — At inception, ABC concluded that the changes in the intrinsic value of the option will be highly (100%) effective at offsetting the changes in the fair value of its investment in the US Treasury bond.
  — On an ongoing basis, ABC will ascertain and document that the hedging relationship has been, and will continue to be, highly (100%) effective.
— The changes in fair values of both the US Treasury bond and the put option that are attributable to credit risk are nominal and are disregarded for purposes of this example.
  - The put option is fully collateralized
  - Credit risk associated with the US Treasury bond is considered to be nominal.
— ABC elects to exclude changes in the time value of the option from the assessment of hedge effectiveness.
— The debt security’s fair value is as shown in the following table.

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, Year 1</td>
<td>$18,500,000</td>
</tr>
<tr>
<td>March 31, Year 1</td>
<td>19,000,000</td>
</tr>
<tr>
<td>June 30, Year 1</td>
<td>18,300,000</td>
</tr>
<tr>
<td>September 30, Year 1</td>
<td>18,000,000</td>
</tr>
<tr>
<td>December 31, Year 1</td>
<td>17,750,000</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>Fair value</th>
<th>Intrinsic value</th>
<th>Time value¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, Year 1</td>
<td>$200,000</td>
<td>$</td>
<td>$200,000</td>
</tr>
<tr>
<td>March 31, Year 1</td>
<td>180,000</td>
<td>-</td>
<td>180,000</td>
</tr>
<tr>
<td>June 30, Year 1</td>
<td>350,000</td>
<td>200,000</td>
<td>150,000</td>
</tr>
<tr>
<td>September 30, Year 1</td>
<td>550,000</td>
<td>500,000</td>
<td>50,000</td>
</tr>
<tr>
<td>December 31, Year 1</td>
<td>750,000</td>
<td>750,000</td>
<td>-</td>
</tr>
</tbody>
</table>

Note:
1. Fair value less intrinsic value.

For simplicity, this example makes the following assumptions.
— It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
— ABC prepares financial reports at the end of every quarter.
— ABC settles the put option through delivery of the US Treasury bond on December 31, Year 1.

Scenario 1: Mark-to-market approach

Journal entries – January 1, Year 1

ABC records the following journal entry at January 1, Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Put option</td>
<td>200,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
</tr>
</tbody>
</table>

To record purchase of put option.
There would also be a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship.

**Journal entries – March 31, Year 1**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>20,000</td>
</tr>
<tr>
<td>Put option</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>To record change in time value of put option.</strong></td>
<td></td>
</tr>
<tr>
<td>US Treasury bond – AFS</td>
<td>500,000</td>
</tr>
<tr>
<td>OCI – Gains on AFS debt securities¹</td>
<td>500,000</td>
</tr>
<tr>
<td><strong>To record change in fair value of US Treasury bond.</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Note:**

1. The entire change in fair value of the US Treasury bond is recorded in OCI, because there was no change in the intrinsic value of the put option.

**Journal entries – June 30, Year 1**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>30,000</td>
</tr>
<tr>
<td>Put option</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>To record change in time value of put option.</strong></td>
<td></td>
</tr>
<tr>
<td>Put option</td>
<td>200,000</td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>To record change in intrinsic value of put option.</strong></td>
<td></td>
</tr>
<tr>
<td>OCI – Gains on AFS debt securities¹</td>
<td>500,000</td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities¹</td>
<td>200,000</td>
</tr>
<tr>
<td>US Treasury bond – AFS</td>
<td>700,000</td>
</tr>
<tr>
<td><strong>To record change in fair value of investment in US Treasury bond.</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Note:**

1. The loss on the 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.
**Journal entries – September 30, Year 1**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>100,000</td>
</tr>
<tr>
<td>Put option</td>
<td>100,000</td>
</tr>
<tr>
<td><em>To record change in time value of put option.</em></td>
<td></td>
</tr>
<tr>
<td>Put option</td>
<td>300,000</td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>300,000</td>
</tr>
<tr>
<td><em>To record change in intrinsic value of put option.</em></td>
<td></td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>300,000</td>
</tr>
<tr>
<td>US Treasury bond – AFS</td>
<td>300,000</td>
</tr>
<tr>
<td><em>To record change in fair value of investment in US Treasury bond.</em></td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. The entire loss on this investment is recognized in earnings because it is equal to the change in the put option’s intrinsic value (i.e. the hedged risk).

**Journal entries – December 31, Year 1**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>50,000</td>
</tr>
<tr>
<td>Put option</td>
<td>50,000</td>
</tr>
<tr>
<td><em>To record change in time value of the put option.</em></td>
<td></td>
</tr>
<tr>
<td>Put option</td>
<td>250,000</td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>250,000</td>
</tr>
<tr>
<td><em>To record change in intrinsic value of put option.</em></td>
<td></td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>250,000</td>
</tr>
<tr>
<td>US Treasury bond – AFS</td>
<td>250,000</td>
</tr>
<tr>
<td><em>To record change in fair value of investment in US Treasury bond.</em></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>18,500,000</td>
</tr>
<tr>
<td>US Treasury bond – AFS</td>
<td>17,750,000</td>
</tr>
<tr>
<td>Put option</td>
<td>750,000</td>
</tr>
<tr>
<td><em>To record settlement of put option through delivery of US Treasury bond.</em></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gains on AFS debt securities</td>
<td>3,500,000</td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>3,500,000</td>
</tr>
<tr>
<td><em>To record realized gain on sale of investment in US Treasury bond.</em></td>
<td></td>
</tr>
</tbody>
</table>
### Financial statement excerpts

At the end of each period, ABC’s financial statements reflect the following related to this hedging relationship.

<table>
<thead>
<tr>
<th>Account</th>
<th>3 months ended Mar 31</th>
<th>6 months ended Jun 30</th>
<th>9 months ended Sep 30</th>
<th>Year ended Dec 31</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt securities AFS</td>
<td>$19,000,000</td>
<td>$18,300,000</td>
<td>$18,000,000</td>
<td>-</td>
</tr>
<tr>
<td>Put option</td>
<td>180,000</td>
<td>350,000</td>
<td>550,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Balance sheet – equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gains (losses) on AFS debt securities</td>
<td>$4,000,000</td>
<td>$3,500,000</td>
<td>$3,500,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>$(20,000)</td>
<td>$(50,000)</td>
<td>$(150,000)</td>
<td>$3,300,000</td>
</tr>
<tr>
<td><strong>Disclosures under subparagraphs 815-10-50-4EE(a) – 50-4EE(c)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carrying amount of AFS debt securities on the balance sheet that are hedged assets¹ [815-10-50-4EE(a), 50-4EE(c)]</td>
<td>$19,000,000</td>
<td>$18,300,000</td>
<td>$18,000,000</td>
<td>-</td>
</tr>
<tr>
<td>Amortized cost of AFS debt securities designated in fair value hedges²</td>
<td>15,000,000</td>
<td>14,800,000</td>
<td>14,500,000</td>
<td>-</td>
</tr>
<tr>
<td>Increase (decrease) in fair value of hedged AFS debt securities recognized in earnings due to fair value hedge accounting³ [815-10-50-4EE(b)]</td>
<td>-</td>
<td>(200,000)</td>
<td>(500,000)</td>
<td>-</td>
</tr>
<tr>
<td>Other changes in fair value (recognized in AOCI)⁴</td>
<td>4,000,000</td>
<td>3,500,000</td>
<td>3,500,000</td>
<td>-</td>
</tr>
</tbody>
</table>

**Notes:**

1. Carrying amount represents the fair value at that date.
2. Amortized cost at January 1, Year 1 ($15,000,000, which equals the purchase price since there were no premiums or discounts) + Increase (decrease) in fair value of hedged AFS debt securities recognized in earnings due to fair value hedge accounting (see Note 3).
3. Fair value at that date - fair value at January 1, Year 1. This amount represents the cumulative basis adjustment (i.e. amount of fair value hedge adjustments) included in

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Note:
1. The entire loss on this investment is recognized in earnings because it is equal to the change in the put option’s intrinsic value (i.e. the hedged risk).
the carrying amount at that date. This equals the intrinsic value of the put option because the hedging relationship was perfectly effective.

4. **Fair value at that date - amortized cost at January 1, Year 1 ($15,000,000, which equals the purchase price because there were no premiums or discounts) - Increase (decrease) in fair value of hedged AFS debt securities recognized in earnings due to fair value hedge accounting.**

The $3,300,000 gain on AFS debt securities for the year ended December 31, Year 1 represents the following.

— **$3,500,000 unrealized gain in AOCI as of the date of inception of the hedging relationship.** Although the US Treasury bond’s fair value fell to $17,750,000, ABC was able to lock in a $18,500,000 sale price as a result of entering into the put option. Therefore, it was able to realize the gain of $3,500,000 (less the premium paid for the option).

Because the intrinsic value of the put option was perfectly effective at offsetting changes in the fair value of the US Treasury bond, 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 fair value of the US Treasury bond.

— **$200,000 premium paid for the put option.** This was recognized in earnings as the fair value of the time value portion of the put option changed over time.

**Scenario 2: Amortization approach – straight-line method**

The following table shows the effect on earnings and AOCI of the time value using the straight-line method:

<table>
<thead>
<tr>
<th>Date</th>
<th>Total change in time value</th>
<th>Recognized in earnings – amortization of initial time value (B)</th>
<th>Recognized in AOCI (A) - (B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31, Year 1</td>
<td>$20,000</td>
<td>$50,000</td>
<td>($30,000)</td>
</tr>
<tr>
<td>June 30, Year 1</td>
<td>30,000</td>
<td>50,000</td>
<td>(20,000)</td>
</tr>
<tr>
<td>September 30, Year 1</td>
<td>100,000</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>December 31, Year 1</td>
<td>50,000</td>
<td>50,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>$200,000</strong></td>
</tr>
</tbody>
</table>

**Journal entries – January 1, Year 1**

ABC records the following journal entry at January 1, Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Put option</td>
<td>200,000</td>
</tr>
<tr>
<td>Cash</td>
<td>200,000</td>
</tr>
</tbody>
</table>

To record purchase of put option.

There would also be a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship.
**Journal entries – March 31, Year 1**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI – Fair value hedge excluded component</td>
<td>20,000</td>
<td>OCI – Fair value hedge excluded component</td>
<td>20,000</td>
</tr>
<tr>
<td>Put option</td>
<td></td>
<td>Put option</td>
<td></td>
</tr>
<tr>
<td><em>To record change in fair value of excluded component (time value).</em></td>
<td></td>
<td><em>To record change in fair value of excluded component (time value).</em></td>
<td></td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>50,000</td>
<td>Gains (losses) on AFS debt securities</td>
<td>50,000</td>
</tr>
<tr>
<td>OCI – Gains on AFS debt securities</td>
<td></td>
<td>OCI – Gains on AFS debt securities</td>
<td></td>
</tr>
<tr>
<td><em>To record amortization of excluded component (time value).</em></td>
<td></td>
<td><em>To record amortization of excluded component (time value).</em></td>
<td></td>
</tr>
<tr>
<td>US Treasury bond – AFS</td>
<td>500,000</td>
<td>US Treasury bond – AFS</td>
<td>500,000</td>
</tr>
<tr>
<td>OCI – Gains on AFS debt securities¹</td>
<td></td>
<td>OCI – Gains on AFS debt securities¹</td>
<td></td>
</tr>
<tr>
<td><em>To record change in fair value of US Treasury bond.</em></td>
<td></td>
<td><em>To record change in fair value of US Treasury bond.</em></td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. There was no change in the intrinsic value of the purchased put option. As a result, amortization of the excluded component is recognized but there are no other changes in the fair value of the option to recognize.

**Journal entries – June 30, Year 1**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI – Fair value hedge excluded component</td>
<td>30,000</td>
<td>OCI – Fair value hedge excluded component</td>
<td>30,000</td>
</tr>
<tr>
<td>Put option</td>
<td></td>
<td>Put option</td>
<td></td>
</tr>
<tr>
<td><em>To record change in fair value of excluded component (time value).</em></td>
<td></td>
<td><em>To record change in fair value of excluded component (time value).</em></td>
<td></td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>50,000</td>
<td>Gains (losses) on AFS debt securities</td>
<td>50,000</td>
</tr>
<tr>
<td>OCI – Gains on AFS debt securities</td>
<td></td>
<td>OCI – Gains on AFS debt securities</td>
<td></td>
</tr>
<tr>
<td><em>To record amortization of excluded component (time value).</em></td>
<td></td>
<td><em>To record amortization of excluded component (time value).</em></td>
<td></td>
</tr>
<tr>
<td>Put option</td>
<td>200,000</td>
<td>Put option</td>
<td>200,000</td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td></td>
<td>Gains (losses) on AFS debt securities</td>
<td></td>
</tr>
<tr>
<td><em>To record change in intrinsic value of put option.</em></td>
<td></td>
<td><em>To record change in intrinsic value of put option.</em></td>
<td></td>
</tr>
<tr>
<td>OCI – Gain on AFS debt securities¹</td>
<td>500,000</td>
<td>OCI – Gain on AFS debt securities¹</td>
<td>500,000</td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities¹</td>
<td>200,000</td>
<td>Gains (losses) on AFS debt securities¹</td>
<td>200,000</td>
</tr>
<tr>
<td>US Treasury bond – AFS</td>
<td>700,000</td>
<td>US Treasury bond – AFS</td>
<td>700,000</td>
</tr>
<tr>
<td><em>To record change in fair value of investment in US Treasury bond.</em></td>
<td></td>
<td><em>To record change in fair value of investment in US Treasury bond.</em></td>
<td></td>
</tr>
</tbody>
</table>
Hedging

4. Accounting for fair value hedges

Note:
1. 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 of the investment is recorded in OCI.

Journal entries – September 30, Year 1

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI – Fair value hedge excluded component</td>
<td>100,000</td>
</tr>
<tr>
<td>Put option</td>
<td>100,000</td>
</tr>
<tr>
<td><em>To record change in fair value of excluded component (time value).</em></td>
<td></td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>50,000</td>
</tr>
<tr>
<td>OCI – Gains on AFS debt securities</td>
<td>50,000</td>
</tr>
<tr>
<td><em>To record amortization of excluded component (time value).</em></td>
<td></td>
</tr>
<tr>
<td>Put option</td>
<td>300,000</td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>300,000</td>
</tr>
<tr>
<td><em>To record change in intrinsic value of put option.</em></td>
<td></td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>300,000</td>
</tr>
<tr>
<td>US Treasury bond – AFS</td>
<td>300,000</td>
</tr>
<tr>
<td><em>To record change in fair value of US Treasury bond.</em></td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. The entire loss on this investment is recognized in earnings because it is equal to the change in the put option’s intrinsic value (i.e. the hedged risk).

Journal entries – December 31, Year 1

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI – Fair value hedge excluded component</td>
<td>50,000</td>
</tr>
<tr>
<td>Put option</td>
<td>50,000</td>
</tr>
<tr>
<td><em>To record change in fair value of excluded component (time value).</em></td>
<td></td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>50,000</td>
</tr>
<tr>
<td>OCI – Gains on AFS debt securities</td>
<td>50,000</td>
</tr>
<tr>
<td><em>To record amortization of excluded component (time value).</em></td>
<td></td>
</tr>
<tr>
<td>Put option</td>
<td>250,000</td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>250,000</td>
</tr>
<tr>
<td><em>To record change in intrinsic value of put option.</em></td>
<td></td>
</tr>
</tbody>
</table>
### Financial statement excerpts

At the end of each period, ABC’s financial statements reflect the following related to this hedging relationship.

<table>
<thead>
<tr>
<th>Account</th>
<th>3 months ended Mar 31</th>
<th>6 months ended Jun 30</th>
<th>9 months ended Sep 30</th>
<th>Year ended Dec 31</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFS debt securities</td>
<td>$19,000,000</td>
<td>$18,300,000</td>
<td>$18,000,000</td>
<td>-</td>
</tr>
<tr>
<td>Put option</td>
<td>180,000</td>
<td>350,000</td>
<td>550,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Balance sheet – equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gains (losses) on AFS debt securities</td>
<td>$4,000,000</td>
<td>$3,500,000</td>
<td>$3,500,000</td>
<td>-</td>
</tr>
<tr>
<td>AOCI – Fair value hedge excluded component</td>
<td>(30,000)</td>
<td>(50,000)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gains (losses) on AFS debt securities</td>
<td>$(50,000)</td>
<td>$(100,000)</td>
<td>$(150,000)</td>
<td>$3,300,000</td>
</tr>
<tr>
<td><strong>Disclosures under subparagraphs 815-10-50-4EE(a) – 50-4EE(c)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carrying amount of AFS debt securities on the balance sheet that are hedged assets¹ [815-10-50-4EE(a), 50-4EE(c)]</td>
<td>$19,000,000</td>
<td>$18,300,000</td>
<td>$18,000,000</td>
<td>-</td>
</tr>
</tbody>
</table>

---

¹ The entire loss on this investment is recognized in earnings because it is equal to the change in the put option’s intrinsic value (i.e., the hedged risk).
Hedging

4. Accounting for fair value hedges

<table>
<thead>
<tr>
<th>Account</th>
<th>3 months ended Mar 31</th>
<th>6 months ended Jun 30</th>
<th>9 months ended Sep 30</th>
<th>Year ended Dec 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortized cost of AFS debt securities designated in fair value hedges²</td>
<td>15,000,000</td>
<td>14,800,000</td>
<td>14,500,000</td>
<td>-</td>
</tr>
<tr>
<td>Increase (decrease) in fair value of hedged AFS debt securities</td>
<td>-</td>
<td>(200,000)</td>
<td>(500,000)</td>
<td>-</td>
</tr>
<tr>
<td>recognized in earnings due to fair value hedge accounting³ [815-10-50-4EE(b)]</td>
<td>-</td>
<td>(200,000)</td>
<td>(500,000)</td>
<td>-</td>
</tr>
<tr>
<td>Other changes in fair value (recognized in AOCI)⁴</td>
<td>4,000,000</td>
<td>3,500,000</td>
<td>3,500,000</td>
<td>-</td>
</tr>
</tbody>
</table>

Notes:
1. Carrying amount represents the fair value at that date.
2. Amortized cost at January 1, Year 1 ($15,000,000, which equals the purchase price since there were no premiums or discounts) + Increase (decrease) in fair value of hedged AFS debt securities recognized in earnings due to fair value hedge accounting (see Note 3).
3. Fair value at that date - fair value at January 1, Year 1. This amount represents the cumulative basis adjustment (i.e. amount of fair value hedge adjustments) included in the carrying amount at that date. This equals the intrinsic value of the put option because the hedging relationship was perfectly effective.
4. Fair value at that date - amortized cost at January 1, Year 1 ($15,000,000, which equals the purchase price because there were no premiums or discounts) - Increase (decrease) in fair value of hedged AFS debt securities recognized in earnings due to fair value hedge accounting.

The $3,300,000 gain on AFS securities for the year ended December 31, Year 1 represents the following.

— **$3,500,000 unrealized gain in AOCI as of the date of inception of the hedging relationship.** Although the US Treasury bond’s fair value fell to $17,750,000, ABC was able to lock in a $18,500,000 sale price as a result of entering into the put option. Therefore, it was able to realize the gain of $3,500,000 (less the premium paid for the option).

Because the intrinsic value of the put option was perfectly effective at offsetting changes in the fair value of the US Treasury bond, 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 fair value of the US Treasury bond.

— **$200,000 premium paid for the put option.** This was recognized in earnings evenly over the term of the put option using an amortization approach (i.e. straight-line method).
4. Accounting for fair value hedges

4.3 Measuring the hedged item (basis adjustments)

4.3.10 Overview

The amortized cost basis of a hedged item in a fair value hedge (i.e. the hedged asset, liability or firm commitment) is adjusted for its change in fair value that is attributable to the risk being hedged. This adjustment is referred to as a basis adjustment. [815-25-35-1]

Additional considerations apply when:

— the hedged risk is interest rate risk (section 4.3.20); and
— basis adjustments are determined at a portfolio level (section 4.3.30).

Question 4.3.10

May a basis adjustment be measured using a method different from that used to assess effectiveness?

Interpretive response: No. A basis adjustment is measured consistently with the entity’s risk management strategy and the method used to assess the hedging relationship’s effectiveness.

For example, in a fair value hedge of a firm commitment, an entity assesses hedge effectiveness based on the entire gain or loss on the derivative hedging instrument – i.e. including the time value component. In this situation, the basis adjustment is also based on the total change in its fair value – i.e. including the time value component.

In contrast, if the hedged item is a recognized asset or liability, its fair value is measured based on current prices – e.g. spot prices for a commodity. As a result, the entity’s risk management strategy and assessment of effectiveness likely considers only changes in spot prices of the hedging derivative instrument – i.e. time value of an option contract is an excluded component (see section 9.2.70). In this situation, the basis adjustment is limited to changes in the fair value of the hedged item attributable to changes based on spot prices.
See also Example 4.3.50 regarding the benchmark rate component for effectiveness assessment and basis adjustment measurement.

**Question 4.3.20**

Is it appropriate to use the change in fair value of the hedging instrument to measure the basis adjustment?

**Interpretive response:** It depends. When the shortcut method is used (see section 9.3), the change in fair value of the hedging instrument is used as a proxy to measure the change in fair value of the hedged item with no effect on net income – i.e. the income statement reflects perfect effectiveness of the hedging relationship.

This approach for measuring the hedged item’s fair value is not appropriate when the shortcut method is not used. As a result, differences may arise between measurement of the hedging instrument and the basis adjustment, resulting in the hedge not being perfectly effective and creating volatility in earnings.

For example, such a difference may result when the discount rate used to measure the fair value of a derivative hedging instrument is not the same as the benchmark interest rate designated as the hedged risk.

**Question 4.3.30**

Do the principles of Topic 820 apply when measuring a basis adjustment?

**Interpretive response:** Yes. Although the hedged item may not be measured at fair value (see Question 4.3.40), we believe the measurement of changes in the fair value of the hedged item attributable to the hedged risk(s) should follow the principles of Topic 820 (fair value measurement).

See also KPMG’s Q&A: Fair value measurement, including Question B70 and Section O, Application issues: Derivatives and hedging.

**Question 4.3.40**

Does a basis adjustment result in the hedged item being measured at its fair value?

**Interpretive response:** Not necessarily. A basis adjustment is measured based on changes in the fair value that are attributable to the hedged risk that occurred since the hedged item was designated in the hedging relationship. As a result, the hedged item’s measurement may not be fair value on the balance sheet unless it is required to be measured at fair value under other applicable US GAAP (e.g. an AFS debt security).
The following two situations demonstrate when a hedged item’s amortized cost basis (including the basis adjustment) does not represent the hedged item’s fair value.

— **Hedge designated after initial recognition of the hedged item carried at amortized cost.** If an asset or liability is not designated in a hedging relationship until after it is initially recognized, any unrealized gain or loss that arose between initial recognition and the time it was designated in a hedging relationship is not recognized.

— **Hedged risk is a specific risk rather than total changes in fair value.** If the hedged risk is changes in fair value attributable to only a specific risk, the basis adjustment is measured based only on changes in fair value attributable to the specific risk rather than all changes in fair value of the hedged item. For example, if the hedged risk for a fixed-rate debt obligation relates to the benchmark interest rate, only changes in fair value attributable to changes in the benchmark interest rate are recognized and changes due to other factors (e.g. credit risk) are not.

**Question 4.3.50**

When the hedged risk is overall changes in fair value, can any of the contractual cash flows be excluded from the basis adjustment measurement?

**Interpretive response:** No. When the hedged risk is overall changes in fair value, all contractual cash flows of the hedged item are considered when measuring the basis adjustment.

**Examples**

The following examples demonstrate measuring the basis adjustment.

— Fair value hedge of inventory after initial recognition (Example 4.3.10).
— Accounting for the hedge of long-term debt with an interest rate swap (shortcut method) (Example 4.3.20).
— Accounting for a fair value hedge of the LIBOR swap rate in a fixed-rate noncallable note (Example 4.3.30).
— Accounting for a hedge of a firm commitment to purchase silver with a forward contract (Example 4.3.40).

**Example 4.3.10**

**Fair value hedge of inventory after initial recognition**

ABC Corp. 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 ABC carries its inventory at the lower of cost or net realizable value, ABC has not recognized the $50,000 appreciation in this inventory.
To hedge the fair value of this inventory, ABC purchases a put option to sell 10,000 widgets at a price of $15 each. ABC assesses effectiveness using the option’s intrinsic value – i.e. ABC excludes time value from its assessment of effectiveness. ABC elects to use the mark-to-market approach for recognizing changes in the fair value of the excluded component (time value).

At the next reporting date, the intrinsic value of the option and fair value of the inventory have changed as reflected in the following table.

<table>
<thead>
<tr>
<th></th>
<th>Intrinsic value increase (decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Put option</td>
<td>$20,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>(20,000)</td>
</tr>
</tbody>
</table>

ABC records the following journal entry.

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Put option</td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>To record change in intrinsic value of put option (hedging instrument).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>To record change in fair value of inventory attributable to hedged risk.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In addition, ABC would record a journal entry to recognize the change in the fair value of the excluded component (i.e. time value of option) as cost of goods sold.

After the above journal entry is recognized, the inventory’s cost basis is $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).

The preexisting gain on the inventory at inception of the hedge is not recognized on the balance sheet. As a result, even though the fair value of the hedged inventory is $130,000, applying the fair value hedge accounting requirements results in it 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 $50,000 gain that existed at the beginning of the hedge. This excludes the cost of the option (time value) – which is excluded from the assessment of effectiveness and is recognized as cost of goods sold during the hedging relationship.

If the inventory’s fair value was equal to $130,000 at the date it was sold and the put option also settled on that date, ABC would record the following journal entry (other than related to the cost of the excluded component).
### Example 4.3.20

**Accounting for the hedge of long-term debt with an interest rate swap (shortcut method)**

On January 1, Year 1, ABC Corp. issues a three-year $1,000,000 debt obligation bearing a fixed interest rate of 10%. ABC 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 ABC effectively paying an 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 is paid or received for the interest rate swap.

ABC 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.

The following additional facts are relevant.

- All criteria for hedge accounting using the shortcut method have been met (see section 9.3). There have been no changes in creditworthiness that would alter the effectiveness of the hedging relationship.
- The six-month LIBOR rates on the annual interest rate swap reset dates are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>6-month LIBOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, Year 1</td>
<td>9.5%</td>
</tr>
<tr>
<td>January 1, Year 2</td>
<td>8.5%</td>
</tr>
<tr>
<td>January 1, Year 3</td>
<td>10.5%</td>
</tr>
</tbody>
</table>
Payments made (received) are as follows.

<table>
<thead>
<tr>
<th></th>
<th>December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td>Fixed-rate debt obligation¹</td>
<td>$100,000</td>
</tr>
<tr>
<td>Interest rate swap²</td>
<td>-</td>
</tr>
<tr>
<td><strong>Net effect</strong></td>
<td><strong>$100,000</strong></td>
</tr>
</tbody>
</table>

Notes:
1. Principal amount of the debt obligation $1,000,000 × the fixed interest rate of 10%.
2. Notional amount of the interest rate swap $1,000,000 × (6-month LIBOR at the beginning of the year less 9.5%).

Assumed fair value amounts (after cash settlements, which is referred to as 'clean' pricing) are as follows.

<table>
<thead>
<tr>
<th></th>
<th>December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td><strong>Asset (liability)</strong></td>
<td></td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>$150,000</td>
</tr>
<tr>
<td>Fixed-rate debt obligation (due solely to changes in the benchmark interest rate)¹</td>
<td>1,150,000</td>
</tr>
<tr>
<td><strong>Change in fair value – gain (loss)</strong></td>
<td></td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>150,000</td>
</tr>
<tr>
<td>Fixed-rate debt obligation¹</td>
<td>$(150,000)</td>
</tr>
</tbody>
</table>

Note:
1. Under the shortcut method, the change in fair value of the interest rate swap (hedging instrument) is used as a proxy to measure the change in the fair value of the fixed-rate debt obligation (hedged item).

For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
- It is based on annual periods; normally the assessment of effectiveness and fair value adjustments of the hedged item and derivative would be done at least quarterly.
- Journal entries are demonstrated for annual periods although payments are made on June 30 and December 31 of each year and the interest rate swap resets on January 1 and July 1 of each year.
- Journal entries (for all years) are presented gross for illustrative purposes but could be combined.
### Journal entries – January 1, Year 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Fixed-rate debt obligation</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

*To record issuance of fixed-rate debt obligation.*

A memorandum entry is also made on January 1, Year 1 documenting the existence of this hedging relationship. The financial records of ABC are not otherwise affected as of this date because the interest rate swap had a fair value of zero at inception.

### Journal entries – December 31, Year 1

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>100,000</td>
</tr>
<tr>
<td>Cash</td>
<td>100,000</td>
</tr>
</tbody>
</table>

*To record interest expense on fixed-rate debt obligation.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate swap</td>
<td>150,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>150,000</td>
</tr>
</tbody>
</table>

*To record change in fair value of interest rate swap (hedging instrument).*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>150,000</td>
</tr>
<tr>
<td>Fixed-rate debt obligation</td>
<td>150,000</td>
</tr>
</tbody>
</table>

*To record change in fair value of fixed-rate debt obligation due to changes in interest rates.*

### Journal entries – December 31, Year 2

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>100,000</td>
</tr>
<tr>
<td>Cash</td>
<td>100,000</td>
</tr>
</tbody>
</table>

*To record interest expense on fixed-rate debt obligation.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>60,000</td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>60,000</td>
</tr>
</tbody>
</table>

*To record change in fair value of interest rate swap (hedging instrument).*
Journal entries – December 31, Year 3

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>100,000</td>
<td>To record interest expense on fixed-rate debt obligation.</td>
</tr>
<tr>
<td>Cash</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>90,000</td>
<td>To record change in fair value of interest rate swap (hedging instrument).</td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>Fixed-rate debt obligation</td>
<td>90,000</td>
<td>To record change in fair value of fixed-rate debt obligation due to changes in interest rates.</td>
</tr>
<tr>
<td>Interest expense</td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>10,000</td>
<td>To record net interest cash payment on interest rate swap as an increase in interest expense.</td>
</tr>
<tr>
<td>Cash</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Fixed-rate debt obligation</td>
<td>1,000,000</td>
<td>To record cash paid by the borrower on maturity of the fixed-rate debt obligation.</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000,000</td>
<td></td>
</tr>
</tbody>
</table>
Financial statement excerpts

At the end of Years 1–3, ABC’s financial statements reflect the following.

<table>
<thead>
<tr>
<th>Account</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>$150,000</td>
<td>$90,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Balance sheet – liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt obligation</td>
<td>$1,150,000</td>
<td>$1,090,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>$100,000 (^1)</td>
<td>$90,000 (^2)</td>
<td>$110,000 (^3)</td>
</tr>
</tbody>
</table>

**Disclosures under 815-10-55-4EE**

<table>
<thead>
<tr>
<th>Description</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount of debt obligations on the balance sheet that are hedged</td>
<td>$1,150,000</td>
<td>$1,090,000</td>
<td>-</td>
</tr>
<tr>
<td>liabilities ([815-10-50-4EE(a), 50-4EE(c)])</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cumulative amount of fair value hedge adjustments included in the carrying</td>
<td>$150,000</td>
<td>$90,000</td>
<td>-</td>
</tr>
<tr>
<td>amount of hedged debt obligations ([815-10-50-4EE(b)])</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1. For Year 1, this can be computed as (9.5% LIBOR at the beginning of the year + 0.50%) × $1,000,000 = $100,000.
2. For Year 2, this can be computed as (8.5% LIBOR at the beginning of the year + 0.50%) × $1,000,000 = $90,000.
3. For Year 3, this can be computed as (10.5% LIBOR at the beginning of the year + 0.50%) × $1,000,000 = $110,000.

Under the shortcut method, the hedging relationship is assumed to be perfectly effective. As a result, recording both the changes in fair value of the interest rate swap (derivative hedging instrument) and the changes in fair value of the fixed-rate debt obligation (hedged item) due to changes in 6-month LIBOR (benchmark interest rate) have the effect of converting the interest expense on the 10% fixed-rate debt obligation to six-month LIBOR plus 50 basis points.

Example 4.3.30

**Accounting for a fair value hedge of the LIBOR swap rate in a fixed-rate noncallable note**

On January 1, Year 1, ABC Corp. 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.

Also on January 1, Year 1, ABC enters into a two-year interest rate swap based on the 12-month LIBOR swap rate. Under the terms of the swap, ABC 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. The shortcut method cannot be used because the
interest rate swap resets annually and the shortcut method requires the frequency of repricing generally to be three to six months. [B15-20-25-105(c)]

On January 1, Year 1, ABC designates the interest rate swap as the hedging instrument in a fair value hedge. 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. Through the interest rate swap, ABC effectively converts its fixed-rate obligation to a 12-month LIBOR-based variable-rate obligation. This results in an effective variable rate of approximately 12-month LIBOR plus 3% because the receiving leg of the swap is fixed at 7% compared to the debt obligation’s 10%.

The assessment of hedge effectiveness is made by comparing the cumulative change in the fair value of the hedged 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 attributable to interest rate risk is calculated based on the full contractual cash flows of the debt obligation. Further, it is based on:

— the note’s coupon rate (i.e. its market interest rate at inception) 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.

This example has been simplified by assuming that the interest rate applicable to all payments is the same – i.e. the yield curve is flat.

The following additional facts are relevant.

— All criteria for hedge accounting have been met (see chapters 2 and 3).

— The 12-month LIBOR swap rates reset as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>12-month LIBOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, Year 1</td>
<td>7.0%</td>
</tr>
<tr>
<td>December 31, Year 1</td>
<td>7.5%</td>
</tr>
</tbody>
</table>

— Payments made (received) are as follows.

<table>
<thead>
<tr>
<th></th>
<th>December 31, Year 1</th>
<th>December 31, Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt obligation¹</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Interest rate swap²</td>
<td>-</td>
<td>500</td>
</tr>
<tr>
<td><strong>Net effect</strong></td>
<td><strong>$10,000</strong></td>
<td><strong>$10,500</strong></td>
</tr>
</tbody>
</table>

Notes:

1. Principal amount of the debt obligation $100,000 × the fixed interest rate of 10%.
2. Notional amount of the interest rate swap $100,000 × (12-month LIBOR at the beginning of the year less 7.0% received on the fixed leg).
Changes in the fair value of the debt obligation attributable to interest rate risk (12-month LIBOR) are as follows (after settlement of interest).

<table>
<thead>
<tr>
<th>December 31, Year 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal and interest payment due at end of Year 2</td>
</tr>
<tr>
<td>Market rate at inception of hedge adjusted for changes in LIBOR, at beginning of Year 1</td>
</tr>
<tr>
<td>Present value based on market rate as adjusted, beginning of period</td>
</tr>
<tr>
<td>Market rate at inception of hedge adjusted for changes in LIBOR, at end of period</td>
</tr>
<tr>
<td>Present value based on market rate as adjusted, end of period¹</td>
</tr>
<tr>
<td>Change in fair value attributable to changes in LIBOR</td>
</tr>
</tbody>
</table>

Note:
1. Final principal and interest amounts of the debt obligation of $110,000 ($100,000 + $10,000) discounted at 10.50%.

<table>
<thead>
<tr>
<th>December 31, Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal payment due at end of Year 2 (equals present value because it is due immediately)</td>
</tr>
<tr>
<td>Change in fair value attributable to changes in LIBOR</td>
</tr>
</tbody>
</table>

Fair value amounts of the interest rate swap are as follows (assumed).

<table>
<thead>
<tr>
<th>December 31, Year 1</th>
<th>December 31, Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate swap (liability) before settlement</td>
<td>(465)¹</td>
</tr>
<tr>
<td>Interest rate swap (liability) after settlement</td>
<td>(465)</td>
</tr>
</tbody>
</table>

Notes:
1. Because the yield curve is assumed to be flat, the fair value of $465 represents the present value of the assumed net settlement of $500 in one year’s time based on 7.5% LIBOR rate at December 31, Year 1.
2. The increase of $35 is due to the passage of time (note that the benchmark rate did not change) and is calculated as the $465 fair value at December 31, Year 1 × 7.5%.

Hedge effectiveness at December 31, Year 1 is as follows.

| Change in fair value of the interest rate swap | $465 |
| Change in fair value of the debt obligation attributable to interest rate risk | 452 |
| Hedge effectiveness¹ | 102.9% |
| Extent to which hedge is not perfectly effective² | $13 |

Notes:
1. $465 ÷ $452.
2. $465 - $452.
For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
- It is based on annual periods; normally the assessment of effectiveness and fair value adjustments of the hedged item and derivative is done at least quarterly.
- Journal entries (for all years) are presented gross for illustrative purposes but could be combined.

**Journal entries – January 1, Year 1**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100,000</td>
</tr>
<tr>
<td>Debt obligation</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>To record issuance of $100,000, 2-year debt obligation.</strong></td>
<td></td>
</tr>
</tbody>
</table>

There would also be a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship. The financial records of ABC would not otherwise be affected as of this date because the interest rate swap had a fair value of zero at inception.

**Journal entries – December 31, Year 1**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>10,000</td>
</tr>
<tr>
<td>Cash</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>To record interest expense on debt obligation.</strong></td>
<td></td>
</tr>
<tr>
<td>Debt obligation</td>
<td>452</td>
</tr>
<tr>
<td>Interest expense</td>
<td>452</td>
</tr>
<tr>
<td><strong>To record change in fair value of debt obligation due to changes in interest rates.</strong></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>465</td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>465</td>
</tr>
<tr>
<td><strong>To record change in fair value of interest rate swap (hedging instrument).</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Journal entries – December 31, Year 2**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>10,000</td>
</tr>
<tr>
<td>Cash</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>To record interest expense on debt obligation.</strong></td>
<td></td>
</tr>
</tbody>
</table>
### Financial statement excerpts

At the end of Years 1–2, ABC’s financial statements reflect the following.

<table>
<thead>
<tr>
<th>Account</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt obligation</td>
<td>$99,548</td>
<td>-</td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>465</td>
<td>-</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>$10,013¹</td>
<td>$10,487²</td>
</tr>
<tr>
<td><strong>Disclosures under 815-10-55-4EE</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carrying amount of debt obligations on the balance sheet that are hedged liabilities [815-10-50-4EE(a), 50-4EE(c)]</td>
<td>$99,548</td>
<td>-</td>
</tr>
<tr>
<td>Cumulative amount of fair value hedge adjustments included in the carrying amount of hedged debt obligations [815-10-50-4EE(b)]</td>
<td>452</td>
<td>-</td>
</tr>
</tbody>
</table>

**Notes:**

1. For Year 1, interest expense reflects the following.
   - Effective interest of 12-month LIBOR at the most recent reset date (7%) + the fixed spread (3%) = 10% ($10,000).
   - The extent to which the hedging relationship is not perfectly effective ($13).

2. For Year 2, interest expense reflects the following.
   - Effective interest of 12-month LIBOR at the most recent reset date (7.5%) + the fixed spread (3%) = 10.5% ($10,500).
   - The slight difference in the expected effective rate of 10.5% and the actual rate of 10.49% ($10,487 ÷ 100,000) is due to the fact that the hedging relationship was not perfectly effective.
Through the interest rate swap, ABC converted its fixed-rate obligation to a 12-month LIBOR-based variable-rate obligation. This results in an effective variable rate of approximately 12-month LIBOR plus 3% because the receiving leg of the swap is fixed at 7% compared to the debt obligation's 10%.

Example 4.3.40
Accounting for a hedge of a firm commitment to purchase silver with a forward contract

This example continues from Example 3.3.50; for ease of reference, this example includes the full fact pattern.

ABC Corp. 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. ABC has a contract to purchase 100,000 ounces of silver from DEF at $4.99 per ounce on December 31, Year 1. This transaction is considered a normal purchase as defined by Topic 815; therefore, the forward contract is not recognized and measured as a derivative.

If ABC does not purchase the silver from DEF, it will be required to pay DEF a substantial penalty of $300,000 – i.e. ABC's contract with DEF is a firm commitment. ABC is not required to make an up-front cash payment.

ABC is concerned that – as a result of fluctuations in the price of silver during the commitment period – 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, ABC enters into an over-the-counter silver forward contract on July 1, Year 1 that settles in cash on a net basis on December 31, Year 1. The forward contract requires ABC to sell 100,000 ounces of silver at $4.99 per ounce.

The forward contract is designated as a fair value hedge of ABC’s firm commitment to purchase 100,000 ounces of silver from DEF in six months.

The following additional facts are relevant.

- The relationship is expected to be highly effective. ABC will assess hedge effectiveness based on the changes in the forward price of silver.
  - At inception, ABC concludes and documents that the hedging relationship is expected to be highly effective.
  - On an ongoing basis, ABC will ascertain and document that the hedging relationship has been, and will continue to be, highly effective.
  - Credit risk (and changes in credit risk) are assumed to be nominal.

- The basis adjustment recognized in earnings related to the firm commitment will equal the changes in the fair value of the forward contract.

- All criteria for hedge accounting have been met (see chapters 2 and 3).

- The forward contract is at market rates; therefore, no cash is exchanged at inception of the contract.

- The spot and forward price of silver, and the fair value of the forward contract, are as follows.
4. Accounting for fair value hedges

### Spot price, Forward price, Fair value asset (liability), Change in fair value

<table>
<thead>
<tr>
<th>Date</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>July 1, Year 1</td>
<td>$5.00</td>
<td>$4.99</td>
<td>$</td>
<td>N/A</td>
</tr>
<tr>
<td>September 1, Year 1</td>
<td>4.98</td>
<td>4.95</td>
<td>3,960</td>
<td>$3,960</td>
</tr>
<tr>
<td>December 31, Year 1</td>
<td>5.10</td>
<td>N/A</td>
<td>(11,000)</td>
<td>(14,960)</td>
</tr>
</tbody>
</table>

Note:
1. Measured using the change in forward rates, discounted at an appropriate discount rate

---

The forward contract settles on December 31, Year 1 with ABC paying $11,000 = $100,000 × ($4.99 - $5.10).

For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
- ABC’s silver purchase contract is considered a normal purchase (see section 3.3.30).
- The hedging relationship is perfectly effective.

### Journal entries – July 1, Year 1

A memorandum entry is made on July 1, Year 1 documenting the existence of this hedging relationship. ABC’s financial records are otherwise not affected as of this date because the forward contract is at market rates.

### Journal entries – September 30, Year 1

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward contract to sell silver</td>
<td>3,960</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>3,960</td>
</tr>
<tr>
<td>To record change in fair value of forward contract attributable to discounted change in forward rate.</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>3,960</td>
</tr>
<tr>
<td>Firm commitment to purchase silver</td>
<td>3,960</td>
</tr>
<tr>
<td>To record change in fair value of firm commitment to purchase silver.</td>
<td></td>
</tr>
</tbody>
</table>

At September 1, Year 1, ABC’s financial statements reflect the following.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance sheet – assets</td>
<td></td>
</tr>
<tr>
<td>Forward contract to sell silver</td>
<td>$3,960</td>
</tr>
<tr>
<td>Balance sheet – liabilities</td>
<td></td>
</tr>
<tr>
<td>Firm commitment to purchase silver</td>
<td>3,960</td>
</tr>
</tbody>
</table>
Accounting for fair value hedges

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>14,960</td>
<td></td>
</tr>
<tr>
<td>Forward contract to sell silver</td>
<td></td>
<td>14,960</td>
</tr>
<tr>
<td>To record change in fair value of forward contract attributable to discounted change in forward rate.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm commitment to purchase silver</td>
<td></td>
<td>14,960</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td></td>
<td>14,960</td>
</tr>
<tr>
<td>To record change in fair value of firm commitment to purchase silver.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward contract to sell silver</td>
<td>11,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>11,000</td>
</tr>
<tr>
<td>To record settlement of forward contract at December 31, Year 1.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Silver inventory</td>
<td>510,000</td>
<td></td>
</tr>
<tr>
<td>Firm commitment to purchase silver</td>
<td>11,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>499,000</td>
<td></td>
</tr>
<tr>
<td>To record purchase of 100,000 ounces of silver at $4.99 per ounce pursuant to contract with DEF.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

At December 31, Year 1, ABC’s financial statements reflect the following.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance sheet – assets</td>
<td></td>
</tr>
<tr>
<td>Silver inventory</td>
<td>$510,000</td>
</tr>
<tr>
<td>Income statement</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>-</td>
</tr>
</tbody>
</table>

ABC enters into this hedging transaction because of concerns that changes in silver prices would cause fluctuations in the fair value of the firm commitment to purchase silver. The silver inventory includes the realized gain on the firm commitment of $11,000. Since silver prices increased, ABC realized a gain of $11,000 on the firm commitment to purchase silver from DEF. This gain is offset by an $11,000 loss on the forward contract to sell silver. Therefore, even though ABC pays $499,000 for the silver inventory (i.e. the contract price), the inventory is recorded at the current market price of $510,000 (i.e. the purchase price plus the fair value of the firm commitment).
4.3.20 Hedges involving interest rate risk

Excerpt from ASC 815-25

>> Changes Involving Interest Rate Risk

35-13 In calculating the change in the hedged item’s fair value attributable to changes in the benchmark interest rate (see paragraph 815-20-25-12(f)(2)), the estimated coupon cash flows used in calculating fair value shall be based on either the full contractual coupon cash flows or the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception.

>>> Measuring the Fair Value of a Prepayable Instrument in Hedges of Interest Rate Risk

35-13A In a hedge of interest rate risk in which the hedged item is a prepayable instrument in accordance with paragraph 815-20-25-6, the factors incorporated for the purpose of adjusting the carrying amount of the hedged item shall be the same factors that the entity incorporated for the purpose of assessing hedge effectiveness in accordance with paragraph 815-20-25-6B. For example, if an entity considers only how changes in the benchmark interest rate affect an obligor’s decision to prepay a debt instrument when assessing hedge effectiveness, it shall consider only that factor when adjusting the carrying amount of the hedged item. The election to consider only how changes in the benchmark interest rate affect an obligor’s decision to prepay a debt instrument does not affect an entity’s election to use either the full contractual coupon cash flows or the benchmark rate component of the contractual coupon cash flows determined at hedge inception for purposes of measuring the change in fair value of the hedged item in accordance with paragraph 815-25-35-13.

>>> Partial-Term Hedges of Interest Rate Risk

35-13B For a fair value hedge of interest rate risk in which the hedged item is designated as selected contractual cash flows in accordance with paragraph 815-20-25-12(b)(2)(ii), an entity may measure the change in the fair value of the hedged item attributable to interest rate risk using an assumed term that begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable. The assumed maturity of the hedged item occurs on the date in which the last hedged cash flow is due and payable.

Interest rate risk. When the risk being hedged is the benchmark interest rate, an entity may choose to measure the change in the hedged item’s fair value attributable to the changes in the benchmark interest rate based on either (see section 3.3.70): [815-25-35-13]

— the entire contractual coupon cash flows of the hedged item; or
— the benchmark rate component of the contractual coupon cash flows of the hedged item determined at inception of the hedging relationship.

When the hedged item is a prepayable financial instrument, the entity is required to consider the prepayment option when measuring the basis
adjustment. An entity can elect either of the following two approaches (see section 3.4.10): [815-20-25-6B, 815-25-35-13A]

— consider only the effect of changes in the benchmark interest rate on the decision to prepay a financial instrument; or
— consider all factors (e.g. credit risk, liquidity, interest rates) when measuring the change in fair value of the call option.

As discussed in Question 4.3.10, a basis adjustment is measured consistently with the method an entity uses to assess the hedging relationship’s effectiveness. As a result, the approaches elected with respect to assessing hedge effectiveness also affect the measurement of the basis adjustment when the hedged risk is the benchmark interest rate and/or when hedging interest rate risk of a prepayable financial instrument. [815-25-35-13A]

For partial-term hedges of interest rate risk (see section 3.3.80), the basis adjustment is measured assuming the hedged item has a term that reflects only the designated cash flows and assumes that the principal payment occurs at the end of the hedge term. [815-25-35-13B]

**Question 4.3.60**

**What discount rate should be applied when calculating the change in fair value of the hedged item attributable to changes in the benchmark rate?**

**Interpretive response:** Subtopic 815-25 does not specify the discount rate to use to calculate the change in the fair value of the hedged item. [815-25-55-56A]

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:

— the benchmark interest rate designated as being hedged; or
— the market interest rate of the hedged item at inception of the hedge, adjusted for changes in the benchmark interest rate being hedged.

See also Example 4.3.60, which illustrates this response.

**Question 4.3.70**

**When the hedged risk is the benchmark interest rate, are changes in sector credit spreads, issuer credit risk or liquidity spreads included in the measurement of the basis adjustment?**

**Interpretive response:** No. These components of an interest rate do not represent components of the benchmark interest rate. As a result, when the hedged risk is changes in fair value attributable to changes in the benchmark interest rate, changes in these components are excluded.
Question 4.3.80
What is the benchmark rate component if the hedged item is a nonprepayable financial instrument?

Interpretive response: We believe the benchmark rate component of the contractual coupon cash flows is the swap rate (i.e. the fixed leg) on an interest rate swap that at hedge inception has a fair value of zero and has no spread on its floating leg.

See also Example 4.3.50, which illustrates this response.

Question 4.3.90
What is the benchmark rate component if the hedged item is a prepayable financial instrument?

Interpretive response: In addition to the factors described in Question 4.3.80, we believe an entity would also have to consider the prepayment option in the financial instrument when determining the benchmark rate component of the contractual coupon cash flows. For example, an entity issues a 10-year fixed-rate bond that is prepayable after Year 7. The entity hedges the debt by entering into a 10-year interest rate swap that may be cancelled without penalty after Year 7 whereby it receives 2.75% and pays three-month LIBOR. The benchmark rate component is the swap rate on a cancellable swap – i.e. 2.75%. It would not be the swap rate on a similar but non-cancellable swap.

Question 4.3.100
What is the benchmark rate component if the hedged item has a premium or discount at hedge inception?

Interpretive response: We believe the benchmark rate component of the contractual coupon cash flows of a financial instrument issued or acquired at a premium or discount is the same as if the instrument was issued or acquired at par at hedge inception. This is the case regardless of whether the financial instrument is acquired or issued before hedge inception (a late hedge). We view the premium or discount as a source of incremental spread that is not part of the benchmark rate component.
Question 4.3.110

Can the benchmark rate component of the contractual coupon be used if it is greater than the entire coupon?

Interpretive response: Yes. An entity may measure the change in the hedged item’s fair value attributable to interest rate risk using the benchmark rate component of its contractual coupon cash flows even when the benchmark rate component is greater than the contractual coupon rate (a sub-benchmark rate).

The benchmark rate component of a fixed-rate asset or liability could be greater than the asset’s or liability’s contractual coupon rate. This can happen if an entity issues or acquires a debt instrument, and subsequently designates it as a hedged item (a late hedge) and interest rates have changed between the date the entity recognized the instrument and the date it designated the hedge.

This can also happen if, for example, an entity issues a bond with a 3% coupon at a time when similar bonds are being issued with a 5% coupon. In this case, the bond is issued at a discount. The benchmark rate component, determined as explained in Example 4.3.50, could be 4%, which is higher than the contractual coupon of 3%.

Question 4.3.120

Does Topic 815 prescribe a method to be used for measuring the basis adjustment when the benchmark interest rate is hedged?

Interpretive response: No. Topic 815 provides examples of how to measure the basis adjustment when the hedged risk is changes in fair value due to changes in the benchmark interest rate but does not prescribe the particular method.

The following table summarizes two methods illustrated in Topic 815.

<table>
<thead>
<tr>
<th>FASB Example</th>
<th>Description</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Example 9</td>
<td>In this example, the change in fair value of the hedged item due to changes in the benchmark interest rate is measured by comparing the present values of the remaining cash flows at the end of the period when discounted by the benchmark rate:</td>
<td>— Because the method in Example 9 measures the periodic change in the fair value of the hedged item (i.e. the periodic basis adjustment) using the cash flows at the end of the period only, it does not capture changes in fair value due to the passage of time.</td>
</tr>
<tr>
<td></td>
<td>— at the beginning of the period; versus</td>
<td>— As a result, a basis adjustment for time value will remain at the end of the hedge term even if the hedge term coincides with</td>
</tr>
<tr>
<td>FASB Example</td>
<td>Description</td>
<td>Comments</td>
</tr>
<tr>
<td>--------------</td>
<td>-------------</td>
<td>----------</td>
</tr>
<tr>
<td><strong>Example 11</strong> [815-25-55-72 – 55-77] and <strong>Example 16</strong> [815-25-55-100 – 55-108]</td>
<td>Under these examples, the change in fair value of the hedged item due to changes in the benchmark interest rate is measured by comparing the present value of the remaining cash flows¹:</td>
<td>— If the method in Examples 11 and 16 is used, the periodic basis adjustment captures the change in fair value due to the passage of time because it compares the present value of the cash flows at the end of the period with the present value of the cash flows at the beginning of the period.</td>
</tr>
<tr>
<td>Both reproduced below</td>
<td></td>
<td>— However, under this method, a basis adjustment may remain unless an entity elects to begin amortizing it during the hedge term when the entity elects to use all contractual cash flows rather than the benchmark component of contractual cash flows. This occurs because the instrument’s coupon rate typically includes a credit spread over the benchmark rate. As a result, the present value of cash flows at inception of the hedge when discounted at the benchmark rate will differ from the instrument’s par amount.</td>
</tr>
</tbody>
</table>

Notes:

1. The remaining cash flows may be either the benchmark component of contractual cash flows or all contractual cash flows.
2. As an alternative to using the applicable benchmark rate at the beginning and end of the period, the discount rates used may be, respectively:
   — the market rate at inception of the hedge as adjusted for changes in the benchmark rate through the beginning of the period; and
   — the market rate at inception of the hedge as adjusted for changes in the benchmark rate through the end of the period. See Question 4.3.60 and Example 4.3.60.

To avoid a basis adjustment remaining at the end of the hedge term, we anticipate that many entities will elect to use the method described in Examples 11 and 16 and to use the benchmark rate component (rather than full contractual cash flows) to measure the basis adjustment.
Examples

The following KPMG and FASB examples demonstrate fair value hedges involving interest rate risk.

- Benchmark rate component for assessment and measurement (Example 4.3.50).
- Fair value hedge of the LIBOR swap rate in a $100,000 BBB-Quality 5-Year Fixed-Rate Noncallable Note (Subtopic 815-25’s Example 9).
- Change in fair value attributable to changes in LIBOR – all contractual cash flows included (Example 4.3.60).
- Fair value hedge of the LIBOR swap rate in a $100 million A1-quality 5-year fixed-rate noncallable debt (Subtopic 815-25’s Example 11).
- Fair value hedge of interest rate risk using the partial-term approach (Subtopic 815-25’s Example 15).
- Fair value hedge of the LIBOR swap rate in a $100 million A1-quality 5-year fixed-rate noncallable debt (Subtopic 815-25’s Example 16).

Example 4.3.50

Benchmark rate component for assessment and measurement

This example illustrates the response in Question 4.3.80.

ABC Corp. issues a 10-year bond with a 5% coupon at par. On the same day, ABC enters into a 10-year interest rate swap whereby it receives 3% and pays the three-month LIBOR rate. ABC designates the bond as the hedged item and the interest rate swap as the hedging instrument in a fair value hedge of interest rate risk.

ABC does not apply the shortcut method and elects to use the benchmark rate component of the bond’s contractual coupon cash flows to measure the change in the bond’s fair value attributable to changes in the benchmark interest rates.

At hedge inception, the fair value of the swap is zero and there is no spread on the floating leg of the swap. Therefore, ABC uses 3% (i.e. the fixed leg of the swap, which is referred to as the swap rate in the 10-year interest rate swap) as the benchmark rate component to measure the change in the bond’s fair value attributable to interest rate risk.

Excerpt from ASC 815-25

>> Example 9: Fair Value Hedge of the LIBOR Swap Rate in a $100,000 BBB-Quality 5-Year Fixed-Rate Noncallable Note

This Example illustrates one method that could be used pursuant to paragraph 815-20-25-12(f)(2) in determining the hedged item’s change in fair value attributable to changes in the benchmark interest rate. Other methods could be used in determining the hedged item’s change in fair value.
attributable to changes in the benchmark interest rate as long as those methods meet the criteria in that paragraph. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-54 On January 1, 20X0, Entity GHI issues at par a $100,000 BBB-quality 5-year fixed-rate noncallable debt instrument with an annual 10 percent interest coupon. On that date, Entity GHI enters into a 5-year interest rate swap based on the LIBOR swap rate and designates it as the hedging instrument in a fair value hedge of the $100,000 liability. Under the terms of the interest rate swap, Entity GHI will receive fixed interest at 7 percent and pay variable interest at LIBOR. The variable leg of the interest rate swap resets each year on December 31 for the payments due the following year. This Example has been simplified by assuming that the interest rate applicable to a payment due at any future date is the same as the rate for a payment at any other date (that is, the yield curve is flat). During the hedge period, the gain or loss on the interest rate swap will be recorded in earnings. The Example assumes that immediately before the interest rate on the variable leg resets on December 31, 20X0, the LIBOR swap rate increased by 50 basis points to 7.50 percent, and the change in fair value of the interest rate swap for the period from January 1 to December 31, 20X0, is a loss in value of $1,675.

55-55 Under this method, the change in a hedged item’s fair value attributable to changes in the benchmark interest rate for a specific period is determined as the difference between two present value calculations that use the remaining cash flows as of the end of the period and reflect in the discount rate the effect of the changes in the benchmark interest rate during the period.

55-56 Both present value calculations are computed using the estimated future cash flows for the hedged item, which would be either its remaining contractual coupon cash flows or the LIBOR benchmark rate component of the remaining contractual coupon cash flows determined at hedge inception as illustrated by the following Cases:

a. Using the full contractual coupon cash flows (Case A)
b. Using the LIBOR benchmark rate component of the contractual coupon cash flows (Case B).

55-56A This Example illustrates two approaches for computing the change in fair value of the hedged item attributable to changes in the benchmark interest rate. This Subtopic does not specify the discount rate that must be used to calculate the change in fair value of the hedged item.

55-56B In Cases A and B in this Example, Entity GHI presents the total change in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same income statement line item (in this case, interest expense) that is used by Entity GHI to present the earnings effect of the hedged item before applying hedge accounting in accordance with paragraph 815-20-45-1A.

>>> Case A: Using the Full Contractual Coupon Cash Flows

55-57 In this Case, assume Entity GHI elected to calculate the change in the fair value of the hedged item attributable to interest rate risk on the basis of the full contractual coupon cash flows of the hedged item. Accordingly, both
present value calculations in accordance with paragraph 815-25-55-55 are computed using the remaining contractual coupon cash flows as of the end of the period and the discount rate that reflects the change in the designated benchmark interest rate during the period. The method chosen by Entity GHI in this Case requires that the discount rate be based on the market interest rate for the hedged item at the inception of the hedging relationship. The discount rates used for those present value calculations would be, respectively:

a. The discount rate equal to the market interest rate for that hedged item at the inception of the hedge adjusted (up or down) for changes in the benchmark rate (designated as the interest rate risk being hedged) from the inception of the hedge to the beginning date of the period for which the change in fair value is being calculated.

b. The discount rate equal to the market interest rate for that hedged item at the inception of the hedge adjusted (up or down) for changes in the designated benchmark rate from the inception of the hedge to the ending date of the period for which the change in fair value is being calculated.

Entity GHI elected to subsequently assess hedge effectiveness on a quantitative basis. In Entity GHI’s quarterly assessments of hedge effectiveness for each of the first three quarters of year 20X0 in this Example, there was zero change in the hedged item’s fair value attributable to changes in the benchmark interest rate because there was no change in the LIBOR swap rate. However, in the assessment for the fourth quarter 20X0, the discount rate for the beginning of the period is 10 percent (the hedged item’s original market interest rate with an adjustment of zero), and the discount rate for the end of the period is 10.50 percent (the hedged item’s original market interest rate adjusted for the change during the period in the LIBOR swap rate [+ 0.50 percent]).

**December 31, 20X0**

Calculate the present value using the beginning-of-period discount rate of 10 percent:

\[
\begin{align*}
\text{Interest payments:} & \quad \$10,000 \text{pmt, } 10\%i, 4 \text{ n, } PV = \$31,699 \\
\text{Principal payment:} & \quad \$100,000fv, 10\%i, 4 \text{ n, } PV = \$68,301 \\
\text{Total present value:} & \quad \$100,000
\end{align*}
\]

**55-59** Calculate the present value using the end-of-period discount rate of 10.50 percent (that is, the beginning-of-period discount rate adjusted for the change during the period in the LIBOR swap rate of 50 basis points):

\[
\begin{align*}
\text{Interest payments:} & \quad \$10,000 \text{pmt, } 10.50\%i, 4 \text{ n, } PV = \$31,359 \\
\text{Principal payment:} & \quad \$100,000fv, 10.50\%i, 4 \text{ n, } PV = \$67,073 \\
\text{Total present value:} & \quad \$98,432
\end{align*}
\]

**55-60** The change in fair value of the hedged item attributable to the change in the benchmark interest rate is \$100,000 – \$98,432 = \$1,568 (the fair value decrease in the liability is a gain on debt).

**55-61** When the change in fair value of the hedged item (\$1,568 gain) attributable to the risk being hedged is compared with the change in fair value of the hedging instrument (\$1,675 loss), a mismatch of \$107 results that will
be reported in earnings, because both changes in fair value are recorded in earnings. The change in the fair value of the hedging instrument will be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

>>> Case B: Using the LIBOR Benchmark Rate Component of the Contractual Coupon Cash Flows

55-61A In this Case, assume Entity GHI elected to calculate the change in the fair value of the hedged item attributable to interest rate risk on the basis of the benchmark rate component of the contractual coupon cash flows determined at hedge inception. Accordingly, both present value calculations in accordance with paragraph 815-25-55-55 are computed using the remaining benchmark rate component of contractual coupon cash flows as of the end period and the discount rate that reflects the change in the designated benchmark rate during the period. The discount rates used by Entity GHI in this Case would be, respectively:

a. The benchmark rate (designated as the interest rate risk being hedged) as of the beginning date of the period for which the change in fair value is being calculated
b. The designated benchmark rate as of the ending date of the period for which the change in fair value is being calculated.

55-61B Entity GHI elected to subsequently assess hedge effectiveness on a quantitative basis. In Entity GHI’s quarterly assessments of hedge effectiveness for each of the first three quarters of year 20X0, there was no change in the hedged item’s fair value attributable to changes in the benchmark interest rate because there was no change in the LIBOR swap rate. However, in the assessment for the fourth quarter 20X0, the discount rate for the beginning of the period is 7 percent, and the discount rate for the end of the period is 7.50 percent reflecting the change during the period in the LIBOR swap rate. The change in fair value of the hedged item attributable to the change in the benchmark interest risk for the period January 1, 20X0, to December 31, 20X0, is a gain of $1,675, calculated as follows.

December 31, 20X0

Calculate the present value using the beginning-of-period benchmark interest rate:

\[
\begin{align*}
\text{\$7,000 pmt, 7\%, 4n, PV} &= \text{\$ 23,710 \ (benchmark component of coupon payments)} \\
\text{\$100,000 fv, 7\%, 4n, PV} &= \text{\$ 76,290 \ (principal payment)} \\
\text{Total present value} &\text{\$100,000}
\end{align*}
\]

Calculate the present value using the end-of-period benchmark interest rate:

\[
\begin{align*}
\text{\$7,000 pmt, 7.50\%, 4n, PV} &= \text{\$ 23,445 \ (benchmark component of coupon payments)} \\
\text{\$100,000 fv, 7.50\%, 4n, PV} &= \text{\$ 74,880 \ (principal payment)} \\
\text{Total present value} &\text{\$ 98,325} \\
\text{Change in value} &\text{\$ 1,675}
\end{align*}
\]
Because the change in fair value of the hedged item ($1,675 gain) attributable to the risk being hedged is the same as the change in fair value of the hedging instrument ($1,675 loss), there is perfect offset and, therefore, a zero net earnings effect.

Example 4.3.60
Change in fair value attributable to changes in LIBOR – all contractual cash flows included

As discussed in Question 4.3.60, Subtopic 815-25 does not specify the discount rate that must be used to calculate the change in the fair value of the hedged item. We believe there are two acceptable discount rates that may be used, which are illustrated in this example as follows.

— **Scenario 1**: the discount rate is the designated benchmark interest rate (LIBOR).
— **Scenario 2**: the discount rate is the market interest rate of the hedged item at inception of the hedge, adjusted for changes in the designated benchmark interest rate (LIBOR).

Borrower hedges the changes in fair value attributable to changes in LIBOR (a Benchmark Interest Rate) of a $1 million, five-year, 4% fixed-rate debt obligation issued at par on January 1, Year 1. Interest is paid quarterly. The hedge is designated at inception of the debt obligation (i.e. January 1, Year 1).

Borrower elects to calculate the change in the fair value of the debt obligation that is due to interest rate risk on the basis of the full contractual coupon cash flows of the debt obligation. Therefore, the cash flows being discounted at each date are the remaining contractual cash flows:

— interest of $10,000 at the end of each quarter; and
— principal of $1 million due on maturity of the debt.

LIBOR is as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>LIBOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, Year 1</td>
<td>2.50%</td>
</tr>
<tr>
<td>March 31, Year 1</td>
<td>3.00%</td>
</tr>
<tr>
<td>June 30, Year 1</td>
<td>3.25%</td>
</tr>
</tbody>
</table>

The quarterly interest payments were made before determining the change in fair value.

**Scenario 1: Discount rate is LIBOR**

If the discount rate is LIBOR, the change in fair value of the total contractual cash flows that is attributable to changes in LIBOR is calculated at March 31, Year 1 as follows.
4. Accounting for fair value hedges

Similarly, the change in fair value of the total contractual cash flows that is attributable to changes in LIBOR is calculated at June 30, Year 1 as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quarterly interest payments, for 19 remaining quarters</td>
<td>$190,000</td>
</tr>
<tr>
<td>Principal payment at end of 19 remaining quarters</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>$1,190,000</td>
</tr>
<tr>
<td>LIBOR at beginning of period</td>
<td>2.50%</td>
</tr>
<tr>
<td>Present value based on LIBOR at beginning of period</td>
<td>$775,317</td>
</tr>
<tr>
<td>LIBOR at end of period</td>
<td>3.00%</td>
</tr>
<tr>
<td>Present value based on LIBOR at end of period</td>
<td>$713,524</td>
</tr>
<tr>
<td>Change in fair value attributable to changes in LIBOR</td>
<td>$(61,793)</td>
</tr>
</tbody>
</table>

**Scenario 2: Discount rate is the market interest rate at inception of the hedge as adjusted for changes in LIBOR**

If the discount rate is the market interest rate at inception of the hedge as adjusted for changes in LIBOR, the change in fair value of the total contractual cash flows that is attributable to changes in LIBOR is calculated at March 31, Year 1 as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quarterly interest payments, for 19 remaining quarters</td>
<td>$190,000</td>
</tr>
<tr>
<td>Principal payment at end of 19 remaining quarters</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>$1,190,000</td>
</tr>
<tr>
<td>Market rate at inception of hedge adjusted for changes in LIBOR, at beginning of period</td>
<td>4.00%</td>
</tr>
<tr>
<td>Present value based on market rate as adjusted, beginning of period</td>
<td>$605,982</td>
</tr>
<tr>
<td>Market rate at inception of hedge adjusted for changes in LIBOR, at end of period</td>
<td>4.50%</td>
</tr>
<tr>
<td>Present value based on market rate as adjusted, end of period</td>
<td>$559,235</td>
</tr>
<tr>
<td>Change in fair value attributable to changes in LIBOR</td>
<td>$(46,747)</td>
</tr>
</tbody>
</table>

Similarly, the change in fair value of the total contractual cash flows that is attributable to changes in LIBOR is calculated at June 30, Year 1 as follows.
Quarterly interest payments, for 18 remaining quarters  $180,000
Principal payment at end of 18 remaining quarters  1,000,000
Total  $1,180,000

Market rate at inception of hedge adjusted for changes in LIBOR, at
beginning of period  4.50%
Present value based on market rate as adjusted, beginning of period  $574,400
Market rate at inception of hedge adjusted for changes in LIBOR, at
end of period  4.75%
Present value based on market rate as adjusted, end of period  $552,951
Change in fair value attributable to changes in LIBOR  $(21,449)

Excerpt from ASC 815-25

>> Example 11: Fair Value Hedge of the LIBOR Swap Rate in a
$100 Million A1-Quality 5-Year Fixed-Rate Noncallable Debt

55-72 This Example illustrates application of the guidance in Sections 815-20-
25, 815-20-35, and 815-25-35 to a fair value hedge of the LIBOR swap rate in a
$100 million A1-quality 5-year fixed-rate noncallable debt. Assume that an
entity elected to calculate the change in the fair value of the hedged item
attributable to LIBOR interest rate risk using the full contractual coupon cash
flows of the hedged item.

55-73 On April 3, 20X0, Global Tech issues at par a $100 million A1-quality
5-year fixed-rate noncallable debt instrument with an annual 8 percent interest
coupon payable semiannually. On that date, Global Tech enters into a 5-year
interest rate swap based on the LIBOR swap rate and designates it as the
hedging instrument in a fair value hedge of the $100 million liability. Under the
terms of the interest rate swap, Global Tech will receive a fixed interest rate at
8 percent and pay variable interest at LIBOR plus 78.5 basis points (current
LIBOR 6.29 percent) on a notional amount of $101,970,000 (semiannual
settlement and interest reset dates). A duration-weighted hedge ratio was
used to calculate the notional amount of the interest rate swap necessary to
offset the debt’s fair value changes attributable to changes in the LIBOR
swap rate.

55-74 This Example has the following assumptions:

a. PV01 debt = 4.14
b. PV01 interest rate swap = 4.06
c. Hedge ratio = PV01 debt / PV01 interest rate swap = 4.14/4.06 = 1.0197
d. Interest rate swap notional = 1.0197 x $100 million = $101,970,000.
e. For simplicity, commissions and most other transaction costs, initial
margin, and income taxes are ignored unless otherwise stated. Assume
that there are no changes in creditworthiness that would alter the
effectiveness of the hedging relationship.
The Example assumes that the LIBOR swap rate increased 100 basis points to 7.29 percent on June 30, 20X0. The change in fair value of the interest rate swap for the period from April 3 to June 30, 20X0, is a loss of $4,016,000. The change in fair value of the debt attributable to changes in the benchmark interest rate for the period April 3 to June 30, 20X0, is calculated as follows.

<table>
<thead>
<tr>
<th>Period</th>
<th>Principal Balance</th>
<th>Coupon Rate</th>
<th>Cash Flow – Interest</th>
<th>Cash Flow – Principal</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.5</td>
<td>$ 100,000,000</td>
<td>0.08</td>
<td>2,000,000</td>
<td>-</td>
<td>1,956,464</td>
</tr>
<tr>
<td>1.5</td>
<td>$ 100,000,000</td>
<td>0.08</td>
<td>4,000,000</td>
<td>-</td>
<td>3,744,429</td>
</tr>
<tr>
<td>2.5</td>
<td>$ 100,000,000</td>
<td>0.08</td>
<td>4,000,000</td>
<td>-</td>
<td>3,583,185</td>
</tr>
<tr>
<td>3.5</td>
<td>$ 100,000,000</td>
<td>0.08</td>
<td>4,000,000</td>
<td>-</td>
<td>3,428,885</td>
</tr>
<tr>
<td>4.5</td>
<td>$ 100,000,000</td>
<td>0.08</td>
<td>4,000,000</td>
<td>-</td>
<td>3,281,230</td>
</tr>
<tr>
<td>5.5</td>
<td>$ 100,000,000</td>
<td>0.08</td>
<td>4,000,000</td>
<td>-</td>
<td>3,139,933</td>
</tr>
<tr>
<td>6.5</td>
<td>$ 100,000,000</td>
<td>0.08</td>
<td>4,000,000</td>
<td>-</td>
<td>3,004,721</td>
</tr>
<tr>
<td>7.5</td>
<td>$ 100,000,000</td>
<td>0.08</td>
<td>4,000,000</td>
<td>-</td>
<td>2,875,331</td>
</tr>
<tr>
<td>8.5</td>
<td>$ 100,000,000</td>
<td>0.08</td>
<td>4,000,000</td>
<td>-</td>
<td>2,751,513</td>
</tr>
<tr>
<td>9.5</td>
<td>$ 100,000,000</td>
<td>0.08</td>
<td>4,000,000</td>
<td>100,000,000</td>
<td>68,458,889</td>
</tr>
</tbody>
</table>

Present value 96,224,380

As of June 30, 20X0, 9.5 periods remain and the cash flows are discounted at 9 percent, determined as the initial 8-percent yield plus a 100 basis point increase attributable to the 100 basis point increase in the LIBOR swap rate. The accrual for the first quarter interest was excluded. The following journal entries illustrate the interest rate swap and debt fair value changes, attributable to changes in the LIBOR swap rate, excluding accruals.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$ 3,775,620</td>
</tr>
<tr>
<td>Interest expense</td>
<td>$ 3,775,620</td>
</tr>
<tr>
<td>Interest expense</td>
<td>$ 4,016,000</td>
</tr>
<tr>
<td>Swap liability</td>
<td>$ 4,016,000</td>
</tr>
</tbody>
</table>

The net earnings effect of the hedging relationship was $240,380 because of the mismatch between the change in the fair value of the hedging instrument and the change in fair value of the hedged item. In accordance with paragraph 815-20-45-1A, Global Tech presents the entire change in the fair value of the hedging instrument (including interest accruals and all other changes in fair value) in the same income statement line item (in this case, interest expense) that is used by Global Tech to present the earnings effect of the hedged item before applying hedge accounting.
This Example illustrates the application of paragraphs 815-20-25-12(b)(2)(ii) and 815-25-35-13B to the designation and measurement of a hedged item as a portion of the term of a financial instrument in a hedge of interest rate risk. Assume that Entity S elected to calculate fair value changes in the hedged item attributable to interest rate risk on the basis of the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception.

On January 1, 20X1, Entity S issues a noncallable, 5-year, $100 million debt instrument with a 3 percent semiannual interest coupon. On that date, the issuer also enters into a 2-year interest rate swap with a notional amount of $100 million. Entity S designates the swap as a fair value hedge of the fixed-rate debt attributable to interest rate risk for the first two years of its term in accordance with the guidance in paragraph 815-20-25-12(b)(2)(ii). The swap pays LIBOR and receives a fixed rate of 2 percent, with semiannual payments. The swap has a fair value of zero at inception. The designated benchmark interest rate is the LIBOR swap rate. For ease of calculation, the yield curve is assumed to be flat at the level of the current benchmark interest rate. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

This Example assumes that the LIBOR swap rate increased by 50 basis points to 2.5 percent on June 30, 20X1. The change in fair value of the interest rate swap for the period January 1, 20X1, to June 30, 20X1, is a loss in value of $731,633.

In calculating the change in fair value of the debt attributable to changes in the benchmark interest rate in accordance with paragraph 815-25-35-13B, Entity S determines that the assumed term of the hedged item is two years because it is hedging only the cash flows associated with the first two years of its debt issuance. The change in fair value of the debt attributable to changes in the benchmark interest rate for the period January 1, 20X1, to June 30, 20X1, is a gain of $731,633, calculated as follows.

\[
\begin{align*}
\text{January 1, 20X1—beginning balance} & \quad \text{beginning balance} \\
& = \$1,000,000 \text{pmt, 1.00\%i, 4n, 100,000,000fv, PV} = \$100,000,000 \\
\text{June 30, 20X1—ending balance} & \quad \text{ending balance} \\
& = \$1,000,000 \text{pmt, 1.25\%i, 3n, 100,000,000fv, PV} = 99,268,367 \\
\text{Change in value} & \quad \text{change in value} \\
& = \$731,633
\end{align*}
\]

As of June 30, 20X1, the change in fair value of the debt attributable to the benchmark interest rate is calculated by discounting the benchmark rate component of the contractual coupon cash flows using the benchmark interest rate at June 30, 20X1 (2.5 percent annual rate and 1.25 percent for each
Hedging

4. Accounting for fair value hedges

semiannual period). The change in fair value of the debt and the change in fair value of the swap result in perfect offset in current-period earnings. In accordance with paragraph 815-20-45-1A, Entity S presents the total change in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same income statement line item (in this case, interest expense) that is used by Entity S to present the earnings effect of the hedged item before applying hedge accounting.

55-99 Although this Example illustrates the hedged item as the first two years of interest payments associated with an existing debt instrument, paragraph 815-20-25-12(b)(2)(ii) permits one interest payment or any consecutive interest payments associated with an existing debt instrument to be designated as the hedged item.

Excerpt from ASC 815-25

>> Example 16: Fair Value Hedge of the LIBOR Swap Rate in a $100 Million A1-Quality 5-Year Fixed-Rate Noncallable Debt

55-100 The following Cases illustrate application of the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 to a fair value hedge of the LIBOR swap rate in a $100 million A1-quality 5-year fixed-rate noncallable debt:

a. Using the full contractual coupon cash flows (Case A)
b. Using the benchmark rate component of the contractual coupon cash flows (Case B).

55-101 On July 2, 20X0, Entity XYZ issues at par a $100 million A1-quality 5-year fixed-rate noncallable debt instrument with an annual 8 percent interest coupon payable semiannually. On that date, Entity XYZ enters into a 5-year interest rate swap based on the LIBOR swap rate and designates it as the hedging instrument in a fair value hedge of interest rate risk of the $100 million liability. Under the terms of the interest rate swap, Entity XYZ will receive a fixed interest rate at 8 percent and pay variable interest at LIBOR plus 200 basis points (current LIBOR 6 percent) on a notional amount of $100 million (semiannual settlement and interest reset dates). For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship. The Example also assumes that the yield curve is flat and that the LIBOR swap rate increased 100 basis points to 7 percent on December 31, 20X0. The change in fair value of the interest rate swap for the period from July 2, 20X0, to December 31, 20X0, is a loss of $3,803,843.

55-102 In both Cases A and B in this Example, Entity XYZ presents the total change in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same income statement line item (in this case, interest expense) that is used by Entity XYZ to present the earnings effect of the hedged item before applying hedge accounting in accordance with paragraph 815-20-45-1A.
Case A: Using the Full Contractual Coupon Cash Flows

55-103 In this Case, assume that Entity XYZ elected to calculate fair value changes in the hedged item attributable to interest rate risk using the full contractual coupon cash flows of the hedged item. The change in fair value of the debt attributable to changes in the benchmark interest rate for the period July 2, 20X0, to December 31, 20X0, is a gain of $3,634,395, calculated as follows.

July 2, 20X0—beginning balance
$4,000,000pmt, 4.0%i, 10n, 100,000,000fv, PV = $ 100,000,000

December 31, 20X0—ending balance
$4,000,000pmt, 4.5%i, 9n, 100,000,000fv, PV = 96,365,605

Change in value $ 3,634,395

55-104 As of December 31, 20X0, the fair value of the debt attributable to interest rate risk is calculated by discounting the full contractual coupon cash flows at the debt’s original market rate with a 100 basis point adjustment related to the increase in the LIBOR swap rate (50 basis point adjustment on a semiannual basis). The following journal entries illustrate the interest rate swap and debt fair value changes attributable to changes in the LIBOR swap rate.

Debt $ 3,634,395
Interest expense $ 3,634,395
Interest expense 3,803,843
Swap liability 3,803,843

55-105 The net earnings effect of the hedge is $169,448 due to the mismatch between the changes in fair value of the hedging instrument and the hedged item attributable to the changes in the benchmark interest rate.

Case B: Using the Benchmark Rate Component of the Contractual Coupon Cash Flows

55-106 In this Case, assume that Entity XYZ elected to calculate fair value changes in the hedged item attributable to interest rate risk using the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception. The change in fair value of the debt attributable to changes in the benchmark interest rate for the period July 2, 20X0, to December 31, 20X0, is a gain of $3,803,843, calculated as follows.

July 2, 20X0—beginning balance
$3,000,000pmt, 3.0%i, 10n, 100,000,000fv, PV = $ 100,000,000

December 31, 20X0—ending balance
$3,000,000pmt, 3.5%i, 9n, 100,000,000fv, PV = 96,196,157

Change in value $ 3,803,843

55-107 As of December 31, 20X0, the fair value of the debt attributable to interest rate risk is calculated by discounting the benchmark rate component of the contractual coupon cash flows using the benchmark interest rate at December 31, 20X0 (7 percent annual rate; 3.5 percent for each semiannual
period). The following journal entries illustrate the interest rate swap and debt fair value changes attributable to changes in the LIBOR swap rate.

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$3,803,843</td>
</tr>
<tr>
<td>Interest expense</td>
<td>$3,803,843</td>
</tr>
<tr>
<td>Interest expense</td>
<td>3,803,843</td>
</tr>
<tr>
<td>Swap liability</td>
<td>3,803,843</td>
</tr>
</tbody>
</table>

55-108 The net earnings effect of the hedge is zero due to the perfect offset in fair value changes between the hedging instrument and the hedged item attributable to the changes in the benchmark interest rate.

### 4.3.30 Portfolio-level basis adjustments

When the hedged item is a portfolio of similar assets or liabilities (see section 3.3.40), the basis adjustment is measured at the portfolio level.

Generally, a portfolio-level basis adjustment is allocated to the individual items in the portfolio. This allocation generally is necessary to determine the amortized cost basis for the items in the portfolio for purposes of complying with other applicable US GAAP, both during and after the hedging relationship, such as:

- applying impairment guidance (see section 4.4.30)
- preparing disclosures;
- measuring the gain or loss when an item in the portfolio is sold or otherwise disposed of; and
- determining amortization when the hedged item is a financial instrument for which interest rate risk was hedged (see section 4.4.20).

A systematic and rational method is used to allocate the portfolio-level basis adjustment to the individual items in the portfolio.

#### Question 4.3.130

When the last-of-layer method is used, is it necessary to allocate the basis adjustment?

#### Excerpt from ASC 815-10

> Basis Adjustment Considerations under the Last-of-Layer Method

50-5B For hedging relationships designated under the last-of-layer method, an entity may need to allocate the outstanding basis adjustment to meet the objectives of disclosure requirements in other Topics. For purposes of those disclosure requirements, the entity may allocate the basis adjustment on an individual asset basis or on a portfolio basis using a systematic and rational method.
**Interpretive response:** In a portfolio hedge that is other than a last-of-layer hedge, all individual items in the portfolio are hedged items. However, in a last-of-layer hedge, only the items that constitute the last of layer that is treated as a nonprepayable item are being hedged (see section 3.3.100). The individual items in that layer are not known during the hedge term. This is because the individual items that may prepay, default or be sold are unknown before the actual event occurs. As a result, it is not clear to which items in the closed portfolio the basis adjustment relates – nor consequently to which items the basis adjustment should be allocated.

For disclosures, Topic 815 provides guidance that the portfolio-level basis adjustment may be allocated on an individual asset basis or on a portfolio basis using a systematic and rational method. However, Topic 815 does not provide guidance for whether or how to allocate the outstanding portfolio-level basis adjustment during the hedge term for any other purpose. [815-10-50-5B]

At its March 28, 2018 meeting, the FASB added a narrow scope project to its agenda to address when and how an entity is permitted or required to allocate a last-of-layer basis adjustment to the individual assets in the closed portfolio. As a result, revisions to this interpretive response may be provided in a future edition.

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**Question 4.3.140**

**When assets in the portfolio from which the last of layer is derived are sold during the hedge term, is the related basis adjustment allocated to individual assets?**

**Interpretive response:** It depends on whether the balance remaining in the portfolio exceeds the designated last of layer.

- If an entity sells an asset from the closed portfolio and the balance remaining in the portfolio after the sale exceeds the designated last of layer, the entity does not need to allocate any of the remaining basis adjustment to the asset that was sold as it would not be part of the last-of-layer. See Question 4.3.130 regarding the FASB’s narrow scope project on the allocation of basis adjustments. [ASU 2017-12.BC121(a)]

- If the sale of the asset causes the remaining balance in the portfolio to be less than the last of layer, the entity discontinues the entire hedging relationship and follows Steps 1 to 3 in Question 4.5.30 as part of full discontinuation. See also Example 4.5.30 (Scenario 2). [815-25-40-8(b)]
4.4 Subsequent accounting for basis adjustments

4.4.10 Overview

Excerpt from ASC 815-25

> Changes in Fair Value of Hedged Item

35-8 The adjustment of the carrying amount of a hedged asset or liability required by paragraph 815-25-35-1(b) 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.

Basis adjustments generally are accounted for in the same manner as other components of the hedged item’s amortized cost basis. Basis adjustments related to interest-bearing financial instruments are amortized to earnings over a period that depends on when amortization commences (see section 4.4.20). [815-25-35-8 – 35-9A]

The following table provides examples of the subsequent accounting for the basis adjustment, including the timing and method for its recognition in earnings.

<table>
<thead>
<tr>
<th>Hedged item</th>
<th>Timing and method of recognizing the basis adjustment in earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset held for sale (e.g. inventory)</td>
<td>The basis adjustment remains part of the asset’s amortized cost basis until the asset is sold. When the asset is sold, its entire carrying amount (including the basis adjustment) is recognized as the cost of the item sold in determining earnings. [815-25-35-8]</td>
</tr>
<tr>
<td>Interest-bearing financial instrument (e.g. long-term borrowing)</td>
<td>The basis adjustment is amortized to earnings. Amortization 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 (see section 4.4.20). [815-25-35-9 – 35-9A]</td>
</tr>
<tr>
<td>Firm commitments</td>
<td>We expect the entity to account for the firm commitment in the same manner as it will account for the related asset or liability once it is recognized (see Question 4.4.10).</td>
</tr>
</tbody>
</table>

Formal documentation. If the hedged item is a firm commitment, the initial hedge documentation 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 (see section 2.9.50). [815-20-25-3(c)(1)]
**Question 4.4.10**

For firm commitments, what is the subsequent accounting for assets (liabilities) recognized due to applying fair value hedge accounting?

**Interpretive response:** In a hedge of a firm commitment (rather than of a recognized asset or liability), adjustments of the hedged item (firm commitment) result in the recognition of assets or liabilities.

For firm commitments to purchase inventory we expect those earnings adjustments will follow the entity’s existing inventory accounting policies. Specifically, the asset (or liability) recognized due to applying fair value hedge accounting will be included in the cost of inventory when the inventory is purchased (i.e. when the firm commitment is settled). As a result, it will be recognized in earnings when the related inventory is sold; this includes consideration of the inventory method, e.g. FIFO, LIFO, average cost.

For firm commitments that relate to assets or liabilities that are prohibited from being recognized – such as those embodied in a lessor’s non-cancellable operating lease or an unrecognized mortgage servicing right – an entity will need to develop a policy for the earnings adjustments.

**FASB Example: Fair value hedge of a commodity inventory**

Excerpt from ASC 815-25

55-30 The following Cases illustrate application of the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 to a fair value hedge of a commodity inventory:

a. The terms of the hedging derivative have been negotiated such that the hedging relationship is perfectly effective (Case A).
b. The hedging relationship is not perfectly effective (Case B).

55-31 To simplify the illustration and focus on basic concepts, the derivative instrument in Cases A and B is assumed to have no time value. In practice, a derivative instrument used for a fair value hedge of a commodity would have a time value that would change over the term of the hedging relationship. The changes in that time value may be accounted for through an amortization approach in accordance with paragraph 815-20-25-83A or a mark-to-market approach in accordance with paragraph 815-20-25-83B. Under either of those approaches, the portion of excluded components recognized in earnings should be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

55-32 Other Examples in this Section illustrate accounting for the time value component of a derivative instrument.
For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

Cases A and B share all of the following assumptions:

a. Entity ABC decides to hedge the risk of changes during the period in the overall fair value of its entire inventory of Commodity A by entering into a derivative instrument, Derivative Z.

b. On the first day of Period 1, Entity ABC enters into Derivative Z and neither receives nor pays a premium (that is, the fair value at inception is zero).

c. Entity ABC designates the derivative instrument as a hedge of the changes in fair value of the inventory due to changes in the price of Commodity A during Period 1.

d. The hedging relationship qualifies for fair value hedge accounting. Entity ABC will assess effectiveness on a quantitative basis both initially and subsequently by comparing the entire change in fair value of Derivative Z with the change in the market price of the hedged commodity inventory.

Case A: Perfect Effectiveness in the Hedging Relationship

In this Case, Entity ABC expects the hedge to be perfectly effective because both of the following conditions exist:

a. The notional amount of Derivative Z matches the amount of the hedged inventory (that is, Derivative Z is based on the same number of bushels as the number of bushels of the commodity that Entity ABC designated as hedged).

b. The underlying of Derivative Z is the price of the same variety and grade of Commodity A as the inventory at the same location.

At inception of the hedge, Derivative Z has a fair value of zero and the hedged inventory has a carrying amount of $1,000,000 and a fair value of $1,100,000. On the last day of Period 1, the fair value of Derivative Z has increased by $25,000, and the fair value of the inventory has decreased by $25,000. The inventory is sold, and Derivative Z is settled on the last day of Period 1. The following table illustrates the accounting for the situation described in this Case.

<table>
<thead>
<tr>
<th>Debit (Credit)</th>
<th>Cash</th>
<th>Derivative</th>
<th>Inventory</th>
<th>Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Period 1</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize change in fair value</td>
<td></td>
<td>$ 25,000</td>
<td>$(25,000)</td>
<td></td>
</tr>
<tr>
<td>of derivative</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize change in fair value</td>
<td></td>
<td></td>
<td>$(25,000)</td>
<td>25,000</td>
</tr>
<tr>
<td>of inventory</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize revenue from</td>
<td>$ 1,075,000</td>
<td></td>
<td>(1,075,000)</td>
<td></td>
</tr>
<tr>
<td>sale</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize cost of sale of</td>
<td>(975,000)</td>
<td></td>
<td>975,000</td>
<td></td>
</tr>
<tr>
<td>inventory</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize settlement of</td>
<td>25,000</td>
<td></td>
<td>(25,000)</td>
<td></td>
</tr>
<tr>
<td>derivative</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ 1,100,000</td>
<td>$ -</td>
<td>$(1,000,000)</td>
<td>$ (100,000)</td>
</tr>
</tbody>
</table>
a. For presentation purposes, the change in the fair value of the hedging instrument is in the same income statement line item as the hedged item.

55-37 If Entity ABC had sold the hedged inventory at the inception of the hedge, its gross profit on that sale would have been $100,000. This Case illustrates that, by hedging the risk of changes in the overall fair value of its inventory, Entity ABC recognized the same gross profit at the end of the hedge period even though the fair value of its inventory decreased by $25,000.

>>> Case B: Hedging Relationship Is Not Perfectly Effective

55-38 The hedge in Case A was perfectly effective because the gain on Derivative Z exactly offsets the loss on the inventory. However, in this Case, assume the terms of Derivative Z do not perfectly match the inventory and its fair value has increased by $22,500 as compared with the decline in fair value of the inventory of $25,000. The mismatch of $2,500 has to be recognized in earnings and presented in the same income statement line item as the earnings effect of the hedged item. The following table illustrates the accounting for the situation described in this Case.

<table>
<thead>
<tr>
<th>Debit (Credit)</th>
<th>Cash</th>
<th>Derivative</th>
<th>Inventory</th>
<th>Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Period 1</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize change in fair value of derivative</td>
<td>$ 22,500</td>
<td>$ (22,500)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize change in fair value of inventory</td>
<td>$ (25,000)</td>
<td>25,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize revenue from sale</td>
<td>$ 1,075,000</td>
<td>(1,075,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize cost of sale of inventory</td>
<td>(975,000)</td>
<td>975,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize settlement of derivative</td>
<td>22,500</td>
<td>(22,500)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$ 1,097,500</td>
<td></td>
<td>$ (1,000,000)</td>
<td>$ (97,500)</td>
</tr>
</tbody>
</table>

a. For presentation purposes, the change in the fair value of the hedging instrument is in the same income statement line item as the hedged item.

55-39 The difference between the effect on earnings in Case B and the effect on earnings in Case A is $2,500.

4.4.20 Interest-bearing financial instruments

---

Excerpt from ASC 815-25

> Changes in Fair Value of Hedged Item

35-9 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.

35-9A For an outstanding hedging relationship, any amortization of adjustments to the carrying amount of the hedged item shall be performed assuming that the amortization period is the remaining life of the hedging relationship. For a discontinued hedging relationship, all remaining adjustments to the carrying amount of the hedged item shall be amortized over a period that is consistent with the amortization of other discounts or premiums associated with the hedged item in accordance with other Topics (for example, Subtopic 310-20 on receivables—nonrefundable fees and other costs).

### Question 4.4.20

**When is amortization of the basis adjustment for interest-bearing financial instruments required to begin?**

**Interpretive response:** Amortization is required to begin no later than when the interest-bearing financial instrument (hedged item) ceases to be adjusted for changes in its fair value attributable to the risk being hedged. However, an entity may begin amortization earlier depending on its accounting policy. [815-25-35-9]

See comments about the FASB examples in Question 4.3.120 for a situation in which an entity may wish to begin amortization before the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

### Question 4.4.30

**Over what period are basis adjustments of interest-bearing financial instruments amortized?**

**Interpretive response:** It depends on whether amortization begins during the hedging relationship or after the hedging relationship has been discontinued, as shown in the following table. [815-25-35-9A]

<table>
<thead>
<tr>
<th>When amortization begins</th>
<th>Amortization period</th>
</tr>
</thead>
<tbody>
<tr>
<td>During the hedging relationship</td>
<td>The remaining life of the hedging relationship, unless the hedging relationship is discontinued. For a partial-term hedge, amortization is therefore over the partial term.</td>
</tr>
<tr>
<td>After the hedging relationship is discontinued – hedge is discontinued for reasons other than derecognition of the hedged item</td>
<td>A period that is consistent with the amortization of other discounts or premiums associated with the hedged item under other applicable US GAAP – e.g. Subtopic 310-20 (receivables – nonrefundable fees and other costs).</td>
</tr>
</tbody>
</table>
### When amortization begins | Amortization period
--- | ---
Because the amortization period during the hedging relationship is different from the amortization period after the hedging relationship is discontinued, a hedge discontinuation may result in a change to the amortization period if amortization was started during the hedging relationship (e.g., for a partial-term hedge).

After the hedging relationship is discontinued – hedged item is derecognized | The basis adjustment is derecognized together with the hedged item (i.e., immediately).

---

**Question 4.4.40**

**Do basis adjustments for interest-bearing borrowings affect the capitalization of interest?**

**Background:** Subtopic 835-20 (capitalization of interest) requires capitalizing interest cost as part of the historical cost of acquiring certain assets. The amount capitalized in a period is based on applying a capitalization rate to the average amount of accumulated expenditures for a qualifying asset during the period. The capitalization rate to be used is based on rates for borrowings outstanding during the period. [835-20-05-1, 30-3]

**Excerpt from ASC 815-25**

**35-14** Amounts recorded in an entity’s income statement as interest costs shall be reflected in the capitalization rate under Subtopic 835-20. Those amounts could include amortization of the adjustments of the carrying amount of the hedged liability, under paragraphs 815-25-35-9 through 35-9A, if an entity elects to begin amortization of those adjustments during the period in which interest is eligible for capitalization.

**Interpretive response:** Whether basis adjustments for interest-bearing borrowings affect the capitalization rate depends on whether the basis adjustments are being amortized during the period for which interest costs are capitalized.

Only amounts recorded in an entity’s income statement as interest costs that are included in the assessment of effectiveness are included in the capitalization rate that is used to determine capitalized interest. Those amounts include amortization of basis adjustments recognized during the period for interest-bearing borrowings. [815-25-35-14]
**FASB Example: Fair value hedge of fixed-rate interest-bearing debt**

>> Example 8: Fair Value Hedge of Fixed-Rate Interest-Bearing Debt

55-40 This Example demonstrates the guidance in Subtopic 815-20 and this Subtopic as applied to the mechanics of reporting an interest rate swap used as a fair value hedge of an interest-bearing liability. It is not intended to demonstrate how to compute the fair value of an interest rate swap or an interest-bearing liability. This Example has been simplified by assuming that the interest rate applicable to a payment due at any future date is the same as the rate for a payment due at any other date (that is, the yield curve is flat). Although that is an unrealistic assumption, it makes the amounts used easier to understand without detracting from the purpose of the Example. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-41 The fair values of the interest rate swap in this Example are determined using the zero-coupon method. The zero-coupon method is not the only acceptable method. Explanations of other acceptable methods of determining the fair value of an interest rate swap can be obtained from various published sources. Fair values also may be available from dealers in interest rate swaps and other derivative instruments.

55-42 In this Example, the term and notional amount of the interest rate swap match the term and principal amount of the interest-bearing liability being hedged. The fixed and variable interest rates used to determine the net settlements on the interest rate swap match the current yield curve, and the sum of the present values of the expected net settlements is zero at inception. Thus, paragraphs 815-20-25-102 through 25-106 permit the reporting entity to assume perfect effectiveness. Assessment of effectiveness at one of the interest rate swap’s repricing dates would confirm the validity of that assumption.

55-43 A shortcut method (see paragraphs 815-20-25-102 through 25-106) can be used to produce the same reporting results as the method illustrated in this Example. This shortcut is only appropriate for a fair value hedge of a fixed-rate asset or liability using an interest rate swap and only if the assumption of perfect effectiveness is appropriate. The steps in the shortcut method are as follows:

a. Determine the difference between the fixed rate to be received on the interest rate swap and the fixed rate to be paid on the bonds.

b. Combine that difference with the variable rate to be paid on the interest rate swap.

c. Compute and recognize interest expense using that combined rate and the fixed-rate liability’s principal amount. (Amortization of any purchase premium or discount on the liability also must be considered, although that complication is not incorporated in this Example.)
d. Determine the fair value of the interest rate swap.
e. Adjust the carrying amount of the interest rate swap to its fair value and adjust the carrying amount of the liability by an offsetting amount.

55-44 Amounts determined using the shortcut method and the facts in this Example will match the amounts in paragraph 815-25-55-48 even though the shortcut does not involve explicitly amortizing the hedge accounting adjustments on the debt. That is, the quarterly adjustments of the debt and explicit amortization of previous adjustments will have the same net effect on earnings as the shortcut method.

55-45 A slightly different shortcut method for interest rate swaps used as cash flow hedges is illustrated in Example 6 (see paragraph 815-30-55-24).

55-46 On July 1, 20X1, Entity ABC borrows $1,000,000 to be repaid on June 30, 20X3. On that same date, Entity ABC also enters into a two-year receive-fixed, pay-variable interest rate swap. Entity ABC designates the interest rate swap as a hedge of the changes in the fair value of the fixed-rate debt attributable to changes in the designated benchmark interest rate. Entity ABC designates changes in London Interbank Offered Rate (LIBOR) swap rates as the benchmark interest rate in hedging interest rate risk. The terms of the interest rate swap and the debt are as follows.

<table>
<thead>
<tr>
<th>Interest Rate Swap</th>
<th>Fixed-Rate Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade date and borrowing date</td>
<td>July 1, 20X1</td>
</tr>
<tr>
<td>Termination date and maturity date</td>
<td>June 30, 20X3</td>
</tr>
<tr>
<td>Notional amount and principal amount</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Fixed interest rate</td>
<td>6.41%</td>
</tr>
<tr>
<td>Variable interest rate</td>
<td>3-month USD LIBOR</td>
</tr>
<tr>
<td>Settlement dates and interest payment dates</td>
<td>End of each calendar quarter</td>
</tr>
<tr>
<td>Reset dates</td>
<td>End of each calendar quarter through March 31, 20X3</td>
</tr>
</tbody>
</table>

a. These terms need not match for the assumption of perfect effectiveness to be appropriate. (See paragraphs 815-20-25-102 through 25-110.)

55-47 The USD LIBOR rates that are in effect at inception of the hedging relationship and at each of the quarterly reset dates are assumed to be as follows.

<table>
<thead>
<tr>
<th>Reset date</th>
<th>3-Month LIBOR Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/1/X1</td>
<td>6.41%</td>
</tr>
<tr>
<td>9/30/X1</td>
<td>6.48%</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>6.41%</td>
</tr>
<tr>
<td>3/31/X2</td>
<td>6.32%</td>
</tr>
<tr>
<td>6/30/X2</td>
<td>7.60%</td>
</tr>
<tr>
<td>9/30/X2</td>
<td>7.71%</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>7.82%</td>
</tr>
<tr>
<td>3/31/X3</td>
<td>7.42%</td>
</tr>
</tbody>
</table>

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The following table summarizes the fair values of the debt and the interest rate swap at each quarter end, the details of the changes in the fair values during each quarter (including accrual and payment of interest, the effect of changes in rates, and level-yield amortization of hedge accounting adjustments), the expense for each quarter, and the net cash payments for each quarter. The calculations of fair value of both the debt and the interest rate swap are made using LIBOR. (A discussion of the appropriate discount rate appears in paragraph 815-20-25-111.)

<table>
<thead>
<tr>
<th></th>
<th>Fixed-Rate Debt</th>
<th>Interest Rate Swap</th>
<th>Expense</th>
<th>Net Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1, 20X1</td>
<td>$ (1,000,000)</td>
<td>$ -</td>
<td>$ (16,025)</td>
<td>$ 16,025</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>(16,025)</td>
<td>-</td>
<td>$ (16,025)</td>
<td>$ 16,025</td>
</tr>
<tr>
<td>Payments (receipts)</td>
<td>16,025</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Effect of change in rates</td>
<td>1,149</td>
<td>(1,149)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>September 30, 20X1</td>
<td>(998,851)</td>
<td>(1,149)</td>
<td>$ (16,025)</td>
<td>$ 16,025</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>(16,025)</td>
<td>(19)</td>
<td>$ (16,044)</td>
<td>$ 16,200</td>
</tr>
<tr>
<td>Payments (receipts)</td>
<td>16,025</td>
<td>175</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization of basis adjustments</td>
<td>156</td>
<td>-</td>
<td>$ (156)</td>
<td></td>
</tr>
<tr>
<td>Effect of changes in rates</td>
<td>(993)</td>
<td>993</td>
<td></td>
<td></td>
</tr>
<tr>
<td>December 31, 20X1</td>
<td>(1,000,000)</td>
<td>-</td>
<td>$ (16,200)</td>
<td>$ 16,200</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>(16,025)</td>
<td>-</td>
<td>$ (16,025)</td>
<td>$ 16,025</td>
</tr>
<tr>
<td>Payments (receipts)</td>
<td>16,025</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization of basis adjustments</td>
<td>-</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Effect of changes in rates</td>
<td>(1,074)</td>
<td>1,074</td>
<td></td>
<td></td>
</tr>
<tr>
<td>March 31, 20X2</td>
<td>(1,001,074)</td>
<td>1,074</td>
<td>$ (16,025)</td>
<td>$ 16,025</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>(16,025)</td>
<td>17</td>
<td>$ (16,008)</td>
<td></td>
</tr>
<tr>
<td>Payments (receipts)</td>
<td>16,025</td>
<td>(225)</td>
<td>$ 15,800</td>
<td></td>
</tr>
<tr>
<td>Amortization of basis adjustments</td>
<td>208</td>
<td>-</td>
<td>208</td>
<td></td>
</tr>
<tr>
<td>Effect of changes in rates</td>
<td>12,221</td>
<td>(12,221)</td>
<td></td>
<td>$ 15,800</td>
</tr>
<tr>
<td>June 30, 20X2</td>
<td>(988,645)</td>
<td>(11,355)</td>
<td>$ (15,800)</td>
<td>$ 15,800</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>(16,025)</td>
<td>(216)</td>
<td>$ (16,241)</td>
<td>$ 19,000</td>
</tr>
<tr>
<td>Payments (receipts)</td>
<td>16,025</td>
<td>2,975</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization of basis adjustments</td>
<td>(2,759)</td>
<td>-</td>
<td>(2,759)</td>
<td></td>
</tr>
<tr>
<td>Effect of changes in rates</td>
<td>789</td>
<td>(789)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>September 30, 20X2</td>
<td>(990,615)</td>
<td>(9,385)</td>
<td>$ (19,000)</td>
<td>$ 19,000</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>(16,025)</td>
<td>(181)</td>
<td>$ (16,206)</td>
<td></td>
</tr>
<tr>
<td>Payments (receipts)</td>
<td>16,025</td>
<td>3,250</td>
<td>$ 19,275</td>
<td></td>
</tr>
<tr>
<td>Amortization of basis adjustments</td>
<td>(3,069)</td>
<td>-</td>
<td>(3,069)</td>
<td></td>
</tr>
<tr>
<td>Effect of changes in rates</td>
<td>532</td>
<td>(532)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>December 31, 20X2</td>
<td>(993,152)</td>
<td>(6,848)</td>
<td>$ (19,275)</td>
<td>$ 19,275</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>(16,025)</td>
<td>(134)</td>
<td>$ (16,159)</td>
<td>$ 19,550</td>
</tr>
<tr>
<td>Payments (receipts)</td>
<td>16,025</td>
<td>3,525</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization of basis adjustments</td>
<td>(3,391)</td>
<td>-</td>
<td>(3,391)</td>
<td></td>
</tr>
<tr>
<td>Effect of changes in rates</td>
<td>(978)</td>
<td>978</td>
<td></td>
<td></td>
</tr>
<tr>
<td>March 31, 20X3</td>
<td>(997,521)</td>
<td>(2,479)</td>
<td>$ (19,550)</td>
<td>$ 19,550</td>
</tr>
</tbody>
</table>
Fixed-Rate Debt | Interest Rate Swap | Expense | Net Payment |
--- | --- | --- | ---
Interest accrued | (16,025) | (46) | $ (16,071) |
Payments (receipts) | 1,016,025 | 2,525 | $ 1,018,550 |
Amortization of basis adjustments | (2,479) | - | (2,479) |
June 30, 20X3 | $ - | $ - | $ (18,550) | $ 1,018,550 |

55-49 The preceding table demonstrates two important points that explain why the shortcut method described in paragraphs 815-25-55-43 through 55-45 produces the same results as the computation in the preceding table if the hedging relationship is perfectly effective:

a. In every quarter, the effect of changes in rates on the interest rate swap completely offsets the effect of changes in rates on the debt. That is as expected because the hedge is perfectly effective.
b. In every quarter except the last when the principal is repaid, the expense equals the cash payment.

55-50 The following table illustrates the computation of interest expense using the shortcut method described in paragraphs 815-25-55-43 through 55-45. The results are the same as the results computed in the preceding table.

<table>
<thead>
<tr>
<th>Quarter Ended</th>
<th>(a) Difference between Fixed Rates</th>
<th>(b) Variable Rate on Swap</th>
<th>(c) Sum (a) + (b)</th>
<th>(d) Debt’s Principal Amount</th>
<th>(e) Interest Expense [(c) x (d)] + 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>September 30, 20X1</td>
<td>0.00%</td>
<td>6.41%</td>
<td>6.41%</td>
<td>$ 1,000,000</td>
<td>$ 16,025</td>
</tr>
<tr>
<td>December 31, 20X1</td>
<td>0.00%</td>
<td>6.48%</td>
<td>6.48%</td>
<td>1,000,000</td>
<td>16,200</td>
</tr>
<tr>
<td>March 31, 20X2</td>
<td>0.00%</td>
<td>6.41%</td>
<td>6.41%</td>
<td>1,000,000</td>
<td>16,025</td>
</tr>
<tr>
<td>June 30, 20X2</td>
<td>0.00%</td>
<td>6.32%</td>
<td>6.32%</td>
<td>1,000,000</td>
<td>15,800</td>
</tr>
<tr>
<td>September 30, 20X2</td>
<td>0.00%</td>
<td>7.60%</td>
<td>7.60%</td>
<td>1,000,000</td>
<td>19,000</td>
</tr>
<tr>
<td>December 31, 20X2</td>
<td>0.00%</td>
<td>7.71%</td>
<td>7.71%</td>
<td>1,000,000</td>
<td>19,275</td>
</tr>
<tr>
<td>March 31, 20X3</td>
<td>0.00%</td>
<td>7.82%</td>
<td>7.82%</td>
<td>1,000,000</td>
<td>19,550</td>
</tr>
<tr>
<td>June 30, 20X3</td>
<td>0.00%</td>
<td>7.42%</td>
<td>7.42%</td>
<td>1,000,000</td>
<td>18,550</td>
</tr>
</tbody>
</table>

55-51 As stated in the introduction to this Example, a flat yield curve is assumed for simplicity. An upward-sloping yield curve would have made the computations more complex. Paragraph 815-25-55-47 would have shown different interest rates for each quarterly repricing date, and the present value of each future payment would have been computed using a different rate (as described in paragraph 815-25-55-41). However, the basic principles are the same. As long as the hedging relationship meets the criteria for the shortcut method, perfect effectiveness can be assumed.

55-52 In this Example of a fair value hedge of fixed-rate interest-bearing debt, it is assumed that Entity ABC elects to immediately begin amortizing the adjustments of the carrying amount of the fixed-rate debt while the hedge is still in place. Because the change in fair value of the interest rate swap attributable to the passage of time is recognized as interest expense by Entity ABC, the amounts recorded as expenses in the table in paragraph 815-25-55-48 would be eligible for capitalization under Subtopic 835-20.
4.4.30 Measuring impairment

Excerpt from Subtopic 310-10

>>>> Impact of Hedging

35-31 Section 815-25-35 implicitly affects the measurement of impairment under this Topic by requiring the present value of expected future cash flows to be discounted by the new effective rate based on the adjusted recorded investment in a 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 adjustment under fair value hedge accounting of the loan’s carrying amount for changes in fair value attributable to the hedged risk under Section 815-25-35 shall be considered to be an adjustment of the loan’s recorded investment. Paragraph 815-25-35-11 explains that the loan’s original effective interest rate becomes irrelevant once the recorded amount of the loan is adjusted for any changes in its fair value.

Pending Content

Transition Date: (P) December 16, 2019; (N) December 16, 2020 | Transition Guidance: 326-10-65-1


Excerpt from Subtopic 326-20

Pending Content

Transition Date: (P) December 16, 2019; (N) December 16, 2020 | Transition Guidance: 326-10-65-1

>> Effect of a Fair Value Hedge on the Discount Rate When Using a Discounted Cash Flow Model

55-9 Section 815-25-35 implicitly affects the measurement of credit losses under this Topic by requiring the present value of expected future cash flows to be discounted by the new effective interest rate based on the adjusted amortized cost basis in a hedged loan. When the amortized cost basis of a loan has been adjusted under fair value hedge accounting, the effective interest rate is the discount rate that equates the present value of the loan’s future cash flows with that adjusted amortized cost basis. The adjustment under fair value hedge accounting of the loan’s carrying amount for changes in fair value attributable to the hedged risk under Section 815-25-35 shall be considered to be an adjustment of the loan’s amortized cost basis. Paragraph 815-25-35-11 explains that the loan’s original effective interest rate becomes irrelevant once the recorded amount of the loan is adjusted for any changes in its fair value.
Excerpt from ASC 815-25

Pending Content

Transition Date: (P) December 16, 2019; (N) December 16, 2020 | Transition Guidance: 326-10-65-1

>> Impairment or Credit Losses of Hedged Item

35-10 An asset or liability that has been designated as being hedged and accounted for pursuant to this Section remains subject to the applicable requirements in generally accepted accounting principles (GAAP) for assessing impairment or credit losses for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment or credit loss 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 815-25-35-1(b). Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment or credit loss requirements to the hedged asset or liability.

>>> Interaction with Measurement of Credit Losses Loan Impairment

35-11 This Subtopic implicitly affects the measurement of credit losses impairment under Section 310-10.35 Subtopic 326-20 on financial instruments measured at amortized cost by requiring the present value of expected future cash flows to be discounted by the new effective rate based on the adjusted amortized cost basis recorded investment in a hedged loan. Paragraph 326-20-55-9 310-10-35-31 requires that, when the amortized cost basis 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 amortized cost basis recorded investment. That paragraph states that the adjustment under fair value hedge accounting of the loan’s carrying amount for changes in fair value attributable to the hedged risk under this Subtopic shall be considered to be an adjustment of the loan’s amortized cost basis recorded investment. As discussed in that paragraph, the loan’s original effective interest rate becomes irrelevant once the recorded amount of the loan is adjusted for any changes in its fair value. Because paragraph 815-25-35-10 requires that the loan’s amortized cost basis carrying amount be adjusted for hedge accounting before the impairment requirements of Subtopic 326-20 310-10 are applied, this Subtopic implicitly supports using the new effective rate and the adjusted amortized cost basis recorded investment.

35-12 This guidance applies to all entities applying Subtopic 326-20 310-10 to financial assets 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 amortized cost basis carrying amount arising from fair value hedge accounting until the hedging relationship is desiganted. The guidance on recalculating the effective rate is not intended to be applied to all other circumstances that result in an adjustment of a loan’s amortized cost basis carrying amount.
The **hedged item** in a fair value hedge remains subject to other applicable US GAAP for assessing impairment. Impairment guidance generally is applied *after* fair value hedge accounting is applied to the hedged item – i.e. after any basis adjustment is recognized. [815-25-35-10]

When assessing impairment, the fair value or cash flows of the derivative hedging instrument generally do 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. However, see Question 6.4.10 regarding application of the full cost method of accounting for entities with oil and gas producing activities.

Specific guidance is provided when measuring impairment for a loan that is deemed impaired under Subtopic 310-10 (receivables). When a loan is the hedged item in a fair value hedging relationship, basis adjustments from applying fair value hedge accounting adjust the recorded investment in the loan. For loans deemed impaired, Subtopic 310-30 requires impairment to be measured based on the present value of expected future cash flows discounted at the loan’s effective interest rate (unless a practical expedient is applied or foreclosure is probable). [815-25-35-11, 310-10–35-31]

Because a basis adjustment changes the recorded investment in a loan, the loan’s original effective interest rate becomes irrelevant. As a result, the effective interest rate to be used when measuring impairment for an impaired loan that is the hedged item in a fair value hedge is the new effective rate implicit in the adjusted amortized cost basis of the hedged loan – i.e. the amortized cost basis including basis adjustments. In this situation, the effective rate is the discount rate that equates the present value of the loan’s future cash flows with the adjusted recorded investment in the loan. This guidance applies even if the basis adjustments are not being amortized because the entity has elected to delay amortizing basis adjustments until the hedging relationship is redesigned. [815-25-35-11 – 35-12]

**FASB Example: Interaction with loan impairment**

Excerpt from ASC 815-25

>> Example 14: Interaction with Measurement of Credit Losses

**Pending Content**

Transition Date: (P) December 16, 2019; (N) December 16, 2020 | Transition Guidance: 326-10-65-1

This Example illustrates the application of paragraph 815-25-35-11 involving the interaction of hedge accounting and measurement of credit losses in Subtopic 326-20 on financial instruments measured at amortized cost loan impairment accounting. The following Cases also illustrate the effect of the two approaches to calculate the change in the fair value of the hedged item attributable to interest rate risk discussed in paragraph 815-25-35-13 on that interaction, as follows:
a. Using the full contractual coupon cash flows (Case A)
b. Using the benchmark rate component of the contractual coupon cash flows (Case B).

55-86 Entity A formally documents a qualifying fair value hedge (for fair value changes attributable to changes in the designated benchmark interest rate) between a fixed-rate loan receivable from Entity B and an interest rate swap. The 5-year, fixed-rate loan to Entity B has a principal amount of $1,000,000 payable at maturity and interest payable annually at a 10 percent rate. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-87 One year after inception of the hedging relationship, the following conditions exist:

a. Subparagraph superseded by Accounting Standards Update No. 2017-12.
b. There has been an adverse change to Entity B’s creditworthiness.
c. The LIBOR swap rate (the designated benchmark interest rate) has decreased from 6 percent to 5.5 percent.

55-88 Assume that the repayment of the loan is not dependent on the underlying collateral. In applying the requirements of Subtopic 326-20 310-10 to the loan, Entity A evaluates the loan for credit losses on an individual basis because it does not have similar risk characteristics with other loans in the portfolio and uses a discounted cash flow approach. Entity 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. (See row C in the table in paragraph 815-25-55-90, which presents calculations—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.)

>>> Case A: Using the Full Contractual Coupon Cash Flows

55-88A In this Case, assume that the entity elected to calculate fair value changes in the hedged item attributable to interest rate risk using the full contractual coupon cash flows of the hedged item. One year after inception of the hedging relationship, the change in the hedged item’s fair value attributable to changes in the LIBOR swap rate (the designated benchmark interest rate) is a gain of $16,022. (See row B in the table in paragraph 815-25-55-90, which presents calculations—at the end of the first year of the loan’s term—of the net present value of contractual cash flows based on the loan’s original effective interest rate adjusted for a 50 basis point decrease in the LIBOR swap rate.)

55-89 After adjusting the amortized cost basis carrying amount of the hedged loan by $16,022 (pursuant to paragraph 815-25-35-1(b)) for the increase in the hedged item’s fair value attributable to changes in the benchmark interest rate, Entity A should apply the guidance in Subtopic 326-20 Section 310-10-35 by doing both of the following:

a. Comparing the amortized cost basis 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 amortized cost basis carrying amount of the hedged loan pursuant to paragraph 815-25-35-1(b) (that is, 9.5 percent).

b. Recognizing an impairment by creating a valuation allowance for credit losses (with the offsetting entry charged to expense) for the difference of $71,121 ($1,016,022 – $944,901).

55-90 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 interest rate and the new implicit rate.

<table>
<thead>
<tr>
<th>Rate</th>
<th>Net Present Value at End of Year 1</th>
<th>Assumed Cash Flow in Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>A.</td>
<td>Original cash flows and original effective rate</td>
<td>10.0%</td>
</tr>
<tr>
<td>B.</td>
<td>Original cash flows and new implicit rate</td>
<td>9.5%</td>
</tr>
<tr>
<td>C.</td>
<td>Expected future cash flows and original effective rate</td>
<td>10.0%</td>
</tr>
<tr>
<td>D.</td>
<td>Expected future cash flows and new implicit rate</td>
<td>9.5%</td>
</tr>
</tbody>
</table>

>>> Case B: Using the Benchmark Rate Component of the Contractual Coupon Cash Flows

55-91 In this Case, assume that Entity A elected to calculate fair value changes in the hedged item attributable to interest rate risk using the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception. One year after inception of the hedging relationship, the change in the hedged item’s fair value attributable to changes in the LIBOR swap rate (the designated benchmark interest rate) is a gain of $17,526, which is calculated as follows.

At the beginning of the loan’s term

\[ \frac{60,000 \text{pmt}, 6\% i, 5n, 1,000,000fv}{\text{PV}} = \frac{1,000,000}{\text{PV}} \]

\[ \frac{60,000 \text{pmt}, 5.5\% i, 4n, 1,000,000fv}{\text{PV}} = \frac{1,017,526}{\text{PV}} \]

Change in value

\[ (17,526) \]

55-92 After adjusting the carrying amount amortized cost basis of the hedged loan by $17,526 (in accordance with paragraph 815-25-35-1(b)) for the increase in the hedged item’s fair value attributable to changes in the benchmark interest rate, Entity A should apply the guidance in Subtopic 326-20 Section 310-10-35 by doing both of the following:

a. Comparing the amortized cost basis recorded investment of the loan after the effect of the fair value hedge, or $1,017,526, to the $946,299 present value of expected future cash flows discounted using the rate that reflects
4. Accounting for fair value hedges

55-93 Following are calculations (at the end of the first year of the loan’s term) of the net present value of the benchmark rate component of the contractual cash flows and the creditor’s best estimate of expected future cash flows based on the loan’s original effective interest rate and the new implicit rate. In row B, the net present value at the end of the first year is equal to the net present value of the benchmark rate component of the contractual coupon cash flows discounted at the 5.5 percent benchmark rate.

<table>
<thead>
<tr>
<th>Rate</th>
<th>Original cash flows and original effective rate</th>
<th>Original cash flows and new implicit rate</th>
<th>Expected future cash flows and original effective rate</th>
<th>Expected future cash flows and new implicit rate impairment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net Present Value at End of Year 1</td>
<td>Assumed Cash Flow in Year</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>A. 10.0%</td>
<td>B. 9.45%</td>
<td>C. 10.0%</td>
<td>D. 9.45%</td>
</tr>
<tr>
<td></td>
<td>$1,000,000</td>
<td>$1,017,526</td>
<td>$930,000</td>
<td>$946,299</td>
</tr>
<tr>
<td></td>
<td>$100,000</td>
<td>$100,000</td>
<td>$93,000</td>
<td>$93,000</td>
</tr>
<tr>
<td></td>
<td>$100,000</td>
<td>$100,000</td>
<td>$93,000</td>
<td>$93,000</td>
</tr>
<tr>
<td></td>
<td>$1,100,000</td>
<td>$1,100,000</td>
<td>$1,023,000</td>
<td>$1,023,000</td>
</tr>
</tbody>
</table>

KPMG observation

Measurement of credit losses on financial instruments

In June 2016, the FASB issued ASU 2016-13, Measurement of Credit Losses on Financial Instruments.

Subtopic 326-20 (financial instruments – credit losses) does not prescribe a specific method that must be used to estimate the allowance for credit losses. Methods that may be used include discounted cash flow methods and other methods. Subtopic 326-20 distinguishes between a discounted cash flow method and other methods. [326-20-30-3, 55-6 – 55-7]

Non-discounted cash flow methods. In estimating expected credit losses of the amortized cost basis for an asset (or group of assets) using a method other than a discounted cash flow method, the estimate needs to reflect the...
expected loss of principal and the effect of unamortized premiums and discounts, including fair value hedge accounting adjustments. \[326-20-30-5\]

**Discounted cash flow methods.** When a discounted cash flow method is used, additional guidance is provided. Because a basis adjustment changes the amortized cost basis of a loan, the loan's original effective interest rate becomes irrelevant. As a result, the relevant effective interest rate is the new effective rate implicit in the adjusted amortized cost basis of the hedged loan—i.e., the amortized cost basis including basis adjustments. \[815-25-35-11, 326-20-55-9\]

In this situation, the effective rate is the discount rate that equates the present value of the loan’s future cash flows with the adjusted amortized cost basis. This guidance applies even if the basis adjustments are not being amortized because the entity has elected to delay amortizing basis adjustments until the hedging relationship is dedesignated. \[815-25-35-11 – 35-12, 326-20-55-9\]

See KPMG’s Handbook, Credit impairment.

**4.5 Discontinuing hedge accounting**

**4.5.10 Overview**

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**Excerpt from ASC 815-25**

> Discontinuing Hedge Accounting

>> Amounts Excluded from the Assessment of Effectiveness under an Amortization Approach

40-7 When applying the guidance in paragraph 815-20-25-83A, any amounts remaining in accumulated other comprehensive income associated with amounts excluded from the assessment of effectiveness shall be recorded in earnings in the current period if the hedged item is derecognized. For all other discontinued fair value hedges, any amounts associated with the excluded component remaining in accumulated other comprehensive income shall be recorded in earnings in the same manner as other components of the carrying amount of the hedged asset or liability in accordance with paragraphs 815-25-35-8 through 35-9A.

---

The following table provides an overview of circumstances that would require an entity to discontinue or partially dedesignate a hedging relationship.

<table>
<thead>
<tr>
<th>Change in eligibility or critical terms of hedged items or transactions (section 2.10.20)</th>
<th>Hedged item no longer meets the eligibility criteria [815-25-40-1(a)]</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Hedged firm commitments are modified such that they no longer meet the definition of a firm commitment (see Question 2.10.50)</td>
</tr>
<tr>
<td></td>
<td>Modification of hedged item or transaction such that critical terms of the original hedging relationship have changed [815-20-55-56]</td>
</tr>
</tbody>
</table>
4. Accounting for fair value hedges

<table>
<thead>
<tr>
<th>Change in eligibility or critical terms of hedging instrument (section 2.10.30)</th>
</tr>
</thead>
<tbody>
<tr>
<td>— Hedging instrument no longer meets the eligibility criteria [815-25-40-1(a)]</td>
</tr>
<tr>
<td>— Hedging instrument expires or is sold, terminated or exercised [815-25-40-1(b)]</td>
</tr>
<tr>
<td>— Modification of hedging instrument such that critical terms of the original hedging relationship have changed [815-20-55-56]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Change in hedged risk (section 2.10.40)</th>
</tr>
</thead>
<tbody>
<tr>
<td>— Change in the hedged risk [815-20-55-56]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Change in hedge effectiveness (section 2.10.50)</th>
</tr>
</thead>
<tbody>
<tr>
<td>— Hedge is no longer highly effective on a retrospective and/or prospective basis, with certain exceptions (see Question 2.10.90) [815-25-40-1(a), 815-30-40-1(a)]</td>
</tr>
<tr>
<td>— Change in quantitative method to assess hedge effectiveness, including whether a component of the hedging instrument is excluded from the assessment (see section 9.6.40) [815-25-55-56]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Elective dedesignation</th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity may elect to discontinue the hedging relationship. [815-30-40-1(c)]</td>
</tr>
</tbody>
</table>

**Treatment of hedging instruments.** When hedge accounting is discontinued, if the derivative instrument has not expired and has not been sold, terminated or exercised, it may be used as the hedging instrument in a new hedging relationship as long as the hedge criteria are met for the new relationship. Unless it is designated as the hedging instrument in a new cash flow or net investment hedging relationship, the derivative instrument continues to be recorded on the balance sheet at fair value and all changes in fair value (including changes related to the previously excluded components) are reflected in earnings. [815-25-40-2]

**Treatment of hedged items.** When hedge accounting is discontinued, the entity may designate prospectively the previously hedged item in a new hedging relationship with a different hedging instrument as long as the hedge criteria are met for the new relationship. Otherwise, changes in the fair value are no longer recognized as basis adjustments.

The following diagram illustrates how to account for the hedged item and hedging instrument after hedge accounting is discontinued. [815-25-40-7]
### 4. Accounting for fair value hedges

#### Accounting for discontinued hedging relationships (if not designated in new hedging relationship)

<table>
<thead>
<tr>
<th>Hedged item</th>
<th>Hedging instrument, including excluded components</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At date of discontinuance:</strong></td>
<td></td>
</tr>
<tr>
<td>Basis adjustment remains in hedged item’s amortized cost basis</td>
<td>Amount in AOCI associated with previously excluded component remains in AOCI</td>
</tr>
<tr>
<td><strong>When fair value subsequently changes:</strong></td>
<td></td>
</tr>
<tr>
<td>Do not record change in earnings</td>
<td>Recorded in earnings, including changes in fair value of previously excluded component</td>
</tr>
<tr>
<td><strong>When hedged item is derecognized:</strong></td>
<td></td>
</tr>
<tr>
<td>Include basis adjustment remaining in amortized cost basis in gain/loss computation</td>
<td>Record amount remaining in AOCI associated with previously excluded component in earnings</td>
</tr>
</tbody>
</table>

The following table provides examples of how a basis adjustment (and any amount that remains in AOCI associated with excluded components) is accounted for after a hedge is discontinued.

<table>
<thead>
<tr>
<th>Hedged item</th>
<th>Timing and method of recognizing the basis adjustment (and amount remaining in AOCI associated with excluded components) in earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>The basis adjustment remains part of the hedged inventory’s cost basis until it is sold (subject to ongoing impairment tests). When the asset is sold, its entire cost basis (including the basis adjustment) is recognized as part of the cost of the item sold. [815-25-35-8] Similarly, the amount remaining in AOCI associated with an excluded component (if any) remains in AOCI until the inventory is sold, at which time it is recognized in earnings immediately. [815-25-40-7]</td>
</tr>
<tr>
<td>Long-term loan receivable with a $100,000 basis adjustment that increased its amortized cost basis (i.e. an interest-bearing financial instrument)</td>
<td>The basis adjustment is treated like a premium or discount and is amortized as interest income using the effective yield method. The amortization period after the hedge is discontinued is a period that is consistent with the amortization of other discounts or premiums associated with the hedged item under other applicable US GAAP – e.g. Subtopic 310-20. [815-25-35-9, 35-9A] Similarly, the amount remaining in AOCI associated with an excluded component (if any) when the hedge is discontinued is amortized as interest income over a period that is consistent with other premiums and discounts associated with the hedged item. [815-25-40-7]</td>
</tr>
</tbody>
</table>
Question 4.5.10

Does amortization begin if a portfolio of hedged items that is hedged by a combination of derivatives is rebalanced?

Background: Some entities hedge portfolios of similar assets or liabilities using a combination of derivatives as hedging instruments (see section 2.6.40). Additions or deletions (a rebalancing) to either the portfolio of hedged items or derivative hedging instruments require a discontinuation of the hedging relationship (see Question 2.10.60). An entity that is required to discontinue a hedging relationship upon a rebalancing may decide to redesignate the portfolio of hedged items in a new hedging relationship.

Interpretive response: 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, we do not believe amortization of the basis adjustment is required to begin. This is because the hedged items continue to be hedged for changes in fair value attributable to the same risk.

Similarly, if the original hedged items are redesignated with additional items added to the portfolio of hedged items in a relationship hedging the same risks, we do not believe amortization is required to begin. However, if the original hedged items are redesignated in a relationship specifically hedging a different risk, amortization should begin.

This response does not relate to hedges using the last-of-layer method (see section 4.5.30).

Example 4.5.10

Accounting for the termination of an interest rate swap hedging fixed-rate debt

On January 1, Year 1, ABC Corp. issues a five-year, $10,000,000 debt obligation. The debt obligation requires annual interest payments at a fixed rate of 10% with principal payable at maturity.

Simultaneously, ABC 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 is designated and is effective as a hedge of changes in the fair value of the debt obligation due to changes in three-month LIBOR, the designated benchmark interest rate.

On December 31, Year 3, ABC terminates the interest rate swap and discontinues hedge accounting. It pays $1,000,000 to the counterparty, which is the interest rate swap’s fair value at the date of termination. As a result of ABC having applied hedge accounting, the carrying amount of the fixed-rate debt obligation is $9,000,000 at December 31, Year 3.

ABC accounts for the $1,000,000 basis adjustment on the fixed-rate debt obligation as a discount on the debt obligation and accretes that amount as
interest expense over the remaining life of the debt obligation using the effective yield method.

The following table summarizes the remaining payments on December 31, Year 3 and the new effective rate for the debt obligation. The new effective rate is the rate that equates the adjusted amortized cost basis of the debt obligation with the present value of future cash flows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual interest payments for remaining 2 years</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Principal payment at end of 2 remaining years</td>
<td>$10,000,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$12,000,000</strong></td>
</tr>
<tr>
<td>Original effective rate</td>
<td>10.00%</td>
</tr>
<tr>
<td>Present value at original effective rate</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Amortized cost basis (with basis adjustment)</td>
<td>$9,000,000</td>
</tr>
<tr>
<td>New effective rate based on adjusted amortized cost basis (rounded)</td>
<td>16.25%</td>
</tr>
</tbody>
</table>

For simplicity, this example makes the following assumptions.

— It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
— It is based on annual periods; normally the assessment of effectiveness and fair value adjustments of the hedged item and derivative would be done at least quarterly.

The following journal entries are required to be made for Year 4 and Year 5.

**Journal entries – December 31, Year 4**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td><em>To record interest payment on debt obligation.</em></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>462,500</td>
</tr>
<tr>
<td>Fixed-rate debt obligation</td>
<td>462,500</td>
</tr>
<tr>
<td><em>To accrete basis adjustment on fixed-rate debt obligation using effective yield method.</em></td>
<td></td>
</tr>
</tbody>
</table>

**Note:**
1. ($9,000,000 beginning amortized cost basis (with basis adjustment) × 16.25% effective rate) - $1,000,000 cash interest expense.

**Journal entries – December 31, Year 5**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td><em>To record interest payment on debt obligation.</em></td>
<td></td>
</tr>
</tbody>
</table>
Financial statement excerpts

At the end of Years 4 and 5, ABC’s financial statements reflect the following.

<table>
<thead>
<tr>
<th>Account</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt obligation</td>
<td>$9,462,500¹</td>
<td>-</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>$1,462,500²</td>
<td>$1,537,500²</td>
</tr>
<tr>
<td><strong>Disclosures under 815-10-55-4EE</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carrying amount of debt obligations on the balance sheet that are hedged liabilities [815-10-50-4EE(a), 50-4EE(c)]</td>
<td>$9,462,500</td>
<td>-</td>
</tr>
<tr>
<td>Cumulative amount of fair value hedge adjustments included in the carrying amount of hedged debt obligations [815-10-50-4EE(b)]</td>
<td>537,500⁴</td>
<td>-</td>
</tr>
<tr>
<td>Cumulative amount of fair value hedge adjustments remaining for hedged debt obligations for which hedge accounting has been discontinued [815-10-50-4EE(d)]</td>
<td>537,500⁴</td>
<td>-</td>
</tr>
</tbody>
</table>

Notes:

1. $9,000,000 beginning amortized cost basis (with basis adjustment) + $462,500 amortization of the basis adjustment.
2. $9,000,000 beginning amortized cost basis (with basis adjustment) × 16.25% effective rate.
3. $9,462,500 beginning amortized cost basis (with basis adjustment) × 16.25% effective rate (rounded).
4. $1,000,000 basis adjustment - $462,500 amortized during Year 4.
Question 4.5.20

What is the accounting for a partially dedesignated fair value hedging relationship?

Interpretive response: We believe it is acceptable to partially dedesignate a fair value hedging relationship under certain circumstances (see section 2.10.60). When an entity partially dedesignates a fair value hedging relationship, hedge accounting should be partially discontinued as follows.

— **Treatment of dedesignated portion of hedging instrument.** Unless it is designated as the hedging instrument in a new cash flow or net investment hedging relationship, the dedesignated portion of the derivative instrument continues to be recorded on the balance sheet at fair value and all changes in fair value (including changes related to the previously excluded components) are reflected in earnings.

— **Treatment of hedged item (basis adjustment).** The cumulative basis adjustment is part of the amortized cost basis of a hedged item. If an entity partially dedesignates a hedging relationship, it is necessary to allocate the basis adjustment between the portion of the hedged item that continues to be hedged versus the portion that is not; also, it may be necessary to allocate a portfolio level basis adjustment to individual items in the portfolio (see section 4.3.30). This is because the basis adjustment recognized through the date of the partial dedesignation relates (in part) to the items that have been partially dedesignated while further changes to the cumulative basis adjustment will relate only to items that continue to be hedged.

Subsequent accounting for the portion of the basis adjustment allocated to the previously hedged item depends on whether it continues to be recognized and on the nature of the hedged item. For example, if a portion of the originally designated hedged item has been derecognized, the basis adjustment is part of the amortized cost basis used to determine the gain or loss recorded on derecognition. As another example, if the dedesignated hedged item is a portion of a financial instrument that has not been derecognized, the entity is required to amortize the related basis adjustment over a period that is consistent with the amortization of other discounts or premiums associated with the hedged item under other applicable US GAAP. For guidance on accounting for basis adjustments, see section 4.4.

This response does not relate to hedges using the last-of-layer method (see section 4.5.30).
Hedge relationship is no longer highly effective

Excerpt from ASC 815-25

Noncompliance with Effectiveness Criterion

40-3 In general, if a periodic assessment indicates noncompliance with the effectiveness criterion in paragraphs 815-20-25-75 through 25-80, an entity shall not recognize the adjustment of the carrying amount of the hedged item described in paragraphs 815-25-35-1 through 35-6 after the last date on which compliance with the effectiveness criterion was established.

40-4 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 before that event or change in circumstances.

A quarterly hedge effectiveness assessment may indicate that a hedging relationship is no longer highly effective and the hedge relationship is discontinued as a result. In that case, generally no changes in the fair value of the hedged item attributable to the hedged risk are recorded after the last date on which effectiveness testing indicated the relationship was highly effective. This date is presumably the date of the immediately preceding quarterly effectiveness assessment. [815-25-40-3]

However, if an event or change in circumstances caused the relationship to fail to be highly effective, the change in fair value of the hedged item attributable to the hedged risk is recognized through the date on which the entity can demonstrate that the hedging relationship was highly effective. [815-25-40-4]

Additionally, if a hedging relationship had not been highly effective retrospectively, but is expected to be highly effective prospectively, hedge accounting is not required to be discontinued prospectively (see Question 2.10.90).

Example 4.5.20

Identifying the date a hedging relationship ceased to be highly effective

On January 1, Year 1, ABC Corp. designated a forward contract for which the underlying is a soybean meal index as the hedging instrument in a hedge of changes in fair value of its cottonseed meal inventory. ABC performs its quarterly hedge effectiveness assessments using the period-by-period dollar-offset approach.

When ABC performs its quarterly hedge effectiveness assessment for the quarterly period ended December 31, Year 1, ABC identifies that the hedging relationship was not highly effective in the period being assessed.
ABC identifies that the cause of the relationship ceasing to be highly effective was a storm that damaged the soybean harvest on December 1, Year 1. The storm caused a shortage in soybean meal and an increase in the soybean meal index, but did not affect the fair value of cottonseed meal inventory. ABC determines that the hedging relationship was highly effective through November 30, Year 1. Accordingly, ABC applies hedge accounting through November 30, Year 1, then discontinues hedge accounting.

If ABC had been unable to identify an event or change in circumstances that caused the relationship to fail to be highly effective, ABC would not apply hedge accounting for the quarterly period ended December 31, Year 1 – i.e. hedge accounting would be applied only through September 30, Year 1. Additionally, ABC would discontinue the hedging relationship unless the hedging relationship is expected to be highly effective prospectively.

4.5.30 Last-of-layer hedging relationships

Excerpt from ASC 815-25

> Hedged Item Is Designated under the Last-of-Layer Method

If a last-of-layer method hedging relationship is discontinued (or partially discontinued), the outstanding basis adjustment (or portion thereof) as of the discontinuation date shall be allocated to the individual assets in the closed portfolio using a systematic and rational method. An entity shall amortize those amounts over a period that is consistent with the amortization of other discounts or premiums associated with the respective assets in accordance with other Topics (for example, Subtopic 310-20 on receivables–nonrefundable fees and other costs).

As discussed in section 3.3.100, Topic 815 permits an entity to designate a fixed amount of a closed portfolio of prepayable financial assets as the hedged item in a fair value hedge of interest rate risk if the entity expects the designated amount will remain outstanding at the end of the hedge term (i.e. last of layer).

There are two situations in which a hedging relationship designated using the last-of-layer method in a closed portfolio of prepayable financial assets is discontinued, as illustrated in the following diagram (see Question 2.10.40).
### Scenario 1: Partial discontinuation

- **Amount outstanding in portfolio on testing date exceeds last of layer (i.e. hedged item) but last of layer not expected to remain outstanding at end of hedge term**
- **Hedge accounting is discontinued for:**
  - The portion of the last of layer no longer expected to remain outstanding at end of hedge term

### Scenario 2: Full discontinuation

- **Amount outstanding in portfolio on testing date is less than the designated last of layer (i.e. hedged item)**
- **Hedge accounting is discontinued for:**
  - The entire hedging relationship

Under a partial discontinuation, the entity allocates the portion of the cumulative basis adjustment related to the discontinued portion to the individual assets in the portfolio at the date of partial discontinuation using a systematic and rational method. It also uses a method to amortize those amounts over a period that is consistent with the amortization of other discounts or premiums associated with the respective assets. [815-25-40-9]

**Question 4.5.30**

How is the outstanding basis adjustment allocated to the individual items in a portfolio on a full discontinuation?

**Interpretive response:** The following table indicates the steps we believe an entity should take when it is required to discontinue the entire hedging relationship as a result of the outstanding amounts in the portfolio falling below the last-of-layer amount on the testing date.

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 1</td>
<td>We believe an entity should recognize in earnings the portion of the cumulative basis adjustment related to the difference between the full amount of the last of layer and the current outstanding amount of the portfolio.</td>
</tr>
<tr>
<td>Step 2</td>
<td>Allocate the remaining portion of the basis adjustment to the individual assets in the closed portfolio.</td>
</tr>
<tr>
<td>Step 3</td>
<td>Amortize the amounts allocated to the individual assets in the closed portfolio over a period that is consistent with the amortization of other discounts or premiums associated with the respective assets.</td>
</tr>
</tbody>
</table>

Given the consequences of full discontinuation, an entity may want to forecast conservatively. In addition, it may want to closely monitor the portfolio balance, and if necessary, proactively make a partial discontinuation.
Example 4.5.30

Discontinuation of a last-of-layer method hedge

ABC Corp. has a closed portfolio of $1 billion of prepayable fixed-rate assets. It designates a hedging relationship comprising a last of layer of $300 million from the closed portfolio as the hedged item and a $300 million plain-vanilla interest rate swap under which ABC pays a fixed rate and receives the 3-month LIBOR rate.

Scenario 1: Partial discontinuation

At a subsequent testing date, ABC has $500 million in prepayable fixed-rate assets remaining in the closed portfolio and its current expectation has changed such that it now expects only $250 million of the portfolio to remain outstanding at the end of the hedge term. Therefore, ABC discontinues hedge accounting related to \( \frac{1}{6} \) \((($300 million - $250 million) ÷ $300 million)\) of the last of layer. However, it may continue hedge accounting on the remaining \( \frac{5}{6} \) of the last of layer.

ABC allocates the portion of the cumulative basis adjustment related to the discontinued portion (i.e. \( \frac{1}{6} \) of the cumulative basis adjustment) to the remaining individual assets in the portfolio (i.e. the $500 million) using a systematic and rational method. ABC then amortizes those amounts using a method that is consistent with the amortization of other discounts or premiums associated with the respective assets.

Scenario 2: Full discontinuation

Assume the same facts as in Scenario 1, except that ABC never changed its expectation and therefore never made a partial discontinuation. Rather, on a subsequent testing date, it determines that the current outstanding amount of the closed portfolio of prepayable financial assets is $270 million. The current outstanding amount of the portfolio is less than the designated last of layer ($300 million).

Therefore, ABC is required to discontinue the hedging relationship entirely and performs the following steps.

<table>
<thead>
<tr>
<th>Step 1</th>
<th>ABC recognizes in earnings ( \frac{1}{10} ) ((($300 million - $270 million) ÷ $300 million)) of the cumulative basis adjustment related to the difference between the full amount of the designated last of layer and the current outstanding amount of the portfolio.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 2</td>
<td>ABC allocates the remaining portion of the basis adjustment to the individual assets in the closed portfolio ($270 million).</td>
</tr>
<tr>
<td>Step 3</td>
<td>ABC amortizes the remaining portion of the basis adjustment as calculated in Step 2 using a method that is consistent with the amortization of other discounts or premiums associated with the respective assets.</td>
</tr>
</tbody>
</table>
5. **Qualifying criteria for cash flow hedges**

**Detailed contents**

- **5.1 How the standard works**
- **5.2 Objective of a cash flow hedge**
- **5.3 Eligibility of hedged transactions**
  - 5.3.10 Basic requirements
  - 5.3.20 Forecasted transactions: Definition
  - 5.3.30 Forecasted transactions: Specific identification
  - 5.3.40 Forecasted transactions: Probability
  - 5.3.50 Forecasted transactions: Party external to the reporting entity
  - 5.3.60 Group of similar forecasted transactions
  - 5.3.70 Hedging a group of transactions: First-payments-received (paid) approach on a group of variable-rate loans
  - 5.3.80 Hedging a group of transactions: Layering with first-payments-received (paid) approach
  - 5.3.90 All-in-one hedge

**Future developments**

**Questions**

- 5.3.10 Can a contract that qualifies for the normal purchases and normal sales scope exception qualify as a hedged transaction?
- 5.3.20 Does a change in the probability assessment of a hedged transaction affect the ability to apply hedge accounting?
- 5.3.30 Does a change in the expected timing of a forecasted transaction affect the ability to apply hedge accounting?
- 5.3.40 What is the difference between a ‘party external to the reporting entity’ and an ‘unrelated party’?
- 5.3.50 Can both forecasted purchases and sales be included in a group for hedge accounting?
- 5.3.60 How does an entity assess whether forecasted transactions of nonfinancial assets or liabilities share similar risk exposure?
5.3.70 Can the first-payments-received (paid) approach be used to hedge credit risk?

5.3.80 How does an entity assess whether the cash flows from variable-rate financial instruments share the same risk exposure?

5.3.90 How does an entity specifically identify the forecasted transaction when using the layering approach for first-payments-received (paid)?

5.3.100 If additional layers are added, or if existing layers are removed, is an entity required to redesignate and redesignate other hedging relationships within the layers?

5.3.110 When does a hedging relationship move up the priority chain into a vacated tranche of a discontinued hedging relationship?

5.3.120 Can a new or redesignated hedging relationship replace a vacated tranche earlier in the priority chain?

5.3.130 If a hedging relationship within a priority chain is redesignated, what happens to the hedging relationships later in the priority chain?

5.3.140 Can a new hedging relationship be inserted earlier in the priority chain than an active hedging relationship?

5.3.150 Which risks are eligible to be designated in an all-in-one hedge?

5.3.160 Is an all-in-one hedge assumed to be perfectly effective?

**Examples**

5.3.10 Probability of transaction to purchase steel

5.3.20 Assessing the probability of the forecasted acquisition of a marketable debt security

5.3.30 Forecasted purchases of fuel when hedging price risk – similarity assessment

5.3.40 Group of variable-rate loans that do not share similar risk exposure

5.3.50 Layering approach: Swap matures and related amounts reclassified from AOCI

5.3.60 Layering approach: Swap terminated and related amounts not reclassified from AOCI

5.3.70 Layering approach: Additional swap terminated and new swap designated at end of priority chain

5.3.80 Layering approach: Swap terminated with interest payments on a portion of principal remaining probable

5.3.90 Layering approach: Swap early in priority chain matures subsequent to other swap terminations

5.3.100 Layering approach: Redesignation of swaps

5.3.110 All-in-one hedge of forecasted sales of gold
### 5. Eligibility of hedged risks

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.4.10</td>
<td>Contractually specified component price risk for nonfinancial items</td>
</tr>
<tr>
<td>5.4.20</td>
<td>Contractually specified component price risk: Existing contracts</td>
</tr>
<tr>
<td>5.4.30</td>
<td>Contractually specified component price risk: Not-yet-existing contracts</td>
</tr>
<tr>
<td>5.4.40</td>
<td>Interest rate risk on the forecasted issuance or purchase of debt instruments</td>
</tr>
<tr>
<td>5.4.50</td>
<td>Hedging interest rate risk on forecasted issuances of fixed-rate debt: Rollover strategies</td>
</tr>
<tr>
<td>5.4.60</td>
<td>Changing the hedged risk</td>
</tr>
</tbody>
</table>

### Questions

<table>
<thead>
<tr>
<th>Section</th>
<th>Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.4.10</td>
<td>Can an entity hedge an index or rate that is not specified in the contract?</td>
</tr>
<tr>
<td>5.4.20</td>
<td>If the contract price includes a variable basis spread, can an entity hedge the contractually specified component?</td>
</tr>
<tr>
<td>5.4.30</td>
<td>Can an entity hedge a contractually specified component of a forecasted purchase or sale of a nonfinancial asset in a spot market transaction?</td>
</tr>
<tr>
<td>5.4.40</td>
<td>What conditions need to be met to designate a contractually specified component as the hedged risk?</td>
</tr>
<tr>
<td>5.4.50</td>
<td>What are the requirements to meet the clearly and closely related criteria?</td>
</tr>
<tr>
<td>5.4.60</td>
<td>What threshold is required to support an entity’s expectation that the criteria to designate a contractually specified component will be met?</td>
</tr>
<tr>
<td>5.4.70</td>
<td>How does an entity assess whether forecasted issuances or purchases of short-term, fixed-rate debt in a rollover strategy share similar interest rate risk exposure?</td>
</tr>
<tr>
<td>5.4.80</td>
<td>Should deposit/investment arrangements without contractually stipulated maturity dates be characterized as rollovers of fixed-rate instruments?</td>
</tr>
<tr>
<td>5.4.90</td>
<td>Does the ability to change the hedged risk also extend to the hedged forecasted transaction?</td>
</tr>
</tbody>
</table>

### Examples

<table>
<thead>
<tr>
<th>Section</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.4.10</td>
<td>Contractually specified component</td>
</tr>
<tr>
<td>5.4.20</td>
<td>Underlying index or price as a contractually specified component</td>
</tr>
<tr>
<td>5.4.30</td>
<td>Contract not accounted for as derivative because normal purchases and normal sales scope exception is met</td>
</tr>
</tbody>
</table>
5. Qualifying criteria for cash flow hedges

5.4.40 Contractually specified component is not eligible to be the hedged risk
5.4.50 Contract pricing with underlying that is clearly and closely related
5.4.60 Contractually specified component in not-yet-existing contracts
5.4.70 Forecasted issuance of fixed-rate debt
5.4.80 Forecasted issuance of debt when it is not known whether the interest rate will be fixed or variable
5.4.90 Hedging interest rate risk on a group of individual transactions related to a rollover strategy
5.4.100 Change in hedged risk for a contractually specified component in not-yet-existing contracts
5.4.110 Defining hedged risk for a cash flow hedge of interest rate payments of You Pick ‘Em debt

5.5 Hedging instruments in cash flow hedges

5.5.10 Special rule for basis swaps
5.5.20 Limitations on mixed-attribute derivative commodity contracts

Questions

5.5.10 How is the hedged forecasted transaction defined in a cash flow hedging relationship involving a basis swap?
5.5.20 How does an entity assess whether a basis swap is highly effective at offsetting changes in the net interest cash flows?
5.5.30 Can an entity hedge net interest cash flows from a group of recognized assets or liabilities in a cash flow hedging relationship involving a basis swap?
5.5.40 Can an entity apply the first-payments-received (paid) approach when designating the net interest cash flows in a hedging relationship involving a basis swap?
5.5.50 Is a cash flow hedge with a basis swap automatically redesignated if there is a change to the contractually specified interest rate?
5.5.60 Can basis swaps other than those involving interest rates be designated as a hedging instrument?

Examples

5.5.10 Basis swap that qualifies for cash flow hedge accounting
5.5.20 Basis swap that does not qualify for cash flow hedge accounting
5.5.30 First-payments-received (paid) approach with basis swap as the hedging instrument
5.1 How the standard works

The objective of a **cash flow hedge** is to reduce or eliminate exposure to variability in expected future cash flows that affect earnings.

Topic 815 requires that certain criteria be met for a hedging relationship to qualify for cash flow hedge accounting. The criteria are organized as follows.

- **Criterion 1:** Eligibility of hedged items or transactions
- **Criterion 2:** Eligibility of hedged risk(s)
- **Criterion 3:** Eligibility of hedging instruments
- **Criterion 4:** Hedge effectiveness
- **Criterion 5:** Formal documentation

Topic 815 specifies certain items and transactions that are eligible for designation as a hedged transaction in a cash flow hedge.

**Criterion 1: Transactions eligible for cash flow hedges** *(section 5.3)*

- Cash flows from existing recognized assets and liabilities *(section 5.3.10)*
- Forecasted transactions – e.g. forecasted purchases or sales *(section 5.3.20)*
- Group of similar forecasted transactions *(section 5.3.60)*
- All-in-one hedge *(section 5.3.90)*

Additionally, the risk(s) associated with the hedged transaction also needs to qualify for hedge accounting. The risks eligible to be designated in a cash flow hedge are different for financial and nonfinancial assets and liabilities.

**Criterion 2: Risks eligible for cash flow hedges**

- **Financial assets and liabilities** *(section 2.3)*
  - Either:
    - changes in a contractually specified interest rate for variable-rate financial instruments or forecasted issuances or purchases of variable-rate financial instruments; or
    - changes in the benchmark interest
- **Nonfinancial assets and liabilities** *(section 2.4)*
  - Not applicable.
Section 5.4 discusses the eligibility criteria for hedged risks that are specific to cash flow hedges, including:

- contractually specified component price risk for nonfinancial items;
- interest rate risk on the forecasted issuance or purchase of debt instruments; and
- changing the hedged risk.

**Foreign currency risk.** For further guidance on hedging foreign currency risk, see chapter 7.
Section 5.5 discusses the eligibility criteria of hedging instruments that are specific to cash flow hedges, including:

- special rule for basis swaps; and
- limitations on mixed-attribute derivative commodity contracts.

**Criterion 4: Hedge effectiveness (chapter 9)**

A derivative hedging instrument can qualify as a hedging instrument only if the entity expects the instrument to be (and the instrument actually is) effective at offsetting changes in cash flows of the hedged transaction.

**Criterion 5: Formal documentation for cash flow hedges**

<table>
<thead>
<tr>
<th>Formal documentation requirements for all hedges</th>
<th>Formal documentation requirements specific to cash flow hedges</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>(section 2.9)</em></td>
<td><em>(section 2.9.60)</em></td>
</tr>
</tbody>
</table>
### 5.2 Objective of a cash flow hedge

Cash flow hedges are structured to reduce or eliminate variability in expected future cash flows due to changes in variable rates or prices. A cash flow hedge is designed to ensure that the amount and timing of those cash flows are either fixed or will change in a single direction (i.e. only increase or decrease).

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 interest rate.

The following are common examples of cash flow exposures and hedging strategies.

<table>
<thead>
<tr>
<th>Hedged transaction</th>
<th>Cash flow exposure / hedged risk</th>
<th>Hedging strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Recognized assets and liabilities</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Variable-rate assets | Exposure to variability in interest receipts. | — 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.  
— Lock in a minimum yield by purchasing an interest rate floor option. |
| Variable-rate liabilities | Exposure to variability in interest payments. | — 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.  
— Lock in a maximum cost of funds by purchasing an interest rate cap option. |
| **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 | Exposure to variability in market interest rates to date of issuance. | Fix the interest rate on the forecasted issuance of debt by entering into an interest rate lock agreement or forward-starting interest rate swap. |
| Forecasted issuance of a variable-rate debt | Exposure to variability in contractually specified interest rates to date of issuance. | Fix the interest rate on the forecasted issuance of debt by entering into an interest rate lock agreement or forward-starting interest rate swap. |
### 5.3 Eligibility of hedged transactions

<table>
<thead>
<tr>
<th>Hedged transaction</th>
<th>Cash flow exposure / hedged risk</th>
<th>Hedging strategy</th>
</tr>
</thead>
</table>
| **Forecasted purchase of inventory** | — Exposure to variability in market prices to date of purchase.  
— Exposure to variability in market prices of a contractually specified component to date of purchase. | Lock in the cost of a forecasted purchase price of inventory, or a contractually specified component, by entering into a forward contract to purchase inventory or the specific component. |
| **Forecasted sale of inventory** | — Exposure to variability in market prices to date of sale.  
— Exposure to variability in market prices of a contractually specified component to date of sale. | Lock in the sales price of inventory, or a contractually specified component, by entering into a forward contract to sell inventory or the specific component. |

### 5.3.10 Basic requirements

**Excerpt from ASC 815-20**

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-13 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 either of the following:

- Foreign currency risk. For guidance on the eligibility of hedged transactions in a cash flow hedge of foreign currency risk, see section 7.6.10.
5. Qualifying criteria for cash flow hedges

a. An existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt)
b. A forecasted transaction (such as a forecasted purchase or sale).

Note that the glossary definition of transaction is intended to clearly distinguish a transaction from an internal cost allocation or an event that happens within an entity.

25-14 For purposes of this Subtopic and Subtopic 815-30, 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.

Cash flows from existing recognized assets or liabilities or forecasted transactions are eligible to be designated as the hedged transaction in a cash flow hedge.

In Topic 815 and throughout this publication, both the cash flows related to a recognized asset or liability and the cash flows related to a forecasted transaction are referred to as the forecasted transaction or the hedged transaction.

5.3.20 Forecasted transactions: Definition

Excerpt from ASC 815-20

20 Glossary

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.

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15 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:

a. The forecasted transaction is specifically identified as either of the following:
   1. A single transaction
   2. A group of individual transactions that share the same risk exposure for which they are designated as being hedged. A forecasted purchase and a forecasted sale shall not both be included in the same group of individual transactions that constitute the hedged transaction.

b. The occurrence of the forecasted transaction is probable.

c. The forecasted transaction meets both of the following conditions:
   1. It is a transaction with a party external to the reporting entity (except as permitted by paragraphs 815-20-25-30 and 815-20-25-38 through 25-40).
2. It presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

A forecasted transaction is essentially a future transaction that is probable and does not meet the definition of a firm commitment. A firm commitment is a (legally) binding agreement between unrelated parties that specifies all significant terms (e.g., quantity, fixed price) and includes a disincentive for nonperformance that is sufficiently large to make performance probable (see section 3.3.20). [815-20 Glossary]

Forecasted transactions are eligible only for cash flow hedge accounting, while firm commitments are generally eligible only for fair value hedge accounting.

Certain criteria must be met for a forecasted transaction to be eligible for designation as a hedged transaction.

**Does forecasted transaction meet eligibility criteria for cash flow hedges?**

(all criteria must be met)

- Must be specifically identified (section 5.3.30)
- Must be probable (section 5.3.40)
- Must be with a party external to the reporting entity (section 5.3.50)

**Question 5.3.10**

Can a contract that qualifies for the normal purchases and normal sales scope exception qualify as a hedged transaction?

**Excerpt from ASC 815-20**

>>> Normal Purchases and Normal Sales as Hedged Items or Transactions

25-7 A contract that is not subject to the requirements of Subtopic 815-10 because it qualifies for the normal purchases and normal sales scope exception may be designated as a hedged item in a fair value hedge, if the provisions of this Section are met. As the hedged item, the contract would be accounted for under fair value hedge accounting. Similarly, the purchase under that contract may be the hedged transaction in a cash flow hedge, if the provisions of paragraph 815-20-25-15 are met. For cash flow hedges, the special accounting applies to the hedging instrument, not to the purchase contract that is related to the hedged forecasted transaction.

**Interpretive response:** Yes. A contract that meets the definition of a derivative but qualifies for the normal purchases and normal sales exception in
Subtopic 815-10 (or any other scope exception in that Subtopic) is eligible to be designated as a hedged transaction.

In contrast, if the contract meets the definition of a derivative and does not meet any of the scope exceptions in Subtopic 815-10, it cannot be designated as a hedged transaction. Rather, it is accounted for as a derivative instrument.

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 entity over a reasonable period in the normal course of business. [815-10-15-22]

Although the requirements for a derivative instrument to qualify for this exception are beyond the scope of this publication, an instrument will not qualify for the exception unless it meets these minimum requirements: [815-10-15-22 – 15-51]

— the asset under the contract is delivered in quantities expected to be used or sold by the entity over a reasonable period in the normal course of business;
— 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 Question 5.4.50 for the requirements to meet this criterion); and
— the entity documents the designation of the contract as a normal purchase or a normal sale.

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 transaction in a cash flow hedge for the forecasted purchase or sale of the asset underlying the contract.

For an example of a contract not accounted for as derivative because the normal purchases and normal sales scope exception is met, see Example 5.4.30.

5.3.30 Forecasted transactions: Specific identification

> Excerpt from ASC 815-20

Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15(a) The forecasted transaction is specifically identified as either of the following:

1. A single transaction
2. A group of individual transactions that share the same risk exposure for which they are designated as being hedged. A forecasted purchase and a forecasted sale shall not both be included in the same group of individual transactions that constitute the hedged transaction.
Example 1: Designation and Documentation of Hedged Forecasted Transaction

55-80 This Example illustrates the requirement in paragraph 815-20-25-3(d)(1) for specific identification of the hedged transaction. Entity A determines with a high degree of probability that it will issue $5,000,000 of fixed-rate bonds with a 5-year maturity sometime during the next 6 months, but it cannot predict exactly when the debt issuance will occur. That situation might occur, for example, if the funds from the debt issuance are needed to finance a major project to which Entity A is already committed but the precise timing of which has not yet been determined. To qualify for cash flow hedge accounting, Entity A might identify the hedged forecasted transaction as, for example, the first issuance of five-year, fixed-rate bonds that occurs during the next six months.

To qualify for cash flow hedge accounting, an entity must specifically identify the single forecasted transaction (or group of transactions) that gives rise to the cash flow exposure that is being hedged. [815-20-25-15(a)]

Does forecasted transaction meet eligibility criteria for cash flow hedges? (all criteria must be met)

- Must be specifically identified
- Must be probable
- Must be with a party external to the reporting entity

The specifically identified transaction may be: [815-20-25-3(d)(1), 25-15(a)]

- the specific asset or liability for which the forecasted transaction relates; or
- the first cash flows received or paid to a specific amount in a particular period (without reference to the specific asset or liability) when hedging a group of similar forecasted transactions (see sections 5.3.60 and 5.3.70).

The key is that the designation is specific enough so that when the transaction occurs, it is clear whether that transaction is or is not the hedged transaction. [815-20-25-3(d)(1)]

Formal documentation. Topic 815 requires an entity to formally document certain details around the specifically identified forecasted transaction, including: [815-20-25-3(d)(1)]

- timing of when the forecasted transaction is expected to occur;
- specific asset or liability involved (if applicable); and
- the expected currency amount and/or the physical quantity (e.g. number of items or unit of measure).

For further guidance on the formal documentation requirements when hedging a forecasted transaction, see section 2.9.60.

Foreign currency risk. If the hedged forecasted transaction is denominated in a foreign currency, an entity needs to specify the exact amount of foreign currency being hedged. Hedges of foreign currency exposures are discussed in detail in section 7.6.30.
Hedging

5. Qualifying criteria for cash flow hedges

Future developments

At a March 2018 meeting, the FASB discussed potential Codification improvements that may extend an entity’s ability to change the hedged risk and/or the hedged forecasted transaction (see Question 5.4.90). This would include clarifying how broadly or narrowly the hedged transaction is defined and whether a change in the hedged risk constitutes a change in the hedged transaction. [FASB meeting 03-18]

5.3.40 Forecasted transactions: Probability

Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15 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: …

b. The occurrence of the forecasted transaction is probable.

>>> Timing and Probability of the Hedged Forecasted Transaction

25-16 Example 4 (see paragraph 815-20-55-88) illustrates that how the hedged forecasted transaction is designated and documented in a cash flow hedge is critically important in determining whether it is probable that the hedged forecasted transaction will occur. The following guidance expands on the timing and probability criteria in paragraphs 815-20-25-3 and 815-20-25-15(b): …

e. The term probable requires a significantly greater likelihood of occurrence than the phrase more likely than not.

f. The cash flow hedging model does not require that it be probable that any variability in the hedged transaction will actually occur—that is, in a cash flow hedge, the variability in future cash flows must be a possibility, but not necessarily a probability. However, the hedging derivative must be highly effective at achieving offsetting cash flows whenever that variability in future interest does occur.

>>>>> Probability of a Forecasted Transaction

55-24 An assessment of the likelihood that a forecasted transaction will take place (see paragraph 815-20-25-15(b)) should not be based solely on management’s intent because intent is not verifiable. The transaction’s probability should be supported by observable facts and the attendant circumstances. Consideration should be given to the following circumstances in assessing the likelihood that a transaction will occur.

a. The frequency of similar past transactions

b. The financial and operational ability of the entity to carry out the transaction
c. Substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity)
d. The extent of loss or disruption of operations that could result if the transaction does not occur
e. The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to a common stock offering).

To qualify for cash flow hedge accounting, a forecasted transaction needs to be probable. [815-20-15(b)]

Does forecasted transaction meet eligibility criteria for cash flow hedges? (all criteria must be met)

- Must be specifically identified
- Must be probable
- Must be with a party external to the reporting entity

Topic 815 defines probable as ‘the future event or events are likely to occur.’ The term ‘probable’ requires a significantly greater likelihood of occurrence than the phrase ‘more likely than not’. [815-20-15(e)]

The assessment of the likelihood that a transaction will occur is not based solely on management’s intent, but rather is supported by observable facts and circumstances. This is illustrated in Example 5.3.10. [815-20-55-24]

In addition to the considerations in paragraph 815-20-55-24, Topic 815 provides guidance to consider when assessing the timing and probability of forecasted transactions: [815-20-25-16]

- time until forecasted transaction is expected to occur;
- quantity of forecasted transaction;
- effect of counterparty creditworthiness;
- probability of forecasted acquisition of a marketable debt security; and
- uncertainty of timing within a range.

Each of these topics is discussed in the subsections that follow.

Formal documentation. In its formal hedge documentation, an entity should specify the circumstances that were considered in concluding that a transaction is probable. For further guidance on the formal documentation requirements when hedging a forecasted transaction, see section 2.9.60.
Does a change in the probability assessment of a hedged transaction affect the ability to apply hedge accounting?

Interpretive response: Yes. A change in the probability of the forecasted transaction may affect whether the hedging relationship remains eligible for hedge accounting. For further discussion, see Question 2.10.10 and 6.5.20.

If an entity has a pattern of determining that it is probable that hedged forecasted transactions will not occur, the appropriateness of management’s previous assertions and its ability to make future assertions regarding forecasted transactions may be called into question. [815-30-40-5]

Example 5.3.10
Probability of transaction to purchase steel

ABC Corp. produces consumer goods called widgets.

The CEO recently decided to expand its operations to include the manufacturing of the equipment used to produce widgets. This will require Board approval for the change in business strategy.

This change will require ABC to purchase steel to manufacture the equipment. ABC has not purchased steel before, but has several possible suppliers. It expects to purchase steel from Steelco within six months but does not have a firm commitment with Steelco. ABC wants to lock in the purchase price of the steel.

Can ABC designate the overall changes in cash flows related to the forecasted purchase of steel as a hedged transaction?

It depends. ABC needs verifiable evidence to conclude the transaction is probable before it is eligible to be designated as a hedged transaction.

There are certain facts that could make it difficult to assert that the transaction is probable, including:

- there are no past purchases of steel;
- if the Board doesn’t approve the strategy change, ABC will not be able to carry out the transaction; and
- ABC could decide to purchase the equipment instead of manufacturing it in-house.

However, ABC may be able to provide other observable information to support its assertion that the forecasted purchase of steel is probable.
5. Qualifying criteria for cash flow hedges

### Time until transaction occurs and quantity of transaction

**Excerpt from ASC 815-20**

#### >>> Probability of a Forecasted Transaction

**55-25** Both the length of time until a forecasted transaction is projected to occur and the quantity of the forecasted transaction are considerations in determining probability. Other factors being equal, the more distant a forecasted transaction is or the greater the physical quantity or future value of a forecasted transaction, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be required to support an assertion that it is probable.

Both the length of time until a forecasted transaction is projected to occur and the quantity of the forecasted transaction is considered in determining probability. [815-20-55-25]

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. Or for an entity whose historical sales volumes are closer to 1,000 units per month, forecasted sales of 1,000 units in a particular month may be more likely than forecasted sales of 2,500 units in that month.

### Effect of counterparty creditworthiness on probability

**Excerpt from ASC 815-20**

#### >>> Timing and Probability of the Hedged Forecasted Transaction

**25-16(a)** Effect of counterparty creditworthiness on probability. An entity using a cash flow hedge shall assess the creditworthiness of the counterparty to the hedged forecasted transaction in determining whether the forecasted transaction is probable, particularly if the hedged transaction involves payments pursuant to a contractual obligation of the counterparty.

When assessing the probability that a transaction will occur, an entity should also consider the effect of counterparty creditworthiness. A counterparty to a transaction may fail to comply with the contractual terms of an agreement because of credit problems or other reasons. [815-20-25-16(a)]

An entity should assess the likelihood that the counterparty will make the contractual payments or deliveries.

**Hedge effectiveness.** In addition, an entity’s own creditworthiness and risk of nonperformance is relevant in its hedge effectiveness assessments. For further discussion of how counterparty credit risk and the entity’s own nonperformance risk may affect the effectiveness of a hedging relationship, see section 9.2.60.
5. Qualifying criteria for cash flow hedges

Probability of forecasted acquisition of a marketable debt security

Excerpt from ASC 815-20

>>> Timing and Probability of the Hedged Forecasted Transaction

25-16(b) Probability of forecasted acquisition of a marketable debt security. To qualify for cash flow hedge accounting for an option designated as a hedge of the forecasted acquisition of a marketable debt security, an entity must be able to establish at the inception of the hedging relationship that the acquisition of the marketable debt security is probable, without regard to the means of acquiring it. In documenting the hedging relationship, the entity shall specify the date on or period within which the forecasted acquisition of the security will occur. The evaluation of whether the forecasted acquisition of a marketable debt security is probable of occurring shall be independent of the terms and nature of the derivative instrument designated as the hedging instrument. Specifically, in determining whether an option designated as a hedge of the forecasted acquisition of a marketable debt security may qualify for cash flow hedge accounting, the probability of the forecasted transaction being consummated shall be evaluated without consideration of whether the option designated as the hedging instrument has an intrinsic value other than zero.

>>>> Forecasted Acquisition of a Marketable Debt Security

55-27 This discussion provides additional information on the forecasted acquisition of a marketable debt security as a hedged item (see paragraph 815-20-25-16[b]).

55-28 An entity seeking to reduce the variability of the price at which it will acquire a marketable debt security in the future might use a forward contract to fix the price today.

55-29 With a forward contract, the typical settlement is the delivery of the marketable debt security at a later date at the pre-fixed price.

55-30 With a purchased option, the typical settlement might be the delivery of the marketable debt security at the ceiling price, or the holder may allow the purchased option to expire unexercised.

55-31 Therefore, to qualify for cash flow hedge accounting in this circumstance, the entity shall be able to establish that it is probable that it will acquire the marketable debt security by any of the following means:

a. Exercising the option designated as the hedging instrument if it is in the money
b. Purchasing the security in the marketplace at its prevailing market price if the option is out of the money.

55-32 If the entity expects to acquire the marketable debt security only by exercising the option and only if the option were in the money, a cash flow hedging relationship typically would not be designated because acquisition of the security is contingent and thus would not be considered probable.
An entity may designate a purchased option or warrant as the hedging instrument in a cash flow hedge of the forecasted acquisition of the marketable security to which the option or warrant relates (i.e. the forecasted transaction).

To qualify for cash flow hedge accounting, the forecasted transaction needs to be probable. The evaluation of whether the forecasted acquisition of the marketable security is probable must be independent of the hedging instrument. Specifically, an entity needs to assert that the marketable debt security will be purchased regardless of whether the option or warrant is in the money. [815-20-25-16(b), 55-32]

Example 5.3.20
Assessing the probability of the forecasted acquisition of a marketable debt security

ABC Corp. purchases an option contract that gives it the right to purchase a marketable debt security at a fixed price. ABC would like to designate the option as a cash flow hedge of the variability in cash flows associated with the forecasted purchase of the marketable debt security.

ABC establishes it is probable that it will acquire the security by either:

— exercising the option designated as the hedging instrument if it is in the money; or
— purchasing the security at its prevailing market price if the option is out of the money.

Therefore, the forecasted acquisition of the marketable debt security is considered probable and eligible for cash flow hedge accounting.

Alternatively, if ABC determines the marketable debt security would be acquired only on exercise of the option (i.e. option is in the money), it is probable the forecasted acquisition will not occur and therefore the transaction is not eligible for cash flow hedge accounting. This is because the acquisition of the security is contingent on the market price of the security.

Uncertainty of timing within a range

Excerpt from ASC 815-20

>>> Timing and Probability of the Hedged Forecasted Transaction

25-16(c) Uncertainty of timing within a range. For forecasted transactions whose timing involves some uncertainty within a range, that range could be documented as the originally specified time period if the hedged forecasted transaction is described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. As long as it remains probable that a forecasted transaction will occur by the end of the originally specified time period, cash flow hedge accounting for that hedging relationship would continue. See paragraph 815-30-40-4 for related
guidance and Example 5 (see paragraph 815-20-55-100), which illustrates the application of this paragraph.

25-16(d) Importance of timing in both documentation and hedge effectiveness. Although documenting only the period within which the forecasted transaction will occur is sufficient to comply with the requirements of paragraph 815-20-25-3, compliance with Section 815-20-35 and paragraph 815-20-25-75(b) requires that the best estimate of the forecasted transaction’s timing be both documented and used in assessing hedge effectiveness. As explained in paragraphs 815-20-25-84 and 815-20-25-120 through 25-121, the time value of money is likely to be important in the assessment of cash flow hedge effectiveness, especially if the entity plans to use a rollover or tailing strategy to hedge its forecasted transaction. The use of time value of money requires information about the timing of cash flows.

>>>> Specificity to Timing of a Forecasted Transaction

55-26 Paragraph 815-20-25-3(d)(1)(vi) requires an entity to identify the hedged forecasted transaction with sufficient specificity to make it clear whether a particular transaction is a hedged transaction when it occurs. Paragraph 815-20-25-3(d)(1)(i) requires that an entity document the date on or period within which the forecasted transaction is expected to occur. An entity should not be able to choose when to reclassify into earnings a gain or loss on a hedging instrument in accumulated other comprehensive income after the gain or loss has occurred by asserting that the instrument hedges a transaction that has or has not yet occurred. However, this Subtopic does not require that an entity be able to specify at the time of entering into a hedge the date on which the hedged forecasted transaction will occur.

Topic 815 requires an entity to specify and document the date or period within which the forecasted transaction is expected to occur. If a forecasted transaction is expected to occur within a timeframe, but the date within that timeframe is uncertain, an entity may document a range of time to comply with this requirement. [815-20-25-3(d)(1), 25-16(c)]

This flexibility allows some forecasted transactions with uncertain timing to be considered probable within a range. For example, an entity could document that a hedged forecasted transaction is a foreign currency denominated payment to a subcontractor to be paid within a five-year contract period for a construction project. As long as it remains probable that the forecasted transaction will occur by the end of the originally projected five-year period, cash flow hedge accounting could continue assuming all other eligibility criteria are met. [815-20-55-102]

Hedge effectiveness. More precision is likely required to assess effectiveness of a forecasted transaction when using an estimated period. This is because the time value of money is likely to be important in the assessment of cash flow hedge effectiveness (see section 9.2.110), especially if an entity plans to use a rollover or tailing strategy. In those analyses, cash flow estimates need to involve estimating points in time when those cash flows will occur. [815-20-25-16(d)]

However, an entity may elect to exclude the forward points/time value component of a derivative from the effectiveness assessment. For guidance on
excluding certain components of a hedging instrument’s cash flows from the effectiveness assessment, see section 9.2.70.

**Question 5.3.30**

*Does a change in the expected timing of a forecasted transaction affect the ability to apply hedge accounting?*

**Interpretive response:** It depends. If the expected timing of a forecasted transaction changes, but is still within the range originally documented, an entity will need to assess effectiveness based on a newly revised best estimate of the cash flows. If it is no longer probable that the forecasted transaction will occur within the originally specified time period, the transaction no longer qualifies for hedge accounting (see Question 2.10.10 and section 6.5.20).

**Hedge effectiveness.** An entity must document and use its best estimate of timing of the forecasted transaction, which needs to be more specific than the period used to support the probability that the forecasted transaction will occur. This could lead to situations where – at some point during the hedge period – it remains probable that the forecasted transaction will occur within the specified time range, but the hedge is no longer highly effective due to changes in the expected timing of the forecasted transaction. Additionally, circumstances may change over time causing the expected timing used in effectiveness assessments to change, even though the revised expected timing would still be within the original range. The entity would have to consider that change because the change would likely affect the assessment of effectiveness.

**FASB Example: Hedged forecasted transaction when timing involves some uncertainty within a range**

The FASB example below illustrates a hedged forecasted transaction that has uncertainty of timing within a range.

**Excerpt from ASC 815-20**

**Example 5: Hedged Forecasted Transaction When Timing Involves Some Uncertainty within a Range**

55-100 This Example Illustrates the application of paragraph 815-20-25-16(c).

55-101 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 entity with a functional currency different from its own. 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 Year 2. 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 by a period of more than two months, 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 (that is, a two-year foreign currency forward) and the expected notional amount of the forecasted transaction.

55-102 The general contractor could document (as required by paragraph 815-20-25-3(d)(1)) 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 (which is the originally specified time period referred to in paragraphs 815-30-40-4 through 40-5). In accordance with paragraph 815-20-25-16(c), as long as it remains probable that the forecasted transaction will occur by the end of the originally projected five-year period of the overall project, cash flow hedge accounting for that hedging relationship would continue. Consequently, if the subcontractor’s payment is delayed by more than two months, but less than three years and two months, then the forecasted transaction would still be considered probable of occurrence within the originally specified time period.

55-103 If the expected timing of the forecasted transaction changes, the contractor must first apply the requirements of paragraph 815-30-35-3 using its originally documented hedging strategy and the newly revised best estimate of the cash flows, and then reevaluate whether continuing hedge accounting is appropriate, pursuant to the requirements of paragraphs 815-30-40-1 through 40-3. If hedge accounting is discontinued prospectively, the derivative instrument’s gains or losses in other comprehensive income should be accounted for pursuant to paragraphs 815-30-35-38 through 35-41 (unless paragraphs 815-30-40-4 through 40-5 require reclassification into earnings).

55-104 If a quantitative assessment of hedge effectiveness is applied and the assessment of effectiveness is based on changes in forward rates, the most recent best estimate would be based on the current forward rate for the hedged transaction relevant for the probable date that the transaction will occur. If the assessment of effectiveness is based on changes in spot rates, the best estimate would be based on the current spot rate.

5.3.50 Forecasted transactions: Party external to the reporting entity

Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15(c) The forecasted transaction meets both of the following conditions:

1. It is a transaction with a party external to the reporting entity (except as permitted by paragraphs 815-20-25-30 and 815-20-25-38 through 25-40).
2. It presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

For a forecasted transaction to qualify as a hedged transaction, it generally needs to be a transaction with a party external to the reporting entity. [815-20-25-15(c)(1)]

**Does forecasted transaction meet eligibility criteria for cash flow hedges?**

- Must be specifically identified
- Must be probable
- Must be with a party external to the reporting entity

Therefore, transactions between a parent and its consolidated subsidiaries do not qualify for hedge accounting at the consolidated level.

**Foreign currency risk.** Topic 815 provides an exception allowing cash flow hedges of foreign currency risk to hedge forecasted intercompany foreign currency denominated transactions (see section 7.3.40). [815-20-25-43(b)(4)]

However, a subsidiary may apply cash flow hedge accounting to a forecasted transaction in its stand-alone financial statements if the transaction is with a ‘party external to the reporting entity’ in the stand-alone financial statements.

**Question 5.3.40**

**What is the difference between a ‘party external to the reporting entity’ and an ‘unrelated party’?**

**Interpretive response:** To qualify as a hedged transaction, a forecasted transaction needs to be with a ‘party external to the reporting entity’. [815-20 Glossary, 815-20-25-15(c)(1)]

We believe using the term ‘party external to the reporting entity’ limits the prohibition on hedging forecasted transactions only to transactions with entities that are 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 from being forecasted transactions in a cash flow hedge. This assumes the effects of the forecasted transaction will not be eliminated or the forecasted transaction is not specifically prohibited (e.g. forecasted sale of an equity method investment) and all other criteria are met.

**Firm commitments.** In contrast, a firm commitment needs to be between two ‘unrelated parties’. [815-20 Glossary]

Topic 815 does not define an ‘unrelated party.’ However, we believe the term ‘related party’ generally includes all parties specified in Topic 850 (related parties).
As a result, we believe transactions with parties such as equity method investees, affiliates, unconsolidated joint ventures, shareholders and directors are precluded from being firm commitments.

### 5.3.60 Group of similar forecasted transactions

<table>
<thead>
<tr>
<th>Excerpt from ASC 815-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Hedged Transaction Criteria Applicable to Cash Flow Hedges Only</strong></td>
</tr>
<tr>
<td><strong>25-15(a)</strong> The forecasted transaction is specifically identified as either of the following:</td>
</tr>
<tr>
<td>1. A single transaction</td>
</tr>
<tr>
<td>2. A group of individual transactions that share the same risk exposure for which they are designated as being hedged. A forecasted purchase and a forecasted sale shall not both be included in the same group of individual transactions that constitute the hedged transaction.</td>
</tr>
</tbody>
</table>

#### >>> Grouping Individual Transactions

**55-20** It sometimes will be impractical (perhaps impossible) and not cost-effective for an entity to identify each individual transaction that is being hedged. An example is a group of sales or purchases over a period of time to or from one or more parties. This Subtopic permits an entity to aggregate individual forecasted transactions for hedging purposes in some circumstances. As it does for a hedge of a single forecasted transaction, paragraph 815-20-25-3(d)(1)(vi) requires that an entity identify the hedged transactions with sufficient specificity that it is possible to determine which transactions are hedged transactions when they occur.

**55-21** For example, an entity that expects to sell at least 300,000 units of a particular product in its next fiscal quarter might designate the sales of the first 300,000 units as the hedged transactions. Alternatively, it might designate the first 100,000 sales in each month as the hedged transactions. It could not, however, simply designate any sales of 300,000 units during the quarter as the hedged transaction because it then would be impossible to determine whether the first sales transaction of the quarter was a hedged transaction. Similarly, an entity could not designate the last 300,000 sales of the quarter as the hedged transaction because it would not be possible to determine whether sales early in the quarter were hedged or not.

**55-22** Under the guidance in this Subtopic, a single derivative instrument of appropriate size could be designated as hedging a given amount of aggregated forecasted transactions, such as any of the following:

- a. Forecasted sales of a particular product to numerous customers within a specified time period, such as a month, a quarter, or a year
- b. Forecasted purchases of a particular product from the same or different vendors at different dates within a specified time period
- c. Forecasted interest payments on several variable-rate debt instruments within a specified time period.
55-23 At the time of hedge designation only, the transactions in each group must share the risk exposure for which they are being hedged. For example, the interest payments in the group in (c) in the preceding paragraph shall vary with the same index to qualify for hedging with a single derivative instrument.

For a group (rather than an individual transaction) to be designated as the hedged transaction, 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.

Similar to a single forecasted transaction, a group of transactions must be identified with sufficient specificity so that it is possible to determine which transactions are the hedged transactions when they occur. The specifically identified group of transactions may be:

— a specific group of assets or liabilities for which the forecasted transaction relates; or
— the first cash flows received or paid up to a specific amount in a particular period (without reference to the specific asset or liability).

For example, an entity expects to sell at least 300,000 units of a particular product in its next fiscal quarter. [815-20-25-21]

<table>
<thead>
<tr>
<th>Is the designation specific enough to qualify for hedge accounting?</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Specific group of assets or liabilities to which forecasted transaction relates</strong></td>
<td>Sales of the first 300,000 units</td>
<td>Any sales of 300,000 units during the quarter</td>
</tr>
<tr>
<td><strong>First cash flows received or paid to a specific amount in a particular period</strong></td>
<td>Sales of the first 100,000 units in each month</td>
<td>Sales of the last 300,000 units</td>
</tr>
</tbody>
</table>

The entity could not designate any sales of 300,000 units during the quarter as the hedged transaction because it would be impossible to determine whether an individual sale during the quarter was a hedged transaction. In addition, the entity could not designate the last 300,000 sales because it would not be possible to determine whether sales during the quarter were hedged until the quarter had ended.

**Future developments**

At a March 2018 meeting, the FASB discussed potential Codification improvements that may extend an entity’s ability to change the hedged risk and/or the hedged forecasted transaction (see Question 5.4.90). This would include clarifying how broadly or narrowly the hedged transaction is defined and whether a change in the hedged risk constitutes a change in the hedged transaction. [FASB meeting 03-18]
For example, future amendments may be provide entities with the ability to retrospectively designate a particular transaction as the hedged transaction, within certain parameters. This may give an entity the ability to determine which purchases or sales were hedged in a prior reporting period. In other words, an entity may not have to know which transactions are the hedged transactions when they occur.

Question 5.3.50
Can both forecasted purchases and sales be included in a group for hedge accounting?

Interpretive response: No. A hedged group of transactions cannot include both cash inflows and outflows, such as forecasted purchases and sales. Although the forecasted purchases and sales may be based on the same underlying, they have opposite exposures. [815-20-25-15(a)(2)]

Question 5.3.60
How does an entity assess whether forecasted transactions of nonfinancial assets or liabilities share similar risk exposure?

Interpretive response: Individual transactions in the hedged portfolio need to share the same risk exposure for which they are designated as being hedged. For nonfinancial assets and liabilities, the designated risk being hedged is either:

- all changes in the purchase price or sales price of the asset (i.e. price risk);
- changes in a contractually specified component (i.e. component price risk).

The different risk exposures require different qualitative and quantitative considerations.

<table>
<thead>
<tr>
<th>Risk</th>
<th>Qualitative considerations</th>
<th>Quantitative considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price risk</td>
<td>For forecasted purchases or sales of nonfinancial assets to be considered similar when hedging price risk, we believe the purchases or sales need to first involve the same asset of the same grade. Therefore, forecasted purchases or sales of individually unique assets would not qualify for aggregation. An entity should also consider whether the physical location of individual transactions in a group affects whether they share similar risk exposure. For example, purchasing jet fuel in the United States may have risk exposures.</td>
<td>An entity also needs to demonstrate that the forecasted transactions are expected to be similar based on changes in the overall market price of the forecasted purchases or sales, including the asset’s physical location (see Question 9.2.20). We believe the quantitative assessment of similar risks for fair value hedges can be used for cash flow hedges (see section 3.3.40).</td>
</tr>
</tbody>
</table>
### Risk Qualifying criteria for cash flow hedges

<table>
<thead>
<tr>
<th>Risk</th>
<th>Qualitative considerations</th>
<th>Quantitative considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Component price risk</td>
<td>We believe individual purchases or sales of different asset grades or in different locations may be considered similar in a hedge of a contractually specified component if each of the transactions is based on the identical contractually specified component. For example, an entity may determine that individual purchases of different plastic grades have exposure to changes in the same contractually specified plastic index. For an illustration of grouping forecasted purchases when hedging component price risk, see Subtopic 815-30’s Example 23 later in this section.</td>
<td>Because each transaction within a group needs to be based on the identical contractually specified component, the forecasted transactions are expected to be similar. This is because all items in the group share the same risk exposure to the contractually specified component. Therefore, we believe performing a quantitative assessment of similar risks is not necessary.</td>
</tr>
</tbody>
</table>

### Example 5.3.30

**Forecasted purchases of fuel when hedging price risk – similarity assessment**

This is a continuation of Example 2.9.50. For ease of reference, key facts from that example are summarized below.

Freight Co. purchases both jet fuel and diesel fuel at various locations across the US and internationally.

<table>
<thead>
<tr>
<th>Types of fuel</th>
<th>Locations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jet fuel</td>
<td>NY Harbor</td>
</tr>
<tr>
<td>Diesel fuel</td>
<td>US Gulf Coast</td>
</tr>
<tr>
<td></td>
<td>LA</td>
</tr>
<tr>
<td></td>
<td>Singapore</td>
</tr>
<tr>
<td></td>
<td>Rotterdam</td>
</tr>
</tbody>
</table>

**Hedged risk.** Freight wants to hedge its exposure to variability in the overall cash outflows (i.e. price risk) for the purchase of fuel due to changes in spot prices at various locations.
Hedging transaction. The hedged forecasted transaction is defined as the first purchases of gallons of fuel over the 30-day period beginning on the first day of the month in which the derivative contract matures/settles that:

1. in aggregate represent the number of gallons (or equivalent barrels) equal to the notional amount of the hedging instrument; and
2. 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.

Assessing similarity of individual forecasted purchases within the group

The overall price of a gallon of fuel is significantly affected by both the type of fuel and the location of the purchase. Therefore, Freight expects purchases of jet fuel to have risk exposure different from purchases of diesel fuel. Furthermore, fuel purchased at different locations may have different risk exposures.

Only individual forecasted purchases that are similar to the risk being hedged can be included within the same hedging relationship. Freight preliminarily identifies transactions within each of the following groups as having similar risk exposure, based first by type of fuel and then more specifically by location:

- Group 1: Jet fuel; NY Harbor, US Gulf Coast, LA
- Group 2: Jet fuel; Singapore, Rotterdam
- Group 3: Diesel fuel; NY Harbor, US Gulf Coast
- Group 4: Diesel fuel; LA

To demonstrate that each group is similar, Freight performs a regression analysis to show that the changes in expected prices for the purchases of fuel at each location within the group are highly correlated with each other.

Because similarity is assessed at both inception and on an ongoing basis, Freight will update its analysis each time the hedging relationships are assessed for effectiveness (i.e. on a quarterly basis). Freight will also monitor both jet fuel and diesel fuel prices by location on a weekly basis for changes in general price trends to determine whether it needs to reconsider its similarity test.

Hedge effectiveness. For the forecasted transactions to qualify for hedge accounting, Freight also needs to demonstrate that the hedging instrument is highly effective at hedging the overall price risk for each individual group. Example 9.6.20 continues this example, illustrating regression analysis to quantitatively assess effectiveness for a cash flow hedge of total price risk for a group of similar transactions.
FASB Example: Cash flow hedge of a forecasted purchase of inventory for which commodity exposure is managed centrally

Excerpt from ASC 815-30

>> Example 23: Designation of a Cash Flow Hedge of a Forecasted Purchase of Inventory for Which Commodity Exposure Is Managed Centrally

55-142 This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to the designation of a cash flow hedge of a forecasted purchase of inventory in which the commodity exposure is managed centrally at the aggregate level. Assume the entity elects to perform subsequent assessments of hedge effectiveness on a qualitative basis and all hedge documentation requirements were satisfied at inception.

55-143 Entity Q is seeking to hedge the variability in cash flows associated with commodity price risk of its monthly plastic purchases for the next 12 months. It has two different manufacturing plant locations (Plant A and Plant B) that are purchasing five different grades of plastic from Supplier A. The plastic purchase price for each month is based on the month-end Joint Plastic (JP) index and a fixed basis differential component. The fixed basis differential offered by the supplier is determined by:

a. The grade of the plastic purchased
b. The distance between the plant location and supplier location.

55-144 At January 1, 20X1, Entity Q enters into a supply agreement with Supplier A to purchase plastic over the next 12 months. The respective agreements allow Entity Q to purchase the various grades of plastic at both of its plant locations as the need arises over the following year. The following table summarizes the pricing provisions contained in the supply agreement for each grade of plastic.

<table>
<thead>
<tr>
<th></th>
<th>Grade 1</th>
<th>Grade 2</th>
<th>Grade 3</th>
<th>Grade 4</th>
<th>Grade 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant A</td>
<td>JP + $0.14</td>
<td>JP + $0.11</td>
<td>JP + $0.09</td>
<td>JP + $0.05</td>
<td>JP – $0.02</td>
</tr>
<tr>
<td>Plant B</td>
<td>JP + $0.16</td>
<td>JP + $0.12</td>
<td>JP + $0.07</td>
<td>JP + $0.06</td>
<td>JP – $0.03</td>
</tr>
</tbody>
</table>

55-145 Entity Q’s risk management objective is to hedge the variability in the purchase price of plastic attributable to changes in the JP index of the first 80,000 pounds of plastic purchased in each month regardless of grade or plant location delivered to. To accomplish this objective, Entity Q executes 12 separate forward contracts at January 1, 20X1, to purchase plastic as follows.
5. Qualifying criteria for cash flow hedges

<table>
<thead>
<tr>
<th>Settlement Date</th>
<th>Notional Amount</th>
<th>Underlying Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan forward</td>
<td>January 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Feb forward</td>
<td>February 28, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Mar forward</td>
<td>March 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>April forward</td>
<td>April 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>May forward</td>
<td>May 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>June forward</td>
<td>June 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>July forward</td>
<td>July 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Aug forward</td>
<td>August 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Sep forward</td>
<td>September 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Oct forward</td>
<td>October 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Nov forward</td>
<td>November 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Dec forward</td>
<td>December 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
</tbody>
</table>

55-146 Entity Q determines that the variable JP index referenced in the supply agreement constitutes a contractually specified component and that the requirements to designate variability in the cash flows attributable to changes in a contractually specified component as the hedged risk in paragraph 815-20-25-22A are met.

55-147 Because Entity Q determined that it will purchase at least 80,000 pounds of plastic each month in the coming 12 months to fulfill its expected manufacturing requirements, it documents that the hedged item (that is, the forecasted transaction within each month) is probable of occurring. Entity Q designates each forward contract as a cash flow hedge of the variability in cash flows attributable to changes in the contractually specified JP index on the first 80,000 pounds of plastic purchased (regardless of grade or plant location delivered to) for the appropriate month. The individual purchases of differing grades of plastic by Plant A and Plant B during each month share the risk exposure to the variability in the purchase price of the plastic attributable to changes in the contractually specified JP index. Therefore, the individual transactions in the hedged portfolio of plastic purchases for each month share the same risk exposure for which they are designated as being hedged in accordance with paragraph 815-20-25-15(a)(2).

55-148 In accordance with paragraph 815-20-25-3(b)(2)(iv)(01)(B), if Entity Q has determined the critical terms of the hedged item and hedging instrument match, it may elect to assess effectiveness qualitatively both at inception of the hedging relationship and on an ongoing basis on the basis of the following factors in accordance with paragraphs 815-20-25-84 through 25-85:

a. The hedging instrument’s underlying matches the index upon which plastic purchases will be determined (that is, the JP Index).
b. The notional of the hedging instrument matches the forecasted quantity designated as the hedged item.
c. The date on which the derivatives mature matches the timing in which the forecasted purchases are expected to be made. That is, the quantity of the hedged item, 80,000 pounds, is an aggregate amount expected to be
purchased over the course of the respective month (that is, the same 31-day period) in which the derivative matures.

d. Each hedging instrument was traded with at-market terms (that is, it has an initial fair value of zero).

e. Assessment of effectiveness will be performed on the basis of the total change in the fair value of the hedging instrument.

f. Although the amount of plastic being hedged each period is a cumulative amount across multiple grades of plastic, the basis differentials between grades of plastic and location are not required to be included in assessments of effectiveness because Entity Q has designated the variability in cash flows attributable to changes in the JP index (the contractually specified component) as the hedged risk within its purchases of plastics.

5.3.70 Hedging a group of transactions: First-payments-received (paid) approach on a group of variable-rate loans

Excerpt from ASC 815-20

>>>> First-Payments-Received Technique in Hedging Variable Interest Payments on a Group of Loans

55-33A A first-payments-received technique for identifying the hedged forecasted transactions (that is, the hedged interest payments) may be used in a cash flow hedge of interest rate risk associated with interest payments for a rolling portfolio of prepayable interest-bearing loans (or other interest-bearing financial assets), provided all other conditions for a cash flow hedge have been met. Such a technique involves identifying the hedged forecasted transactions in a cash flow hedge as the first interest payments based on the contractually specified interest rate received by an entity during each recurring period of a specified length and beginning date for the period covered by the hedging instrument. Example 4, Case A (see paragraphs 815-20-55-91 through 55-96) illustrates this technique.

55-33B Similarly, a comparable first-payments-made technique may be used to identify the hedged forecasted transactions in a cash flow hedge of the contractually specified rate-based interest payments for a group of the reporting entity’s financial liabilities, provided all other conditions for a cash flow hedge have been met.

55-33E This implementation guidance regarding use of a first-cash-flows technique also may be applied to a cash flow hedging relationship in which the hedging instrument is a basis swap as discussed beginning in paragraph 815-20-25-50. However, use of that technique for those basis-swap hedging relationships may not be common because that paragraph limits designating a basis swap as the hedging instrument to cash flow hedges of the contractually specified interest payments of only recognized financial assets and liabilities existing at the inception of the hedge, whereas the first-cash-flows technique is typically applied to the contractually specified interest payments for rolling...
In a cash flow hedge of **interest rate risk**, an entity may use a first-payments-received (paid) approach for identifying the hedged forecasted transaction. This approach can be used for interest rate risk associated with interest payments for a rolling portfolio of prepayable interest-bearing loans, or other interest-bearing financial assets, provided all other conditions for a cash flow hedge are met.

When using this approach, the specifically identified group of transactions may be the first interest payments based on the contractually specified interest rate received by an entity during each recurring period of a specified length and beginning date for the period covered by the hedging instrument.

For example, an entity may specifically identify the hedged forecasted transaction as the first three-month LIBOR-based interest payments received each quarter for the next two years on its $100 million LIBOR-based loan.

See Example 4 in Subtopic 815-20 (reproduced below) for an illustration of hedging variable interest payments on a group of variable-rate loans.

**Question 5.3.70**

**Can the first-payments-received (paid) approach be used to hedge credit risk?**

**Interpretive response:** No. We believe 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 is permitted without affecting the original hedging relationship.

**Question 5.3.80**

**How does an entity assess whether the cash flows from variable-rate financial instruments share the same risk exposure?**

**Interpretive response:** Under the first-payments-received (paid) approach, an entity is hedging forecasted interest payments for a group of variable-rate financial instruments for exposure to changes in cash flows attributable to changes in an interest rate index (i.e. the contractually specified interest rate). Under this approach, each variable-rate financial instrument within the group must vary with the same interest rate index to qualify for hedge accounting with a single derivative instrument. [815-20-55-23]

Therefore, three-month LIBOR-based interest payments cannot be grouped with US Prime-based interest payments, even if a historical analysis of the movement in these rates indicates they are highly correlated.
We believe 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 a 30-day rate and an interest payment that varies on a 60-day rate would not vary with the same index. Therefore, they would not be eligible for grouping as a single hedged transaction.

However, in a March 2018 meeting, the FASB discussed potential Codification improvements related to an entity’s ability to change the hedged risk and whether that extends to the hedged forecasted transaction (see Question 5.4.90). These amendments may provide additional guidance that could affect our interpretation that each variable-rate financial instrument must have exactly the same index to be eligible for grouping in a portfolio hedge. As a result, revisions to this interpretive response may be provided in a future edition.

**Example 5.3.40**

**Group of variable-rate loans that do not share similar risk exposure**

Bank has a pool of variable-rate commercial mortgages. The interest rates on these mortgages are based on US Treasury, Canadian Treasury or LIBOR. A historical analysis of the movement in these rates indicates that they are highly correlated.

**Can Bank designate the pool of variable-rate commercial mortgages as the hedged transaction in a cash flow hedge of interest rate risk?**

No. The 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. Therefore, Bank cannot designate the pool of commercial mortgages with interest rates based on multiple indices as the hedged transaction in a cash flow hedge.

**FASB Example: Variable interest payments on a group of variable-rate, interest-bearing loans as hedged item**

**Excerpt from ASC 815-20**

**Example 4: Variable Interest Payments on a Group of Variable-Rate, Interest-Bearing Loans as Hedged Item**

55-88 The following Cases illustrate the implications of two different approaches to designation of variable interest payments on a group of variable-rate, interest-bearing loans:

a. Designation based on first payments received (Case A)
b. Designation based on a specific group of individual loans (Case B).
For Cases A and B, assume Entity A and Entity B both make to their respective customers London Interbank Offered Rate- (LIBOR-) indexed variable-rate loans for which interest payments are due at the end of each calendar quarter, and the 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. Both entities determine that they will each always have at least $100 million of those LIBOR-indexed variable-rate loans outstanding throughout the next 3 years, even though the composition of those loans will likely change to some degree due to prepayments, loan sales, and potential defaults.

This Example does not address cash flow hedging relationships in which the hedged risk is the risk of overall changes in the hedged cash flows related to an asset or liability, as discussed in paragraph 815-20-25-15(j)(1).

Case A: Designation Based on First Payments Received

In this Case, Entity A wishes to hedge its interest rate exposure to changes in the quarterly interest receipts on $100 million principal of those LIBOR-indexed variable-rate loans by entering into a 3-year interest rate swap that provides for quarterly net settlements based on Entity A receiving a fixed interest rate on a $100 million notional amount and paying a variable LIBOR-based rate on a $100 million notional amount.

In a cash flow hedge of interest rate risk, Entity A may identify the hedged forecasted transactions as the first LIBOR-based interest payments received by Entity A during each 4-week period that begins 1 week before each quarterly due date for the next 3 years that, in the aggregate for each quarter, are payments on $100 million principal of its then existing LIBOR-indexed variable-rate loans. The LIBOR-based interest payments received by Entity A after it has received payments on $100 million aggregate principal would be unhedged interest payments for that quarter.

The hedged forecasted transactions for Entity A in this Case are described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction.

Because Entity A has designated the hedging relationship as hedging the risk of changes attributable to changes in the LIBOR interest rate in Entity A’s first LIBOR-based interest payments received, any prepayment, sale, or credit difficulties related to an individual LIBOR-indexed variable-rate loan would not affect the designated hedging relationship.

Provided Entity A determines it is probable that it will continue to receive interest payments on at least $100 million principal of its then existing LIBOR-indexed variable-rate loans, Entity A can conclude that the hedged forecasted transactions in the documented cash flow hedging relationships are probable of occurring.

An entity may not assume perfect effectiveness in such a hedging relationship as described in paragraph 815-20-25-102 because the hedging relationship does not involve hedging the interest payments related to the same recognized interest-bearing loan throughout the life of the hedging relationship. Consequently, at a minimum, Entity A must consider the timing of the hedged cash flows vis-à-vis the swap’s cash flows when assessing effectiveness.
>>> Case B: Designation Based on a Specific Group of Individual Loans

55-97 In this Case, Entity B wishes to hedge its interest rate exposure to changes in the quarterly interest receipts on $100 million principal of those LIBOR-indexed variable-rate loans by entering into a 3-year interest rate swap that provides for quarterly net settlements based on Entity B receiving a fixed interest rate on a $100 million notional amount and paying a variable LIBOR-based rate on a $100 million notional amount. Entity B initially designates cash flow hedging relationships of interest rate risk and identifies as the related hedged forecasted transactions each of the variable interest receipts on a specified group of individual LIBOR-indexed variable-rate loans aggregating $100 million principal but then some of those loans experience prepayments, are sold, or experience credit difficulties.

55-98 This Case addresses whether the original cash flow hedging relationships 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 variable-rate interest-bearing loans. Entity B cannot conclude that the original cash flow hedging relationships have remained 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 originally specified loans with similar variable-rate interest-bearing loans. Paragraph 815-20-25-15(a) requires that, for a cash flow hedge, the forecasted transaction be specifically identified as a single transaction or group of transactions. At inception, the entity designated cash flow hedging relationships for each of the variable interest receipts on a specified group of variable-rate loans. If a loan within the group experiences a prepayment, has been sold, or experiences an unexpected change in its expected cash flows due to credit difficulties, the remaining hedged interest payments to Entity B specifically related to that loan are now no longer probable of occurring. Pursuant to paragraphs 815-30-40-1 through 40-3, Entity B must discontinue the hedging relationships with respect to the hedged forecasted transactions that are now no longer probable of occurring. However, had the hedged forecasted transactions been designated in a manner similar to that described in Case A, the consequences of a loan’s prepayment, a loan sale, or an unexpected change in a loan’s expected cash flows due to credit difficulties would not have been the same. How the forecasted transaction in a cash flow hedge is designated can have a significant effect on the application of the Derivatives and Hedging Topic.

55-99 Changing the composition of the specified individual loans within the group of variable-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 probability of the identified hedged forecasted transactions for the hedging relationships related to the individual loans removed from the group of variable-rate interest-bearing loans. Consequently, the hedging relationships for future interest payments that are no longer probable of occurring must be terminated. The provisions related to immediately reclassifying a derivative instrument’s gain or loss out of accumulated other comprehensive income into earnings are based on the hedged forecasted transaction being probable that it will not occur—not no longer being probable of occurring—and includes consideration of an additional two-month period of time. After the discontinuation of the hedging relationships for interest payments related to the individual loans removed
from the group of variable-rate interest-bearing loans and the reclassification into earnings of the net gain or loss in accumulated other comprehensive income related to those hedging relationships, the derivative instrument (or a proportion thereof) specifically related to the hedging relationships that have been terminated is eligible to be redesignated as the hedging instrument in a new cash flow hedging relationship. However, paragraph 815-30-40-5 warns that a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both the entity’s ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.

5.3.80 **Hedging a group of transactions: Layering with first-payments-received (paid) approach**

When hedging groups of forecasted transactions using a first-payments-received (paid) approach, an entity may choose to enter into multiple derivative contracts and layer these contracts such that each derivative is designated in a separate individual hedging relationship.

For example, 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 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.

The illustration below demonstrates an example layering approach where an entity identifies the hedged transactions in two separate hedging relationships.

This example is in the context of hedging interest receipts. However, the layering approach for first-payments-received (paid) can be applied to other forecasted transactions, including forecasted sales or expenses in a foreign currency, sales of nonfinancial items, etc.
Question 5.3.90

How does an entity specifically identify the forecasted transaction when using the layering approach for first-payments-received (paid)?

**Interpretive response:** For each hedging relationship within the layer, an entity should specifically identify the hedged forecasted transaction as the *first payments received (paid)* after:

1. cash flows identified as hedged forecasted transactions in an active hedging relationship; and
2. probable cash flows previously identified in a hedging relationship that was terminated (i.e. is inactive), such that some portion of the gain or loss on the dedesignated hedging relationship remains in AOCI.

We believe that using this layering approach meets all the requirements in Topic 815 to identify – for each of the individual hedging relationships – the transaction being hedged can be identified when it occurs.

**Formal documentation.** An entity is required to apply a hedge documentation approach that considers the ‘priority chain’ when designating forecasted transactions. This is because complexities arise when an entity is:

- actively managing groups of existing relationships (e.g. terminating or dedesignating derivatives before maturity); or
- experiencing shortfalls of forecasted transactions.

The following questions and examples in this section provide our view on how to address such complex hedging situations.

Question 5.3.100

If additional layers are added, or if existing layers are removed, is an entity required to dedesignate and redesignate other hedging relationships within the layers?

**Interpretive response:** No. We believe the layering approach provides an entity with the flexibility to add additional hedging relationships (i.e. add layers) and/or remove existing relationships (i.e. remove layers), without having to dedesignate and redesignate other hedging relationships. This is because no change to the identification of the hedged forecasted transactions associated with the other relationships is required.

The designation of each relationship will always identify the hedged forecasted transactions as the first payments received after:

1. cash flows identified as hedged forecasted transactions in an active hedging relationship; and
2. probable cash flows previously identified in a hedging relationship that was terminated (i.e. is inactive), such that some portion of the gain or loss on the dedesignated hedging relationship remains in AOCI.
Adding a layer

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 (1) and (2) above, without affecting the designation of those earlier relationships.

For example, an entity has two active hedging relationships:

- Swap 1 is designated as hedging the first interest payments made on $100 million of principal of a LIBOR-based loan portfolio and is currently hedging interest payments on principal $1–$100 million.

- Swap 2 is designated as hedging the first interest payments made on $150 million of principal of a LIBOR-based loan portfolio and is currently hedging interest payments on principal $100,000,001–$250 million.

The following illustration summarizes the two active hedging relationships.

The entity could designate the first payments received on the next $50 million of principal of the LIBOR-based loan portfolio that (1) are not currently being hedged by a previously designated hedging relationship earlier in the priority chain or (2) were not included in a terminated hedging relationship with amounts remaining in AOCI earlier in the priority chain.

Removing a layer

If a derivative matures such that a relationship earlier in the priority chain terminates, the forecasted transactions for hedging relationships later in the priority chain will not be affected. This is because an entity would continue to hedge the first payments received after:

1. those that are already hedged in active hedging relationships; and
2. those that were previously identified in a hedging relationship that has been terminated with amounts remaining in AOCI.
If no amounts remain in AOCI, the forecasted transactions with active relationships or inactive relationships that continue to have amounts in AOCI will move up in the priority chain. This is 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.

For example, if Swap 1 matured, the first hedging relationship would be discontinued and the second and third hedging relationships would continue. If no gains/losses related to Swap 1 remained in AOCI, the second and third hedging relationships would move up the priority chain. Alternatively, if Swap 1 was terminated early and some of its gains/losses remained in AOCI, the second and third hedging relationships would not move up the priority chain.

For guidance on when amounts related to a swap are reclassified from AOCI, see section 6.3.10. In general, the gain or loss related to a derivative that is terminated before maturity remains in AOCI unless it is probable that the forecasted transaction will not occur.

**Hedge effectiveness.** When a relationship moves up in the priority chain, the perfectly effective hypothetical (PEH) derivative instrument associated with that relationship must be adjusted to reflect the most recent best estimate of the forecasted transactions that are identified with that relationship for purposes of assessing hedge effectiveness. For further discussion of the PEH derivative, see section 9.7.30.

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**Question 5.3.110**

**When does a hedging relationship move up the priority chain into a vacated tranche of a discontinued hedging relationship?**

**Interpretive response:** We believe when an entity redesignates a hedging relationship under the layering approach, 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. However, the ongoing relationships could be repositioned in the priority chain through a formal redesignation and redesignation (see Question 5.3.120).
Continuing the layering approach example in Question 5.3.100, assume Swap 1 is terminated early and only interest payments on $150 million of principal remain probable.

Correct: Swap 2 maintains position in priority chain
Incorrect: Swap 2 automatically moves up in priority chain

For Swap 1, no reclassification of amounts from AOCI is necessary because the first payments received on $100 million of principal (determined based on its original position in the priority chain) are still probable.

Swap 2 maintains its position in the priority chain:

Correct: Swap 2 maintains position in priority chain

Swap 2’s relationship must be fully or partially discontinued because the relationship is no longer expected to be highly effective and a portion of the forecasted transaction is no longer probable of occurring (see section 6.5.20).

Swap 2 has a notional amount of $150 million and only interest payments on $50 million remain probable after interest payments on the first $100 million of principal continue to be identified with Swap 1 to support retaining amounts in AOCI.

Incorrect: Swap 2 automatically moves up in priority chain

Swap 2’s relationship may continue undisturbed.

Interest payments on $150 million are still probable and the first payments received can be attributed entirely to Swap 2 because it has moved up into Swap 1’s position in the priority chain.

An entity is required to discontinue hedge accounting for those specific hedged forecasted transactions that are no longer probable.

The entity is required to reclassify amounts from AOCI for any specific forecasted transactions that it is probable will not occur (i.e. interest payments related to $100 million of the principal balance). For guidance on the discontinuation of hedge accounting when it is probable a forecasted transaction will not occur, see section 6.5.20.

**Missed forecast.** If it is probable that a forecasted transaction will not occur, an entity must consider this missed forecast when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions (see Question 6.5.110).
Qualifying criteria for cash flow hedges

Interpretive response: Yes. Ongoing relationships can be repositioned in the priority chain through a formal dedesignation and redesignation, with certain limitations (see Question 5.3.140).

Continuing with the example in Question 5.3.110 assuming Swap 1 was terminated, the entity would 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 this strategy executed through formal redesignation is appropriate because:

— 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;

— it does not allow an entity to cherry pick which amounts from AOCI will be reclassified from the shortfall – a shortfall will always affect the last relationship in the priority chain first regardless of which swaps are terminated or dedesignated; and

— it requires an entity that must stop a hedging relationship due to a shortfall in forecasted transactions to formally redesignate that hedging relationship to continue hedge accounting.

Interpretive response: When a hedging relationship is dedesignated within a priority chain and amounts remain in AOCI for that relationship, for an entity to formally re-hedge the position that was vacated (with a new or existing
derivative), it needs to redesignate all the relationships that follow the dedesignated relationship in the priority chain.

Therefore, 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, assume the same facts and circumstances in the example used in Question 5.3.120, except for the following:

— Swap 3 is designated as hedging interest payments on the next $50 million of principal; and
— the entity terminates Swap 1, but interest payments on $200 million principal remain probable.

If an entity wishes to re-hedge the position that Swap 1 vacated with one of the remaining swaps, it needs to dedesignate both Swaps 2 and 3 and then formally redesignate one or both, assuming there are enough interest payments that remain probable.

**Before redesignation**

1st hedging relationship
- Terminated with amounts remaining in AOCI

2nd hedging relationship
- $100m

3rd hedging relationship
- $150m

**After redesignation**

1st hedging relationship
- Redesignated 2nd hedging relationship
- $150m

2nd hedging relationship
- Redesignated 3rd hedging relationship
- $50m

3rd hedging relationship
- Interest payments of $200 million remain probable

**Question 5.3.140**

*Can a new hedging relationship be inserted earlier in the priority chain than an active hedging relationship?*

**Interpretive response:** No. If a new relationship is layered on to an existing priority chain, that relationship must be designated to immediately follow the latest active relationship in the chain without disturbing any of the other relationships.

An entity may re-hedge a layer of forecasted transactions that was previously identified in a terminated hedging relationship with amounts remaining in AOCI, provided that terminated relationship was designated later in the priority chain than the latest active hedging relationship.
This occurs because the latest active relationship has not been dedesignated. Therefore, it and all the relationships before it in the priority chain (active and inactive for which amounts remain in AOCI), remain in their originally designated positions.

For example, assume the entity in Question 5.3.100 started with just the two original swaps (Swaps 1 and 2). The entity terminates Swap 1, but interest payments on $250 million principal are still probable.

After considering Swap 2’s original position in the priority chain after terminated Swap 1 – because amounts remain in AOCI for Swap 1 – forecasted interest payments on $150 million of principal relationship remain probable and Swap 2 continues to be highly effective.

Assume the entity later elects to newly designate Swap 3. Swap 3 may be designated to immediately follow Swap 2 without disturbing Swap 2’s relationship, but it would also remain behind Swap 1. If swaps designated after Swap 2 had been terminated with amounts remaining in AOCI, Swap 3 may re-hedge interest payments on the inactive layers in the priority chain after Swap 2.

This occurs because Swap 2’s relationship has not been dedesignated. Therefore, Swap 2 and all the relationships before Swap 2 (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.

Therefore, 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 combined.
In this example, there are not sufficient forecasted transactions that are probable for Swap 3 to be eligible for hedge accounting.

**Example 5.3.50**

**Layering approach: Swap matures and related amounts reclassified from AOCI**

**Designation of original hedging relationships**

ABC Corp. has five swaps, each with a notional amount of $10,000. ABC wishes to hedge interest payments on $50,000 in total principal and designates five different hedging relationships as follows.

— Swap 1 is designated as hedging the first interest payments made on $10,000 of principal expected to occur each month for the next five years. At inception of the hedge, Swap 1 is hedging interest payments on principal $1–$10,000.

— Swap 2 is designated as hedging the first interest payments made on $10,000 of principal expected to occur each month for the next five years that (1) are not currently being hedged in another hedging relationship (i.e. hedged by a swap that is earlier in priority – in this case Swap 1) or (2) were not included in a terminated hedging relationship with amounts remaining in AOCI earlier in the priority chain. No relationships currently fall into category (2) because no relationships designated earlier in priority have been discontinued after Swap 2’s designation. At inception of the hedge, Swap 2 is hedging interest payments on principal $10,001–$20,000.

— Swaps 3, 4 and 5 are all designated similar to the designation for Swap 2.

— All of the swaps have different maturities.

The following illustration summarizes the five hedging relationships.
Swap 3 matures and no amounts remaining in AOCI

When Swap 3 matures, the third hedging relationship is terminated and there are no amounts remaining in AOCI.

The hedging relationships involving Swaps 1, 2, 4 and 5 continue.

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 redesignated.

When Swap 3 matures, Swap 4 is still hedging the first interest payments made on $10,000 of principal expected to occur each month for the next five years that:

1. are not currently being hedged by a previously designated hedging relationship earlier in the priority chain (Swaps 1 and 2); or
2. were not included in a terminated hedging relationship with amounts remaining in AOCI earlier in the priority chain.

Therefore, Swaps 4 and 5 will move up in the priority chain. The following illustration summarizes the hedging relationships after the maturity of Swap 3.

Hedge effectiveness. ABC is required to adjust the PEH derivatives associated with the fourth and fifth hedging relationships to reflect any changes in the most recent best estimates of forecasted transactions associated with the new tranches of interest payments.

Example 5.3.60
Layering approach: Swap terminated and related amounts not reclassified from AOCI

Assume the same facts and circumstances as in Example 5.3.50, except that the hedging relationship involving Swap 3 is terminated early. However, all amounts of the originally specified hedged forecasted transactions remain probable, including the interest payments on principal $20,001–$30,000, which were being hedged by Swap 3. Therefore, the amounts related to Swap 3 are not immediately reclassified from AOCI.
The hedging relationships involving Swaps 1, 2, 4 and 5 continue.

When a swap in the priority chain is terminated and amounts related to the hedging relationship have not been reclassified out of AOCI, all the swaps that follow in the priority will not move up.

When Swap 3 is terminated, Swap 4 is still hedging the first interest payments made on $10,000 of principal expected to occur each month for the next five years that:

1. are not currently being hedged in a previously designated hedging relationship earlier in the priority chain (Swaps 1 and 2), or
2. were not included in a terminated hedging relationship with amounts remaining in AOCI earlier in the priority chain (Swap 3).

Therefore, Swaps 4 and 5 will not move up in the priority chain. The following illustration summarizes the hedging relationships after the termination of Swap 3.

The gain or loss on Swap 3 is reclassified from AOCI when interest payments on principal $20,001–$30,000 affect earnings. For further discussion on cash flow hedge accounting, see section 6.2.10. Once amounts related to Swap 3 are fully reclassified out of AOCI, Swaps 4 and 5 will automatically move up in the priority chain.

**Hedge effectiveness.** In this example, ABC does not adjust the PEH derivatives associated with the fourth and fifth hedging relationships because they continue to hedge the same tranche of forecasted transactions and their terms have not changed.

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**Example 5.3.70**

**Layering approach: Additional swap terminated and new swap designated at end of priority chain**

Assume the same facts and circumstances as in Example 5.3.60, except that ABC also terminates Swap 5 and amounts are not immediately reclassified from...
AOCl. In addition, ABC obtains Swap 6 and wishes to designate a new hedging relationship. This requires ABC to add Swap 6 to the end of the existing priority chain.

An entity is not permitted to move the existing priority chain without dedesignating and redesignating the current hedging relationships that were originally designated as following the vacated tranche. Therefore, ABC is not permitted to insert Swap 6 to hedge interest payments on principal $20,001–$30,000 (the tranche previously hedged by Swap 3) without dedesignating and redesignating Swap 4. This is because doing so would break the existing priority chain.

Instead, ABC identifies Swap 6 as hedging the first interest payments made on $10,000 of principal expected to occur each month for the next five years that:

1. are not currently being hedged in a previously designated hedging relationship earlier in the priority chain (Swaps 1, 2 and 4); or
2. were not included in a terminated hedging relationship with amounts remaining in AOCI earlier in the priority chain (Swap 3).

Swap 6 may fill in the position vacated by Swap 5. Although 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 (i.e. Swap 4).

However, Swap 6 remains behind relationships designated earlier in the priority chain than Swap 4 that were terminated with amounts remaining in AOCI (i.e. Swap 3). This occurs because Swap 4’s relationship has not been dedesignated. Accordingly, the fourth hedging relationship and all the relationships before it, both active and terminated with amounts remaining in AOCI (i.e. Swaps 1-3), remain in their originally designated positions in the priority chain.

This designation results in Swap 6 hedging interest payments on principal $40,001–$50,000. The following illustration summarizes the hedging relationships after the termination of Swap 5 and the addition of Swap 6.
The gain or loss on Swaps 3 and 5 is reclassified from AOCI when interest payments on principal $20,001–$30,000 and $40,001–$50,000 affect earnings, respectively.

**Hedge effectiveness.** In this example, ABC does not adjust the PEH derivatives associated with the first, second or fourth hedging relationships because they continue to hedge the same tranches of forecasted transactions and their terms have not changed.

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**Example 5.3.80**

**Layering approach: Swap terminated with interest payments on a portion of principal remaining probable**

This example uses the same five hedging relationships originally designated in Example 5.3.50.

ABC terminates Swap 3 and the hedging relationship is discontinued. Additionally, interest on only $40,000 of principal remains probable. It is probable that interest payments on $10,000 of principal will not occur.

Because interest payments on principal $20,001–$30,000 (i.e. Swap 3’s forecasted transaction) are still probable, amounts related to Swap 3 will remain in AOCI. Therefore, Swap 4 will not move up in priority and continues to hedge interest payments on principal $30,001–$40,000.

Because it is probable that interest payments on principal $40,001–$50,000 will not occur, ABC is required to terminate the original hedging relationship for each of the forecasted transactions that are not probable. Therefore, ABC is required to dedesignate Swap 5 and immediately reclassify any amounts in AOCI into earnings.

The following illustration summarizes the hedging relationships after the termination of Swaps 3 and 5.
The gain or loss on Swap 3 is reclassified from AOCI when interest payments on principal $20,001–$30,000 affect earnings.

**Hedge effectiveness.** In this example, ABC does not adjust the PEH derivative associated with the first, second or fourth hedging relationships because they continue to hedge the same tranches of forecasted transactions and their terms have not changed.

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**Example 5.3.90**

**Layering approach: Swap early in priority chain matures subsequent to other swap terminations**

Assume the same facts as in Example 5.3.80, except that Swap 1 matures after the termination of Swaps 3 and 5. All amounts related to Swaps 1 and 5 have been reclassified out of AOCI.

The hedging relationships involving Swaps 2 and 4 continue and move up the priority chain. In addition, the amounts remaining in AOCI related to the discontinued Swap 3 move up the priority chain.

The following illustration summarizes the hedging relationships after the termination of Swaps 1, 3 and 5.

| Interest payments on principal of $1–$10,000 | Swap 2 | 2nd hedging relationship |
| Interest payments on principal of $20,001–$30,000 | Swap 4 | 4th hedging relationship |

The gain or loss on Swap 3 is reclassified from AOCI when interest payments on principal $10,001–$20,000 affect earnings.

**Hedge effectiveness.** In addition, ABC is required to adjust the PEH derivatives associated with the second and fourth hedging relationships to reflect any changes in the most recent best estimates of forecasted transactions associated with the new tranches of interest payments.
Layering approach: Redesignation of swaps

Assume the same facts as in Example 5.3.80. However, ABC now wishes to hedge all interest payments on principal that remains probable (i.e. $1–$40,000).

To hedge interest payments on $20,001–$30,000 that were previously hedged by Swap 3, ABC needs to dedesignate and redesignate all swaps prioritized later than Swap 3 (i.e. Swap 4). This is because a new swap cannot leapfrog Swap 4 in the priority chain, as demonstrated in Example 5.3.70 (i.e. a new swap cannot replace Swap 3’s position in the priority chain). As a reminder, Swap 3 was previously terminated with amounts remaining in AOCI.

Therefore, ABC decides to dedesignate Swap 4 and formally redesignate both Swaps 4 and 5 (similar to hedges in the previous examples) to hedge interest payments on principal $20,001–$30,000 and $30,001–$40,000, respectively. The newly redesignated Swap 4 may re-hedge the tranche previously hedged by Swap 3, even though amounts remain in AOCI pertaining to Swap 3.

If any relationships had been designated earlier in the priority chain than Swap 2 and were terminated with amounts remaining in AOCI, Swaps 4 and 5 would also remain behind those relationships because Swap 2’s relationship had not been dedesignated. Therefore, all the relationships designated before Swap 2 in the priority chain (active and inactive for which amounts remain in AOCI) would remain in their originally designated positions.

The following illustration summarizes the hedging relationships after the redesignation of Swaps 4 and 5.

The gain or loss on Swap 3, which was terminated in Example 5.3.80, is reclassified from AOCI when the related interest payments on principal $20,001–$30,000 affect earnings. For amounts remaining in AOCI related to Swap 4 before its dedesignation and redesignation, the gain or loss is reclassified from AOCI when the related interest payments on principal $30,001–$40,000 affect earnings.
5.3.90 All-in-one hedge

Excerpt from ASC 815-20

>> All-in-one hedge

25-21 Paragraph 815-10-15-4 states that, if a contract meets the definition of both a derivative instrument and a firm commitment under the Derivatives and Hedging Topic (as illustrated in Example 8 [see paragraph 815-20-55-111]), then an entity shall account for the contract as a derivative instrument unless one of the exceptions in this Topic applies. In that circumstance, either of the following may be true:

a. The forecasted transaction and the derivative instrument used to hedge it are with the same counterparty.
b. The derivative instrument is the same contract under which the entity executes the forecasted transaction.

25-22 Assuming other cash flow hedge criteria are met, a derivative instrument that will involve gross settlement may be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in a forecasted transaction that will occur upon gross settlement of the derivative instrument itself (an all-in-one hedge). This guidance applies to fixed-price contracts to acquire or sell a nonfinancial or financial asset that are accounted for as derivative instruments under this Topic provided the criteria for a cash flow hedge are met.

20 Glossary

All-in-one hedge – In an all-in-one hedge, a derivative instrument that will involve gross settlement is 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 gross settlement of the derivative instrument itself.

In many cases, a firm commitment (such as a forward contract) can itself meet the definition of a derivative. If the derivative does not meet any of the scope exceptions in Subtopic 815-10, it must be recorded at fair value through earnings and cannot be designated as the hedged item or transaction in a fair value or cash flow hedge. [815-10-15-4, 815-20-25-21]

However, if the derivative instrument (i.e. the contract) is expected to be settled gross through a delivery of the underlying asset, an entity 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. This is referred to as an ‘all-in-one’ hedge. [815-20-25-22]
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. In addition, the entity may hedge the forecasted purchase or sale that implicitly caused it to enter into the fixed-price contract.

An all-in-one hedge is most commonly used with forecasted transactions related to nonfinancial assets, where contracts for the purchase or sale of a commodity that is readily convertible to cash do not meet the ‘normal purchases and normal sales’ scope exclusion. However, all-in-one hedges can also be applied to financial assets. Examples 5.3.110 and 5.3.120 illustrate the application of all-in-one hedges for nonfinancial assets and financial assets, respectively. [815-20-25-22]

The criteria that must be met for a contract to qualify for designation in an all-in-one hedge are summarized in the following diagram.

Gross settlement of a contract involves delivery of an asset in exchange for payment of cash or other assets. This is different from net settlement, which typically involves payment for the change in a contract’s value. [815-20-55-112]

In addition to the contract meeting the above criteria to be the hedging instrument, the implicit forecasted purchase or sale needs to meet the qualifying criteria to be designated as a hedged transaction in a cash flow hedge. This includes a requirement that the implicit forecasted transaction presents an exposure to variations in cash flows for the hedged risk that could affect earnings. [815-20-25-15(c)(2)]

The contract meets the definition of a firm commitment only if its price is fixed. However, the implied forecasted purchase or sale exposes an entity to variability in cash flows (which is a requirement to be a hedged transaction) because the total consideration paid or received is variable. Total consideration is the fixed amount of cash paid or received and the fair value of the fixed-price purchase or sale contract, which is a derivative instrument recognized as an asset or liability that may fluctuate over time. [815-20-55-113 – 55-114]
5. Qualifying criteria for cash flow hedges

**Question 5.3.150**

Which risks are eligible to be designated in an all-in-one hedge?

**Interpretive response:** An all-in-one hedge must be a hedge of total variability in cash flows (i.e. total price risk), not a hedge of a contractually specified component.

Topic 815 allows an entity to designate a contractually specified component of a hedged transaction. However, the proportion of a derivative that is designated as the hedging instrument must have the same risk exposure profile as the entire derivative instrument (see section 2.6.30). Therefore, an entity cannot designate a contractually specified component of the derivative as the hedging instrument.

Because the derivative instrument is the same contract under which the transactions will be purchased or sold, we believe an entity is precluded from designating a contractually specified component as the hedged risk.

**Example 5.3.110**

All-in-one hedge of forecasted sales of gold

Goldco wants to manage the price risk associated with forecasted sales of gold. To do so, it enters into a forward contract to sell gold at a fixed price.

The forward gold sales contract contains a net settlement provision and meets the definition of a derivative instrument. The contract does not meet any of the scope exclusions in Subtopic 815-10.

As a derivative instrument, the forward gold sales contract is recorded at fair value with changes in fair value reported in earnings. However, the forward contract may be designated as an all-in-one hedge of total price risk provided the contract is expected to be settled gross. Goldco expects to deliver the gold in exchange for cash.

Goldco can designate the fixed-price forward gold sales contract (i.e. the derivative instrument) as a cash flow hedge of the variability of the consideration to be received for the sale of gold (i.e. the forecasted transaction) even though the derivative instrument is the same contract under which the gold itself will be sold.

**Example 5.3.120**

All-in-one hedge of forecasted sales of loans

Bank wants to manage the total price risk associated with forecasted sales of loans that it originates by entering into a forward loan sale agreement to sell mortgage loans at a fixed price.

The forward contract meets the definition of a firm commitment and a derivative. The contract does not meet any of the scope exclusions in Subtopic 815-10.
Bank expects to gross settle the contract by transferring the mortgage loans in exchange for cash. Therefore, all criteria have been met for an all-in-one hedge of total price risk.

Bank can designate the fixed-price forward loan sales agreement (i.e. the derivative instrument) as a cash flow hedge of the variability of the consideration to be received for the sale of mortgage loans (i.e. the forecasted transaction) even though the derivative instrument is the same contract under which the mortgage loans themselves will be sold.

**Question 5.3.160**

*Is an all-in-one hedge assumed to be perfectly effective?*

**Interpretive response:** It depends. If the hedging relationship is designated at the inception of the fixed price contract and the contract is at market terms (i.e. contract has a fair value of zero), we believe an entity can assume that the all-in-one hedging relationship will be perfectly effective.

Under these circumstances, changes in the fair value of the derivative instrument (i.e. the contract) are expected to entirely offset the change in cash flows attributable to the change in the entire price of the hedged transaction. This is because the hedged transaction and the hedging instrument are in effect the same. Therefore, an entity may use the critical terms match method to assess effectiveness of an all-in-one hedge. For further guidance on the conditions that must be met to apply the critical terms match method, which assumes perfect effectiveness, see section 9.4.

If the hedging relationship is not designated at inception of the fixed price contract, the contract will not have a fair value of zero at inception of the hedging relationship. This may result in a hedge that is not perfectly effective. See section 9.7 for guidance on assessing effectiveness of cash flow hedges when the critical terms are not the same – e.g. because the fair value of the forward contract is not zero at inception of the hedging relationship.

**FASB Example: All-in-one hedges**

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<td><strong>Example 8: All-in-One Hedges</strong></td>
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<td><strong>55-111</strong> The following Cases illustrate the application of paragraph 815-20-25-21:</td>
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<td><strong>55-112</strong> Settling a forward contract gross involves delivery of an asset in exchange for the payment of cash or other assets and is differentiated from</td>
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settling net, which typically involves a payment for the change in a contract’s value as the method of settling the contract.

55-113 A forecasted purchase or sale meets the definition of forecasted transaction and, if it is probable, meets the criteria in paragraph 815-20-25-15 for designation as a hedged transaction. An entity 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. Because the fixed-price purchase or sale contract is a derivative instrument, it is eligible for use as a hedging instrument.

55-114 The forecasted purchase or sale at a fixed price is eligible for cash flow hedge accounting because the total consideration 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 and the fair value of the fixed price purchase or sale contract, which is recognized as an asset or liability, and which can vary over time.

>>> Case A: Purchase of a Nonfinancial Asset

55-115 Entity A plans to purchase a nonfinancial asset. To fix the price to be paid (that is, to hedge the price), Entity A enters into a contract that meets the definition of a firm commitment with an unrelated party to purchase the asset at a fixed price at a future date. Assume that the terms of the contract (such as net settlement under the default provisions) or the nature of the asset cause the contract to meet the definition of a derivative instrument and the contract is not excluded by paragraphs 815-10-15-13 through 15-82 from the scope of the Derivatives and Hedging Topic. As such, Entity A has entered into a derivative instrument under which it is expected to take delivery of the asset. Entity A may designate the fixed-price purchase contract (that is, the derivative instrument) as a cash flow hedge of the variability of the consideration to be paid for the purchase of the asset (that is, the forecasted transaction) even though the derivative instrument is the same contract under which the asset itself will be acquired.

>>> Case B: Purchase of a Financial Asset

55-116 Entity B plans to purchase U.S. government bonds and expects to classify those bonds in its available-for-sale portfolio. To fix the price to be paid (that is, to hedge the price), Entity B enters into a contract that meets the Derivatives and Hedging Topic’s definition of a firm commitment with an unrelated party to purchase the bonds at a fixed price at a future date. Assume the contract meets the definition of a derivative instrument and is not excluded by paragraphs 815-10-15-13 through 15-82 from the scope of this Topic. As such, Entity B has entered into a derivative instrument under which it is expected to take delivery of the asset. Entity B may designate the fixed-price purchase contract (that is, the derivative instrument) as a cash flow hedge of the variability of the consideration to be paid for the purchase of the bonds (that is, the forecasted transaction) even though the derivative instrument is the same contract under which the asset itself will be acquired.
5.4 Eligibility of hedged risks

Sections 2.3 and 2.4 provide an overview of the eligible hedged risks for both financial and nonfinancial instruments, including limitations on certain risks for hedged transactions.

Section 5.4 provides detail around eligibility criteria of hedged risks that are specific to cash flow hedges, including:

- contractually specified component price risk for nonfinancial items (see sections 5.4.10 to 5.4.30);
- interest rate risk on the forecasted issuance or purchase of debt instruments (see sections 5.4.40 to 5.4.50); and
- changing the hedged risk (see section 5.4.60).

Foreign currency risk. For further guidance on foreign currency risk as it relates to cash flow hedges, see chapter 7.

5.4.10 Contractually specified component price risk for nonfinancial items

Excerpt from ASC 815-20

>>> Determining Whether a Contractually Specified Component Exists

55-26A The definition of a contractually specified component is considered to be met if the component is explicitly referenced in agreements that support the price at which a nonfinancial asset will be purchased or sold. For example, an entity intends to purchase a commodity in the commodity’s spot market. If as part of the governing agreements of the transaction or commodities exchange it is noted that prices are based on a pre-defined formula that includes a specific index and a basis, those agreements may be utilized to identify a contractually specified component. After an entity determines that a contractually specified component exists, it must assess whether the variability in cash flows attributable to changes in the contractually specified component may be designated as the hedged risk in accordance with paragraphs 815-20-25-22A through 25-22B.
5. Qualifying criteria for cash flow hedges

**20 Glossary**

**Contractually Specified Component** – An index or price explicitly referenced in an agreement to purchase or sell a nonfinancial asset other than an index or price calculated or measured solely by reference to an entity’s own operations.

**Price risk.** For a cash flow hedge of a forecasted transaction that involves a nonfinancial asset or liability, an entity is permitted to designate either:

- all changes in the purchase price or sales price (i.e. **total price risk**); or
- a contractually specified component of the purchase or sale of a nonfinancial asset or liability (i.e. **contractually specified component price risk**).

A contractually specified component is an index or price explicitly referenced in an agreement to purchase or sell a nonfinancial asset other than an index or price calculated or measured solely by reference to an entity’s own operations. Additionally, the definition of a contractually specified component is considered to be met if the component is explicitly referenced in agreements that support the price at which a nonfinancial asset will be purchased or sold. [815-20 Glossary, 815-20-55-26A]

Once a contractually specified component is identified, it needs to be included in either:

| Existing contracts (section 5.4.20) | — An existing contract that meets the definition of a derivative and qualifies for the normal purchases and normal sales scope exception, which requires a price based on an underlying that is clearly and closely related to the asset being sold or purchased. [815-20-25-22A(a)]
| | or
| | — An existing contract that does not meet the definition of a derivative and includes a price based on an underlying that is clearly and closely related to the asset being sold or purchased. [815-20-25-22A(b)]

| Not-yet-existing contracts (section 5.4.30) | A not-yet-existing contract if the entity expects that the contract, when executed, will meet the criteria outlined for existing contracts. [815-20-25-22B]

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**Example 5.4.10**

**Contractually specified component**

At the beginning of Year 1, ABC Corp. enters into a contract to purchase natural gas at Location 1. The contract specifies the purchase price per unit of measure as the NYMEX Henry Hub futures price plus a fixed basis reflecting local supply/demand and transportation.

The NYMEX Henry Hub futures price meets the definition of a contractually specified component. Therefore, ABC is eligible to designate the NYMEX Henry Hub futures price as the hedged risk in its cash flow hedge of forecasted purchases of natural gas.
Question 5.4.10
Can an entity hedge an index or rate that is not specified in the contract?

Background: A contract to buy or sell a nonfinancial asset is based on a price that is derived/calculated by reference to another index or rate pursuant to market convention. The contract does not specify how the price is calculated.

Interpretive response: No. We believe the FASB’s intent in permitting hedges of components (e.g. indices, rates) is to allow such hedges only when the components are specified in the contract or a contract that supports the price.

The FASB considered, but rejected, an approach that would have permitted hedge accounting for components that are not contractually specified when it is market convention to use the component as the underlying basis for determining the price of the overall product. The FASB rejected this approach because the concept of market convention would:

- be difficult to define across industries;
- lead to confusion when there is no market convention or multiple market conventions; and
- potentially be difficult to demonstrate objectively to third parties.

Therefore, if the contract (or a contract that supports the price) does not specify an index or rate, an entity cannot designate it as a contractually specified component.

Example 5.4.20
Underlying index or price as a contractually specified component

At the beginning of Year 1, ABC Corp. enters into a contract to purchase Commodity X in Canada. The contract specifies the purchase price per unit of measure is based on the Industry Standard price at the time of delivery.

Although not defined in the contract, ABC considers it is market convention that the Industry Standard price is calculated as the XYZ index plus a fixed basis reflecting transportation. ABC is not permitted to designate the XYZ index as a contractually specified component because the XYZ index is not specified in the contract (or a contract that supports the price).

Question 5.4.20
If the contract price includes a variable basis spread, can an entity hedge the contractually specified component?

Interpretive response: It depends. If the contract pricing includes a variable basis spread, an entity should evaluate whether it has exposure to the contractually specified component.
We believe it would be inappropriate to identify the hedged risk as a contractually specified component in a contract with pricing structured such that an entity does not have exposure to the contractually specified component.

For example, an entity has a contract with a price defined as ABC index plus a variable spread based on the difference between ABC index and XYZ index. The entity should evaluate whether it has exposure to the ABC index, or whether its exposure is actually to the XYZ index.

**Question 5.4.30**

**Can an entity hedge a contractually specified component of a forecasted purchase or sale of a nonfinancial asset in a spot market transaction?**

**Interpretive response:** It depends. Topic 815 contemplates that an entity is able to hedge a contractually specified component of a forecasted purchase or sale in a spot market transaction if the component is specifically referenced in an agreement that supports the price at which the asset will be purchased or sold.

The FASB did not elaborate on the nature or form of contracts that could contain a contractually specified component or whether a contract/agreement needs to be entered into before completion of the spot purchase or sale transaction.

However, Topic 815 provides examples of circumstances in which a component is considered specifically referenced in the contract, such as when a pre-defined formula is incorporated into agreements that govern either: [815-20-55-26A]

- the transaction – i.e. an agreement between the counterparties to the spot purchase transaction; or
- the market exchange on which the transaction will take place.

It is not clear how broadly this guidance was intended to be interpreted. In a March 2018 meeting, the FASB clarified that if an entity does not have a contract at hedge inception (e.g. a not-yet-existing contract), it needs to develop an expectation that when the transaction is entered into:

- the written agreement for a forecasted purchase or sale will contain an explicitly referenced contractually specified component;
- the pricing formula that references the explicitly referenced contractually specified component will determine the price of the nonfinancial item;
- the requirements for cash flow hedge accounting will be met; and
- the agreement will be substantive.

Setting these expectations will require judgment. The FASB established a project group to monitor implementation in this area, and we expect this issue to be the subject of future discussions. As a result, revisions to this interpretive response may be provided in a future edition.
5.4.20 Contractually specified component price risk: Existing contracts

Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

>>> Eligibility Criteria for Designating the Variability in Cash Flows Attributable to Changes in a Contractually Specified Component for the Purchase or Sale of a Nonfinancial Asset as the Hedged Risk

25-22A For existing contracts, determining whether the variability in cash flows attributable to changes in a contractually specified component may be designated as the hedged risk in a cash flow hedge is based on the following:

a. If the contract to purchase or sell a nonfinancial asset is a derivative in its entirety and an entity applies the normal purchases and normal sales scope exception in accordance with Subtopic 815-10, any contractually specified component in the contract is eligible to be designated as the hedged risk. If the entity does not apply the normal purchases and normal sales scope exception, no pricing component is eligible to be designated as the hedged risk.

b. If the contract to purchase or sell a nonfinancial asset is not a derivative in its entirety, any contractually specified component remaining in the host contract (that is, the contract to purchase or sell a nonfinancial asset after any embedded derivatives have been bifurcated in accordance with Subtopic 815-15) is eligible to be designated as the hedged risk.

After an entity determines that a contractually specified component exists, it needs to determine whether it can designate that risk as the hedged risk.

Question 5.4.40

What conditions need to be met to designate a contractually specified component as the hedged risk?

Interpretive response: We believe the following conditions need to be met for a contractually specified component to be designated as the hedged risk:

— the contractually specified component is included in a contract that is not being accounted for as a derivative in the scope of Topic 815 (either freestanding or bifurcated); and

— the contract has pricing that is clearly and closely related to the asset being sold or purchased (see Question 5.4.50).

Topic 815 states that if the contract to purchase or sell a nonfinancial asset is not a derivative in its entirety, any contractually specified component remaining in the host contract is eligible to be designated as the hedged risk. [815-20-25-22A]

However, the FASB’s intention in applying the normal purchases and normal sales scope exception in combination with the embedded derivatives guidance
was to prevent any extraneous pricing feature from being designated as the hedged risk. The FASB was concerned that an entity could inappropriately elect hedge accounting by fabricating a contractually specified component that it does not have price exposure to and then enter into a derivative to hedge that component. [ASU 2017-12.BC53]

Therefore, we believe a contractually specified component is eligible to be designated as the hedged risk only if the contract has pricing that is clearly and closely related to the asset being sold or purchased. An extraneous contractually specified component in a contract does not meet the clearly and closely related criteria and therefore is not eligible to be the hedged risk.

This is also true for contracts that meet the definition of a derivative in their entirety. For a contractually specified component to be eligible for designation as the hedged risk, the existing contract must meet the normal purchases and normal sales scope exception, which includes a requirement to meet the clearly and closely related criteria. As discussed in section 2.5.70, freestanding derivatives cannot be designated as hedged items or transactions because they are remeasured with changes in fair value reported in earnings. [815-10-15-30 – 15-34, 815-20-25-22A]

**Question 5.4.50**

What are the requirements to meet the clearly and closely related criteria?

**Interpretive response:** For a contract to qualify for the normal purchases and normal sales scope exception, it cannot have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased. As discussed in Question 5.4.40, we believe a contractually specified component within a contract must meet the clearly and closely related criteria to be eligible for designation as a hedged risk. [815-10-15-30]

The underlying in a price adjustment feature may incorporate a purchase or sale contract that is reasonably related to either the cost or the fair value of the asset subject to the contract. In that case, generally the price adjustment feature would not be an impediment for the contract to qualify for the normal purchases and normal sales exception.

A price adjustment feature incorporated into a contract is **not clearly and closely related** to the asset being sold or purchased in any of the following circumstances. [815-10-15-32]

- The underlying is extraneous (i.e. 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; this includes being extraneous to an ingredient or direct factor in the customary or specific production of that asset.
- The magnitude and direction of the effect of the price adjustment is not consistent with the relevancy of the underlying. That is, the magnitude of the price adjustment based on the underlying is significantly disproportionate to the effect 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).
5. Qualifying criteria for cash flow hedges

The underlying is a currency exchange rate involving a foreign currency that meets none of the criteria in paragraph 815-15-15-10(b).

Example 5.4.30
Contract not accounted for as derivative because normal purchases and normal sales scope exception is met

ABC Corp. enters into a forward contract to buy crude oil at a price that is based on a crude oil futures price in the month of delivery plus a fixed basis differential for transportation costs. There is no net settlement provision in the contract. Furthermore, the quantities of crude oil delivered under the contract are expected to be used by ABC over a reasonable period in the normal course of business.

ABC has met two of the important elements needed to qualify for the normal purchases and normal sales scope exception:

- the underlying (price of crude oil) is clearly and closed related to the asset being purchased (crude oil); and [815-10-15-30 – 15-34]
- the quantities delivered under the contract are expected to be used over a reasonable period in the normal course of business. [815-10-15-27 – 15-29]

All other criteria to apply the normal purchases and normal sales scope exception are met, and therefore the contract is not accounted for as a derivative under Topic 815.

Designating the contractually specified component

The conditions to designate the contractually specified component (the crude oil futures price in the month of delivery, excluding the fixed basis differential) as the hedged risk have been met because:

- the forward contract is not accounted for as a derivative under Topic 815; and
- the contract pricing is clearly and closely related.

Example 5.4.40
Contractually specified component is not eligible to be the hedged risk

Goldco, a gold miner, requires crude oil in its extraction business and enters into a forward contract to buy crude oil at a price that is indexed to gold. The forward contract meets the definition of a derivative in its entirety.

The price is based on an underlying (gold) that is not clearly and closely related to the asset being purchased (crude oil).

Therefore, Goldco may not designate the contractually specified component (i.e. the gold index) as the hedged risk.
Example 5.4.50

**Contract pricing with underlying that is clearly and closely related**

Candy Co. enters into a forward contract to sell chocolate at a price that is based on a sugar cane index plus a fixed spread. The forward contract meets the definition of a derivative in its entirety.

The price of sugar is reasonably related to the cost and fair value of chocolate. Even though the contract contains a price adjustment clause that is based on an underlying (price of sugar) that is different from the asset being sold (chocolate), it is not considered an impediment for the contract to meet the clearly and closely related criteria.

Candy concludes that the underlying (price of sugar) is clearly and closely related to the asset being sold (chocolate).

If Candy concludes that the forward contract should not be accounted for as a derivative under Topic 815 (e.g., the other criteria to apply the normal purchases and normal sales scope exception are met), it may designate the contractually specified component (the sugar cane index) as the hedged risk.

### 5.4.30 Contractually specified component price risk: Not-yet-existing contracts

**Excerpt from ASC 815-20**

- **Hedged Transaction Criteria Applicable to Cash Flow Hedges Only**
- **Eligibility Criteria for Designating the Variability in Cash Flows Attributable to Changes in a Contractually Specified Component for the Purchase or Sale of a Nonfinancial Asset as the Hedged Risk**

**25-22B** An entity may designate the variability in cash flows attributable to changes in a contractually specified component in accordance with paragraph 815-20-25-15(i)(3) to purchase or sell a nonfinancial asset for a period longer than the contractual term or for a not-yet-existing contract to purchase or sell a nonfinancial asset if the entity expects that the requirements in paragraph 815-20-25-22A will be met when the contract is executed. Once the contract is executed, the entity shall apply the guidance in paragraph 815-20-25-22A to determine whether the variability in cash flows attributable to changes in the contractually specified component can continue to be designated as the hedged risk. See paragraphs 815-20-55-26A through 55-26E for related implementation guidance.

The ability to hedge a contractually specified component extends to a not-yet-existing contract if the entity expects that the contract, when executed, will meet the criteria in paragraph 815-20-25-22A, and all other cash flow hedge criteria are met. [815-20-25-22B]
This means that an entity needs to consider whether the contract to be executed will meet the conditions outlined in Question 5.4.40 for the contractually specified component to be eligible to be a hedged risk.

**Question 5.4.60**

**What threshold is required to support an entity’s expectation that the criteria to designate a contractually specified component will be met?**

**Interpretive response:** There is no threshold related to an entity’s expectation that the criteria will be met. The FASB cited the practical issues encountered in applying the ‘probable’ threshold for hedging forecasted transactions and determined that there does not need to be an expectation that it is probable that the criteria will be met. [ASU 2017-12.BC56]

Once the contract is executed, an entity undergoes a more rigorous analysis to:

— assess whether the contract is accounted for as a derivative within the scope of Topic 815; and
— evaluate the clearly and closely related guidance to determine if it can continue to designate the contractually specified component as the hedged risk.

**Example 5.4.60**

**Contractually specified component in not-yet-existing contracts**

ABC Corp. expects to make future purchases from a supplier of natural gas in December Year 1 at a price based on the NYMEX natural gas index plus a fixed basis. This forward contract is expected to meet the definition of a derivative in its entirety.

ABC expects the contractually specified component that will be in the contract once it is executed to be the NYMEX natural gas index.

ABC further concludes that this contractually specified component will meet the criteria to be a hedged risk because:

— the underlying (price of natural gas) is clearly and closed related to the asset being purchased (natural gas); and
— the contract, once executed, will qualify for the normal purchases and normal sales scope exception based on similar contracts executed in the past – i.e. the forward contract will not be accounted for as a derivative under Topic 815.

On January 1, Year 1, ABC enters into a futures contract indexed to the NYMEX Henry Hub natural gas index to serve as the hedging instrument.

ABC determines that all of the requirements for cash flow hedge accounting are met and the requirements to designate the contractually specified component as the hedged risk will be met once the contract with the supplier is executed.
Therefore, ABC may designate the hedged risk as variability in cash flows attributable to changes in the contractually specified NYMEX natural gas index in the not-yet-existing purchase contract.

**After contract with the supplier is executed**

Once the contract with the supplier is executed, ABC is required to evaluate whether the requirements to designate a contractually specified component for existing contracts are met.

At the beginning of Year 1, ABC enters into a contract to purchase natural gas at Location 1. The contract specifies the purchase price per unit of measure as the NYMEX Henry Hub futures price plus a fixed basis reflecting local supply/demand and transportation.

The NYMEX Henry Hub futures price meets the definition of a contractually specified component. ABC concludes that:

— the forward contract will not be accounted for as a derivative under Topic 815; and
— the contract pricing is clearly and closely related.

Therefore, ABC is eligible to designate the NYMEX Henry Hub futures price as the hedged risk in its cash flow hedge of forecasted purchases of natural gas.

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**FASB Example: Contractually specified component in a not-yet-existing contract**

Excerpt from ASC 815-20

>>> Contractually Specified Component in a Not-Yet Existing Contract

55-26B This guidance discusses the implementation of paragraphs 815-20-25-22B and 815-30-35-37A. Entity A’s objective is to hedge the variability in cash flows attributable to changes in a contractually specified component in forecasted purchases of a specified quantity of soybeans on various dates during June 20X1. Entity A has executed contracts to purchase soybeans only through the end of March 20X1. Entity A’s contracts to purchase soybeans typically are based on the ABC soybean index price plus a variable basis differential representing transportation costs. Entity A expects that the forecasted purchases during June 20X1 will be based on the ABC soybean index price plus a variable basis differential.

55-26C On January 1, 20X1, Entity A enters into a forward contract indexed to the ABC soybean index that matures on June 30, 20X1. The forward contract is designated as a hedging instrument in a cash flow hedge in which the hedged item is documented as the forecasted purchases of a specified quantity of soybeans during June 20X1. As of the date of hedge designation, Entity A expects the contractually specified component that will be in the contract once it is executed to be the ABC soybean index. Therefore, in accordance with paragraph 815-20-25-3(d)(1), Entity A documents as the hedged risk the variability in cash flows attributable to changes in the contractually specified ABC soybean index in the not-yet-existing contract. On January 1, 20X1, Entity A determines that all requirements for cash flow hedge accounting are
met and that the requirements of paragraph 815-20-25-22A will be met in the contract once executed in accordance with paragraph 815-20-25-22B. Entity A also will assess whether the criteria in 815-20-25-22A are met when the contract is executed.

55-26D As part of its normal process of assessing whether it remains probable that the hedged forecasted transactions will occur, on March 31, 20X1, Entity A determines that the forecasted purchases of soybeans in June 20X1 will occur but that the price of the soybeans to be purchased will be based on the XYZ soybean index rather than the ABC soybean index. As of March 31, 20X1, Entity A begins assessing the hedge effectiveness of the hedging relationship on the basis of the changes in cash flows associated with the forecasted purchases of soybeans attributable to variability in the XYZ soybean index. Because the hedged forecasted transactions (that is, purchases of soybeans) are still probable of occurring, Entity A may continue to apply hedge accounting if the hedging instrument (indexed to the ABC soybean index) is highly effective at achieving offsetting cash flows attributable to the revised contractually specified component (the XYZ soybean index). On April 30, 20X1, Entity A enters into a contract to purchase soybeans throughout June 20X1 based on the XYZ soybean index price plus a variable basis differential representing transportation costs.

55-26E If the hedging instrument is not highly effective at achieving offsetting cash flows attributable to the revised contractually specified component, the hedging relationship must be discontinued. As long as the hedged forecasted transactions (that is, the forecasted purchases of the specified quantity of soybeans) are still probable of occurring, Entity A would reclassify amounts from accumulated other comprehensive income to earnings when the hedged forecasted transaction affects earnings in accordance with paragraphs 815-30-35-38 through 35-41. The reclassified amounts should be presented in the same income statement line item as the earnings effect of the hedged item. Immediate reclassification of amounts from accumulated other comprehensive income to earnings would be required only if it becomes probable that the hedged forecasted transaction (that is, the purchases of the specified quantity of soybeans in June 20X1) will not occur. As discussed in paragraph 815-30-40-5, a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity’s ability to accurately predict forecasted transactions and the propriety of applying cash flow hedge accounting in the future for similar forecasted transactions.
5.4.40 Interest rate risk on the forecasted issuance or purchase of debt instruments

Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

>>> Forecasted Issuances or Purchases of Debt Instruments

25-17 In this Subtopic, the phrase issuance of fixed-rate debt includes the issuance of a zero-coupon instrument because the interest element in a zero-coupon instrument is fixed at its issuance.

25-18 Provided the entity meets all the other cash flow hedging criteria, an entity may designate as the hedged risk the risk of changes in either of the following:

a. The coupon payments (or the interest element of the final cash flow if interest is paid only at maturity) related to the forecasted issuance of fixed-rate debt

b. The total proceeds attributable to changes in the benchmark interest rate related to the forecasted issuance of fixed-rate debt.

The derivative instrument used to hedge either of these risks must provide offsetting cash flows for the hedging relationship to be effective in accordance with paragraph 815-20-35-3.

25-19 An entity shall not characterize its variable-rate debt as fixed-rate debt that, at each interest reset date, is effectively rolled over to another issuance of fixed-rate debt that has a new fixed interest rate until the next reset date.

25-19A In accordance with paragraph 815-20-25-6, if an entity designates a cash flow hedge of interest rate risk attributable to the variability in cash flows of a forecasted issuance or purchase of a debt instrument, it shall specify the nature of the interest rate risk being hedged as follows:

a. If an entity expects that it will issue or purchase a fixed-rate debt instrument, the entity shall designate the variability in cash flows attributable to changes in the benchmark interest rate as the hedged risk.

b. If an entity expects that it will issue or purchase a variable-rate debt instrument, the entity shall designate the variability in cash flows attributable to changes in the contractually specified interest rate as the hedged risk.

25-19B If an entity does not know at the inception of the hedging relationship whether the debt instrument that will be issued or purchased will be fixed rate or variable rate, the entity shall designate as the hedged risk the variability in cash flows attributable to changes in a rate that would qualify both as a benchmark interest rate if the instrument issued or purchased is fixed rate and as a contractually specified interest rate if the instrument issued or purchased is variable rate.
An entity can apply cash flow hedge accounting to the variability in cash proceeds from a forecasted issuance or purchase of a debt instrument, or to the forecasted interest payments on the future issuance or purchase of a debt instrument.

**Interest rate risk.** An entity may specify the hedged risk based on its expectation of the interest rate on the debt as follows. [815-20-25-19A]

- If the entity expects to issue or purchase fixed-rate debt, it designates the hedged risk as the variability in cash flows attributable to changes in the benchmark interest rate.
- If the entity expects to issue or purchase variable-rate debt, it designates the hedged risk as the variability in cash flows attributable to changes in the contractually specified interest rate.

If the entity does not know whether the debt instrument will have a fixed or variable rate, it designates the hedged risk as variability in cash flows attributable to changes in a rate that would qualify both as a benchmark interest rate and a contractually specified interest rate. [815-20-25-19B]

**Example 5.4.70  
Forecasted issuance of fixed-rate debt**

ABC Corp. forecasts that it will issue a five-year fixed-rate debt instrument in six months. The debt’s fixed rate will be determined on the date it is issued and will be based on current market interest rates.

ABC may designate the hedged risk as changes in either:

- the interest payments related to the forecasted issuance of fixed-rate debt;
- or
- the total proceeds attributable to changes in the benchmark interest rate related to the forecasted issuance of fixed-rate debt.

ABC wants to hedge its exposure to variability in cash flows related to changes in its forecasted interest payments on the debt to be issued.

ABC enters into a forward-starting pay-fixed, receive-LIBOR interest rate swap with a LIBOR leg to hedge the interest rate risk associated with the forecasted interest payments. At inception of the hedge of the forecasted interest payments, ABC designates the variability in cash flows attributable to changes in the LIBOR rate as the hedged risk. The LIBOR rate may be designated as the hedged risk because it is a benchmark interest rate.

**Example 5.4.80  
Forecasted issuance of debt when it is not known whether the interest rate will be fixed or variable**

Assume the same fact pattern as in Example 5.4.70 except that ABC Corp. does not know whether the interest rate on the debt will be fixed or variable rate.
ABC expects that if variable-rate debt is issued, the debt agreement will specify the variable index as the LIBOR rate plus a spread.

ABC enters into a forward-starting pay-fixed, receive-LIBOR interest rate swap to hedge the interest rate risk associated with the forecasted interest payments. At inception of the hedge of the forecasted interest payments, ABC designates the variability in cash flows attributable to changes in the LIBOR rate as the hedged risk.

The LIBOR rate qualifies as a:

- benchmark interest rate if the debt issued is fixed-rate; and
- contractually specified interest rate if the debt issued is variable-rate.

5.4.50 Hedging interest rate risk on forecasted issuances of fixed-rate debt: Rollover strategies

Interest rate risk. Cash flow hedging relationships for forecasted debt issuances commonly include rollovers of short-term, fixed-rate debt such as commercial paper or certificates of deposit issued by banks.

Commercial paper and similar instruments are issued on a fixed-rate discounted basis with relatively short maturities (e.g. seven to 270 days). Specifically, the issuer receives a single discounted amount as proceeds of the issuance and makes a single payment of the stated amount at maturity. There are no periodic interest payments. The interest rate established on the issuance of these fixed-rate instruments is based on current market interest rates for a specific debtor.

An entity may 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). Because the debt is fixed-rate, an entity can designate either the benchmark interest rate or the total change in cash flows as the hedged risk.

Question 5.4.70

How does an entity assess whether forecasted issuances or purchases of short-term, fixed-rate debt in a rollover strategy share similar interest rate risk exposure?

Interpretive response: To designate a group of forecasted transactions as the hedged transactions, they must share the same risk exposure for which they are being hedged. [815-20-55-23]

For hedging strategies involving rollovers of short-term, fixed-rate debt issuances (or purchases), an entity has to demonstrate that the implicit index of each individual fixed-rate instrument in the portfolio (based on its maturity) is highly correlated with the benchmark interest rate designated as being hedged.

Because an entity is hedging the forecasted issuance of fixed-rate debt with an interest rate that has yet to be determined, we believe the guidance for
5. Qualifying criteria for cash flow hedges

assessing the similarity of interest payments related to variable-rate debt instruments in Question 5.3.80 does not necessarily apply.

Example 5.4.90

Hedging interest rate risk on a group of individual transactions related to a rollover strategy

This example has been adapted from a draft DIG Issue referred to as Agenda Item 13-11.

ABC Corp. has an ongoing five-year commercial paper (CP) program involving a series of issuances of short-term fixed-rate borrowings with varying maturities (e.g. 7 days to 270 days) that are expected to rollover at each maturity date.

Each individual CP borrowing is issued at a fixed rate through its term to maturity (at a discount, similar to a Treasury Bill or other zero-coupon instrument). ABC expects a virtually constant average maturity of 30 days across its entire portfolio of CP borrowings over the life of the program.

ABC wishes to hedge the forecasted interest payments arising from future issuances of CP borrowings. It enters into a LIBOR-based interest rate swap that reprices every 30 days to match the average rollover period.

**Similarity test**

ABC has to determine whether the portfolio of commercial paper issuances share the same risk exposure. For guidance on the similarity test when hedging a group of forecasted transactions, see section 5.3.60.

ABC expects interest payments on seven-day CP borrowings to have exposure related to one-week LIBOR, whereas interest payments on 270-day CP borrowings will have exposure related to nine-month LIBOR. To group issuances with maturities ranging from seven days to 270 days, ABC has to demonstrate that seven-day and nine-month LIBOR rates share the same risk exposure.

To accomplish this, ABC performs regression analysis to determine whether historical changes in the CP borrowing rates for each maturity ranging from seven days to 270 days have been highly correlated with the seven-day and nine-month LIBOR rates.

If ABC is unable to demonstrate high correlation, it may need multiple groupings with narrower ranges of maturities. For example, ABC may consider grouping issuances with maturities in the following ranges:

- 7 days – 30 days
- 31 days – 60 days
- 61 days – 90 days
- 91 days – 180 days
- 181 days – 270 days

Similarly, the hedging instruments for each grouping must have benchmark interest rates that align with the maturities of each respective group.
Hedge effectiveness

Because the terms of the forecasted debt issuances will vary from period to period, ABC has to estimate the changes in the hedged forecasted cash flows or construct a hypothetical derivative that represents the best estimate of the future cash flows of each hedged portfolio. This requires an estimate of the hedged forecasted cash flows at the beginning and end of the period for which effectiveness is being assessed.

To do this, ABC could assume that the underlying portfolio is a single instrument with a single maturity equal to the average maturity of the actual portfolio (e.g. 30 days). The cash flow forecast would be developed by assuming the hypothetical item will be continually reissued on its maturity for the same average term as the average maturity.

Question 5.4.80
Should deposit/investment arrangements without contractually stipulated maturity dates be characterized as rollovers of fixed-rate instruments?

Interpretive response: No. Deposit/investment arrangements without contractually stipulated maturity dates (e.g. money market deposits, negotiable order of withdrawal (NOW) accounts and savings accounts), cannot be characterized as a series of daily, or other periodic, rollovers of fixed-rate instruments. This is true even if such arrangements permit both the financial institution and the investor to cancel the arrangement at any time.

Instead, we believe these represent ongoing variable-rate arrangements. Specifically, 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 either overall changes in cash flows, or the contractually specified interest rate.

However, this assumes an entity would be able to find a derivative instrument that is highly effective. This may be difficult 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 product’s rate-setting process may not coincide with the derivative.

FASB Example: Prohibition on characterization of variable-rate debt as rolled fixed-rate debt

The following FASB example illustrates that an entity cannot characterize variable-rate debt as fixed-rate debt that is effectively rolled over at each interest reset date. [815-20-25-19]
5. Qualifying criteria for cash flow hedges

5.4.60 Changing the hedged risk

Excerpt from ASC 815-30

>> Change in Designated Hedged Risk

35-37A If the designated hedged risk changes during the life of a hedging relationship, an entity may continue to apply hedge accounting if the hedging instrument is highly effective at achieving offsetting cash flows attributable to the revised hedged risk. The guidance in paragraph 815-20-55-56 does not apply to changes in the hedged risk for a cash flow hedge of a forecasted transaction.

Topic 815 requires an entity to discontinue hedge accounting when the critical terms of the original hedging relationship have changed (see section 2.10), with the exception of changes to hedged risk when hedging forecasted transactions. [815-20-55-56]

A unique attribute of a cash flow hedge of a forecasted transaction is that:

[ASU 2017-12.BC65]

— an entity’s expectation about the terms of the transaction as established at hedge inception may change during the forecast period; but
— the forecasted transaction may remain probable and the hedging relationship may remain highly effective based on the revised terms.

Topic 815 specifies that if there is a change to the hedged risk in a cash flow hedge of a forecasted transaction, an entity is not required to automatically redesignate the hedging relationship. Instead, it determines whether the hedging instrument continues to be highly effective at achieving offsetting cash flows attributable to the revised forecasted transaction. [815-30-35-37A]
Hedging

5. Qualifying criteria for cash flow hedges

This guidance applies to both nonfinancial and financial risks, and is demonstrated in the following examples.

— Contractually specified component in a not-yet existing contract (Example 5.4.100).
— Changes in a cash flow hedge of forecasted interest payments with an interest rate swap (see Subtopic 815-30’s Example 9 in section 6.5.10).

Example 5.4.100
Change in hedged risk for a contractually specified component in not-yet-existing contracts

The following example is adapted from the example in paragraphs 815-20-55-26B to 55-26E (reproduced in section 5.4.60).

**Contractually specified component in not-yet-existing contract**

On January 1, Year 1, ABC Corp. expects to make future purchases of soybeans on December 31, Year 1. ABC’s contracts to purchase soybeans are typically at a price based on XYZ soybean index plus a variable basis differential for transportation costs.

ABC enters into a forward derivative contract indexed to the XYZ soybean index that will mature on December 31, Year 1. The forward derivative is designated as the hedging instrument in a cash flow hedge. The hedged transaction is the forecasted purchase of a specified quantity of soybeans on December 31, Year 1.

As of the date of the hedge designation, ABC expects that XYZ index will be the contractually specified component in the contract once the contract is executed. ABC documents as the hedged risk the variability in cash flows attributable to changes in the contractually specified XYZ soybean index in the not-yet-existing purchase contract.

On January 1, Year 1, ABC determines that all of the requirements for cash flow hedge accounting are met and the requirements in paragraph 815-20-25-22A will be met once the contract is executed.

**Change in hedged risk**

On July 1, Year 1, ABC executes a contract to purchase soybeans on December 31, Year 1 at a price based on the DEF soybean index plus a variable basis differential for transportation costs instead of the XYZ soybean index.
When ABC executes the contract on July 1, Year 1, it does not automatically
designate the hedging relationship because the hedged risk changed from
XYZ soybean index to DEF soybean index. Instead, it evaluates whether the
hedge is highly effective considering the revised soybean index.

If the hedging relationship is not highly effective using the DEF soybean index,
ABC discontinues the hedging relationship.

**Question 5.4.90**

Does the ability to change the hedged risk also extend to the hedged forecasted transaction?

**Interpretive response:** Current guidance is not clear as to whether the ability
to change the hedged risk also provides an ability to change the hedged
forecasted transaction.

At a March 2018 meeting, the FASB discussed potential Codification
improvements that include the following clarifications. [FASB meeting 03-18]

— The hedged forecasted transaction and hedged risk are distinct.

— The hedged risk may change, and an entity may retain hedge accounting if
the revised hedging relationship is highly effective even if a distinction is
not made between the hedged forecasted transaction and the hedged risk
in an entity’s hedge documentation.

— The hedged forecasted transaction may not be documented so broadly that
it could be changed to another transaction that does not share the same
risk exposure as the originally designated hedged forecasted transaction.

— If the hedging relationship based on the revised hedged risk is not highly
effective, the entity must cease hedge accounting; however, amounts
previously recorded in AOCI remain until the hedged forecasted transaction
affects earnings if the forecasted transaction is still probable.

— An entity may retrospectively designate a particular transaction as the
hedged transaction, within the following parameters.
  — An entity must first identify hedged transactions based on the originally
documented hedged risk.
  — Only when there are no other transactions or insufficient transactions
based on the originally documented hedged risk may the entity
consider transactions based on other risks.
  — If a transaction occurred in a prior reporting period, it cannot be
retrospectively identified as a hedged transaction if it has already
affected reported earnings.

The FASB is in the process of collecting external feedback on these potential
amendments to the Codification. Revisions to this interpretive response may be
provided in a future edition.
5. Qualifying criteria for cash flow hedges

Example 5.4.110

Defining hedged risk for a cash flow hedge of interest rate payments of You Pick ‘Em debt

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, US Treasury or Prime) on which its interest payments are based.

ABC 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.

ABC wishes to hedge the risk of changes in interest rates associated with this instrument. It enters into a receive three-month LIBOR, pay-fixed interest rate swap to hedge the variable interest payments.

**Defining the forecasted transaction and hedged risk**

ABC specifically identifies and defines the forecasted transaction as LIBOR based payments on the specified You Pick ‘Em Debt.

ABC expects to select the three-month LIBOR at each reset date and documents the hedged risk as variability in cash flows attributable to changes in three-month LIBOR. ABC determines that all of the requirements for cash flow hedge accounting are met.

**Hedge effectiveness.** ABC must select a specific tenor of LIBOR as the hedged risk to support hedge effectiveness. The PEH derivative would be a receive three-month LIBOR, pay-fixed interest rate swap. The terms of the PEH do not need to consider the optionality of other rates that may be elected. This is because ABC needs to perform a single hedge effectiveness assessment based on the hedged risk currently expected to occur in the forecasted transaction (i.e. three-month LIBOR). There is no requirement for ABC to perform effectiveness tests associated with multiple potential hedged risks. [ASU 2017-12.BC66-BC67]

For further guidance on PEH derivatives, see section 9.7.30.

**ABC selects a different LIBOR tenor at reset date**

ABC chooses to reset the interest rate during the period from three-month LIBOR to one-month LIBOR. The forecasted interest payments remain probable.

ABC does not automatically dedesignate the hedging relationship because the hedged risk changed from three-month to one-month LIBOR. Instead, it evaluates whether the hedge is highly effective considering the revised LIBOR tenor – i.e. whether the hedging instrument (indexed to three-month LIBOR) is highly effective at achieving offsetting cash flows attributable to the revised contractually specified component (one-month LIBOR).

Further, the change in the designated hedged risk does not represent a missed forecast for ABC because the interest payments remain probable. [ASU 2017-12.BC66]

**Hedge effectiveness.** Because of the change in the LIBOR tenor from three-month to one-month, the PEH must be adjusted to reflect the most recent best estimate of the forecasted transactions that are identified with that relationship.
for purposes of assessing hedge effectiveness. ABC performs an assessment based on the hedged risk currently expected to occur, which is now one-month LIBOR. [ASU 2017-12.BC66–BC67]

If the hedging relationship is not highly effective using one-month LIBOR, ABC will discontinue the hedging relationship.

**ABC selects Prime rate at reset date**

If ABC chooses to reset the interest rate during the period from three-month LIBOR to the Prime rate, the reset would be a change in hedged risk.

Current guidance is unclear as to whether this represents a change in the hedging relationship that would require redesignation, or if the hedging relationship could continue if it remained highly effective. The FASB discussed potential Codification improvements that would clarify this issue (see Question 5.4.90). Revisions to this example may be provided in a future edition.

### 5.5 Hedging instruments in cash flow hedges

**Criterion 1**
- Eligibility of hedged items or transactions

**Criterion 2**
- Eligibility of hedged risk(s)

**Criterion 3**
- Eligibility of hedging instruments

**Criterion 4**
- Hedge effectiveness

**Criterion 5: Formal documentation**

Topic 815 specifies certain criteria that must be met for financial instruments to be eligible for designation as hedging instruments, the primary requirement being that the instrument meets the definition of a derivative. Topic 815 also specifically prohibits certain instruments and outlines limitations involving written options. These concepts are discussed in sections 2.6 and 2.7.

Topic 815 includes additional guidance specific to cash flow hedges around the eligibility of hedging instruments, including:

— special rules for basis swaps (see section 5.5.10); and
— limitations on mixed-attribute derivative commodity contracts (see section 5.5.20).

**Foreign currency risk.** For guidance on the eligibility of hedging instruments in a cash flow hedge of foreign currency risk, see section 7.6.10.
5.5.10 **Special rule for basis swaps**

### Excerpt from ASC 815-20

**> Hedging instrument in a Cash Flow Hedge of Basis Risk**

**25-50** If a hedging instrument is used to modify the contractually specified interest receipts or payments associated with a recognized financial asset or liability from one variable rate to another variable rate, the hedging instrument shall meet both of the following criteria:

a. It is a link between both of the following:
   1. An existing designated asset (or group of similar assets) with variable cash flows
   2. An existing designated liability (or group of similar liabilities) with variable cash flows.

b. It is highly effective at achieving offsetting cash flows.

**25-51** For purposes of paragraph 815-20-25-50, a link exists if both of the following criteria are met:

a. 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 contractually specified interest receipts for the designated asset.

b. The basis of the other leg of the swap is the same as the basis of the contractually specified interest payments for the designated liability.

In this situation, the criterion in paragraph 815-20-25-15(a) is applied separately to the designated asset and the designated liability.

A basis swap is a derivative instrument that is used to change the interest rate characteristics of a variable-rate financial asset or liability from one variable-rate index to another. Instead of fixing the cash flows associated with a variable-rate instrument, a basis swap reduces basis risk by changing the variability of the interest cash flows from one index to another.

Basis risk arises when an entity acquires a financial asset that is funded with a financial liability. 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.

For example, an entity that has a one-month LIBOR-based asset funded by a Prime-based liability has economic basis risk between LIBOR and Prime interest rates. If one-month LIBOR rates decrease significantly and Prime rates remain unchanged, the entity would experience a significant change in the margin between the interest rates associated with the two positions. A basis swap could effectively alter future cash flows from a LIBOR basis to a prime basis, or vice versa.
The following illustrates a basis swap strategy.

By using a basis swap, an entity is able to lock in a net margin of 125 basis points (bps)

Basis swaps do not reduce or eliminate the variability of cash flows associated with the *individual* financial instruments. However, they reduce or eliminate the variability of cash flows attributable to the combined asset-liability position.

Topic 815 only allows a basis swap to be used to modify the interest receipts of a recognized financial asset and the interest payments of a recognized financial liability. To designate a basis swap as the hedging instrument in a cash flow hedging relationship, the following criteria must be met: [815-20-25-50]

— each leg of the basis swap is linked to a designated item with the same underlying; and
— the basis swap is highly effective in achieving offsetting cash flows.
Basis swap links with same underlying

To qualify for hedge accounting, each leg of the basis swap must provide 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. [815-20-25-50(a), 25-51]

For example, an entity with one-month LIBOR-based assets funded by variable-rate debt that has an interest rate of Prime is required to use a swap with one leg based on one-month LIBOR and one leg based on the Prime rate. In contrast, it cannot use a swap with one one-month LIBOR-based leg and one leg based on the bond market association (BMA) rate. This is illustrated in the following table, along with other combinations and whether the requirement is met.

<table>
<thead>
<tr>
<th>Variable-rate asset</th>
<th>Variable-rate liability</th>
<th>Basis swap</th>
<th>Permitted?</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-month LIBOR</td>
<td>Prime</td>
<td>One-month LIBOR and Prime</td>
<td>✓</td>
</tr>
<tr>
<td>One-month LIBOR</td>
<td>Prime</td>
<td>One-month LIBOR and BMA rate</td>
<td>❌</td>
</tr>
<tr>
<td>One-month LIBOR + 300 bps</td>
<td>Prime</td>
<td>(One-month LIBOR + 175 bps) and Prime</td>
<td>✓</td>
</tr>
<tr>
<td>One-month LIBOR</td>
<td>Prime</td>
<td>Six-month LIBOR and Prime</td>
<td>❌</td>
</tr>
</tbody>
</table>

Basis swap is highly effective in offsetting net interest cash flows

To qualify for hedge accounting, the basis swap must be highly effective in achieving offsetting cash flows attributable to the hedged risk. [815-20-25-50(b)]

Specifically, 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.

Question 5.5.10

How is the hedged forecasted transaction defined in a cash flow hedging relationship involving a basis swap?

Interpretive response: We believe a cash flow hedging relationship involving a basis swap is considered a single hedging relationship.

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.
Although each leg of the basis swap must be linked to the designated item with the same underlying, the hedged forecasted transactions are the net interest cash flows of those combined designated items. [815-20-25-51]

The ability to hedge the net interest cash flows of a recognized financial asset and a recognized financial liability is not permitted anywhere else in Topic 815.

**Formal documentation.** 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. [815-20-25-3(d)(1)]

When an entity designates a cash flow hedge of interest rate risk, it must formally document the hedged risk as exposure to both contractually specified interest rates. For example (using the basis swap strategy above).

**Example 5.5.10 Basis swap that qualifies for cash flow hedge accounting**

Bank 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 Prime plus 1%.

To reduce its basis risk, Bank enters into a five-year basis swap with a notional amount of $10,000,000 to receive interest at a variable rate equal to 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 identifies the basis swap as the hedging instrument in a hedging relationship to hedge the risk of changes in the contractually specified interest rates.

Bank links the one-month LIBOR-based leg of the basis swap to the $10,000,000 commercial loan and the 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 because:

— the underlying asset is a recognized financial asset and the underlying liability is a recognized financial liability, and both have been individually identified;
— the basis swap is used to offset changes in the contractually specified interest rates associated with the commercial loan and the debt obligation; and
— each leg of the basis swap has been linked to a designated hedged transaction with the same underlying.

Example 5.5.20

Basis swap that does not qualify for cash flow hedge accounting

Bank has a five-year $10,000,000 variable-rate commercial loan that earns one-month LIBOR.

ABC Corp. 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.

ABC issues a five-year, $10,000,000 debt obligation. The interest rate on the debt obligation is variable at one-month LIBOR.

ABC 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.

Question 5.5.20

How does an entity assess whether a basis swap is highly effective at offsetting changes in the net interest cash flows?

Interpretive response: Although the interest rate index of each leg of the basis swap must be identical to the contractually specified interest rates of the underlying, an entity cannot automatically assume the hedge will perfectly offset the net interest cash flows or always be highly effective.

For example, an entity should consider whether the recognized financial asset, the recognized financial liability and/or the basis swap reprice or have payments at different dates. This could affect whether the hedge is highly effective.
For an example of assessing effectiveness of a cash flow hedge with a basis swap, see Subtopic 815-30's Example 2 in section 9.2.10.

Question 5.5.30
Can an entity hedge net interest cash flows from a group of recognized assets or liabilities in a cash flow hedging relationship involving a basis swap?

Interpretive response: It depends. 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. However, the requirement that a group of individual transactions share the same risk exposure for which they are being hedged (see section 5.3.60) must be met separately for the group of assets and/or group of liabilities to qualify for hedge accounting.

Question 5.5.40
Can an entity apply the first-payments-received (paid) approach when designating the net interest cash flows in a hedging relationship involving a basis swap?

Background: In a cash flow hedge of interest rate risk, the specifically identified group of transactions may be the first interest payments received (paid) for a rolling portfolio of prepayable interest-bearing loans, or other interest-bearing financial assets, provided all other conditions for a cash flow hedge have been met. For further guidance, see section 5.3.70.

Excerpts from ASC 815-20

>>> First-Payments-Received Technique in Hedging Variable Interest Payments on a Group of Loans

55-33E This implementation guidance regarding use of a first-cash-flows technique also may be applied to a cash flow hedging relationship in which the hedging instrument is a basis swap as discussed beginning in paragraph 815-20-25-50. However, use of that technique for those basis-swap hedging relationships may not be common because that paragraph limits designating a basis swap as the hedging instrument to cash flow hedges of the contractually specified interest payments of only recognized financial assets and liabilities existing at the inception of the hedge, whereas the first-cash-flows technique is typically applied to the contractually specified interest payments for rolling portfolios whose composition of financial assets changes over the period of the hedge.
Interpretive response: Yes. An entity may apply the first-payments-received (paid) approach to a cash flow hedging relationship in which the hedging instrument is a basis swap. [815-20-55-33E]

However, using this approach may not be common because Topic 815 limits designating a basis swap as a hedging instrument for contractually specified interest receipts (or payments) associated with a recognized financial asset or liability existing at hedge inception. In contrast, the first-payments-received (paid) approach is typically applied to the contractually specified interest receipts (or payments) for a rolling portfolio of financial liabilities (or assets) that change over the life of the hedging relationship. [815-20-55-33E]

We believe 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:

— the entity is using the first-payments-received approach to identify the hedged forecasted transactions; and
— all identified hedged cash flows are associated with assets or liabilities that existed at the inception of the hedge.

Example 5.5.30
First-payments-received (paid) approach with basis swap as the hedging instrument

Bank has a portfolio of variable-rate loans totaling $400 million in principal that earn Prime plus 1%. These loans are funded by a portfolio of variable-rate financial liabilities totaling $500 million in principal that pays one-month LIBOR plus 4%.

To reduce its basis risk, Bank enters into a basis swap with a notional amount of $100 million to receive interest at a variable rate equal to one-month LIBOR plus 2% and to pay interest at a variable rate equal to Prime.

Bank uses the first-payments-received (paid) approach and identifies the hedged transaction as follows:

— first Prime-based interest payments received at the beginning of each quarter that are payments on $100 million principal of Prime-based loans existing at inception of the hedge – e.g. Prime-based loans totaling $400 million in principal; and
— first LIBOR-based interest payments at the beginning of each quarter that are payments on $100 million principal of LIBOR-based debt obligations existing at inception of the hedge – e.g. LIBOR-based loans totaling $500 million in principal.
**Question 5.5.50**

Is a cash flow hedge with a basis swap automatically redesignated if there is a change to the contractually specified interest rate?

**Interpretive response:** Yes. Because each leg of the basis swap must be linked to the designated item with the same underlying, we do not believe an entity could change the contractually specified interest rate without redesignating the hedging relationship.

For example, an entity designates the hedged forecasted transaction as interest receipts and payments on a recognized asset and liability, respectively. The hedged risk is identified as changes in the contractually specified interest rates, being one-month LIBOR for the asset and Prime for the liability. Each leg of the basis swap properly links to the index of the underlying.

If the contractually specified interest rate for the asset changed from one-month LIBOR to a different index (e.g. BMA or six-month LIBOR), there would be a mismatch and the requirement that each leg of the basis swap properly link to the index of the underlying would no longer be met.

**Question 5.5.60**

Can basis swaps other than those involving interest rates be designated as a hedging instrument?

**Interpretive response:** No. There are 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.

However, we believe an entity is prohibited from using basis swaps other than those involving exchanges of interest rates in a cash flow hedging relationship.

### 5.5.20 Limitations on mixed-attribute derivative commodity contracts

**Excerpt from ASC 815-20**

***Mixed-Attribute Derivative Commodity Contracts as Cash Flow Hedging Instruments***

55-46 Commodity contracts commonly have features of both fixed-price contracts and variable-price contracts, such as an agreement to purchase a commodity in the future at the prevailing market index price at that future date plus or minus a fixed basis differential set at the inception of the contract. Assume an example mixed-attribute contract has the characteristics of notional amount, underlying, and no initial net investment and the commodity to be
Contracts with both a fixed and variable exercise price are commonly referred to as mixed-attribute contracts or fixed-basis contracts. These are common in the commodities industry.

For example, a buyer seeks to use crude oil in the production of unleaded gasoline. In January, the buyer agrees to buy 1,000 barrels of a specific type of crude oil in July from a 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 the timing and location of delivery.

In general, this type of mixed-attribute contract would qualify as a derivative instrument. The basis differential is an underlying to the contract and changes in the basis differential will affect the fair value of the contract as a whole.

However, the mixed-attribute contract is unlikely to be able to function as the sole hedging instrument in a cash flow hedge of the anticipated purchase or sale of the commodity. This is because that forecasted transaction is one whose variability in cash flows is based on changes in both the basis differential and the base commodity price (e.g. WTI price index). This type of derivative contract would essentially be hedging only a portion of the variability in cash flows (i.e. the basis differential). In other words, it doesn’t consider changes in the base commodity price. [815-20-55-47]
However, this mixed-attribute contract may be effective if combined with another derivative whose underlying is the base commodity price. This would address both the basis differential and the base commodity price. [815-20-55-47]
6. Accounting for cash flow hedges

Detailed contents

6.1 How the standard works

6.2 Cash flow hedge accounting model
   6.2.10 Overview
   6.2.20 Excluded components

Examples
   6.2.10 Accounting for a cash flow hedge of a variable-rate loan with an interest rate swap
   6.2.20 Accounting for a cash flow hedge of a variable-rate debt obligation with an interest rate swap that has a cap and a floor
   6.2.30 Accounting for a cash flow hedge of a forecasted purchase of inventory with a forward contract (critical terms match – forward value method)
   6.2.40 Comparison of approaches to recognize the excluded component for a cash flow hedge
   6.2.50 Accounting for a cash flow hedge of forecasted purchase of inventory with a call option (critical terms do not match – intrinsic value method)

6.3 Reclassifying amounts from AOCI into earnings
   6.3.10 Overview
   6.3.20 Hedging instruments with periodic settlements

Questions
   6.3.10 What method is used to reclassify amounts in AOCI into earnings?
   6.3.20 When are amounts in AOCI related to specific borrowings associated with assets under construction reclassified into earnings?
   6.3.30 Why is a loss in AOCI reclassified into earnings if the combination of the hedging instrument and hedged transaction would result in a future loss?
   6.3.40 Can an impairment loss be recognized before a forecasted transaction occurs?
6.3.50 What are acceptable methods to reclassify the initial non-zero fair value of a hedging instrument with periodic cash settlements?

6.3.60 What method is appropriate to reclassify amounts from AOCI when an interest rate swap with scheduled increases in its fixed leg is used to hedge interest payments on variable-rate debt?

6.3.70 What method is appropriate to reclassify amounts from AOCI when multiple derivatives are used to hedge interest payments on variable-rate debt?

**Examples**

6.3.10 Accounting for an all-in-one hedge of a forecasted equipment purchase

6.3.20 Combination of loss reported in AOCI and hedged transaction would give rise to a loss

6.3.30 Accounting for a cash flow hedge of a variable-rate, long-term debt with an interest rate cap

### 6.4 Assessing impairment

**Questions**

6.4.10 Are the fair value or expected cash flows of a hedging instrument ever considered when evaluating impairment of an asset related to the hedged transaction?

6.4.20 Are net gains in AOCI reclassified if an impairment loss is recognized on an existing asset to which a current or previous hedged forecasted transaction relates?

**Examples**

6.4.10 Hedged asset is impaired and related amount in AOCI is a net derivative loss

6.4.20 Hedged asset is impaired and related amount in AOCI is a net derivative gain

### 6.5 Discontinuing hedge accounting

**Questions**

6.5.10 If a hedging relationship has been retrospectively highly effective, is hedge accounting required to be applied in the previous period?

6.5.20 What is the accounting for amounts in AOCI related to a partially dedesignated cash flow hedging relationship?
6.5.30 Is hedge accounting applied through the date an event causes a hedging relationship to no longer be highly effective?

6.5.40 Is it appropriate to assume the last date of high effectiveness is the date insolvency is declared or significant financial difficulties are disclosed?

6.5.50 Can amounts be reclassified from AOCI when a hedge is discontinued, even if the forecasted transaction is reasonably possible?

6.5.60 Does an entity consider an additional two-month period when deciding whether to discontinue hedge accounting?

6.5.70 May an entity ignore the additional two-month period when deciding whether to immediately reclassify amounts from AOCI into earnings?

6.5.80 How is the additional two-month period considered when an entity has a series of hedging relationships?

6.5.90 How common are extenuating circumstances that extend the additional two-month period?

6.5.100 Where are amounts reclassified from AOCI into earnings in connection with a missed forecast presented in the income statement?

6.5.110 What factors are considered when evaluating whether missed forecasts represent a pattern?

Examples

6.5.10 Terminating an interest rate swap used in a cash flow hedge

6.5.20 Terminating a cash flow hedge when hedge designation is removed

6.5.30 Accounting for amounts in AOCI when a hedged forecasted transaction becomes a firm commitment

6.5.40 Dedesignation and redesignation of a hedging relationship due to failing to qualify for cash flow hedge accounting in one period

6.5.50 Identification of the date credit deterioration caused a hedge to cease being highly effective

6.5.60 Whether a delay in a forecasted transaction is due to extenuating circumstances that extend the additional two-month period
6.1 How the standard works

A **cash flow hedge** is 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.

In general, the cash flow hedge accounting model works as follows.

- A **derivative hedging instrument** is recorded at fair value in the balance sheet. Changes in its fair value that are included in the assessment of hedge effectiveness are reported in OCI.
- The amounts in AOCI are recognized in earnings – in the same income statement line item as the effect of the hedged transaction – when the hedged transaction affects earnings.

The following shows the general accounting and presentation for a highly effective cash flow hedging relationship (this assumes there are no excluded components).

The effect of the above is to defer earnings recognition of changes in fair value of the hedging instrument (that are included in the assessment of effectiveness) until the hedged transaction affects earnings.

When a cash flow hedge is discontinued, the net derivative gain or loss reported in AOCI generally is not recognized immediately in earnings. Instead, it is reclassified into earnings when the hedged forecasted transaction is reported in earnings. However, the net derivative gain or loss reported in AOCI is reclassified into earnings immediately if it is probable that the hedged forecasted transaction will not occur in the original period specified in the hedge documentation or within an additional two-month period.
6.2 Cash flow hedge accounting model

6.2.10 Overview

Excerpt from Subtopic 815-20

35-1 Paragraph 815-10-35-2 states that the accounting for subsequent changes in the fair value (that is, gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Specifically, subsequent gains and losses on derivative instruments shall be accounted for as follows: …

c. Cash flow hedge. 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 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 paragraphs 815-30-35-3 and 815-30-35-38 through 35-41. If an entity excludes a portion of the hedging instrument from the assessment of hedge effectiveness in accordance with paragraph 815-20-25-82, the initial value of the excluded component shall be recognized in earnings using a systematic and rational method over the life of the hedging instrument with any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method recognized in other comprehensive income in accordance with paragraph 815-20-25-83A. An entity also may elect to recognize the excluded component of the gain or loss currently in earnings in accordance with paragraph 815-20-25-83B. 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 815-20-25-65.

> Income Statement Classification

45-1A For qualifying fair value and cash flow hedges, an entity shall present both of the following in earnings in the same income statement line item that is used to present the earnings effect of the hedged item:

a. The change in the fair value of the hedging instrument that is included in the assessment of hedge effectiveness
b. Amounts excluded from the assessment of hedge effectiveness in accordance with paragraphs 815-20-25-83A through 25-83B.

See paragraphs 815-20-55-79W through 55-79AD for related implementation guidance.

45-1B For cash flow hedges in which the hedged forecasted transaction is probable of not occurring in accordance with paragraph 815-30-40-5, this Subtopic provides no guidance on the required income statement classification of amounts reclassified from accumulated other comprehensive income to earnings.
6. Accounting for cash flow hedges

While the Derivatives and Hedging Topic does not specify whether certain income statement line items are either permitted or appropriate, the other hedging-related Subtopics in this Topic do contain specific disclosure requirements for those items. See Section 815-10-50 and Subtopics 815-25, 815-30, and 815-35.

> Statement of Cash Flows

For guidance on the classification of cash receipts and payments related to hedging activities, see paragraph 230-10-45-27.

> Other Comprehensive Income

An entity shall display as a separate classification within other comprehensive income the net gain or loss on derivative instruments designated and qualifying as fair value or cash flow hedging instruments that are reported in comprehensive income pursuant to paragraphs 815-20-25-65, 815-20-25-83A, and 815-30-35-3.

> Entities

The guidance in this Subtopic does not apply to the following entities:

a. Entities that do not report earnings. Those entities are not permitted to use cash flow hedge accounting because they do not report earnings separately.

b. Amounts in accumulated other comprehensive income related to the derivative designated as a hedging instrument included in the assessment of hedge effectiveness are reclassified to earnings in the same period or periods during which the hedged forecasted transaction affects earnings in accordance with paragraphs 815-30-35-38 through 35-41 and presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A. The balance in accumulated other comprehensive income associated with the hedged transaction shall be the cumulative gain or loss on the derivative instrument from inception of the hedge less all of the following:
6. Accounting for cash flow hedges

1. Subparagraph superseded by Accounting Standards Update No. 2017-12.
   1a. The derivative instrument’s gains or losses previously reclassified from accumulated other comprehensive income into earnings pursuant to paragraphs 815-30-35-38 through 35-41.
   1b. The cumulative amount amortized to earnings related to excluded components accounted for through an amortization approach in accordance with paragraph 815-20-25-83A.
   1c. The cumulative change in fair value of an excluded component for which changes in fair value are recorded currently in earnings in accordance with paragraph 815-20-25-83B.

2. Subparagraph superseded by Accounting Standards Update No. 2017-12.

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 (b) would exclude the gains or losses occurring during that period. 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 would be highly effective in future periods. Consequently, the hedging relationship continued even though hedge accounting was not permitted for a specific previous effectiveness assessment period.

A derivative **hedging instrument** that qualifies for cash flow hedge accounting is measured at fair value in the balance sheet. Changes in its fair value that are included in the assessment of hedge effectiveness are reported in OCI. Net gains or losses on derivative hedging instruments that are included in AOCI are displayed as a separate classification within AOCI. These amounts are reclassified from AOCI into earnings – in the same income statement line item as the effect of the hedged transaction – when the hedged transaction affects earnings. When the earnings effect of the hedged transaction is presented in more than one line item, the change in the fair value of the hedging instrument is allocated to the different line items. [815-20-45-3, 55-79Z – 55-79AD, 815-30-35-3]

In contrast, changes in the derivative hedging instrument’s fair value related to components that are excluded from the assessment of hedge effectiveness are recognized in earnings using either an amortization approach or a mark-to-market approach. When an amortization approach is used, the difference between the amount that is amortized and the change in fair value of the excluded component each period is recognized in OCI. [815-20-25-83A – 25-83B, 815-30-35-3]

The following table summarizes the timing and presentation for recognizing in earnings changes in a derivative hedging instrument’s fair value that arise during the hedging relationship.
### Hedging:

#### 6. Accounting for cash flow hedges

<table>
<thead>
<tr>
<th>Component</th>
<th>Timing of earnings recognition for changes in fair value</th>
<th>Presentation in income statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changes in fair value that are included in the assessment of hedge effectiveness</td>
<td>Reclassified from AOCI into earnings when the hedged transaction affects earnings (see sections 6.3 and 6.4). However, when it is probable that a forecasted transaction will not occur (i.e. a missed forecast), related amounts in AOCI are immediately reclassified into earnings (see section 6.5.20).</td>
<td>Same line item as effect of <strong>hedged transaction</strong>. However, Topic 815 provides no guidance when amounts are reclassified from AOCI due to a missed forecast (see Question 6.5.110).</td>
</tr>
</tbody>
</table>

| Changes in fair value of excluded components | Depends on the approach elected (see section 6.2.20):  
--- Amortization approach. Recognized in earnings using a systematic and rational method over the life of the hedging instrument. However, when it is probable that a forecasted transaction will not occur (i.e. a missed forecast), related amounts in AOCI are immediately reclassified into earnings (see section 6.5.20).  
--- Mark-to-market approach. Immediately recognized in earnings (i.e. as the changes occur). | Same line item as effect of **hedged transaction**. However, Topic 815 provides no guidance when amounts are reclassified from AOCI due to a missed forecast (see Question 6.5.110). |

**Notes:**

1. These amounts do not include changes in fair value arising during periods that the hedging relationship was not highly effective retrospectively (see Question 2.10.90).

2. When the earnings effect of the hedged transaction is presented in more than one line item, the change in the fair value of the hedging instrument is allocated to the different line items.

The effect of the cash flow hedge accounting model is to defer earnings recognition of changes in fair value of the hedging instrument (that are included in the assessment of effectiveness) until the hedged transaction affects earnings.

If the hedging relationship is:

--- **Perfectly effective.** The net derivative gain or loss that is reclassified from AOCI will exactly offset gains or losses on the hedged transaction that are attributable to the hedged risk within one line item of the income statement.
Not perfectly effective. The extent to which the gains and losses on the hedging instrument do not offset gains and losses on the forecasted transaction is reflected in a single line item of the income statement.

Cumulative measurement

The amount recognized in AOCI for a derivative hedging instrument is a cumulative measurement. This means that the balance in AOCI related to a cash flow hedging instrument comprises the following. [815-30-35-3(b)]

- Cumulative change in fair value of hedging instrument since inception
- Amounts previously reclassified into earnings (see section 6.3)
- Amounts previously recognized in earnings related to excluded components (see section 6.2.20)
- Amounts arising from changes in fair value during periods when the hedging relationship was not highly effective on a retrospective basis

An example of an adjustment that may occur (in the right box) is discussed in Question 2.10.90. In limited circumstances, it may be appropriate to continue applying hedge accounting when the entity’s:

- retrospective hedge effectiveness assessment for the assessment period indicates that the relationship was not highly effective; but
- prospective assessment indicates that the relationship is expected to be highly effective in the future.

Discontinuance of hedging relationship

When a cash flow hedge is discontinued (see section 6.5), the net derivative gain or loss reported in AOCI generally is not immediately recognized in earnings. Instead, it generally is recognized in earnings when the hedged forecasted transaction is reported in earnings (see section 6.3). However, a net derivative gain or loss reported in AOCI is immediately reclassified into earnings if it is probable that the hedged forecasted transaction will not occur in the original period specified in the hedge documentation or within an additional two-month period (see section 6.5.20).

Income tax considerations

The tax effect of gains or losses recorded in OCI also should be charged or credited directly to OCI. This includes gains or losses arising from changes in fair value of derivatives designated in qualifying cash flow hedging relationships and from derivatives designated in qualifying fair value hedging relationships for which an amortization approach is used to recognize excluded components. See KPMG’s Handbook, Accounting for Income Taxes, including paragraphs 9.043 and 9.050, for further information.
Examples

The examples in this section demonstrate cash flow hedge accounting.

— Accounting for a cash flow hedge of a variable-rate loan with an interest rate swap (Example 6.2.10).
— Accounting for a cash flow hedge of a variable-rate debt obligation with an interest rate swap that has a cap and a floor (Example 6.2.20).
— Accounting for a cash flow hedge of a forecasted purchase of inventory with a forward contract (critical terms match – forward value method) (Example 6.2.30).
— Accounting for a cash flow hedge of a variable-rate interest-bearing asset (Subtopic 815-30’s Example 6).
— Reporting cash flow hedges in the income statement and AOCI (Subtopic 815-30’s Example 12).

Example 6.2.10
Accounting for a cash flow hedge of a variable-rate loan with an interest rate swap

On January 1, Year 1, Bank originates a three-year, $10,000,000 loan receivable that matures on December 31, Year 3. The interest rate earned on the loan is variable at 12-month LIBOR plus 2%.

Because it is concerned that 12-month LIBOR will decline, Bank 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 12-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 designates the swap as a cash flow hedge of the variability in interest payments received on the loan attributable to the changes in the contractually specified interest rate, which is 12-month LIBOR.

The following additional facts are relevant.
— All criteria for cash flow hedge accounting have been met.
— The hedging relationship was highly effective in all periods.
— 12-month LIBOR and related amounts are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>12-month LIBOR on January 1</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>Year 1</td>
<td>7%</td>
<td>$</td>
<td>$900,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>6%</td>
<td>100,000</td>
<td>800,000</td>
<td>900,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>5%</td>
<td>200,000</td>
<td>700,000</td>
<td>900,000</td>
</tr>
</tbody>
</table>
Notes:
1. $10,000,000 notional amount of the swap × (fixed rate - 12-month LIBOR for the respective Year).
2. $10,000,000 principal amount of the loan × 12-month LIBOR + 2% for the respective Year.
3. Swap net receipt for the year + Loan interest for the year.

The fair value of the interest rate swap and changes therein at the end of each accounting period (i.e. December 31) after cash settlement (which is referred to as ‘clean’ pricing) are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair value asset</th>
<th>Change in fair value gain (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>125,000</td>
<td>(175,000)</td>
</tr>
<tr>
<td>Year 3</td>
<td>-</td>
<td>(125,000)</td>
</tr>
</tbody>
</table>

For simplicity, this example makes the following assumptions.

— It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
— It is based on annual periods; normally the assessment of effectiveness and related accounting entries would be performed at least quarterly.
— Journal entries (for all years) are presented gross for illustrative purposes but could be combined.
— There has been no change in creditworthiness of either party that would affect the likelihood of hedged transactions occurring.

**Journal entries – January 1, Year 1**

Bank records the following journal entry on January 1, Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan receivable 10,000,000</td>
<td></td>
</tr>
<tr>
<td>Cash 10,000,000</td>
<td></td>
</tr>
</tbody>
</table>

*To record origination of 12-month LIBOR + 2% loan.*

There is also a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship. The financial records of Bank are not otherwise affected as of this date because the interest rate swap had a fair value of zero at inception.

**Journal entries – December 31, Year 1**

Bank records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 900,000</td>
<td></td>
</tr>
<tr>
<td>Interest income 900,000</td>
<td></td>
</tr>
</tbody>
</table>

*To record interest received on 12-month LIBOR + 2% loan.*
Journal entries – December 31, Year 2

Bank records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate swap</td>
<td>300,000</td>
</tr>
<tr>
<td>OCI – Gain (loss) on cash flow hedge</td>
<td>300,000</td>
</tr>
<tr>
<td>To record change in fair value of interest rate swap (hedging instrument).</td>
<td></td>
</tr>
</tbody>
</table>

Note:

1. This is the adjustment required to bring interest income on the loan to $900,000.

Journal entries – December 31, Year 3

Bank records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>700,000</td>
</tr>
<tr>
<td>Interest income</td>
<td>700,000</td>
</tr>
<tr>
<td>To record interest received on 12-month LIBOR + 2% loan.</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>200,000</td>
</tr>
<tr>
<td>AOCI – Gain (loss) on cash flow hedge</td>
<td>200,000</td>
</tr>
<tr>
<td>To record cash paid on settlement of interest rate swap in AOCI.</td>
<td></td>
</tr>
</tbody>
</table>
### Hedge Accounting

#### Financial Statement Excerpts

At the end of Years 1–3, Bank’s financial statements reflect the following.

<table>
<thead>
<tr>
<th>Account</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan receivable</td>
<td>$10,000,000</td>
<td>$10,000,000</td>
<td>-</td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>300,000</td>
<td>125,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Balance sheet – equity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gain (loss) on cash flow hedge</td>
<td>$300,000</td>
<td>$125,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>$900,000</td>
<td>$900,000</td>
<td>$900,000</td>
</tr>
</tbody>
</table>

As a result of entering into the hedging relationship, Bank locked in a 9% rate for the term of the loan. Because cash flow hedge accounting is used and the hedge is highly effective, earnings do not reflect any volatility that would otherwise result from changes in the interest rate swap’s fair value.

However, Bank’s OCI reflects volatility as a result of the requirement to report the interest rate swap (derivative hedging instrument) at fair value on the balance sheet. This is evidenced by the following roll-forward of AOCI.

---

Note:
1. This is the adjustment required to bring interest income on the loan to $900,000.
6. Accounting for cash flow hedges

<table>
<thead>
<tr>
<th>Debit (credit)</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>$</td>
<td>$300,000</td>
<td>$125,000</td>
</tr>
<tr>
<td>Cash settlement</td>
<td>-</td>
<td>100,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Reclassification to earnings</td>
<td>-</td>
<td>(100,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Gain (loss) on the swap</td>
<td>300,000</td>
<td>(175,000)</td>
<td>(125,000)</td>
</tr>
<tr>
<td><strong>Closing balance</strong></td>
<td><strong>$300,000</strong></td>
<td><strong>$125,000</strong></td>
<td><strong>$</strong></td>
</tr>
</tbody>
</table>

Example 6.2.20

**Accounting for a cash flow hedge of a variable-rate debt obligation with an interest rate swap that has a cap and a floor**

On January 1, Year 1, ABC Corp. issues a three-year, $10,000,000 debt instrument that matures on December 31, Year 3. The interest rate on the debt instrument is variable at six-month LIBOR.

ABC is concerned that six-month LIBOR will increase above the current level. Therefore, on January 1, Year 1, ABC 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 ABC 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.

ABC designates the swap as a cash flow hedge of the variability in interest payments on the debt instrument attributable to the changes in the contractually specified interest rate, which is six-month LIBOR.

The following additional facts are relevant.

— All criteria for cash flow hedge accounting have been met.

— 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 contractually specified interest rate (six-month LIBOR), ABC determines that the interest rate swap is not a net written option (see section 2.7.60).

Based on statistical analysis, ABC concludes and documents 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. This is 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, ABC determines 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. ABC notes that it could have entered into the same interest rate swap on January 1, Year 1 without the cap and floor and without paying or receiving a premium.

— ABC assesses effectiveness 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.

— Six-month LIBOR and related amounts are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Six-month LIBOR on January 1</th>
<th>Swap net payment for the year¹</th>
<th>Debt interest for the year²</th>
<th>Net interest for the year³</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>7%</td>
<td>$-</td>
<td>$700,000</td>
<td>$700,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>6%</td>
<td>100,000</td>
<td>600,000</td>
<td>700,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>5%</td>
<td>200,000</td>
<td>500,000</td>
<td>700,000</td>
</tr>
</tbody>
</table>

Notes:
1. $10,000,000 notional amount of the swap × (six-month LIBOR for the respective Year - fixed rate).
2. $10,000,000 principal amount of the debt × six-month LIBOR for the respective Year.
3. Swap net payment for the year + Debt interest for the year.

— The fair value of the interest rate swap and changes therein at the end of each accounting period (i.e. December 31) after cash settlement (which is referred to as ‘clean’ pricing) are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair value liability</th>
<th>Change in fair value gain (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$(300,000)</td>
<td>$(300,000)</td>
</tr>
<tr>
<td>Year 2</td>
<td>(125,000)</td>
<td>175,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>-</td>
<td>125,000</td>
</tr>
</tbody>
</table>
For simplicity, this example makes the following assumptions.

— It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
— It is based on annual periods; normally the assessment of effectiveness and related accounting entries would be done at least quarterly.
— Journal entries (for all years) are presented gross for illustrative purposes but could be combined.

**Journal entries – January 1, Year 1**

ABC records the following journal entry as of January 1, Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Debt obligation</td>
<td>10,000,000</td>
</tr>
<tr>
<td><em>To record issuance of six-month LIBOR debt obligation.</em></td>
<td></td>
</tr>
</tbody>
</table>

There is also a memorandum entry made on January 1, Year 1, documenting the existence of this hedging relationship. ABC’s financial records are not otherwise affected as of this date because the interest rate swap had a fair value of zero at inception.

**Journal entries – December 31, Year 1**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>700,000</td>
</tr>
<tr>
<td>Cash</td>
<td>700,000</td>
</tr>
<tr>
<td><em>To record interest paid on six-month LIBOR debt obligation.</em></td>
<td></td>
</tr>
</tbody>
</table>

| OCI – Loss on cash flow hedge               | 300,000                       |
| Interest rate swap                         | 300,000                       |
| *To record change in fair value of interest rate swap (hedging instrument).* | |

**Journal entries – December 31, Year 2**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>600,000</td>
</tr>
<tr>
<td>Cash</td>
<td>600,000</td>
</tr>
<tr>
<td><em>To record interest paid on six-month LIBOR debt obligation.</em></td>
<td></td>
</tr>
</tbody>
</table>
### Journal entries – December 31, Year 3

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>500,000</td>
</tr>
<tr>
<td>Cash</td>
<td>500,000</td>
</tr>
<tr>
<td>To record interest paid on six-month LIBOR debt obligation.</td>
<td></td>
</tr>
<tr>
<td>AOCI – Loss on cash flow hedge</td>
<td>200,000</td>
</tr>
<tr>
<td>Cash</td>
<td>200,000</td>
</tr>
<tr>
<td>To record cash paid on settlement of interest rate swap in AOCI.</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>200,000</td>
</tr>
<tr>
<td>AOCI – Loss on cash flow hedge</td>
<td>200,000</td>
</tr>
<tr>
<td>To reclassify into earnings amounts in AOCI as a result of cash flow hedge.</td>
<td></td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>125,000</td>
</tr>
<tr>
<td>OCI – Loss on cash flow hedge</td>
<td>125,000</td>
</tr>
<tr>
<td>To record change in fair value of interest rate swap (hedging instrument).</td>
<td></td>
</tr>
<tr>
<td>Debt obligation</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>10,000,000</td>
</tr>
<tr>
<td>To record cash paid by borrower on maturity of the six-month LIBOR debt obligation.</td>
<td></td>
</tr>
</tbody>
</table>
Financial statement excerpts

At the end of Years 1–3, ABC’s financial statements reflect the following.

<table>
<thead>
<tr>
<th>Account</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt obligation</td>
<td>$10,000,000</td>
<td>$10,000,000</td>
<td>-</td>
</tr>
<tr>
<td>Interest rate swap</td>
<td>300,000</td>
<td>125,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Balance sheet – equity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gain (loss) on cash flow hedge</td>
<td>$(300,000)</td>
<td>$(125,000)</td>
<td>-</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>$700,000</td>
<td>$700,000</td>
<td>$700,000</td>
</tr>
</tbody>
</table>

As a result of entering into the hedging relationship, ABC locked in a 7% rate for the term of the debt. Because cash flow hedge accounting is used and the hedge is highly effective, earnings do not reflect any volatility that would otherwise result from changes in the interest rate swap’s fair value.

This is the case even though the terms of the interest rate swap included a cap and a floor on the interest rate, because neither the cap nor the floor was triggered during the hedging relationship. If the cap or the floor had been triggered in any periods, the interest rate would not have been 7% during those periods.

The existence of the cap and floor in the interest rate swap – but not in the debt – would cause the relationship to not be perfectly effective. This is because these features would not affect the changes in cash flows of the debt obligation, but would affect the fair value of the interest rate swap.

However, ABC’s OCI reflects volatility as a result of the requirement to report the interest rate swap (derivative hedging instrument) at fair value in the balance sheet. This is evidenced by the following roll-forward of AOCI.

<table>
<thead>
<tr>
<th>Debit (credit)</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>$ -</td>
<td>$(300,000)</td>
<td>$(125,000)</td>
</tr>
<tr>
<td>Cash settlement</td>
<td>-</td>
<td>(100,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Reclassification to earnings</td>
<td>-</td>
<td>100,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Gain (loss) on the swap</td>
<td>(300,000)</td>
<td>175,000</td>
<td>125,000</td>
</tr>
<tr>
<td><strong>Closing balance</strong></td>
<td>$(300,000)</td>
<td>$(125,000)</td>
<td>$ -</td>
</tr>
</tbody>
</table>
Example 6.2.30

Accounting for a cash flow hedge of a forecasted purchase of inventory with a forward contract (critical terms match – forward value method)

ABC Corp. purchases gold to use in its manufacturing process. On January 1, Year 1, ABC determines 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.

ABC 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, Year 1. It has a contract with Supplier DEF for which the purchase price is based on the spot price of gold at the date of purchase (a contractually specified component).

To hedge against an increase in the market price of gold, on January 1, Year 1, ABC 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, Year 1. 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, Year 1 is $300 per ounce.

ABC designates the forward contract as a hedge of variability of cash flows attributable to changes in the spot price of gold (a contractually specified component) for its forecasted purchase of 10,000 ounces of gold on or around June 30, Year 1.

The following additional facts are relevant.

— All criteria for cash flow hedge accounting have been met.
— ABC’s contract to purchase gold from Supplier DEF represents a derivative for which the normal purchases and normal sales scope exception is applied.
— ABC 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, ABC concludes at inception and documents that the hedging relationship is expected to be highly effective (in this example, 100% effective) in achieving offsetting cash flows attributable to changes in the forward price of gold.

On an ongoing basis, ABC 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; therefore, not causing a different conclusion about hedge effectiveness.

— Because the hedge is expected to be 100% effective, it is 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 is exchanged at inception of the contract.

— The spot and forward prices per ounce of gold and the fair value of the forward contract are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot price (per ounce)</th>
<th>Forward price (per ounce)</th>
<th>Change in expected future cash flows¹</th>
<th>Fair value asset (liability)²</th>
<th>Change in fair value gain (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 1, Year 1</td>
<td>$300</td>
<td>$310</td>
<td>$</td>
<td>-</td>
<td>$</td>
</tr>
<tr>
<td>Mar 31, Year 1</td>
<td>310</td>
<td>315</td>
<td>50,000</td>
<td>49,008</td>
<td>49,008</td>
</tr>
<tr>
<td>Jun 30, Year 1</td>
<td>330</td>
<td>N/A</td>
<td>200,000</td>
<td>200,000</td>
<td>150,992</td>
</tr>
</tbody>
</table>

Notes:
1. 10,000 ounce notional of the forward contract x (forward price for the respective date - forward price at January 1, Year 1). The forward price at June 30, Year 1 is equal to the spot price because it is the settlement date.
2. Present value of the change in expected future cash flows discounted at the risk-free rate.

For simplicity, this example ignores the effect of commissions and other transaction costs, initial margins and income taxes.

**Journal entries – January 1, Year 1**

There is a memorandum entry made on January 1, Year 1, documenting the existence of this hedging relationship. ABC’s financial records are not otherwise affected as of this date because the forward contract had a fair value of zero at inception.

**Journal entries – March 31, Year 1**

ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward contract</td>
<td>49,008</td>
</tr>
<tr>
<td>OCI − Gain on forward contract</td>
<td>49,008</td>
</tr>
</tbody>
</table>

*To recognize in OCI change in fair value of forward contract attributable to changes in forward price of gold.*

**Journal entries – June 30, Year 1**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward contract</td>
<td>150,992</td>
</tr>
<tr>
<td>OCI − Gain on forward contract</td>
<td>150,992</td>
</tr>
</tbody>
</table>

*To recognize in OCI change in fair value of forward contract attributable to changes in forward price of gold.*
Debit | Credit
--- | ---
Cash | 200,000
Forward contract | 200,000
To record cash received on settlement of forward contract.
Gold inventory | 3,300,000
Cash | 3,300,000
To record purchase of 10,000 ounces of gold on June 30, Year 1 at market price of $330 per ounce.

Financial statement excerpts

At the end of March 31 and June 30, Year 1, ABC’s financial statements reflect the following.

<table>
<thead>
<tr>
<th>Account</th>
<th>March 31</th>
<th>June 30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance sheet – assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold inventory</td>
<td>$ -</td>
<td>$3,300,000</td>
</tr>
<tr>
<td>Forward contract</td>
<td>49,008</td>
<td>-</td>
</tr>
<tr>
<td>Balance sheet – equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gain (loss) on forward contract</td>
<td>$49,008</td>
<td>$200,000</td>
</tr>
<tr>
<td>Income statement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

ABC was concerned that gold prices would increase between January 1 and June 30, Year 1 (the date of the forecasted purchase of the 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. Therefore, the cost of goods sold related to the sale of the hedged forecasted purchase of gold inventory will be reported in earnings at $3,100,000.
Excerpt from ASC 815-30

20 Glossary

Zero-Coupon Method – A swap valuation method that involves computing and summing the present value of each future net settlement that would be required by the contract terms if future spot interest rates match the forward rates implied by the current yield curve. The discount rates used are the spot interest rates implied by the current yield curve for hypothetical zero coupon bonds due on the date of each future net settlement on the swap.

>> Example 6: Cash Flow Hedge of Variable-Rate Interest-Bearing Asset

55-24 This Example demonstrates the mechanics of accounting for an interest rate swap used as a cash flow hedge of variable interest receipts in accordance with the guidance in Subtopic 815-20 and this Subtopic. It is not intended to demonstrate how to compute the fair value of an interest rate swap. As in Example 8 (see paragraph 815-25-55-40), the zero-coupon method is used to determine the fair values. (Unlike in that Example, the yield curve in this Example is assumed to be upward sloping, that is, interest rates are higher for payments due further into the future.) In this Example, the term, notional amount, and repricing date of the interest rate swap match the term, repricing date, and principal amount of the interest-bearing asset on which the hedged interest receipts are due. The swap terms are at the market (as described in paragraphs 815-20-25-104, 815-20-25-106, and 815-20-25-109), so it has a zero value at inception. Thus, the reporting entity is permitted to assume that the hedging relationship will achieve perfect offset in the variability of cash flows of the hedged item.

55-25 As discussed beginning in paragraph 815-20-25-102, a shortcut method can be used to produce the same reporting results as the method illustrated in this Example. This shortcut is appropriate only if the assumption of perfect offset applies for an interest rate swap used as a cash flow hedge of interest receipts on a variable-rate asset (or interest payments on a variable-rate liability). The steps in the shortcut method are as follows:

a. Determine the difference between the variable rate to be paid on the interest rate swap and the variable rate to be received on the bond.
b. Combine that difference with the fixed rate to be received on the interest rate swap.
c. Compute and recognize interest income using that combined rate and the variable-rate asset’s principal amount. (Amortization of any purchase premium or discount on the asset must also be considered, although that complication is not incorporated in this Example.)
d. Determine the fair value of the interest rate swap.
e. Adjust the carrying amount of the interest rate swap to its fair value and adjust other comprehensive income by an offsetting amount.

A slightly different shortcut method for interest rate swaps used as fair value hedges is illustrated in Example 8 (see paragraph 815-25-55-40)

55-26 For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that
there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-27 On July 1, 20X1, Entity XYZ invests $10,000,000 in variable-rate corporate bonds that pay interest quarterly at a rate equal to the 3-month USD LIBOR rate plus 2.25 percent. The $10,000,000 principal will be repaid on June 30, 20X3.

55-28 Also on July 1, 20X1, Entity XYZ enters into a two-year receive-fixed, pay-variable interest rate swap and designates it as hedging instrument in a cash flow hedge of the variable-rate interest receipts on the corporate bonds. The risk designated as being hedged is the risk of variability in cash flows received attributable to changes in the contractually specified interest rate. The terms of the interest rate swap and the corporate bonds are shown in the following table.

<table>
<thead>
<tr>
<th>Trade date and borrowing date</th>
<th>Interest Rate Swap</th>
<th>Corporate Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Termination date</td>
<td>June 30, 20X3</td>
<td>June 30, 20X3</td>
</tr>
<tr>
<td>Notional amount</td>
<td>$10,000,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Fixed interest rate</td>
<td>6.65%</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Variable interest rate</td>
<td>3-month USD LIBOR</td>
<td>3-month USD LIBOR + 2.25%</td>
</tr>
<tr>
<td>Settlement dates and interest payment dates</td>
<td>End of each calendar quarter</td>
<td>End of each calendar quarter</td>
</tr>
<tr>
<td>Reset dates</td>
<td>End of each calendar quarter through March 31, 20X3</td>
<td>End of each calendar quarter through March 31, 20X3</td>
</tr>
</tbody>
</table>

(a) These terms need not match for the assumption of perfect offset to be appropriate. (See paragraphs 815-20-25-102 through 25-110.)

(b) Only the interest rate basis (for example, LIBOR) must match. The spread over LIBOR does not invalidate the assumption of perfect offset.

55-29 Because the conditions described in paragraphs 815-20-25-104 and 815-20-25-106 are met, Entity XYZ is permitted to assume that there is perfect offset in the hedging relationship and to recognize in other comprehensive income the entire change in the fair value of the interest rate swap.

55-30 The three-month USD LIBOR rates in effect at the inception of the hedging relationship and at each of the quarterly reset dates are assumed to be as follows.

<table>
<thead>
<tr>
<th>Reset Date</th>
<th>3-Month LIBOR Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/1/X1</td>
<td>5.56%</td>
</tr>
<tr>
<td>9/30/X1</td>
<td>5.63%</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>5.56%</td>
</tr>
<tr>
<td>3/31/X2</td>
<td>5.47%</td>
</tr>
<tr>
<td>6/30/X2</td>
<td>6.75%</td>
</tr>
<tr>
<td>9/30/X2</td>
<td>6.86%</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>6.97%</td>
</tr>
<tr>
<td>3/31/X3</td>
<td>6.57%</td>
</tr>
</tbody>
</table>
Entity XYZ must reclassify to earnings the amount in accumulated other comprehensive income as each interest receipt affects earnings. In determining the amounts to reclassify each quarter, it is important to recognize that the interest rate swap does not hedge the bonds. Instead, it hedges the eight variable interest payments to be received. That is, each of the eight quarterly settlements on the swap is associated with an interest payment to be received on the bonds. Under the zero-coupon method discussed in paragraph 815-30-55-24, the present value of each quarterly settlement is computed separately. Because each payment occurs at a different point on the yield curve, a different interest rate must be used to determine its present value. As each individual interest receipt on the bonds is recognized in earnings, the fair value of the related quarterly settlement on the swap is reclassified to earnings. The fair values and changes in fair values of the interest rate swap and the effects on earnings and other comprehensive income for each quarter are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Swap Debit (Credit)</th>
<th>Other Comprehensive Income Debit (Credit)</th>
<th>Earnings Debit (Credit)</th>
<th>Cash Debit (Credit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1, 20X1</td>
<td>$</td>
<td>-</td>
<td>(27,250)</td>
<td>$ 27,250</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>(27,250)</td>
<td>52,100</td>
<td>(27,250)</td>
<td></td>
</tr>
<tr>
<td>Payment (receipt)</td>
<td>(27,250)</td>
<td>52,100</td>
<td>(27,250)</td>
<td></td>
</tr>
<tr>
<td>Effect of change in rates</td>
<td>52,100</td>
<td>(52,100)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reclassification to earnings</td>
<td>27,250</td>
<td>(27,250)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>September 30, 20X1</td>
<td>24,850</td>
<td>(24,850)</td>
<td>(27,250)</td>
<td>$ 27,250</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>(25,500)</td>
<td>74,120</td>
<td>(25,500)</td>
<td>$ 25,500</td>
</tr>
<tr>
<td>Payment (receipt)</td>
<td>(25,500)</td>
<td>74,120</td>
<td>(25,500)</td>
<td></td>
</tr>
<tr>
<td>Effect of change in rates</td>
<td>74,120</td>
<td>(74,120)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reclassification to earnings</td>
<td>25,500</td>
<td>(25,500)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>December 31, 20X1</td>
<td>73,800</td>
<td>(73,800)</td>
<td>(25,500)</td>
<td>$ 25,500</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>(27,250)</td>
<td>38,150</td>
<td>(27,250)</td>
<td>$ 27,250</td>
</tr>
<tr>
<td>Payment (receipt)</td>
<td>(27,250)</td>
<td>38,150</td>
<td>(27,250)</td>
<td></td>
</tr>
<tr>
<td>Effect of change in rates</td>
<td>38,150</td>
<td>(38,150)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reclassification to earnings</td>
<td>27,250</td>
<td>(27,250)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>March 31, 20X2</td>
<td>85,910</td>
<td>(85,910)</td>
<td>(27,250)</td>
<td>$ 27,250</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>(29,500)</td>
<td>100,610</td>
<td>(29,500)</td>
<td>$ 29,500</td>
</tr>
<tr>
<td>Payment (receipt)</td>
<td>(29,500)</td>
<td>100,610</td>
<td>(29,500)</td>
<td></td>
</tr>
<tr>
<td>Effect of change in rates</td>
<td>100,610</td>
<td>100,610</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reclassification to earnings</td>
<td>29,500</td>
<td>(29,500)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
6. Accounting for cash flow hedges

The preceding table shows that, in each quarter, the net cash receipt or payment on the swap equals the income or expense to be recorded. The net effect on earnings of the interest on the bonds and the reclassification of gains or losses on the interest rate swap are presented in the same income statement line item as the earnings effect of the hedged item. The net earnings effect is shown in the following table.

<table>
<thead>
<tr>
<th>Earnings</th>
<th>Gains (Losses) Reclassified from Other Comprehensive Income</th>
<th>Net Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>For the Quarter Ending</td>
<td>Interest on Bonds</td>
<td>$195,250</td>
</tr>
<tr>
<td>9/30/X1</td>
<td>197,000</td>
<td>25,500</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>195,250</td>
<td>27,250</td>
</tr>
<tr>
<td>3/31/X2</td>
<td>193,000</td>
<td>29,500</td>
</tr>
<tr>
<td>6/30/X2</td>
<td>225,000</td>
<td>(2,500)</td>
</tr>
<tr>
<td>9/30/X2</td>
<td>227,750</td>
<td>(5,250)</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>230,500</td>
<td>(8,000)</td>
</tr>
<tr>
<td>3/31/X3</td>
<td>220,500</td>
<td>2,000</td>
</tr>
<tr>
<td>6/30/X3</td>
<td>Totals</td>
<td>$1,684,250</td>
</tr>
</tbody>
</table>

In this Example, the shortcut method described in paragraph 815-30-55-25 works as follows. The difference between the variable rate on the interest rate swap and the variable rate on the asset is a net receipt of 2.25 percent. That rate combined with the 6.65 percent fixed rate received on the interest rate swap is 8.9 percent. The computed interest income is $890,000 per year.
or $222,500 per quarter, which is the same as the amount in the table in the preceding paragraph.

Excerpt from ASC 815-30

**Example 12: Reporting Cash Flow Hedges in Comprehensive Income and Accumulated Other Comprehensive Income**

55-77 This Example illustrates application of the guidance in this Subtopic to reporting cash flow hedges in comprehensive income and accumulated other comprehensive income. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-78 Entity TUV’s cash flow hedge transactions through the end of 20X4 include all of the following:

a. It continually purchases pork belly futures contracts to hedge its anticipated purchases of pork belly inventory.

b. In 20X2, it entered into a Euro (EUR) forward exchange contract to hedge the foreign currency risk associated with the expected purchase of a pork belly processing machine with a five-year life that it bought from a vendor in Germany at the end of 20X2.

c. In 20X2, it entered into a 10-year interest rate swap concurrent with the issuance of 10-year variable rate debt (cash flow hedge of future variable interest payments).

d. In January 20X4, it entered into a two-year Swiss franc (CHF) forward exchange contract to hedge a forecasted export sale (denominated in CHF, expected to occur in December 20X5) of hot dogs to a large customer in Switzerland. In June 20X4, it closed the forward contract, but the forecasted transaction is still expected to occur.

55-79 The following table reconciles the beginning and ending accumulated other comprehensive income balances for 20X4. It supports the comprehensive income display and disclosures that are required under Topic 220. It is assumed that there are no other amounts in accumulated other comprehensive income. The after-tax amounts assume a 30 percent effective tax rate.
6. Accounting for cash flow hedges

The following tables illustrate an acceptable method, under the provisions of Topic 220, of reporting the transactions described by this Example in earnings, comprehensive income, and shareholders’ equity.

### Effect of Selected Items on Earnings and Comprehensive Income

#### Year Ended December 31, 20X4

<table>
<thead>
<tr>
<th>Debit (Credit)</th>
<th>Before-tax totals</th>
<th>After-tax totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>$ 270</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>(5)</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>295</strong></td>
<td><strong>207</strong></td>
</tr>
<tr>
<td>Income tax effect</td>
<td>(88)</td>
<td></td>
</tr>
<tr>
<td>Effect on earnings after taxes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income, net of tax:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash flow hedges:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net derivative losses, net of tax effect of $13</td>
<td>32</td>
<td></td>
</tr>
<tr>
<td>Reclassification adjustments, net of tax effect of $98</td>
<td>(207)</td>
<td></td>
</tr>
<tr>
<td>Net change</td>
<td></td>
<td>(175)</td>
</tr>
<tr>
<td><strong>Effect on total comprehensive income</strong></td>
<td><strong>32</strong></td>
<td></td>
</tr>
</tbody>
</table>

(a) This Example assumes that it is appropriate under the circumstances, in accordance with Topic 740, to recognize the related income tax benefit in the current year.

### Effect of Selected Items on Shareholders’ Equity

#### Year Ended December 31, 20X4

<table>
<thead>
<tr>
<th>Debit (Credit)</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated other comprehensive income:</td>
<td>$ 217</td>
</tr>
<tr>
<td>Balance on December 31, 20X3</td>
<td>$ 217</td>
</tr>
<tr>
<td>Net change during the year related to cash flow hedges</td>
<td>(175)</td>
</tr>
<tr>
<td><strong>Balance on December 31, 20X4</strong></td>
<td><strong>$ 42</strong></td>
</tr>
</tbody>
</table>
6.2.20 Excluded components

Excerpt from ASC 815-30

> Subsequent Recognition and Measurement of Gains and Losses on Hedging Instrument

35-3 When the relationship between the hedged item and hedging instrument is highly effective at achieving offsetting changes in cash flows attributable to the hedged risk, an entity shall record in other comprehensive income the entire change in the fair value of the designated hedging instrument that is included in the assessment of hedge effectiveness. More specifically, a qualifying cash flow hedge shall be accounted for as follows:

a. An entity’s defined risk management strategy for a particular hedging relationship may exclude 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 paragraphs 815-20-25-81 through 25-83B). That excluded component of the gain or loss shall be recognized in earnings either through an amortization approach in accordance with paragraph 815-20-25-83A or through a mark-to-market approach in accordance with paragraph 815-20-25-83B. Under either approach, the amount recognized in earnings for an excluded component shall be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A. For example, if the effectiveness of a hedging relationship with an option is assessed based on changes in the option’s intrinsic value, the changes in the option’s time value would be excluded from the assessment of hedge effectiveness and either may be recognized in earnings through an amortization approach in accordance with paragraph 815-20-25-83A or currently in earnings in accordance with paragraph 815-20-25-83B. …

>> Amounts Excluded from the Assessment of Effectiveness under an Amortization Approach

40-6A When applying the guidance in paragraph 815-20-25-83A, if the hedged forecasted transaction is probable of not occurring, any amounts remaining in accumulated other comprehensive income related to amounts excluded from the assessment of effectiveness shall be recorded in earnings in the current period. For all other discontinued cash flow hedges, any amounts associated with the excluded component remaining in accumulated other comprehensive income shall be recorded in earnings when the hedged forecasted transaction affects earnings.

If an entity has excluded components of the hedging instrument from its assessment of hedge effectiveness, it recognizes the initial value of the excluded components in earnings using either an amortization approach or a mark-to-market approach. [815-20-25-83A – 25-83B]

— Amortization approach. The initial value of the excluded component is amortized into earnings using a systematic and rational method over the life of the hedging instrument. The difference between the amortized amount
and the change in the excluded component’s fair value is recognized in OCI for the period.

— Mark-to-market approach. The entire change in fair value of the excluded component is immediately recognized in earnings.

Under both methods, any amount recognized in earnings is presented in the same income statement line item that is used to present the earnings effect of the hedged transaction. [815-20-45-1A(b)]

Any amounts associated with the excluded component remaining in AOCI when a cash flow hedge is discontinued are recognized in earnings when the hedged forecasted transaction affects earnings. However, these amounts are immediately recognized in earnings if it is probable that the forecasted transaction will not occur within the originally specified period or within a two-month period thereafter. See also section 6.5. [815-30-40-6A]

Examples

The following examples demonstrate cash flow accounting for excluded components.

— Accounting for a derivative instrument’s gain or loss in a cash flow hedge – effectiveness based on changes in intrinsic value (Subtopic 815-30’s Example 10).

— Comparison of approaches to recognize the excluded component for a cash flow hedge (Example 6.2.40).

— Accounting for a cash flow hedge of forecasted purchase of inventory with a call option (critical terms do not match – intrinsic value method) (Example 6.2.50).

Excerpt from ASC 815-30

>> Example 10: Accounting for a Derivative Instrument’s Gain or Loss in a Cash Flow Hedge—Effectiveness Based on Changes in Intrinsic Value

55-63 This Example illustrates application of the accounting guidance for cash flow hedges described in paragraph 815-30-35-3. At the beginning of Period 1, Entity XYZ purchases for $9.25 an at-the-money call option on 1 unit of Commodity X with a strike price of $125.00 to hedge a forecasted purchase of 1 unit of that commodity projected to occur early in Period 5. Entity XYZ’s documented policy is to assess hedge effectiveness by comparing changes in expected cash flows on the hedged transaction (based on changes in the Commodity X spot price) with changes in the option contract’s intrinsic value. Because the hedging instrument is a purchased call option, its intrinsic value cannot be less than zero. If the price of the commodity is less than the option’s strike price, the option is out-of-the-money. Its intrinsic value cannot decrease further regardless of how far the commodity price falls, and the intrinsic value will not increase until the commodity price increases to exceed the strike price. Thus, changes in cash flows from the option due to changes in its intrinsic...
value will offset changes in cash flows on the forecasted purchase only when the option is in the money or at the money. That phenomenon is demonstrated in Period 3 in the following table when the commodity price declines by $1.25. Because the commodity price is $.75 below the option’s strike price, the option’s intrinsic value declines by only $.50 (to zero). The effect reverses in Period 4 when the commodity index price increases by $6.50 and the option’s intrinsic value increases by $5.75. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

<table>
<thead>
<tr>
<th>Assumptions</th>
<th>Period 1</th>
<th>Period 2</th>
<th>Period 3</th>
<th>Period 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ending market price of Commodity X</td>
<td>$127.25</td>
<td>$125.50</td>
<td>$124.25</td>
<td>$130.75</td>
</tr>
<tr>
<td>Ending fair value of option:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time value</td>
<td>$7.50</td>
<td>$5.50</td>
<td>$3.00</td>
<td>$0</td>
</tr>
<tr>
<td>Intrinsic value</td>
<td>2.25</td>
<td>0.50</td>
<td>-</td>
<td>5.75</td>
</tr>
<tr>
<td>Total</td>
<td>$9.75</td>
<td>$6.00</td>
<td>$3.00</td>
<td>$5.75</td>
</tr>
<tr>
<td>Change in time value</td>
<td>$(1.75)</td>
<td>$(2.00)</td>
<td>$(2.50)</td>
<td>$(3.00)</td>
</tr>
<tr>
<td>Change in intrinsic value</td>
<td>2.25</td>
<td>(1.75)</td>
<td>(0.50)</td>
<td>5.75</td>
</tr>
<tr>
<td>Total current-period gain (loss) on derivative</td>
<td>$0.50</td>
<td>$(3.75)</td>
<td>$(3.00)</td>
<td>$2.75</td>
</tr>
</tbody>
</table>

Gain (loss) on derivative, adjusted to remove the component excluded from effectiveness test:

<table>
<thead>
<tr>
<th></th>
<th>For the current period</th>
<th>Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>For the current period</td>
<td>$2.25</td>
<td>$(1.75)</td>
</tr>
<tr>
<td>Cumulative</td>
<td>2.25</td>
<td>0.50</td>
</tr>
</tbody>
</table>

Change in expected future cash flows on hedged transaction:

<table>
<thead>
<tr>
<th></th>
<th>For the current period</th>
<th>Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>For the current period</td>
<td>(2.25)</td>
<td>1.75</td>
</tr>
<tr>
<td>Cumulative</td>
<td>(2.25)</td>
<td>(0.50)</td>
</tr>
</tbody>
</table>

55-64 The following are the entries required to account for the cash flow hedge. Note that consistent with paragraph 815-20-35-1(c), the change in fair value of the hedging instrument that is included in the assessment of hedge effectiveness is recorded in other comprehensive income for qualifying hedging relationships. For this type of hedging relationship, Entity XYZ elects to record changes in the option’s time value excluded from the assessment of hedge effectiveness currently in earnings in accordance with paragraph 815-20-25-83B. Amounts recorded in earnings should be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.
Hedging

6. Accounting for cash flow hedges

Debit (Credit)

<table>
<thead>
<tr>
<th>Period</th>
<th>Description</th>
<th>Derivative</th>
<th>Earnings</th>
<th>Other Comprehensive Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Adjust derivative to fair value and other comprehensive income by the calculated amount</td>
<td>0.50</td>
<td>1.75</td>
<td>(2.25)</td>
</tr>
<tr>
<td>2</td>
<td>Adjust derivative to fair value and other comprehensive income by the calculated amount</td>
<td>(3.75)</td>
<td>2.00</td>
<td>1.75</td>
</tr>
<tr>
<td>3</td>
<td>Adjust derivative to fair value and other comprehensive income by the calculated amount</td>
<td>(3.00)</td>
<td>2.50</td>
<td>0.50</td>
</tr>
<tr>
<td>4</td>
<td>Adjust derivative to fair value and other comprehensive income by the calculated amount</td>
<td>2.75</td>
<td>3.00</td>
<td>(5.75)</td>
</tr>
</tbody>
</table>

55-65 Paragraph superseded by Accounting Standards Update No. 2017-12

55-66 The amount reflected in earnings relates to the component excluded from the effectiveness test, that is, the time value component. The change in cash flows from the hedged transaction was not fully offset in Period 3. However, as described in paragraph 815-20-25-76, a purchased call option is considered effective if it provides one-sided offset.

Example 6.2.40

Comparison of approaches to recognize the excluded component for a cash flow hedge

In Subtopic 815-30’s Example 10, Entity XYZ elects to use the mark-to-market method to account for the excluded component (in this case, the hedging instrument’s time value). This example shows the effect on earnings if Entity XYZ had elected to recognize the change in the excluded component using the straight-line method (an example of an amortization approach).

<table>
<thead>
<tr>
<th>Assumptions</th>
<th>Period 1</th>
<th>Period 2</th>
<th>Period 3</th>
<th>Period 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of the option (end of period):</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time value</td>
<td>7.50</td>
<td>5.50</td>
<td>3.00</td>
<td>-</td>
</tr>
<tr>
<td>Intrinsic value</td>
<td>2.25</td>
<td>0.50</td>
<td>-</td>
<td>5.75</td>
</tr>
<tr>
<td>Total</td>
<td>9.75</td>
<td>6.00</td>
<td>3.00</td>
<td>5.75</td>
</tr>
<tr>
<td>Change in time value</td>
<td>(1.75)</td>
<td>(2.00)</td>
<td>(2.50)</td>
<td>(3.00)</td>
</tr>
<tr>
<td>Change in intrinsic value</td>
<td>2.25</td>
<td>(1.75)</td>
<td>(0.50)</td>
<td>5.75</td>
</tr>
<tr>
<td>Total current-period gain (loss) on derivative</td>
<td>0.50</td>
<td>(3.75)</td>
<td>(3.00)</td>
<td>2.75</td>
</tr>
</tbody>
</table>
### Assumptions

<table>
<thead>
<tr>
<th></th>
<th>Period 1</th>
<th>Period 2</th>
<th>Period 3</th>
<th>Period 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization of initial time value¹</td>
<td>$(2.31)</td>
<td>$(2.31)</td>
<td>$(2.31)</td>
<td>$(2.32)</td>
</tr>
<tr>
<td>Difference between change in fair value of excluded component (time value) and its amortization</td>
<td>$0.56</td>
<td>$0.31</td>
<td>$(0.19)</td>
<td>$(0.68)</td>
</tr>
<tr>
<td><strong>Total change in time value</strong></td>
<td><strong>$(1.75)</strong></td>
<td><strong>$(2.00)</strong></td>
<td><strong>$(2.50)</strong></td>
<td><strong>$(3.00)</strong></td>
</tr>
</tbody>
</table>

**Note:**
1. Initial time value of the option $(9.25) ÷ 4 periods.

The following are the journal entries required to adjust the derivative to fair value and OCI by its calculated amount.

<table>
<thead>
<tr>
<th>Period</th>
<th>Derivative ¹</th>
<th>Earnings ²</th>
<th>Other comprehensive income (loss)³</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$(0.50)</td>
<td>$(2.31)</td>
<td>$2.81</td>
</tr>
<tr>
<td>2</td>
<td>3.75</td>
<td>(2.31)</td>
<td>(1.44)</td>
</tr>
<tr>
<td>3</td>
<td>3.00</td>
<td>(2.31)</td>
<td>(0.69)</td>
</tr>
<tr>
<td>4</td>
<td>(2.75)</td>
<td>(2.32)</td>
<td>5.07</td>
</tr>
</tbody>
</table>

**Notes:**
1. The total current-period gain (loss) on derivative.
2. The straight-line amortization of the option’s initial time value.
3. The difference between the total current-period gain (loss) on derivative less the straight-line amortization of the option’s initial time value. It represents the intrinsic value of the option plus the difference between the change in the fair value of the excluded component (time value) and its amortization.

The following table compares the earnings effect of the excluded component under the two methods:

- amortization approach (KPMG example); and
- mark-to-market approach (FASB example).

<table>
<thead>
<tr>
<th>Approach</th>
<th>Period 1</th>
<th>Period 2</th>
<th>Period 3</th>
<th>Period 4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization</td>
<td>$2.31</td>
<td>$2.31</td>
<td>$2.31</td>
<td>$2.32</td>
<td>$9.25</td>
</tr>
<tr>
<td>Mark-to-market</td>
<td>1.75</td>
<td>2.00</td>
<td>2.50</td>
<td>3.00</td>
<td>9.25</td>
</tr>
<tr>
<td>Difference</td>
<td>$0.56</td>
<td>$0.31</td>
<td>$(0.19)</td>
<td>$(0.68)</td>
<td>$ -</td>
</tr>
</tbody>
</table>
Example 6.2.50

Accounting for a cash flow hedge of forecasted purchase of inventory with a call option (critical terms do not match – intrinsic value method)

ABC Corp. expects to purchase 10,000 units of Commodity B on December 31, Year 1. ABC 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, Year 1, ABC purchases for $10,000 an at-the-money call option with Commodity A as the underlying. ABC 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 ABC to purchase 10,000 units of Commodity A at a strike price of $10.00 per unit on December 31, Year 1.

ABC 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, Year 1.

The following additional facts are relevant.

— All criteria for cash flow hedge accounting have been met.

— Based on statistical analysis, ABC 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 in the cash flows of the purchase price (at spot) of Commodity B.

  — ABC will exclude changes in the time value of the option from the assessment of the hedge’s effectiveness. ABC has elected to recognize changes in the fair value of the excluded component (i.e. time value) using the mark-to-market method (i.e. currently in earnings).

  — ABC assesses effectiveness 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 ABC to purchase 10,000 units of Commodity B at a strike price of $15.00 per unit on December 31, Year 1.

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 because the underlying of the forecasted purchase is Commodity B and the underlying of the purchased call option is Commodity A.

— The spot price, fair value, intrinsic value, time value and change in time value of the call option related to Commodity A (i.e. the actual derivative) are as follows.
## Hedging

6. Accounting for cash flow hedges

<table>
<thead>
<tr>
<th>Date</th>
<th>Jan 1, Year 1</th>
<th>Mar 31, Year 1</th>
<th>Jun 30, Year 1</th>
<th>Sep 30, Year 1</th>
<th>Dec 31, Year 1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Spot price</strong></td>
<td>$10.00</td>
<td>$10.10</td>
<td>$12.10</td>
<td>$12.30</td>
<td>$14.80</td>
</tr>
<tr>
<td><strong>Fair value before settlement:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Intrinsic value</strong></td>
<td>$</td>
<td>-</td>
<td>$1,000</td>
<td>$21,000</td>
<td>$23,000</td>
</tr>
<tr>
<td><strong>Time value</strong></td>
<td>10,000</td>
<td>8,000</td>
<td>5,000</td>
<td>1,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total fair value before settlement</strong></td>
<td>$10,000</td>
<td>$9,000</td>
<td>$26,000</td>
<td>$24,000</td>
<td>$48,000</td>
</tr>
<tr>
<td><strong>Change in intrinsic value</strong></td>
<td>1,000</td>
<td>20,000</td>
<td>2,000</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td><strong>Change in time value</strong></td>
<td>(2,000)</td>
<td>(3,000)</td>
<td>(4,000)</td>
<td>(1,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Total change in fair value before settlement</strong></td>
<td>$(1,000)</td>
<td>$17,000</td>
<td>$(2,000)</td>
<td>$24,000</td>
<td></td>
</tr>
<tr>
<td><strong>Settlement</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>48,000</td>
</tr>
<tr>
<td><strong>Fair value after settlement</strong></td>
<td>$10,000</td>
<td>$9,000</td>
<td>$26,000</td>
<td>$24,000</td>
<td>$</td>
</tr>
</tbody>
</table>

### Note:
1. ABC measures intrinsic value as the difference between the strike price and the spot price of the underlying asset (see Question 9.2.240).
2. Total fair value before settlement - Intrinsic value (see Question 9.2.230).

— The spot prices of Commodity B (i.e. spot price for the hypothetical derivative) are $15.00 as of January 1, Year 1 and $19.78 as of December 31, Year 1. Settlement for the hypothetical derivative would have been $47,800.

— Because the hedging relationship was highly effective in all periods, the financial statements will reflect the following.
  - The fair value of the actual call option will be recorded on the balance sheet.
  - Changes in the time value of the actual call option will be recorded in cost of goods sold (earnings) because ABC elected the mark-to-market approach for the excluded component.
  - AOCI will be adjusted to a balance that represents the cumulative change in the intrinsic value of the actual call option.

For simplicity, this example makes the following assumptions.

— It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
— Journal entries (for all years) are presented gross for illustrative purposes but could be combined.

### Journal entries – January 1, Year 1

ABC records the following journal entry on January 1, Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchased call option</td>
<td>10,000</td>
</tr>
<tr>
<td>Cash</td>
<td>10,000</td>
</tr>
</tbody>
</table>

*To record purchase of call option on Commodity A.*
There is also a memorandum entry made on January 1, Year 1, documenting the existence of this hedging relationship.

**Journal entries – March 31, Year 1**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold¹</td>
<td>2,000</td>
</tr>
<tr>
<td>Purchased call option</td>
<td>1,000</td>
</tr>
<tr>
<td>OCI – Gain on purchased call option²</td>
<td>1,000</td>
</tr>
</tbody>
</table>

*To record change in fair value of purchased call option on Commodity A (hedging instrument).*

Notes:
1. Represents the change in value of the excluded component (time value), which is recognized using the mark-to-market method (i.e. currently in earnings).
2. Represents the change in the intrinsic value of the derivative hedging instrument.

**Journal entries – June 30, Year 1**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold¹</td>
<td>3,000</td>
</tr>
<tr>
<td>Purchased call option</td>
<td>17,000</td>
</tr>
<tr>
<td>OCI – Gain on purchased call option²</td>
<td>20,000</td>
</tr>
</tbody>
</table>

*To record change in fair value of purchased call option on Commodity A (hedging instrument).*

Notes:
1. Represents the change in value of the excluded component (time value), which is recognized using the mark-to-market method (i.e. currently in earnings).
2. Represents the change in the intrinsic value of the derivative hedging instrument.

**Journal entries – September 30, Year 1**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold¹</td>
<td>4,000</td>
</tr>
<tr>
<td>Purchased call option</td>
<td>2,000</td>
</tr>
<tr>
<td>OCI – Gain on purchased call option²</td>
<td>2,000</td>
</tr>
</tbody>
</table>

*To record change in fair value of purchased call option on Commodity A (hedging instrument).*

Notes:
1. Represents the change in value of the excluded component (time value), which is recognized using the mark-to-market method (i.e. currently in earnings).
2. Represents the change in the intrinsic value of the derivative hedging instrument.
Journal entries – December 31, Year 1

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold(^1)</td>
<td>1,000</td>
</tr>
<tr>
<td>Purchased call option</td>
<td>24,000</td>
</tr>
<tr>
<td>OCI – Gain on purchased call option(^2)</td>
<td>25,000</td>
</tr>
</tbody>
</table>

*To record change in fair value of purchased call option on Commodity A (hedging instrument).*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>48,000</td>
</tr>
<tr>
<td>Purchased call option</td>
<td>48,000</td>
</tr>
</tbody>
</table>

*To record settlement of purchased call option on Commodity A (hedging instrument).*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory – Commodity B(^3)</td>
<td>197,800</td>
</tr>
<tr>
<td>Cash</td>
<td>197,800</td>
</tr>
</tbody>
</table>

*To record purchase of Commodity B at market rates.*

Notes:

1. Represents the change in value of the excluded component (time value), which is recognized using the mark-to-market method (i.e. currently in earnings).
2. Represents the change in the intrinsic value of the derivative hedging instrument before settlement.
3. 10,000 units of Commodity B × $19.78 per unit.

Financial statement excerpts

At the end of each quarter during Year 1, ABC’s financial statements reflect the following.

<table>
<thead>
<tr>
<th>Account</th>
<th>3 months ended Mar 31</th>
<th>6 months ended Jun 30</th>
<th>9 months ended Sep 30</th>
<th>Year ended Dec 31</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory - Commodity B</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$197,800</td>
</tr>
<tr>
<td>Purchased call option</td>
<td>9,000</td>
<td>26,000</td>
<td>24,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Balance sheet – equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gain (loss) on purchased call option</td>
<td>$1,000</td>
<td>$21,000</td>
<td>$23,000</td>
<td>$48,000</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$2,000</td>
<td>$5,000</td>
<td>$9,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

The effect of the hedge during the hedging relationship on the income statement is a $10,000 increase to cost of goods sold. This represents the time value of the purchased call option, which was excluded from the assessment of effectiveness (with changes recognized using the mark-to-market approach – i.e. currently in earnings).
Changes in the value of the excluded component (time value) are recognized using the mark-to-market approach (i.e. when they occur). Because the hedged transaction (the purchase of inventory) does not affect earnings until the inventory is sold, this results in the changes in time value affecting cost of goods sold (earnings) before the hedged transaction affects earnings.

The $48,000 gain on the call option remains in AOCI until the hedged Commodity B inventory is sold. At that point, the $48,000 is reclassified into earnings, reducing the inventory’s cost of goods sold. Therefore, the cost of goods sold related to the sale of the hedged forecasted purchase of Commodity B will be reported in earnings as $149,800 ($197,800 purchase price - $48,000 gain on call option).

ABC was concerned that Commodity B prices would increase between January 1 and December 31, Year 1 (the date of the forecasted purchase of 10,000 units of Commodity B). Using a purchased call option as a hedging instrument reduced the effect of increased prices during the hedging relationship. However, because the purchased call option was tied to price changes of Commodity A – rather than Commodity B – the relationship was not perfectly effective.

Had the relationship been perfectly effective:

— the amount recognized in AOCI as of December 31, Year 1 would have been $47,800; and
— the cost of goods sold related to the sale of Commodity B would have been $150,000 (10,000 units of Commodity B at the $15.00 spot price of Commodity B at inception of the hedging relationship).

The extent to which the relationship was not perfectly effective ($200) is recognized when the hedged forecasted transaction is reported in earnings.

### 6.3 Reclassifying amounts from AOCI into earnings

#### 6.3.10 Overview

> Reclassifications from Accumulated Other Comprehensive Income into Earnings

**35-38** Amounts in accumulated other comprehensive income that are included in the assessment of effectiveness 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) and shall be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A. If an entity excludes a component of a hedging instrument from the assessment of effectiveness, an entity shall apply the guidance in paragraphs 815-20-25-83A through 25-83B.

**35-39** 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 that are included in the assessment of effectiveness 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).

35-40 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.

35-41 For example, a loss shall be reported in earnings for a derivative instrument 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 815-30-35-42 through 35-43.)

35-44 If the reclassification to earnings of the amount in accumulated comprehensive income resulting from a cash flow hedge of debt is required under this Subsection when that debt is extinguished, the amount reclassified from accumulated comprehensive income to earnings shall be excluded from extinguishment gain or loss.

35-46 For forecasted transactions whose timing involves some uncertainty within a range, paragraph 815-20-25-16(c) states that, as long as it remains probable that the forecasted transaction will occur by the end of the originally specified time period, cash flow hedge accounting for that hedging relationship shall continue.

Net derivative gains or losses reported in AOCI that are included in the assessment of effectiveness are reclassified into earnings in the same period(s) that the forecasted hedged transaction is reported in earnings. [815-30-35-38 – 35-39]

However, if an entity expects that continued reporting of a net derivative 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 future periods, the loss is immediately reclassified into earnings (see Question 6.3.30 and Example 6.3.20). For additional discussion of assessing impairment, see section 6.4. [815-30-35-40 – 35-41]

When amounts are reclassified into earnings from AOCI, they are presented in the same income statement line item as the effect of the hedged transaction. If the event causing reclassification is extinguishment of debt, the amount reclassified from AOCI into earnings is not included in the extinguishment gain or loss. See also Question 6.5.100. [815-20-45-1A(a), 815-30-35-3, 35-38, 35-44]
Question 6.3.10

What method is used to reclassify amounts in AOCI into earnings?

Interpretive response: Topic 815 does not specifically address the method for reclassifying amounts in AOCI into earnings. We believe the method should be consistent with the accounting policy used for recognizing income or expense on the hedged transaction. [815-30-35-38 – 35-39]

The following table illustrates reclassifications into earnings of amounts from AOCI that are included in the assessment of effectiveness, including the timing and method for recognition in earnings. [815-30-35-38 – 35-39]

<table>
<thead>
<tr>
<th>Hedged transaction</th>
<th>Reclassification from AOCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecasted acquisition of a depreciable asset</td>
<td>The related amount in AOCI continues to be reported in AOCI after the acquisition of the asset. It is reclassified into earnings (as depreciation expense) in the same periods that the entity recognizes depreciation expense on the acquired asset (e.g. straight line over the asset’s estimated useful life).</td>
</tr>
<tr>
<td>Forecasted purchase of inventory</td>
<td>The related amount in AOCI is reclassified into earnings in the period that the sale of the inventory whose purchase was hedged is recognized. This includes consideration of the method used to account for the inventory (e.g. FIFO, LIFO, weighted-average cost).</td>
</tr>
<tr>
<td>Forecasted interest receipt or payment on a financial asset or liability</td>
<td>The related amounts in AOCI are reclassified into earnings when interest is accrued on the hedged transaction.</td>
</tr>
</tbody>
</table>

Example 6.3.10

Accounting for an all-in-one hedge of a forecasted equipment purchase

On September 1, Year 1, ABC Corp. forecasts that it will purchase equipment on January 1, Year 2. The equipment’s current price is $100,000.

ABC is concerned that the price of the equipment will rise in the next three months and enters into a forward purchase contract with Retailer to buy the equipment for $102,000 (the at-market price for the equipment to be purchased in three months). The forward purchase contract is binding on both ABC and Retailer, specifies all significant terms, and includes a disincentive for nonperformance that is sufficiently large to make performance probable. Therefore, it meets the definition of a firm commitment.

Although ABC expects to settle the contract gross, the forward purchase contract includes a clause that requires net settlement under its default
provisions. Retailer does not own the equipment. Therefore, it also meets the definition of a derivative instrument.

ABC 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.

The following additional facts are relevant.

— All cash flow hedging criteria are met.
— The equipment’s price as of December 31, Year 1 is $110,000.
— The equipment has an estimated useful life of two years.

For simplicity, this example ignores the effect of commissions and other transaction costs, initial margins and income taxes.

**Journal entries – September 30, Year 1**

There is a memorandum entry made on September 30, Year 1 documenting the existence of this hedging relationship.

**Journal entries – December 31, Year 1**

ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward purchase contract</td>
<td>8,000</td>
</tr>
<tr>
<td>OCI – Gain on forward contract</td>
<td>8,000</td>
</tr>
</tbody>
</table>

*To record change in fair value of forward contract (derivative instrument).*

**Note:**

1. Current price of the equipment ($110,000) less the fixed price of the equipment in the forward purchase contract ($102,000).

**Journal entries – January 1, Year 2**

On January 1, Year 2, ABC takes delivery of the equipment and records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>110,000</td>
</tr>
<tr>
<td>Cash</td>
<td>102,000</td>
</tr>
<tr>
<td>Forward purchase contract</td>
<td>8,000</td>
</tr>
</tbody>
</table>

*To record gross settlement of forward contract.*

**Note:**

1. Cost of the equipment under the forward purchase contract ($102,000) plus the fair value of the forward contract ($8,000).
Journal entries – December 31, Years 2-3

ABC records the following journal entries at the end of each of Years 2 and 3.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense¹</td>
<td>55,000</td>
<td></td>
</tr>
<tr>
<td>Equipment – accumulated depreciation</td>
<td>55,000</td>
<td></td>
</tr>
<tr>
<td>To record depreciation expense on equipment over its two-year useful life.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gain on forward contract</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Depreciation expense²</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>To reclassify amounts in AOCI into earnings when hedged forecasted transaction affects earnings.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1. Equipment’s carrying amount of $110,000 ÷ 2 years (its useful life).
2. Amount in AOCI as of the date of the equipment’s purchase (i.e. the hedged forecasted transaction) of $8,000 ÷ 2 years (its useful life).

Financial statement excerpts

At the end of Years 1–3, ABC’s financial statements reflect the following.

<table>
<thead>
<tr>
<th>Account</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance sheet – assets</td>
<td>$ -</td>
<td>$110,000</td>
<td>$110,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$ -</td>
<td>$110,000</td>
<td>$110,000</td>
</tr>
<tr>
<td>Equipment – accumulated depreciation</td>
<td>-</td>
<td>(55,000)</td>
<td>(110,000)</td>
</tr>
<tr>
<td>Forward contract</td>
<td>8,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Balance sheet – equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gain (loss) on cash flow hedge</td>
<td>$8,000</td>
<td>$4,000</td>
<td>-</td>
</tr>
<tr>
<td>Income statement</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>-</td>
<td>$51,000</td>
<td>$51,000</td>
</tr>
</tbody>
</table>

Because the equipment is recorded as the sum of the cash paid under the forward contract and the fair value of the forward contract, its carrying amount to be depreciated is the current price of the equipment as of the purchase date.

However, depreciation expense on the equipment’s carrying amount is partially offset because the $8,000 derivative gain reported in AOCI is reclassified into earnings as the purchased equipment is depreciated. The effect of the amounts reclassified from AOCI into earnings result in total net depreciation expense over the estimated useful life of the equipment of $102,000, which is the forward purchase price of the equipment.
Reclassifying AOCI when hedging relationship is discontinued

Excerpt from ASC 815-30

>> Example 20: Amounts Reclassified into Earnings for Purchased Option Used in a Cash Flow Hedge

55-126 This Example illustrates when the hedging instrument’s gain or loss that is reported in accumulated other comprehensive income should be reclassified out of accumulated other comprehensive income into earnings under paragraph 815-30-35-36.

55-127 An entity forecasts that 1 year later it will purchase 1,000 ounces of gold at 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 1-year cash-settled at-the-money gold option on 1,000 ounces of gold, paying 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. If the price of gold is $275 or below at the maturity date, the contract expires worthless. The option cannot be exercised before its contractual maturity date. The entity designates the purchased 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. The entity would reclassify the purchased option’s gain or loss that is reported in accumulated other comprehensive income in earnings when the cost of the gold affects earnings (such as being included in cost of goods sold) and present that gain or loss in the same income statement line item as the earnings effect of the hedged item.

Question 6.3.20

When are amounts in AOCI related to specific borrowings associated with assets under construction reclassified into earnings?

Background: Subtopic 835-20 requires capitalizing interest cost as part of the historical cost of acquiring certain assets. An entity’s financing plans may associate a specific borrowing with such an acquisition. If the variability in interest payments under a specific borrowing is hedged in a cash flow hedge that is highly effective, gains and losses on the hedging instrument are recognized in AOCI and are reclassified into earnings when the forecasted transaction affects earnings. [835-20-05-1, 30-3, 30-7]
Excerpt from ASC 815-30

>> Forecasted Interest Payment Capitalized as a Cost of an Asset under Construction

35-45 If the 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 accumulated other comprehensive income related to a cash flow hedge of the variability of that interest shall be reclassified into earnings over the depreciable life of the constructed asset, because that depreciable life coincides with the amortization period for the capitalized interest cost on the debt.

Interpretive response: If variable-rate interest on a specific borrowing is capitalized as a cost of an asset under construction, amounts reported in AOCI that were included in the assessment of effectiveness related to a cash flow hedge of the variability of that interest are reclassified into earnings over the depreciable life of the constructed asset. This is because 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. [815-30-35-45]

This guidance relates only to the amount reported 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.

Question 6.3.30

Why is a loss in AOCI reclassified into earnings if the combination of the hedging instrument and hedged transaction would result in a future loss?

Interpretive response: When a net derivative loss is reported in AOCI related to a hedged transaction in a cash flow hedge, it represents an amount that is expected to offset a future gain (revenue) related to the hedged transaction. In other words, the loss reported in AOCI offsets an unrecognized gain on the hedged transaction that arose during the hedging relationship. However, market prices may fall to the point that there are no longer anticipated revenues (gains) being offset by the loss in AOCI.

If an entity does not expect to recover both the amount recognized as the cost of the hedged transaction and the net derivative loss reported in AOCI when the hedged item is sold, the amount that is not expected to be recovered is immediately reclassified from AOCI into earnings. The FASB’s rationale for including this guidance was that it could not justify delaying recognizing a derivative loss in earnings when the loss is not expected to be recovered through revenues from the hedged transaction. [815-30-35-40 – 35-41, FAS 133.BC499]
Example 6.3.20
Combination of loss reported in AOCI and hedged transaction would give rise to a loss

ABC Corp. 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.

ABC expects that it will purchase 100,000 ounces of silver on June 30, Year 1. ABC has a contract with a supplier for which the purchase price is based on the spot price of silver. ABC is concerned about fluctuations in the price of silver. Therefore, on January 1, Year 1, ABC enters into an OTC silver forward contract to purchase 100,000 ounces of silver at $16 per ounce on June 30, Year 1. The forward contract will settle in cash on a net basis (i.e. for the difference between the $16 per ounce stated price and the spot rate) on June 30, Year 1. The forward contract is designated as a cash flow hedge of variability of cash flows attributable to changes in the spot price of silver (a contractually specified component) for ABC’s forecasted purchase of 100,000 ounces of silver on or around June 30, Year 1. ABC’s contract to purchase silver from a supplier represents a derivative for which the normal purchases and normal sales exception is applied.

Throughout the hedging relationship, the hedge was highly effective. As a result, ABC records changes in the fair value of the forward contract in OCI.

On June 30, Year 1, the spot price for silver is $15.50 per ounce. ABC purchases 100,000 ounces of silver as forecast, and pays the market price of $1,550,000. ABC also pays $50,000 to settle the forward contract, which represents the fair value (liability) of the forward contract on June 30, Year 1 and therefore also represents the loss reported in AOCI related to the cash flow hedge on that date.

As a result of the forward contract, ABC locked in a purchase price for the silver of $1,600,000 (100,000 ounces at $16 per ounce). This is reflected in ABC’s balance sheet on June 30, Year 1 as follows.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount (debit balances)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Silver platter inventory</td>
<td>$1,550,000</td>
</tr>
<tr>
<td>AOCI – Loss on hedging instrument (forward contract)</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total amounts related to inventory for which the purchase was hedged</strong></td>
<td><strong>$1,600,000</strong></td>
</tr>
</tbody>
</table>

Three months later on September 30, Year 1, the net realizable value of the silver platter inventory to which the cash flow hedge relates is $2,030,000. The inventory has a carrying amount of $2,000,000 – i.e. the initial purchase of silver of $1,550,000 plus costs incurred after the silver was purchased.

In addition, ABC:
— uses the first-in-first-out (FIFO) method to account for its inventory; and
— continues to report in AOCI the loss on the forward contract.
As of September 30, Year 1, ABC evaluates the combination of the inventory and the net loss on the forward contract that is reported in AOCI as follows.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount (debit balances)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Silver platter inventory</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>AOCI – Loss on hedging derivative</td>
<td>50,000</td>
</tr>
<tr>
<td>Total amounts related to hedged inventory</td>
<td>2,050,000</td>
</tr>
<tr>
<td>Net realizable value of inventory</td>
<td>2,030,000</td>
</tr>
</tbody>
</table>

**Amount that is not expected to be recovered** $20,000

Notes:
1. Silver platter inventory + AOCI – Loss on hedging derivative.
2. Total amounts related to hedged inventory - Net realizable value of inventory.

ABC reclassifies $20,000 from AOCI into cost of goods sold – i.e. the same income statement line item as the earnings effect of the hedged inventory will be in when it is sold. This represents the amount recognized in ABC’s balance sheet related to the silver platter inventory that is not expected to be recovered through its sale.

**Question 6.3.40**

**Can an impairment loss be recognized before a forecasted transaction occurs?**

**Interpretive response:** Yes. Ordinarily, forecasted transactions that are not related to an existing asset are not subject to impairment assessments until the assets are acquired. This is because forecasted transactions or events occur – by definition – at the prevailing market price. However, the requirement to review any amount in AOCI related to a current or previous hedging relationship that represents a net loss may result in recognition of an impairment loss before the forecasted transaction occurs.

**6.3.20 Hedging instruments with periodic settlements**

**Excerpt from ASC 815-30**

>> Non-Zero Fair Value of Hedging Derivative at Hedge Inception

35-41A An entity may designate a hedging derivative with periodic cash settlements and a non-zero fair value at hedge inception as the hedging instrument in a qualifying cash flow hedging relationship. In this situation, amounts related to the initial fair value that are recorded in other comprehensive income during the hedging relationship shall be reclassified from accumulated other comprehensive income to earnings on a systematic and rational basis over the periods during which the hedged forecasted...
transactions affect earnings. Amounts reclassified to earnings shall be presented in the same income statement line item as the earnings effect of the hedged item. This guidance applies to both option-based and non-option-based derivatives designated as hedging instruments in a cash flow hedge.

35-41B This paragraph illustrates a method of reclassifying amounts from accumulated other comprehensive income to earnings when an option-based derivative is designated as a hedging instrument and the assessment of effectiveness is based on total changes in the derivative’s cash flows. Those amounts include changes in fair value related to the derivative’s initial intrinsic value in accordance with paragraph 815-30-35-41A. 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 should be allocated to the respective caplets within the single cap on a fair value basis at the inception of the hedging relationship. The change in each respective allocated fair value amount should be reclassified out of accumulated other comprehensive income into earnings when each of the hedged forecasted transactions (the eight interest payments) affects earnings. Because the amount in accumulated other comprehensive income is a net amount composed of both derivative instrument gains and derivative instrument losses, the change in the respective allocated fair value amount for an individual caplet that is reclassified out of accumulated other comprehensive income into earnings may possibly be greater than the net amount in accumulated other comprehensive income.

35-41C This guidance has no effect on the accounting for fair value hedging relationships. In addition, in determining the accounting for seemingly similar cash flow hedging relationships, it would be inappropriate to analogize to this guidance.

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 in 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. 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.

**Additional complexity: Derivative instrument has a non-zero fair value at hedge inception**

An additional complexity occurs when a single derivative with a non-zero fair value at hedge inception is used to hedge the variability in multiple cash flows. For example, if an interest rate swap with a fair value of zero at hedge inception is used to hedge the payments on a variable-rate debt obligation, it may be appropriate to reclassify amounts from AOCI based on the periodic net cash settlements of the interest rate swap.
In contrast, if the interest rate swap has a non-zero fair value at hedge inception, reclassifying amounts from AOCI based solely on the periodic net cash settlements will not result in that initial fair value being reclassified from AOCI into earnings by the end of the hedge term. Instead, the initial non-zero fair value will remain in AOCI after all hedged interest payments have been made and the swap has expired.

As a result of that additional complexity, Topic 815 provides specific guidance related to hedging instruments with multiple cash flows or periodic cash settlements (e.g. interest rate swaps, purchased caps) that have non-zero fair values at hedge inception. In these situations, amounts in AOCI that are related to the initial fair value are required to be reclassified into earnings on a systematic and rational basis over the periods during which the hedged forecasted transactions affect earnings. [815-30-35-41A]

When amounts are reclassified from AOCI related to an initial non-zero fair value of a hedging instrument, they are presented in the same income statement line item as the earnings effect of the hedged transaction. [815-30-35-41A]

**Question 6.3.50**

**What are acceptable methods to reclassify the initial non-zero fair value of a hedging instrument with periodic cash settlements?**

**Interpretive response:** Topic 815 describes one acceptable method for reclassifying the initial non-zero fair value of a hedging instrument with periodic cash settlements into earnings. This is the ‘caplet method’ used for interest rate caps.

The caplet method involves associating the initial fair value of an interest rate cap with each caplet within the rate cap, and reclassifying the amount of each caplet from AOCI into earnings when the respective forecasted interest payment occurs. [815-30-35-41B]

In addition to the caplet method, other systematic and rational methods that may be appropriate for recognizing the initial fair value over the term of the hedging relationship include:

- straight-line amortization – as interest expense is recognized in earnings during the hedging relationship; or
- the interest method, resulting in a constant rate of interest expense during the hedging relationship.

Whether the caplet method or another method is appropriate depends on the nature and terms of the hedging instrument and the hedged transaction(s).
Question 6.3.60

What method is appropriate to reclassify amounts from AOCI when an interest rate swap with scheduled increases in its fixed leg is used to hedge interest payments on variable-rate debt?

Background: ABC Corp. 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.

All hedge accounting criteria are met, including that the swap is expected to be highly effective at offsetting changes in interest payment cash flows throughout the life of the hedging relationship.

Interpretive response: We believe the net derivative gain or loss reported in AOCI should be reclassified into earnings over the life of the hedging relationship using the interest method, resulting in a constant rate of interest expense over the life of the hedging relationship despite the increasing interest rate on the pay-fixed leg of the swap. This treatment is consistent with 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.

In this situation, 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. We do not believe it would be appropriate in this circumstance to view each interest payment as a separate hedging relationship given the inherently interrelated nature of the hedged interest payments and the swap instrument.

Question 6.3.70

What method is appropriate to reclassify amounts from AOCI when multiple derivatives are used to hedge interest payments on variable-rate debt?

Background: ABC Corp. issues variable-rate debt with a maturity of three years. ABC 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.

ABC 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 ABC’s debt.
All hedge accounting criteria are met for each relationship, including that each swap is expected to be highly effective at offsetting changes in interest payment cash flows throughout the life of its separate hedging relationship.

**Interpretive response:** We believe the net derivative gain or loss reported in AOCI should be reclassified into earnings over the life of each separate hedging relationship on an individual hedging relationship-by-relationship basis – e.g. following the periodic net settlements on each interest rate swap.

The net result of applying hedge accounting for the three individual relationships results in an increasing rate of interest expense over the course of the hedging relationship. This result differs from that in Question 6.3.60 because it is the result of three separately documented hedge accounting relationships with three separate derivatives.

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**Example 6.3.30**

**Accounting for a cash flow hedge of a variable-rate, long-term debt with an interest rate cap**

On January 1, Year 1, ABC issues a $10,000,000 debt obligation that matures on December 31, Year 3 (i.e. three years). The interest rate on the debt obligation is variable at a rate of 12-month LIBOR plus 2%.

ABC is concerned that 12-month LIBOR may rise during the three-year term of the debt obligation, but wants to retain the ability to benefit when it is below 8%. To protect itself from this exposure, ABC purchases for $300,000 an out-of-the-money interest rate cap from Bank. The interest rate cap pays interest to ABC when 12-month LIBOR exceeds 8%. The amount paid to ABC by Bank is equal to $10,000,000 multiplied by (12-month LIBOR minus 8%) in those years in which 12-month LIBOR exceeds 8%. The interest rate cap can be exercised only at its contractual dates.

The combination of the cap and the debt obligation results in ABC paying interest at a variable rate (12-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.

ABC designates the purchased interest rate cap as a hedge of risk of changes in cash flows of the forecasted interest payments that are attributable to the changes in the contractually specified interest rate (i.e. 12-month LIBOR) that exceed 8%.

The following additional facts are relevant.

---

ABC determines that:

- the critical terms of the interest rate cap completely match the related terms of the hedged forecasted transactions;
- the strike price of the interest rate cap matches the specified level beyond which the entity’s exposure is being hedged;
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.

Given that the critical terms of the cap are identical to those of the debt obligation, at inception of the hedge ABC concludes and documents that the hedging relationship is expected to be highly effective (in this example, 100% effective) in achieving offsetting cash flows attributable to changes in 12-month LIBOR when 12-month LIBOR is greater than 8%. On an ongoing basis, ABC 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; therefore, not causing a different conclusion about hedge effectiveness.

Because the cap is being used to purchase one-way protection against an increase in 12-month LIBOR, ABC does not need to assess effectiveness if 12-month LIBOR is less than 8%.

12-month LIBOR and related amounts are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>12-month LIBOR at January 1</th>
<th>Cap receipt for the year</th>
<th>Debt interest for the year</th>
<th>Net interest for the year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>7%</td>
<td>$0</td>
<td>$900,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>9%</td>
<td>(100,000)</td>
<td>1,100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>10%</td>
<td>(200,000)</td>
<td>1,200,000</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

Notes:
1. Calculated as follows:
   - When 12-month LIBOR for year is less than 8%, $0.
   - When 12-month LIBOR for year is greater than 8%: the $10,000,000 notional amount of the interest rate cap × (8% - 12-month LIBOR for the respective year).
2. $10,000,000 principal amount of the debt × (12-month LIBOR + 2%) for the respective year.
3. Cap receipt for the year + Debt interest for the year.

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 before settlement:</th>
<th>Jan 1, Year 1</th>
<th>Dec 31, Year 1</th>
<th>Dec 31, Year 2</th>
<th>Dec 31, Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intrinsic value</td>
<td>$0</td>
<td>$ -</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Time value</td>
<td>300,000</td>
<td>280,000</td>
<td>150,000</td>
<td>-</td>
</tr>
<tr>
<td>Total fair value before settlement</td>
<td>$300,000</td>
<td>$280,000</td>
<td>$350,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>
### 6. Accounting for cash flow hedges

<table>
<thead>
<tr>
<th></th>
<th>Jan 1, Year 1</th>
<th>Dec 31, Year 1</th>
<th>Dec 31, Year 2</th>
<th>Dec 31, Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Changes in fair value</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>after settlement:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fair value after</td>
<td>$ -</td>
<td>$300,000</td>
<td>$280,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>settlement, beginning</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>of period</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase of option</td>
<td>300,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Change in intrinsic</td>
<td>-</td>
<td>-</td>
<td>200,000</td>
<td>100,000</td>
</tr>
<tr>
<td>value(^\text{a})</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in time value</td>
<td>-</td>
<td>(20,000)</td>
<td>(130,000)</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Settlement of intrinsic</td>
<td>-</td>
<td>-</td>
<td>(100,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>value</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Fair value after</strong></td>
<td>$300,000</td>
<td>$280,000</td>
<td>$250,000</td>
<td>$ -</td>
</tr>
<tr>
<td>settlement, end of</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>period</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Notes:**
1. This example assumes that the intrinsic value of the cap is equal to the expected future cash flows, holding constant the cap’s current period cash flow for the remaining term of the hedge (see Question 9.2.250).
2. Total fair value before settlement - Intrinsic value before settlement.
3. Intrinsic value at respective date - Settlement at immediately preceding period-end - Intrinsic value at immediately preceding period-end-
4. As of December 31, Year 1, the cap’s current period cash flow is $0 because 12-month LIBOR is less than 8%. Using the method explained in Note 1 above, the current period cash flow of $0 is held constant for expected future cash flows. As a result, the intrinsic value is assumed to be $0 as of December 31, Year 1 despite the fact that the rate cap resets on the next day (January 1, Year 2).
5. As of December 31, Year 2, the cap’s current period cash flow is 1% (i.e. 9% - 8%) of $1,000,000, or $100,000. The intrinsic value of $200,000 represents $100,000 related to the current period and $100,000 related to the projected receipt for the next period using the method explained in Note 1 above.

For simplicity, this example makes the following assumptions.

— It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
— It is based on annual periods; normally the assessment of effectiveness and related accounting entries would be done at least quarterly.
— Journal entries (for all years) are presented gross for illustrative purposes but could be combined.

**Scenario 1: Intrinsic value method – excluded component (time value) recognized in earnings using mark-to-market approach**

In this scenario, ABC uses the intrinsic value method to assess effectiveness. ABC excludes changes in the time value of the option from the assessment of the hedge’s effectiveness.

ABC has elected to recognize changes in the fair value of the excluded component (i.e. time value) using the mark-to-market method (i.e. currently in earnings).
Journal entries – January 1, Year 1

ABC records the following journal entries on January 1, Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 10,000,000</td>
<td>Debt obligation 10,000,000</td>
</tr>
<tr>
<td>To record origination of 12-month LIBOR + 2% debt obligation.</td>
<td></td>
</tr>
<tr>
<td>Interest rate cap 300,000</td>
<td>Cash 300,000</td>
</tr>
<tr>
<td>To record purchase of interest rate cap at fair value.</td>
<td></td>
</tr>
</tbody>
</table>

There is also a memorandum entry made on January 1, Year 1, documenting the existence of this hedging relationship.

Journal entries – December 31, Year 1

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense 900,000</td>
<td>Cash 900,000</td>
</tr>
<tr>
<td>To record interest paid on 12-month LIBOR + 2% debt obligation.</td>
<td></td>
</tr>
<tr>
<td>Interest expense 20,000</td>
<td>Interest rate cap 20,000</td>
</tr>
<tr>
<td>To record change in time value of interest rate cap.¹</td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. The entire change in fair value of the interest rate cap relates to the change in the value of the excluded component (time value), which is recognized using the mark-to-market method (i.e. currently in earnings).

Journal entries – December 31, Year 2

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense 1,100,000</td>
<td>Cash 1,100,000</td>
</tr>
<tr>
<td>To record interest paid on 12-month LIBOR + 2% debt obligation.</td>
<td></td>
</tr>
<tr>
<td>Interest rate cap 200,000</td>
<td>OCI – Gain (loss) on interest rate cap</td>
</tr>
<tr>
<td>To record change in intrinsic value of interest rate cap.¹</td>
<td></td>
</tr>
</tbody>
</table>
### Journal entries – December 31, Year 3

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,200,000</td>
</tr>
<tr>
<td>To record interest paid on 12-month LIBOR + 2% debt obligation.</td>
<td></td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>100,000</td>
</tr>
<tr>
<td>OCI – Gain (loss) on interest rate cap</td>
<td>100,000</td>
</tr>
<tr>
<td>To record change in intrinsic value of interest rate cap.</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>150,000</td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>150,000</td>
</tr>
<tr>
<td>To record change in time value of interest rate cap.</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>200,000</td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>200,000</td>
</tr>
<tr>
<td>To record cash received on settlement of interest rate cap.</td>
<td></td>
</tr>
<tr>
<td>AOCI – Gain (loss) on interest rate cap</td>
<td>200,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>200,000</td>
</tr>
<tr>
<td>To reclassify into earnings amounts in AOCI that hedged variable interest expense recognized in earnings.</td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. Represents the change in the intrinsic value of the interest rate cap before settlement.
Accounting for cash flow hedges

Financial statement excerpts
At the end of Years 1–3, ABC’s financial statements reflect the following.

<table>
<thead>
<tr>
<th>Account</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>$280,000</td>
<td>$250,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Balance sheet – liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt obligation</td>
<td>$10,000,000</td>
<td>$10,000,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Balance sheet – equity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gain (loss) on cash flow hedge</td>
<td>-</td>
<td>$100,000*</td>
<td>-</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>$920,000</td>
<td>$1,130,000</td>
<td>$1,150,000</td>
</tr>
</tbody>
</table>

Note:
1. Represents the $100,000 intrinsic value of the interest rate cap after settlement.

As a result of entering into the hedging relationship, ABC effectively capped its interest expense at 10% on the three-year debt obligation. During periods in which the contractual terms of the debt obligation resulted in interest expense greater than 10% (because 12-month LIBOR exceeded 8% plus the fixed spread of 2%), 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 the excluded component (time value) resulted in additional variability of total interest expense.

<table>
<thead>
<tr>
<th>Debit (credit)</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on debt obligation</td>
<td>$900,000</td>
<td>$1,100,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Reclassification to earnings from AOCI</td>
<td>-</td>
<td>(100,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Change in time value of interest rate cap</td>
<td>20,000</td>
<td>130,000</td>
<td>150,000</td>
</tr>
<tr>
<td><strong>Total interest expense</strong></td>
<td><strong>$920,000</strong></td>
<td><strong>$1,130,000</strong></td>
<td><strong>$1,150,000</strong></td>
</tr>
</tbody>
</table>
Scenario 2: Intrinsic value method – excluded component (time value) recognized using straight-line method (an amortization approach)

As in Scenario 1, ABC uses the intrinsic value method to assess effectiveness and ABC excludes changes in the time value of the option from the assessment of the hedge’s effectiveness.

Unlike Scenario 1 in which ABC used the mark-to-market approach, in this scenario ABC elects to recognize the initial value of the excluded component (time value) using the straight-line method (an amortization approach) over the life of the interest rate cap (the hedging instrument).

The following table shows the effect on earnings of the time value using the straight-line method.

<table>
<thead>
<tr>
<th></th>
<th>Dec 31, Year 1</th>
<th>Dec 31, Year 2</th>
<th>Dec 31, Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization of initial time value¹</td>
<td>$(100,000)</td>
<td>$(100,000)</td>
<td>$(100,000)</td>
</tr>
<tr>
<td>Difference between change in fair value of time value and amortization of initial time value</td>
<td>80,000</td>
<td>(30,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td><strong>Total change in time value</strong></td>
<td><strong>$(20,000)</strong></td>
<td><strong>$(130,000)</strong></td>
<td><strong>$(150,000)</strong></td>
</tr>
</tbody>
</table>

Note:
1. Initial time value of the interest rate cap of $300,000 ÷ 3 periods.

Journal entries – January 1, Year 1

ABC records the following journal entries on January 1, Year 1.

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10,000,000</td>
<td></td>
</tr>
<tr>
<td>Debt obligation</td>
<td>10,000,000</td>
<td></td>
</tr>
<tr>
<td>To record origination of 12-month LIBOR + 2% debt obligation.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>300,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>300,000</td>
<td></td>
</tr>
<tr>
<td>To record purchase of interest rate cap at fair value.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

There is also a memorandum entry made on January 1, Year 1, documenting the existence of this hedging relationship.

Journal entries – December 31, Year 1

ABC records the following journal entries.

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>900,000</td>
<td>900,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To record interest paid on 12-month LIBOR + 2% debt obligation.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Hedging

6. Accounting for cash flow hedges

<table>
<thead>
<tr>
<th>Debit Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI – Gain (loss) on interest rate cap</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Interest rate cap</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To record change in time value of excluded component in OCI</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>OCI – Gain (loss) on interest rate cap</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To record amortization of excluded component (time value)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. The entire change in fair value of the interest rate cap relates to the change in the value of the excluded component (time value), which is recognized using the straight-line method (an amortization approach).

Journal entries – December 31, Year 2

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>1,100,000</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To record interest paid on 12-month LIBOR + 2% debt obligation</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate cap</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>OCI – Gain (loss) on interest rate cap</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To record change in intrinsic value of interest rate cap</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI – Gain (loss) on interest rate cap</td>
<td>130,000</td>
<td>130,000</td>
</tr>
<tr>
<td>Interest rate cap</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To record change in fair value of excluded component in OCI</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>OCI – Gain (loss) on interest rate cap</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To record amortization of excluded component</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Interest rate cap</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To record cash received on settlement of interest rate cap</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>AOCI – Gain (loss) on interest rate cap</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
<td>100,000</td>
</tr>
<tr>
<td>To reclassify into earnings amounts in AOCI that hedged variable interest expense recognized in earnings</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Note:
1. Represents the change in the intrinsic value of the interest rate cap before settlement.

**Journal entries – December 31, Year 3**

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,200,000</td>
</tr>
<tr>
<td>To record interest paid on 12-month LIBOR +</td>
<td></td>
</tr>
<tr>
<td>2% debt obligation.</td>
<td></td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>100,000</td>
</tr>
<tr>
<td>OCI – Gain (loss) on interest rate cap</td>
<td>100,000</td>
</tr>
<tr>
<td>To record change in intrinsic value of</td>
<td></td>
</tr>
<tr>
<td>interest rate cap.</td>
<td></td>
</tr>
<tr>
<td>OCI – Gain (loss) on interest rate cap</td>
<td>150,000</td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>150,000</td>
</tr>
<tr>
<td>To record change in fair value of excluded</td>
<td></td>
</tr>
<tr>
<td>component in OCI.</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>100,000</td>
</tr>
<tr>
<td>OCI – Gain (loss) on interest rate cap</td>
<td>100,000</td>
</tr>
<tr>
<td>To record amortization of excluded</td>
<td></td>
</tr>
<tr>
<td>component.</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>200,000</td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>200,000</td>
</tr>
<tr>
<td>To record cash received on settlement of</td>
<td></td>
</tr>
<tr>
<td>interest rate cap.</td>
<td></td>
</tr>
<tr>
<td>AOCl – Gain (loss) on interest rate cap</td>
<td>200,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>200,000</td>
</tr>
<tr>
<td>To reclassify into earnings amounts in AOCl</td>
<td></td>
</tr>
<tr>
<td>that hedged variable interest expense</td>
<td></td>
</tr>
<tr>
<td>recognized in earnings.</td>
<td></td>
</tr>
<tr>
<td>Debt obligation</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>10,000,000</td>
</tr>
<tr>
<td>To record repayment of 12-month LIBOR +</td>
<td></td>
</tr>
<tr>
<td>2% debt obligation.</td>
<td></td>
</tr>
</tbody>
</table>

Note:
1. Represents the change in the intrinsic value of the interest rate cap before settlement.
Financial statement excerpts

At the end of Years 1–3, ABC’s financial statements reflect the following.

<table>
<thead>
<tr>
<th>Account</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>$280,000</td>
<td>$250,000</td>
<td></td>
</tr>
<tr>
<td><strong>Balance sheet – liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt obligation</td>
<td>$10,000,000</td>
<td>$10,000,000</td>
<td></td>
</tr>
<tr>
<td><strong>Balance sheet – equity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gain (loss) on cash flow hedge(^1)</td>
<td>$80,000</td>
<td>$150,000</td>
<td></td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>$1,000,000</td>
<td>$1,100,000</td>
<td>$1,100,000</td>
</tr>
</tbody>
</table>

Note:
1. Intrinsic value of the interest rate cap + Cumulative difference between the change in fair value of time value (excluded component) and the amortization of the initial time value.

As a result of entering into the hedging relationship, ABC effectively capped its interest expense at 10% on the three-year debt obligation. During periods in which the contractual terms of the debt obligation resulted in interest expense greater than 10% (because 12-month LIBOR exceeded 8% plus the fixed spread of 2%), the payments received from the interest rate cap effectively reduced interest expense to 10% (plus amortization of the excluded component – time value) as illustrated below.

<table>
<thead>
<tr>
<th>Debit (credit)</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on debt obligation</td>
<td>$ 900,000</td>
<td>$1,100,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Reclassification into earnings from AOCI</td>
<td>-</td>
<td>(100,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Amortization of excluded component (time value)</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Total interest expense</strong></td>
<td>$1,000,000</td>
<td>$1,100,000</td>
<td>$1,100,000</td>
</tr>
</tbody>
</table>

**Scenario 3: Terminal value method – caplet method used for recognizing initial non-zero fair value**

The assessment of effectiveness is documented based on total changes in the purchased option’s cash flows – i.e. the assessment includes the purchased option’s entire change in fair value. As explained in section 9.7.20, this approach focuses on the rate cap’s terminal value – i.e. the expected pay-off at its maturity date. As a result, the entity concludes that the hedging relationship is considered perfectly effective and all changes in the purchased option’s fair value will be recorded in AOCI.
Under this approach, the time value component of the interest rate cap is included in the assessment of effectiveness – i.e. is not an excluded component. As a result, the premium paid (which reflects time value and results in the rate cap having a non-zero fair value at hedge inception) for the interest rate cap is required to be recognized when the hedged transaction affects earnings.

In this scenario, ABC elects to use the caplet method for recognizing the premium paid when the hedged transactions affect earnings.

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 January 1, Year 1 is as follows.

<table>
<thead>
<tr>
<th>Caplet</th>
<th>Fair value at inception</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, Year 1</td>
<td>$ -</td>
</tr>
<tr>
<td>December 31, Year 2</td>
<td>140,000</td>
</tr>
<tr>
<td>December 31, Year 3</td>
<td>160,000</td>
</tr>
<tr>
<td>Total</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

Note:
1. 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 December 31, Year 1 is based on 12-month LIBOR in effect at December 31, Year 1. Accordingly, the first interest payment on December 31, Year 1 has no variability at the inception of the hedging relationship and is not being hedged.

**Journal entries – January 1, Year 1**

ABC records the following journal entries on January 1, Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Debt obligation</td>
<td>10,000,000</td>
</tr>
<tr>
<td>To record origination of 12-month LIBOR + 2% debt obligation.</td>
<td></td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>300,000</td>
</tr>
<tr>
<td>Cash</td>
<td>300,000</td>
</tr>
<tr>
<td>To record purchase of interest rate cap at fair value.</td>
<td></td>
</tr>
</tbody>
</table>

There would also be a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship.
### Journal entries – December 31, Year 1

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>900,000</td>
</tr>
<tr>
<td>Cash</td>
<td>900,000</td>
</tr>
</tbody>
</table>

*To record interest paid on 12-month LIBOR + 2% debt obligation.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI – Gain (loss) on interest rate cap</td>
<td>20,000</td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>20,000</td>
</tr>
</tbody>
</table>

*To record change in time value of interest rate cap.*

**Note:**

1. The entire change in fair value of the interest rate swap relates to the change in time value of the interest rate cap.

### Journal entries – December 31, Year 2

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,100,000</td>
</tr>
</tbody>
</table>

*To record interest paid on 12-month LIBOR + 2% debt obligation.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate cap</td>
<td>200,000</td>
</tr>
<tr>
<td>OCI – Gain (loss) on interest rate cap</td>
<td>200,000</td>
</tr>
</tbody>
</table>

*To record change in intrinsic value of interest rate cap.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI – Gain (loss) on interest rate cap</td>
<td>130,000</td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>130,000</td>
</tr>
</tbody>
</table>

*To record change in time value of interest rate cap.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100,000</td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>100,000</td>
</tr>
</tbody>
</table>

*To record cash received on settlement of interest rate cap.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>AOCI – Gain (loss) on interest rate cap</td>
<td>100,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>100,000</td>
</tr>
</tbody>
</table>

*To reclassify into earnings amounts in AOCI that hedged variable interest expense recognized in earnings.*
### Journal entries – December 31, Year 3

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,200,000</td>
</tr>
<tr>
<td>To record interest paid</td>
<td></td>
</tr>
<tr>
<td>on 12-month LIBOR + 2%</td>
<td></td>
</tr>
<tr>
<td>debt obligation.</td>
<td></td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>100,000</td>
</tr>
<tr>
<td>OCI – Gain (loss) on</td>
<td>100,000</td>
</tr>
<tr>
<td>interest rate cap</td>
<td></td>
</tr>
<tr>
<td>To record change in</td>
<td></td>
</tr>
<tr>
<td>intrinsic value of</td>
<td></td>
</tr>
<tr>
<td>interest rate cap</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td></td>
</tr>
<tr>
<td>OCI – Gain (loss) on</td>
<td>150,000</td>
</tr>
<tr>
<td>interest rate cap</td>
<td>150,000</td>
</tr>
<tr>
<td>To record change in</td>
<td></td>
</tr>
<tr>
<td>time value of interest</td>
<td></td>
</tr>
<tr>
<td>rate cap.</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>200,000</td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>200,000</td>
</tr>
<tr>
<td>To record cash received</td>
<td></td>
</tr>
<tr>
<td>on settlement of interest</td>
<td></td>
</tr>
<tr>
<td>rate cap.</td>
<td></td>
</tr>
<tr>
<td>AOCI – Gain (loss) on</td>
<td>200,000</td>
</tr>
<tr>
<td>interest rate cap</td>
<td>200,000</td>
</tr>
<tr>
<td>To reclassify into</td>
<td></td>
</tr>
<tr>
<td>earnings amounts in</td>
<td></td>
</tr>
<tr>
<td>AOCI that hedged</td>
<td></td>
</tr>
<tr>
<td>variable interest</td>
<td></td>
</tr>
<tr>
<td>expense recognized in</td>
<td></td>
</tr>
<tr>
<td>earnings.</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>160,000</td>
</tr>
<tr>
<td>AOCI – Gain (loss) on</td>
<td>160,000</td>
</tr>
<tr>
<td>interest rate cap</td>
<td></td>
</tr>
<tr>
<td>To reclassify original</td>
<td></td>
</tr>
<tr>
<td>fair value of first</td>
<td></td>
</tr>
<tr>
<td>caplet from AOCI into</td>
<td></td>
</tr>
<tr>
<td>earnings as debt interest</td>
<td></td>
</tr>
<tr>
<td>payment being hedged is</td>
<td></td>
</tr>
<tr>
<td>reported in earnings.</td>
<td></td>
</tr>
</tbody>
</table>
### Debit Credit

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt obligation</td>
<td></td>
<td>10,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>10,000,000</td>
<td></td>
</tr>
</tbody>
</table>

*To record repayment of 12-month LIBOR + 2% debt obligation.*

**Note:**
1. Represents the change in the intrinsic value of the interest rate cap before settlement.

### Financial statement excerpts

At the end of Years 1–3, ABC’s financial statements reflect the following.

#### Account Year 1 Year 2 Year 3

<table>
<thead>
<tr>
<th>Balance sheet – assets</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate cap</td>
<td>$280,000</td>
<td>$250,000</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Balance sheet – liabilities</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt obligation</td>
<td>$10,000,000</td>
<td>$10,000,000</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Balance sheet – equity</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>AOCI – Gain (loss) on cash flow hedge</td>
<td>$(20,000)</td>
<td>$90,000¹</td>
<td>-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income statement</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>$900,000</td>
<td>$1,140,000</td>
<td>$1,160,000</td>
</tr>
</tbody>
</table>

**Note:**
1. Represents the $100,000 intrinsic value of the interest rate cap less the $10,000 change (i.e. decrease) in time value of the interest rate cap that has not yet been recognized in earnings. The $10,000 change in time value that has not yet been recognized in earnings is calculated as the $150,000 total decrease in time value less the initial time value of $140,000 associated with the first caplet that was recognized in earnings.

As a result of entering into the hedging relationship, ABC effectively capped its interest expense at 10% on the three-year debt obligation. During periods in which the contractual terms of the debt obligation resulted in interest expense greater than 10% (because the contractually specified interest rate – 12-month LIBOR – exceeded 8% plus the fixed spread of 2%), 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 interest expense.
### hedging

6. Accounting for cash flow hedges

#### Debit (credit)

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on debt obligation</td>
<td>$900,000</td>
<td>$1,100,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Reclassification of amounts from AOCI that hedged the variable interest expense into earnings</td>
<td>-</td>
<td>(100,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Reclassification from AOCI of caplet’s initial fair value</td>
<td>-</td>
<td>140,000</td>
<td>160,000</td>
</tr>
<tr>
<td>Total interest expense</td>
<td>$900,000</td>
<td>$1,140,000</td>
<td>$1,160,000</td>
</tr>
</tbody>
</table>

#### Comparison of scenarios – recognition of time value

The following table compares the amount by which earnings are decreased in each period for recognition of the options’ time value under each method:

<table>
<thead>
<tr>
<th>Approach</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approach for recognizing time value when it is an excluded component</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mark-to-market approach (Scenario 1)</td>
<td>$20,000</td>
<td>$130,000</td>
<td>$150,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Amortization approach (Scenario 2)</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Method that includes time value in effectiveness assessment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Terminal value (Scenario 3)</td>
<td>-</td>
<td>$140,000</td>
<td>$160,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

#### 6.4 Assessing impairment

6.4.10 Overview

Excerpt from ASC 815-30

Pending Content

Transition Date: (P) December 16, 2019; (N) December 16, 2020 | Transition Guidance: 326-10-65-1

>> Interaction with Impairment and Credit Loss Principles

35-42 Existing requirements in generally accepted accounting principles (GAAP) for assessing asset impairment or credit losses 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 815-30-35-3 and 815-30-35-38 through 35-41. Those impairment or credit loss requirements shall be applied each period after hedge accounting has been applied for the period, pursuant to those paragraphs. 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 paragraphs 815-30-35-38 through 35-41.

35-43 If, under existing requirements in GAAP, an asset impairment loss or writeoff due to credit losses is recognized on an asset or an additional obligation is recognized on a liability to which a hedged forecasted transaction relates, any offsetting or corresponding 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.

An entity is required to apply the existing requirements in other applicable US GAAP for:

— assessing asset impairment; and
— recognizing an increased obligation regarding an existing asset or liability for which the variable cash flows have been or currently are designated as being hedged.

Those requirements are performed after cash flow hedge accounting is applied for the period. This includes performing those requirements after evaluating whether a net derivative loss is reported in AOCI that should be reclassified because, when combined with the hedged transaction, it would lead to a loss in a future reporting period, as discussed in section 6.3.10. [815-30-35-42]

The following table shows examples of US GAAP that may be applicable for impairment of assets that are related to hedged transactions in cash flow hedging relationships.

<table>
<thead>
<tr>
<th>Hedged transaction (related asset or liability)</th>
<th>Guidance for assessing impairment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecasted sale of a long-lived asset that is recognized on the balance sheet</td>
<td>Subtopic 360-10 (property, plant and equipment)</td>
</tr>
</tbody>
</table>
| Inventory recognized on the balance sheet for which the purchase was a hedged forecasted transaction | Paragraphs 330-10-35-1A to 35-2:  
— for inventory measured using LIFO or the retail inventory method: lower of cost or market principles  
— for inventory measured using all other methods: lower of cost or net realizable value |
| Variability in cash flows associated with a specific variable-rate commercial loan receivable | Subtopic 310-10 (receivables) |
When applying applicable US GAAP for assessing asset impairment or recognizing an increased obligation to an existing asset or liability, generally neither the fair value (or the expected cash flows) of the related derivative instruments nor any derivative gains or losses reported in AOCI related to the hedging relationship should be considered. However, in three situations, an entity may be required to reclassify certain amounts from AOCI into earnings when considering the combination of the hedged transaction and the amount in AOCI: [815-30-35-40, 35-42 – 35-43]

- A net derivative loss is reported in AOCI that, when combined with the hedged transaction, would lead to a loss in a future reporting period. As discussed in section 6.3.10, if an entity expects 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 is immediately reclassified into earnings. This evaluation is required to be performed before applying applicable US GAAP for assessing asset impairment or recognizing an increased obligation to an existing asset or liability.

- An impairment loss is recognized and a net derivative gain is reported in AOCI. 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 in AOCI that relates directly to that transaction is reclassified into earnings.

- A recovery is recognized and a net derivative loss is reported in AOCI. If a recovery is recognized, any related offsetting net loss in AOCI is immediately reclassified into earnings.

Additionally, when impairment is recognized for a hedged asset, the entity should consider whether:

- the likelihood of the forecasted transaction occurring has changed; and
- additional amounts are required to be reclassified from AOCI into earnings due to such a change (see section 6.5.20).
Question 6.4.10

Are the fair value or expected cash flows of a hedging instrument ever considered when evaluating impairment of an asset related to the hedged transaction?

Interpretive response: Generally, no. Ordinarily, the fair value or expected cash flows of a derivative hedging instrument do not affect the determination of whether an asset related to the hedged transaction is impaired because the derivative is a separate asset or liability. [815-30-35-42]

However, the SEC staff has specific guidance for entities with oil- and gas-producing activities that apply the full cost method of accounting. In this situation, the prices to be received after taking into account cash flow hedging arrangements are 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 reporting date. The current price is then used to determine whether the capitalized cost of the oil- and gas-producing entity exceeds the full cost limitation. [932-360-599-2]

Example 6.4.10

Hedged asset is impaired and related amount in AOCI is a net derivative loss

This example is a modification of Example 6.3.20.

In that example, ABC Corp. uses a forward contract in a cash flow hedge of a forecasted purchase of silver. As a result of the forward contract, ABC locks in a purchase price for the silver of $1,600,000 (100,000 ounces at $16 per ounce). After settlement of the forward contract and purchase of silver, ABC’s balance sheet on June 30, Year 1 reflects the following amounts.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount (debit balances)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Silver platter inventory</td>
<td>$1,550,000</td>
</tr>
<tr>
<td>AOCI – Loss on hedging instrument (forward contract)</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total amounts related to inventory for which the purchase was hedged</strong></td>
<td><strong>$1,600,000</strong></td>
</tr>
</tbody>
</table>

Three months later on September 30, Year 1, the net realizable value of the silver platter inventory to which the cash flow hedge relates is $1,975,000. The inventory has a carrying amount of $2,000,000 – i.e. the initial purchase of silver of $1,550,000 plus costs incurred after the silver was purchased.

In addition, ABC:

— uses the FIFO method to account for its inventory; and
— continues to report in AOCI the loss on the forward contract.
As of September 30, Year 1, ABC first evaluates the combination of the inventory and the net loss on the forward contract that is reported in AOCI as follows.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount (debit balances)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Silver platter inventory</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>AOCI – Loss on hedging derivative</td>
<td>50,000</td>
</tr>
<tr>
<td>Total amounts related to hedged inventory</td>
<td>2,050,000</td>
</tr>
<tr>
<td>Net realizable value of inventory</td>
<td>1,975,000</td>
</tr>
</tbody>
</table>

**Portion of total amount that is not expected to be recovered**

$75,000

**Amount of AOCI – loss on hedging derivative to be reclassified into earnings**

$50,000

Notes:
1. Silver platter inventory + AOCI – Loss on hedging derivative.
2. Total amounts related to hedged inventory – Net realizable value of inventory.
3. Represents the entire amount in AOCI – Loss on hedging derivative ($50,000).

ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>50,000</td>
</tr>
<tr>
<td>AOCI – Loss on hedging derivative</td>
<td>50,000</td>
</tr>
</tbody>
</table>

*To reclassify from AOCI to earnings a loss on hedging derivative not expected to be recovered.*

As of September 30, Year 1, ABC next evaluates whether the silver platter inventory is impaired as follows.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount (debit balances)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Silver platter inventory</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Net realizable value of inventory</td>
<td>1,975,000</td>
</tr>
</tbody>
</table>

**Amount of impairment to recognize**

$25,000

Note:
1. Silver platter inventory - Net realizable value of inventory.

ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>25,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>25,000</td>
</tr>
</tbody>
</table>

*To recognize impairment of inventory due to market value being less than carrying amount.*

As this example demonstrates, when the net realizable value is less than the carrying amount of inventory, related net derivative losses reported in AOCI are
Hedging

6. Accounting for cash flow hedges

required to be reclassified into earnings \textit{in addition to} (and in advance of) recognition of the inventory’s impairment loss. This is because Topic 815 is applied before the impairment guidance.

**Question 6.4.20**

Are net gains in AOCI reclassified if an impairment loss is recognized on an existing asset to which a current or previous hedged forecasted transaction relates?

**Interpretive response:** When an impairment loss is recognized on an existing asset to which a current or previous hedged forecasted transaction relates, it generally is necessary to reclassify an offsetting net gain related to the transaction (if any) from AOCI into earnings. However, before any offsetting net gain in AOCI is reclassified into earnings, an entity should 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. [815-30-35-43]

For example, if interest rate risk is hedged on a variable-rate financial asset and results in a gain in AOCI, that gain would not be reclassified into earnings if an impairment loss due to credit risk is recognized on the financial asset. This is because the hedged risk that resulted in the gain in AOCI was interest rate risk while the risk resulting in recognition of an impairment loss is credit risk.

Additionally, the entity would need to consider whether recognizing the impairment loss indicates the likelihood of the forecasted transaction is no longer probable (and may indicate it is probable that the forecasted transaction will not occur). See section 6.5.20, which discusses the impact on hedge accounting and the treatment of the net derivative gain or loss reported in AOCI when the likelihood of the forecasted transaction is no longer probable.

**Example 6.4.20**

Hedged asset is impaired and related amount in AOCI is a net derivative gain

This example is a modification of Example 6.3.20.

In that example, ABC Corp. uses a forward contract in a cash flow hedge of a forecasted purchase of silver. As a result of the forward contract, ABC locked in a purchase price for the silver of $1,600,000 (100,000 ounces at $16 per ounce).

Unlike that example, it is now assumed that the spot price for silver is $16.30 per ounce. ABC purchases 100,000 ounces of silver as forecast, and pays the market price of $1,630,000. Additionally, ABC receives $30,000 to settle the forward contract, which represents the fair value (asset) of the forward contract on June 30, Year 1. As a result, ABC’s balance sheet reflects a net derivative gain in this example – rather than loss as in Example 6.3.20 – in AOCI after settlement of the forward contract and purchase of silver.
After settlement of the forward contract and purchase of silver, ABC’s balance sheet on June 30, Year 1 reflects the following amounts.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Silver platter inventory</td>
<td>$1,630,000</td>
</tr>
<tr>
<td>AOCI – Gain on hedging instrument (forward contract)</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Total amounts related to inventory for which the purchase was hedged</strong></td>
<td><strong>$1,600,000</strong></td>
</tr>
</tbody>
</table>

Three months later on September 30, Year 1, the net realizable value of the silver platter inventory to which the cash flow hedge relates is $1,975,000. The inventory has a carrying amount of $2,000,000 – i.e. the initial purchase of silver of $1,630,000 plus costs incurred after the silver was purchased.

In addition, ABC:

— continues to report in AOCI the gain on the forward contract; and
— uses the FIFO method to account for its inventory.

As of September 30, Year 1, ABC evaluates whether the silver platter inventory is impaired as follows.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount (debit balances)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Silver platter inventory</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Net realizable value of inventory</td>
<td>1,975,000</td>
</tr>
<tr>
<td><strong>Amount of impairment to recognize</strong></td>
<td><strong>$25,000</strong></td>
</tr>
</tbody>
</table>

Note:
1. Silver platter inventory - Net realizable value of inventory.

ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>25,000</td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
</tr>
<tr>
<td>To recognize impairment of inventory due to market value being less than carrying amount.</td>
<td>25,000</td>
</tr>
</tbody>
</table>

ABC performs an analysis to determine why the inventory’s net realizable value is less than its cost. ABC concludes that it is primarily because of a decrease in the spot price of silver (i.e. the hedged risk) after the silver was purchased. Therefore, ABC evaluates the amount of the net gain on the forward contract that is reported in AOCI by comparing it to the amount of the impairment loss that was recognized.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impairment loss recognized</td>
<td>$25,000</td>
</tr>
<tr>
<td>AOCI – Gain on hedging instrument (forward contract)</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Amount of AOCI – gain on hedging derivative to be reclassified into earnings</strong></td>
<td><strong>$25,000</strong></td>
</tr>
</tbody>
</table>
6. Accounting for cash flow hedges

Note:
1. Represents the lesser of the impairment loss recognized and the amount in AOCI – Gain on hedging instrument (forward contract).

ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>AOCI – Gain on hedging derivative</td>
<td>25,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>25,000</td>
</tr>
<tr>
<td><strong>To reclassify from AOCI into earnings a gain on hedging derivative to offset impairment loss recognized on hedged transaction.</strong></td>
<td></td>
</tr>
</tbody>
</table>

As this example demonstrates, when an impairment loss is recognized, net derivative gains reported in AOCI related to the hedged forecasted transaction are required to be reclassified into earnings to the extent of that impairment loss.

6.5 Discontinuing hedge accounting

6.5.10 Overview

Excerpt from ASC 815-30

>> Change in Designated Hedged Risk

35-37A If the designated hedged risk changes during the life of a hedging relationship, an entity may continue to apply hedge accounting if the hedging instrument is highly effective at achieving offsetting cash flows attributable to the revised hedged risk. The guidance in paragraph 815-20-55-56 does not apply to changes in the hedged risk for a cash flow hedge of a forecasted transaction.

> Discontinuing Hedge Accounting

40-2 In the circumstances discussed in paragraph 815-30-40-1, the net gain or loss shall remain in accumulated other comprehensive income and be reclassified into earnings as specified in paragraphs 815-30-35-38 through 35-41. Example 16 (see paragraph 815-30-55-94) illustrates the application of paragraph 815-30-35-3 if a hedging relationship is terminated.

The following table provides an overview of circumstances that would require an entity to discontinue or partially redesignate a hedging relationship.
Hedging

6. Accounting for cash flow hedges

<table>
<thead>
<tr>
<th>Change in eligibility or critical terms of hedged transactions (section 2.10.20)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedged transaction no longer meets the eligibility criteria [815-30-40-1(a)]</td>
</tr>
<tr>
<td>Modification of hedged transaction such that critical terms of the original hedging relationship have changed [815-20-55-56]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Change in eligibility or critical terms of hedging instrument (section 2.10.30)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedging instrument no longer meets the eligibility criteria [815-30-40-1(a)]</td>
</tr>
<tr>
<td>Hedging instrument expires or is sold, terminated or exercised [815-30-40-1(b)]</td>
</tr>
<tr>
<td>Modification of hedging instrument such that critical terms of the original hedging relationship have changed [815-20-55-56]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Change in hedged risk (sections 2.10.40 and 5.4.60)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in the hedged risk, except in certain circumstances [815-20-55-56]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Change in hedge effectiveness (section 2.10.50)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedge no longer highly effective on a retrospective and/or prospective basis, with certain exceptions (see Question 2.10.90) [815-30-40-1(a)]</td>
</tr>
<tr>
<td>Change in quantitative method to assess hedge effectiveness, including whether a component of the hedging instrument is excluded from the assessment (see section 9.6.40) [815-20-55-56]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Elective dedesignation</th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity may elect to discontinue the hedging relationship. [815-30-40-1(c)]</td>
</tr>
</tbody>
</table>

Future developments

Current guidance is not clear as to whether the ability to change the hedged risk also provides an ability to change the hedged forecasted transaction (see Question 5.4.90). The FASB discussed potential Codification improvements related to this issue at a March 2018 meeting and is in the process of collecting external feedback on these potential amendments. [FASB meeting 03-18]

**Treatment of hedging instruments.** If the derivative instrument remains outstanding after hedge accounting is discontinued, it continues to be recorded on the balance sheet at fair value. However, changes in the derivative’s fair value (including changes in excluded components) are reflected in earnings – rather than AOCI – unless the derivative is designated as the hedging instrument in a new hedging relationship. It may be used as the hedging instrument in a new hedging relationship as long as the hedging criteria are met for the new relationship. [815-30-40-3]

**Treatment of amounts remaining in AOCI and effect of discontinuation on future hedging relationships.** When a hedging relationship is discontinued,
accounting for the net derivative gain or loss reported in AOCI and the effect of
the discontinuation on future hedging relationships depends on several
considerations. Those considerations are summarized in the following decision
tree.

Has any one of the following occurred?
— Any of the hedging criteria are no longer met
— The derivative has expired or been sold, terminated or exercised
— The entity has removed or partially removed the hedge designation
   (section 2.10)

Continue the cash flow hedging relationship

Yes

Discontinue the cash flow hedging relationship (or portion thereof) prospectively

Is it probable that the originally forecasted transaction will not occur within the originally specified period or within a two-month period thereafter?

This evaluation is continuous as long as derivative gains or losses are reported in AOCI related to a hedged forecasted transaction (section 6.5.20)

No

Yes

Reclassify the amount remaining in AOCI related to the hedging relationship into earnings when the hedged forecasted transaction is reported in earnings (section 6.3.10)

Are there extenuating circumstances related to the nature of the originally forecasted transaction that resulted in it being probable that it will not occur within the original period specified in the hedge documentation or within a two-month period thereafter? (section 6.5.20)

No

Yes

Were these extenuating circumstances outside the control or influence of the entity? (This should be very rare)

No

Yes

Reclassify the amount remaining in AOCI related to the hedging relationship into earnings immediately.

Consider whether the missed forecast results in the entity having a pattern of missing forecasts that calls into question its ability to predict future transactions. (see also Question 6.5.110)
Examples

The following examples demonstrate discontinuation of cash flow hedge accounting.

— Terminating an interest rate swap used in a cash flow hedge (Example 6.5.10).
— Terminating a cash flow hedge when hedge designation is removed (Example 6.5.20).
— Accounting for amounts in AOCI when a hedged forecasted transaction becomes a firm commitment (Example 6.5.30).
— Designation and discontinuance of a cash flow hedge of the forecasted purchase of inventory (Subtopic 815-30’s Example 8).
— Changes in a cash flow hedge of forecasted interest payments with an interest rate swap (Subtopic 815-30’s Example 9).

Example 6.5.10
Terminating an interest rate swap used in a cash flow hedge

Three years ago, ABC Corp. entered into a five-year interest rate swap to receive interest at a variable rate (US 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 contractually specified interest rate (i.e. US Treasury rates) on a specific five-year, variable-rate debt obligation.

Since that time, interest rates have declined and ABC 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.

ABC pays the swap counterparty $1,000,000 to terminate the interest rate swap and derecognizes the $1,000,000 liability related to the swap.

In this example, the hedging instrument is terminated but the hedged transaction (interest cash flows on a specific five-year, variable-rate debt obligation) continues to be probable. As a result, the net derivative loss reported in AOCI related to the discontinued hedging relationship is reclassified into earnings when the hedged forecasted transactions affect earnings – e.g. over the remaining two-year life of the specific debt obligation.

Example 6.5.20
Terminating a cash flow hedge when hedge designation is removed

Three years ago, ABC Corp. 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 contractually specified rate (six-month LIBOR) on a specific five-year, variable-rate (six-month LIBOR) AFS debt security.
Since that time, interest rates decreased and ABC 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.

ABC removes the hedging designation.

In this example, the hedging relationship has been discontinued but the hedged transaction (interest cash flows on a specific five-year, variable-rate AFS debt security) continues to be probable. As a result, the net derivative gain reported in AOCI related to the discontinued hedging relationship is reclassified into earnings when the hedged forecasted transactions affect earnings – e.g. over the remaining two-year life of the specific debt security.

As of the date the hedging designation is removed, ABC accounts for the swap as a nonhedging derivative instrument with all subsequent changes in its fair value recognized currently in earnings unless it is designated as the hedging instrument in a new hedging relationship that meets all of the relevant hedging criteria.

---

**Example 6.5.30**

**Accounting for amounts in AOCI when a hedged forecasted transaction becomes a firm commitment**

On January 1, Year 1, ABC Corp. purchases a call option to hedge the total price risk of a forecasted purchase of 10,000 units of inventory, which is expected to occur in 12 months. At June 30, Year 1, a $5,000,000 net gain on the call option remains in AOCI.

On July 1, Year 1, ABC enters into a firm commitment to acquire the 10,000 units of inventory in six months at a fixed price, thereby transforming the forecasted transaction into a firm commitment.

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. As a result, ABC discontinues prospectively applying cash flow hedge accounting to the forecasted transaction/call option hedging relationship.

ABC continues to report the $5,000,000 net derivative gain in AOCI until the date the hedged forecasted transaction is reported in earnings. Because the hedged forecasted transaction is the purchase of inventory, the $5,000,000 gain in AOCI will be reclassified into earnings when either the hedged inventory is sold or impairment is recognized (sections 6.3.10 and 6.4.10).
Example 8: Designation and Discontinuance of a Cash Flow Hedge of the Forecasted Purchase of Inventory

This Example illustrates the effect on earnings and other comprehensive income of discontinuing a cash flow hedge by redesignating the hedging derivative under paragraph 815-30-40-1(c) before the variability of the cash flows from the hedged forecasted transaction has been eliminated. It also discusses the effect that the location of a physical asset has on the effectiveness of a hedging relationship. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

On February 3, 20X1, Entity JKL forecasts the purchase of 100,000 bushels of corn on May 20, 20X1. The contract does not contain a contractually specified component, and Entity JKL designates changes in cash flows related to the forecasted transaction attributable to all changes in the purchase price as the hedged risk. It expects to sell finished products produced from the corn on May 31, 20X1. On February 3, 20X1, Entity JKL enters into 20 futures contracts, each for the purchase of 5,000 bushels of corn on May 20, 20X1 (100,000 in total), and designates those contracts as a hedging instrument in a cash flow hedge of the forecasted purchase of corn.

Entity JKL chooses to assess effectiveness by comparing the entire change in fair value of the futures contracts to changes in the expected cash flows on the forecasted transaction. Entity JKL estimates its expected cash flows on the forecasted transaction based on the futures price of corn adjusted for the difference between the cost of corn delivered to Chicago and the cost of corn delivered to Minneapolis. Entity JKL does not choose to use a tailing strategy (as described in paragraph 815-20-25-121). Entity JKL expects changes in fair value of the futures contracts to be highly effective at offsetting changes in the expected cash outflows for the forecasted purchase of corn because both of the following conditions exist:

a. The futures contracts are for the same variety and grade of corn that Entity JKL plans to purchase.

b. On May 20, 20X1, the futures price for delivery on May 20, 20X1 will be equal to the spot price (because futures prices and spot prices converge as the delivery date approaches).

However, the hedge may not achieve perfect offset between the hedged item and hedging instrument because of the difference in the delivery location between the hedging instrument and forecasted transaction.

Entity JKL will purchase corn for delivery to its production facilities in Minneapolis, but the price of the futures contracts is based on delivery of corn to Chicago. Changes in the difference between the price of corn delivered to Chicago and the price of corn delivered to Minneapolis would result in not achieving perfect offset between the hedged item and hedging instrument.
and, if of significant magnitude, may preclude the hedging relationship from achieving highly effective offset.

55-44 On February 3, 20X1, the futures price of corn for delivery to Chicago on May 20, 20X1, is $2.6875 per bushel resulting in a total price of $268,750 for 100,000 bushels.

55-45 On May 1, 20X1, Entity JKL dedesignates the related futures contracts and closes them out by entering into offsetting contracts on the same exchange. As of that date, Entity JKL had recognized in accumulated other comprehensive income gains on the futures contracts of $26,250. Entity JKL still plans to purchase 100,000 bushels of corn on May 20, 20X1. Consequently, the gains that occurred before dedesignation will remain in other comprehensive income until the finished product is sold. If Entity JKL had not closed out the futures contracts when it dedesignated them, any further gains or losses would have been recognized in earnings.

55-46 On May 20, 20X1, Entity JKL purchases 100,000 bushels of corn, and on May 31, 20X1, Entity JKL sells the finished product.

55-47 The futures prices of corn that are in effect on key dates are assumed to be as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Futures Price per Bushel for Delivery to Chicago on May 20, 20X1</th>
<th>Futures Price Adjusted for Delivery to Minneapolis on May 20, 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inception of hedging relationship—February 3, 20X1</td>
<td>$ 2.6875</td>
<td>$ 2.7375</td>
</tr>
<tr>
<td>End of quarter—March 31, 20X1</td>
<td>3.1000</td>
<td>3.1500</td>
</tr>
<tr>
<td>Discontinue hedge—May 1, 20X1</td>
<td>2.9500</td>
<td>3.0000</td>
</tr>
<tr>
<td>Purchase of corn—May 20, 20X1</td>
<td>2.8500</td>
<td>2.9000</td>
</tr>
</tbody>
</table>

55-48 The changes in fair value of the futures contracts between inception (February 3, 20X1) and discontinuation (May 1, 20X1) of the hedge are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Futures Price at beginning of period</th>
<th>Futures Price at end of period</th>
<th>Change in price per bushel</th>
<th>Bushels under contract (20 contracts @ 5,000 bushels each)</th>
<th>Change in fair value—gain (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>February 3–March 31, 20X1</td>
<td>$ 2.6875</td>
<td>3.1000</td>
<td>0.4125</td>
<td>x 100,000</td>
<td>$ 41,250</td>
</tr>
<tr>
<td>April 1–May 1, 20X1</td>
<td>$ 3.1000</td>
<td>2.9500</td>
<td>(0.1500)</td>
<td>x 100,000</td>
<td>(15,000)</td>
</tr>
</tbody>
</table>

55-49 The following table displays the entries to recognize the effects of all of the following:

a. Entering into futures contracts as a hedge of the forecasted purchase of corn
b. Dedesignating and closing out the futures contracts
c. Completing the forecasted purchase of corn
d. Selling the finished products produced from the corn.

Because the difference in prices between corn delivered to Chicago and corn delivered to Minneapolis ($0.05 per bushel, as illustrated in paragraph 815-30-55-47) did not change during the period of the hedge, the hedging relationship
achieved perfect offset between the hedged item and the hedging instrument. If that difference had changed, the entire change in fair value of the futures contracts would still have been recorded in accumulated other comprehensive income until the discontinuation date assuming the hedging relationship remained highly effective at offsetting variability in cash flows and the hedged forecasted transaction was still probable of occurring.

| Debit (Credit)                              | Cash | Inventory | Other Comprehensive Income | Earnings 

(a) |
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31, 20X1 (end of quarter)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize change in fair value of futures contracts</td>
<td>$ 41,250</td>
<td>$ (41,250)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>May 1, 20X1 (discontinue hedge)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize change in fair value of futures contracts</td>
<td>(15,000)</td>
<td>15,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>May 20, 20X1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize purchase of corn</td>
<td>(290,000)</td>
<td>290,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>May 31, 20X1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognize cost of sale of product</td>
<td>(290,000)</td>
<td>290,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reclassify changes in fair value of futures contracts to earnings</td>
<td>26,250</td>
<td>(26,250)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$ (263,750)</td>
<td>$ -</td>
<td>$ -</td>
<td>$ 263,750</td>
</tr>
</tbody>
</table>

(a) The change in the fair value of the hedging derivative is presented in the same income statement line item as the earnings effect of the hedged item.

55-50 To simplify this Example and focus on the effects of the hedging relationship, the margin account with the clearinghouse and certain amounts that would be involved in a sale of Entity JKL’s inventory (for example, additional costs of production, selling costs, and sales revenue) have been ignored.

55-51 The effect of the hedging strategy is that the cost of the corn recognized in earnings when the finished product was sold was $263,750. If the hedging relationship had not been discontinued early, the cost recognized in earnings would have been $273,750, which was the futures price of the corn, adjusted for delivery to Minneapolis, at the inception of the hedge. Without the strategy, Entity JKL would have recognized $290,000, which was the price of corn delivered to Minneapolis at the time it was purchased.
Excerpt from ASC 815-30

>> Example 9: Changes in a Cash Flow Hedge of Forecasted Interest Payments with an Interest Rate Swap

55-52 The following Cases describe the effects on earnings and other comprehensive income of certain changes in a cash flow hedging relationship:

a. The variability of the hedged interest payments is eliminated before the hedging derivative expires (Case A).

b. The interest rate index that is the basis for the hedged interest payments is changed to a different index before the hedging derivative expires (Case B).

55-53 Cases A and B share the following assumptions. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-54 Entity MNO enters into an interest rate swap (Swap 1) and designates it as a hedge of the variable quarterly interest payments on Entity MNO’s 5-year $5 million borrowing program, initially expected to be accomplished by a series of $5 million notes with 90-day terms. Entity MNO plans to continue issuing new 90-day notes over the next 5 years as each outstanding note matures. The interest on each note will be determined based on the contractually specified LIBOR rate at the time each note is issued. Swap 1 requires a settlement every 90 days, and the variable interest rate is reset immediately following each payment. Entity MNO pays a fixed rate of interest (6.5 percent) and receives interest at LIBOR. Entity MNO neither pays nor receives a premium at the inception of Swap 1. The notional amount of the contract is $5 million, and it expires in 5 years.

55-55 Because Swap 1 and the hedged forecasted interest payments are based on the same notional amount, have the same reset dates, and are based on the same contractually specified interest rate (that is, the LIBOR rate) designated under paragraph 815-20-25-15(j)(2), Entity MNO may conclude that the hedging relationship will perfectly offset changes in cash flows of the hedged item attributable to the hedged risk and the hedging instrument (absent a default by the interest rate swap counterparty).

55-56 This paragraph explains why the guidance in Example 4, Case B (see paragraph 815-20-55-97) does not conflict with the guidance in this Example. In the cash flow hedge in this Example, had the hedged forecasted transaction been narrowly limited to the interest payments on specific future debt issuances rather than on the five-year borrowing program, the failure to engage in future debt issuances would cause the related derivative instrument net gain or loss in other comprehensive income to be immediately reclassified into earnings pursuant to paragraphs 815-30-40-4 through 40-5 because it would have been probable that the hedged forecasted transactions would not occur. Furthermore, if that failure is part of a pattern of hedged forecasted transactions being probable of not occurring, it would call into question both an
entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions, pursuant to paragraph 815-30-40-5. In contrast, in Example 4, Case B (see paragraph 815-20-55-97), the hedged quarterly interest payments were directly linked to Entity B’s existing LIBOR-indexed floating-rate assets. When those existing assets are later prepaid or sold, the future quarterly interest payments on those specific assets are no longer probable of occurring (that is, no longer probable of being received by Entity B). Consequently, the hedging relationships for those future quarterly interest payments fail to meet the criterion in paragraph 815-20-25-15(b) and must be discontinued under paragraph 815-30-40-1. Because it is probable that the hedged quarterly interest payments that were directly linked to assets that were prepaid or sold will not occur, the related derivative instrument net gain or loss in other comprehensive income must be immediately reclassified into earnings pursuant to paragraphs 815-30-40-4 through 40-5.

55-57 At the end of the second year of the 5-year hedging relationship, Entity MNO discontinues its practice of issuing 90-day notes. Instead, Entity MNO issues a 3-year, $5 million note with a fixed rate of interest (7.25 percent). Because the interest rate on the three-year note is fixed, the variability of the future interest payments has been eliminated. Thus, Swap 1 no longer qualifies for cash flow hedge accounting. However, the net gain or loss on Swap 1 in accumulated other comprehensive income is not reclassified to earnings immediately. Immediate reclassification is required (and permitted) only if it becomes probable that the hedged transactions (future interest payments) will not occur. The variability of the payments has been eliminated, but it still is probable that they will occur. Thus, those gains or losses will continue to be reclassified from accumulated other comprehensive income to earnings as the interest payments affect earnings (as required by paragraphs 815-30-35-38 through 35-41) and presented in the same income statement line item as the earnings effect of the hedged item. If the term of the fixed rate note had been longer than three years, the amounts in accumulated other comprehensive income still would have been reclassified into earnings over the next three years, which was the term of the designated hedging relationship.

55-58 Rather than liquidate the pay-fixed, receive-variable Swap 1, Entity MNO enters into a pay-floating, receive-fixed interest rate swap (Swap 2) with a 3-year term and a notional amount of $5 million. Entity MNO neither pays nor receives a premium. Like Swap 1, Swap 2 requires a settlement every 90 days and reprices immediately following each settlement. The relationship between 90-day interest rates and longer term rates has changed since Entity MNO entered into Swap 1 (that is, the shape of the yield curve is different). As a result, Swap 2 has different terms and its settlements do not exactly offset the settlements on Swap 1. Under the terms of Swap 2, Entity MNO will receive a fixed rate of 7.25 percent and pay interest at LIBOR.

55-59 The two swaps are not designated as hedging instruments and are reported at fair value. The changes in fair value are reported immediately in earnings and offset each other to a significant degree.
Case B: Basis of Hedged Forecasted Transactions Is Changed

At the end of the second year of the 5-year hedging relationship, Entity MNO discontinues its practice of issuing 90-day notes and issues a 3-year, $5 million note with a different contractually specified interest rate (that is, an interest rate that is not LIBOR) that adjusts every 90 days. As of this date, Entity MNO must begin performing assessments of effectiveness for the hedging relationship by comparing changes in fair value of the hedging instrument (indexed to LIBOR) with changes in the value of the hedged item based on the revised contractually specified interest rate. Because the hedged forecasted transactions (future interest payments) are still probable of occurring, Entity MNO may continue to apply hedge accounting in accordance with paragraph 815-30-35-37A if the hedging instrument (indexed to LIBOR) is highly effective at achieving offsetting cash flows attributable to the revised contractually specified interest rate.

If the revised hedging relationship is not determined to be highly effective, the hedging relationship must be discontinued. However, the net gain or loss on Swap 1 in accumulated other comprehensive income as of the date Entity MNO issues the three-year note is not reclassified into earnings immediately. Immediate reclassification would be required only if, as part of its normal process of assessing whether it remains probable that the hedged forecasted transaction will occur, Entity MNO determines that it is probable that the payments (future interest payments) will not occur. In this case, the expected amounts of those payments have changed (because they will be based on a revised contractually specified interest rate instead of LIBOR, as originally expected), but it still is probable that the payments will occur. Thus, those gains or losses will continue to be reclassified to earnings as the interest payments affect earnings and presented in the same income statement line item as the earnings effect of the hedged item.

Accounting in the period a hedge is discontinued

The following Questions and Examples address several interpretive issues regarding how to account for a cash flow hedge in the period it is discontinued.

Question 6.5.10

If a hedging relationship has been retrospectively highly effective, is hedge accounting required to be applied in the previous period?

Interpretive response: Yes. If an entity determines that a hedging relationship had been retrospectively highly effective at the current assessment date, the entity is required to apply hedge accounting.

This means that the amount reported in AOCI should be measured through the date of the assessment (see section 6.2.10). This is the case even if the entity believes the hedging relationship will not be highly effective on a prospective basis or if the entity is discontinuing hedge accounting prospectively.
Example 6.5.40
Dedesignation and redesignation of a hedging relationship due to failing to qualify for cash flow hedge accounting in one period

On January 1, Year 1, ABC Corp. enters into a hedging relationship of a forecasted transaction that will occur in Year 2. ABC 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. The fair value of the hedging instrument is zero at inception.

On March 31, Year 1 (the first assessment period), ABC concludes that the hedging relationship was highly effective retrospectively and is expected to continue to be highly effective prospectively.

On June 30, Year 1 (the second assessment period), ABC concludes that the hedging relationship was not highly effective retrospectively but is expected to be highly effective prospectively. There are circumstances in which it is appropriate to continue applying hedge accounting when a hedging relationship is expected to be highly effective prospectively when it was not retrospectively (see Question 2.10.90). However, ABC concludes that this is not one of those limited circumstances – i.e. ABC does not identify any 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 terminated.

On June 30, Year 1, ABC immediately redesignates the derivative to a new hedging relationship with terms identical to the previous hedging relationship (except that its retrospective and prospective assessments of effectiveness will be based on regression analyses rather than by period-by-period dollar-offset).

On September 30, Year 1, and December 31, Year 1, ABC concludes that the new hedging relationship was highly effective retrospectively and is expected to continue to be highly effective prospectively.

The following data are also relevant.

<table>
<thead>
<tr>
<th>Assessment date</th>
<th>Derivative fair value asset (liability)</th>
<th>Cumulative change in derivative fair value during the hedging relationship gain (loss)</th>
<th>Change in derivative’s fair value during current assessment period (Adjustment to AOCI) (debit) credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Original hedging relationship</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>March 31, Year 1</td>
<td>$(100)</td>
<td>$(100)</td>
<td>$(100)¹</td>
</tr>
<tr>
<td>June 30, Year 1</td>
<td>(120)</td>
<td>(120)</td>
<td>2</td>
</tr>
<tr>
<td><strong>New hedging relationship</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>September 30, Year 1</td>
<td>$80</td>
<td>$200</td>
<td>$200¹</td>
</tr>
<tr>
<td>December 31, Year 1</td>
<td>30</td>
<td>150</td>
<td>(50)¹</td>
</tr>
</tbody>
</table>
Notes:
1. Because the hedge was highly effective in the retrospective assessment period, the change in derivative fair value is recognized in OCI. It is calculated as the cumulative change in derivative fair value during the hedge as of the current assessment date less the cumulative change in the derivative fair value during the hedge as of the previous assessment date.
2. Because the hedge was not highly effective in the retrospective assessment period, hedge accounting is not applied. As a result, the change in the fair value of the derivative is recognized in earnings rather than in OCI.

Journal entry – January 1, Year 1
There is a memorandum entry made on January 1, Year 1, documenting the existence of this hedging relationship. ABC’s financial records are not otherwise affected as of this date because the derivative hedging instrument had a fair value of zero at inception.

Journal entries – March 31, Year 1
ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI – Gains (losses) on cash flow hedging derivatives</td>
<td>100</td>
</tr>
<tr>
<td>Derivative liability</td>
<td>100</td>
</tr>
<tr>
<td>To record change in fair value of derivative during period as a result of applying hedge accounting.</td>
<td></td>
</tr>
</tbody>
</table>

Journal entries – June 30, Year 1
ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gains (losses) on derivatives (income statement)</td>
<td>20</td>
</tr>
<tr>
<td>Derivative liability</td>
<td>20</td>
</tr>
<tr>
<td>To record change in fair value of derivative during period for which hedge accounting is not applied.</td>
<td></td>
</tr>
</tbody>
</table>

Journal entries – September 30, Year 1
ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivative asset</td>
<td>80</td>
</tr>
<tr>
<td>Derivative liability</td>
<td>120</td>
</tr>
<tr>
<td>OCI – Gains (losses) on cash flow hedging derivatives</td>
<td>200</td>
</tr>
<tr>
<td>To record change in fair value of derivative during period as a result of applying hedge accounting.</td>
<td></td>
</tr>
</tbody>
</table>
Note:
1. The derivative instrument represented a liability as of June 30, Year 1 and an asset as of September 30, Year 1.

**Journal entries – December 31, Year 1**

ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI – Gains (losses) on cash flow hedging derivatives</td>
</tr>
<tr>
<td>Derivative asset</td>
</tr>
</tbody>
</table>

To record change in fair value of derivative during period as a result of applying hedge accounting.

**Financial statement excerpts**

At the end of each period, ABC’s financial statements reflect the following related to this hedging relationship.

<table>
<thead>
<tr>
<th>Account</th>
<th>3 months ended Mar 31</th>
<th>6 months ended Jun 30</th>
<th>9 months ended Sep 30</th>
<th>Year ended Dec 31</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Derivatives</td>
<td>-</td>
<td>-</td>
<td>$80</td>
<td>$30</td>
</tr>
<tr>
<td><strong>Balance sheet – liabilities</strong></td>
<td>$100</td>
<td>$120</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Balance sheet – equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gains (losses) on cash flow hedging derivatives</td>
<td>$(100)</td>
<td>$(100)</td>
<td>$100</td>
<td>$50</td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gains (losses) on derivatives (P&amp;L)</td>
<td>-</td>
<td>$(20)</td>
<td>$(20)</td>
<td>$(20)</td>
</tr>
</tbody>
</table>

Because the original hedging relationship was not highly effective under the retrospective assessment of effectiveness during the second assessment period, the entire change in the derivative’s fair value for that period is recognized in earnings.

The net derivative gains or losses reported in AOCI related to the new hedging relationship established subsequently includes changes in the derivative’s fair value for the new hedging period – i.e. July 1, Year 1 to December 31, Year 1.
Question 6.5.20

What is the accounting for amounts in AOCI related to a partially dedesignated cash flow hedging relationship?

**Background:** We believe it is acceptable to partially dedesignate a cash flow hedging relationship under certain circumstances (see section 2.10.60).

**Interpretive response:** The accounting when a hedging relationship is partially dedesignated is summarized as follows.

**Treatment of hedging instruments.** The derivative instrument continues to be recorded on the balance sheet at fair value. However, changes in its fair value are recorded differently for the portion that was (versus was not) dedesignated from the hedging relationship.

— **Portion that remains designated in the hedging relationship:** Changes in this portion of the derivative’s fair value that are included in the effectiveness assessment continue to be reported in OCI. Changes in the portion of the fair value that relate to excluded components continue to be recognized in earnings using either an amortization or mark-to-market approach (see section 6.2). These amounts relate to the forecasted transactions that continue to be hedged.

— **Portion that is no longer designated:** Subsequent changes in this portion of the derivative’s fair value (including changes in excluded components) are reflected in earnings – rather than OCI – unless this portion is designated as the hedging instrument in a new hedging relationship.

**Treatment of amounts remaining in AOCI and other considerations.** When a hedging relationship is partially dedesignated because some of the originally forecasted transactions are no longer probable, a portion of the net derivative gain or loss reported in AOCI at the time of partial dedesignation relates to the forecasted transactions that continue to be hedged and another portion relates to those forecasted transactions that are no longer hedged.

— **Forecasted transactions that continue to be hedged:** The entity continuously evaluates the likelihood that the forecasted transactions will occur. These amounts generally remain in AOCI until the period(s) that the forecasted transactions are reported in earnings (see sections 6.3 and 6.4).

— **Forecasted transactions that are no longer hedged:** Until these transactions occur, the entity continuously evaluates related amounts that remain in AOCI. If at any time it is probable that the previously hedged forecasted transactions will not occur in the originally specified period or within an additional two months, related amounts remaining in AOCI are immediately reclassified into earnings unless extenuating circumstances apply. Additionally, this represents a missed forecast that the entity would be required to consider when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions (see also Question 6.5.110).
Question 6.5.30

Is hedge accounting applied through the date an event causes a hedging relationship to no longer be highly effective?

**Background:** If in a *fair value hedge* an event or change in circumstances results in the 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 (see section 4.5.20). Topic 815 does not contain similar language for a cash flow hedge. [815-25-40-4]

**Interpretive response:** Yes. Based on discussions with the FASB staff, we believe cash flow hedge accounting should be applied through the date of such an event or change.

When an entity determines that a hedging relationship had not been retrospectively highly effective at the current assessment date, the entity generally should discontinue hedge accounting (see section 2.10.50) and should not recognize changes in the fair value of the hedging instrument in AOCI for that assessment period.

However, if the entity is able to identify the event or change in circumstances that resulted in the cash flow hedging relationship being discontinued, the entity must apply hedge accounting up to the date of that event or change in circumstances. All subsequent changes in fair value of the derivative that occurred from that date to the current assessment date are reported in earnings.

Question 6.5.40

Is it appropriate to assume the last date of high effectiveness is the date insolvency is declared or significant financial difficulties are disclosed?

**Background:** 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 in the entity’s own nonperformance risk).

**Interpretive response:** Not necessarily. If a hedge is no longer highly effective because of the counterparty’s creditworthiness or the entity’s nonperformance risk, the hedging relationship is discontinued as of the date it is no longer probable that the counterparty or the entity will *not* default. Careful analysis and significant judgment are often necessary to determine this date.

Deterioration in credit can occur over a period of time. As a result, an entity should review all available information, including the pricing of relevant instruments in 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 transaction due to changes in the hedged risk. For example, credit spreads may widen to the point of causing the
changes in the fair value of a derivative to cease being highly effective at offsetting changes in the cash flows of the hedged transaction in advance of insolvency being declared, public disclosure of significant financial difficulties, and/or a credit downgrade by the national rating agencies.

Example 6.5.50
Identification of the date credit deterioration caused a hedge to cease being highly effective

On September 30, Year 1, ABC Corp. has a highly effective cash flow hedging relationship that involves a derivative in an asset position with a fair value of $18. ABC has not excluded any components from the assessment of effectiveness; therefore, the cumulative change in the derivative's fair value (i.e. $18) is in AOCI at September 30, Year 1.

On December 31, Year 1, the fair value of the derivative hedging instrument decreases to $1 due to credit deterioration of the derivative counterparty. As a result, ABC determines that the cash flow hedging relationship was not highly effective for the three months ended December 31, Year 1 and is not expected to be highly effective on a prospective basis.

ABC performs an analysis and determines that the fair value of the derivative was $16 on October 14, Year 1 but decreased overnight to $2 on October 15 because of a severe increase in the credit spread of the counterparty. ABC determines that the hedging relationship was highly effective through October 14, Year 1. Therefore, ABC applies hedge accounting through October 14, Year 1 – i.e. ABC recognizes the change in fair value of the hedging instrument through that date in AOCI.

ABC then discontinues hedge accounting. All changes in the fair value of the derivative after October 14, Year 1 are reflected in earnings.

Excerpt from ASC 815-30

>> Example 16: Impact on Accumulated Other Comprehensive Income of Issuing Debt with a Term That Is Shorter Than Originally Forecasted

55-94 This Example illustrates the effect on accumulated other comprehensive income of issuing debt with a term that is shorter than originally forecasted.

55-95 Entity A expects to borrow $100 million over a 10-year period beginning in 6 months. Entity A initially plans to issue $100 million of 10-year fixed-rate debt at or near par at the then-current market interest rate; consequently, Entity A will be exposed to variability in cash flows in the future quarterly interest payments on the debt due to changes in credit risk and interest rate risk that occur during this 6-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 6-month period, Entity A does all of the following:

a. It enters into a derivative instrument (for example, a forward-starting interest rate swap).
b. It documents that it is hedging the variability in the 40 future quarterly interest payments, attributable to changes in the benchmark interest rate, over the next 10 years related to its 10-year $100 million borrowing program that begins in 6 months.
c. It documents that it will assess the effectiveness of the hedging relationship semimonthly on a quantitative basis.

55-96 Six months after inception of the hedging relationship, Entity A issues debt. However, due to market conditions, Entity A decides in the week before issuance that it will issue $100 million of fixed-rate debt with a 5-year maturity and quarterly interest payments.

55-97 When Entity A decides that the term of the debt to be issued will differ from the term of the debt originally expected to be issued, Entity A should not immediately reclassify into earnings the entire net gain or loss in accumulated other comprehensive income related to the derivative instrument. Instead, Entity A must first apply the requirements of paragraph 815-30-35-3 using its originally documented hedging strategy and the newly revised best estimate of the cash flows. That is, the assessment of hedge effectiveness should be based on the most recent best estimate of the hedged forecasted transaction as of the date that a cash flow hedge is discontinued prospectively.

55-98 Entity A’s strategy is a cash flow hedge of 40 individual probable quarterly interest payments. A cash flow hedge of future interest payments is a hedge of a series of forecasted transactions; consequently, Entity A must first determine the likelihood of whether and when each forecasted transaction in the series will occur. If at any time during the hedging relationship Entity A determines that it is no longer probable that any of the forecasted transactions in the series will occur by the date (or within the time period) originally specified, it must terminate the original hedging relationship for each of those specific nonprobable forecasted transactions (even if the forecasted transaction will occur within an additional two-month period of time after that originally specified date).

55-98A When Entity A performs its semimonthly assessment of effectiveness for the half-month period immediately preceding the issuance of the debt, it could also possibly conclude that the hedging relationship is no longer considered highly effective under paragraph 815-20-25-75 because the actual variability in the hedged interest payments for Years 1–5 is now based on the 5-year borrowing rate—not on 10-year rates as expected at the inception of the hedge when the entity selected the hedging derivative. In that circumstance, the hedging relationship is terminated. After the hedging relationship is terminated, Entity A must determine whether it is probable that any or all of those specific nonprobable forecasted transactions will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter (see paragraphs 815-30-40-4 through 40-5).

55-99 When Entity A originally documented the hedging relationship, it was hedging 40 forecasted transactions (forecasted quarterly interest payments) that would begin in 6 months’ time and continue over a 10-year period. In this
Example, Entity A terminates the hedging relationship no later than on the date it issues the 5-year debt (because the variability of the first 20 hedged payments ceases on that date) and must determine the amount, if any, to be reclassified into earnings from accumulated other comprehensive income related to the net derivative gain or loss of the terminated cash flow hedge. Because Entity A issued a 5-year debt instrument, Entity A would determine that it is probable that the first 20 forecasted transactions would occur because they are now contractual obligations. Entity A must determine that it is not probable that any of the last 20 forecasted transactions will not occur to continue reporting the net derivative gain or loss related to these forecasted transactions in accumulated other comprehensive income. At issue is whether it is probable that the five-year debt will not be replaced by new borrowings that will involve the quarterly payment of interest. Provided that the entity determines that it is not probable that any of the original 40 forecasted transactions will not occur, Entity A must apply paragraph 815-30-35-3 and continue to report an amount in accumulated other comprehensive income based on the most recent best estimate of the hedged forecasted transactions related to all 40 forecasted transactions and reclassify an appropriate amount into earnings when each hedged forecasted transaction affects earnings and present those amounts in the same income statement line item as the earnings effect of the hedged item. If Entity A determines that it is probable that any of those forecasted transactions will not occur either by the end of the date (or within the time period) originally specified or within an additional two-month period of time thereafter (see paragraphs 815-30-40-4 through 40-5), Entity A should reclassify into earnings from accumulated other comprehensive income the amount of the net derivative instrument gain or loss related to those specific nonoccurring forecasted transactions. That amount should be equivalent to the portion of the present value of the derivative instrument’s cash flows intended to offset the changes in the original forecasted transactions for which Entity A has determined it is probable that they will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter. Thus, the nonoccurrence of one of the hedged forecasted transactions described in this Example could potentially jeopardize Entity A’s ability to use cash flow hedge accounting in the future for the situation described.

6.5.20 When it is probable a forecasted transaction will not occur

Excerpt from ASC 815-30

> Discontinuing Hedge Accounting

40-4 The net derivative instrument 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 instrument 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 paragraphs 815-30-35-38 through 35-41.

**40-5** 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 paragraph, that derivative instrument gain or loss reported in accumulated other comprehensive income shall be reclassified into earnings immediately. A pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity’s ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.

**40-6** Derivative instrument gains and losses that had initially been reported in other comprehensive income as a result of a cash flow hedge and then reclassified to earnings (because the entity subsequently concluded that it was probable that the forecasted transaction would not occur within the originally specified time period or the additional period of time described in paragraph 815-30-40-4) shall not later be reclassified out of earnings and back into accumulated other comprehensive income due to a reassessment of probabilities.

Hedge accounting is required to be discontinued when a forecasted transaction is not probable. When a net derivative gain or loss related to the hedge of a forecasted transaction is reported in earnings depends on the likelihood of the forecasted transaction occurring within the original specified time period plus two months. [815-30-40-4 – 40-5, 40-6A, 815-20-45-1B]

The following table summarizes the effect of different levels of likelihood of the forecasted transaction occurring on the application of hedge accounting and the treatment of amounts remaining in AOCI. [815-30-40-4 – 40-6]

<table>
<thead>
<tr>
<th>Likelihood that the forecasted transaction will occur in the originally specified time period</th>
<th>Impact on hedge accounting and treatment of the net derivative gain or loss reported in AOCI</th>
</tr>
</thead>
</table>
| Forecasted transaction is probable | — Hedge accounting is permitted to continue.  
— Amounts in AOCI are reclassified into earnings when the forecasted transaction affects earnings (section 6.3). |
| Forecasted transaction is reasonably possible but not probable | — Hedge accounting must be discontinued. Further changes in the hedging instrument’s fair value are recognized in earnings rather than in OCI unless it is designated in a different cash flow hedging relationship. |
### Likelihood that the forecasted transaction will occur in the originally specified time period

<table>
<thead>
<tr>
<th>Impact on hedge accounting and treatment of the net derivative gain or loss reported in AOCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Amounts in AOCI are reclassified into earnings when the forecasted transaction affects earnings (section 6.3).</td>
</tr>
<tr>
<td>- Hedge accounting must be discontinued. Further changes in the hedging instrument’s fair value are recognized in earnings rather than in OCI unless it is designated in a different cash flow hedging relationship.</td>
</tr>
<tr>
<td>- Amounts in AOCI are immediately reclassified into earnings, unless the forecasted transaction will occur within an additional two-month period or extenuating circumstances apply (see Question 6.5.90).</td>
</tr>
</tbody>
</table>

An entity continuously evaluates the likelihood of the hedged forecasted transaction occurring as long as derivative gains or losses are reported in AOCI related to a hedged forecasted transaction. Once an amount has been reclassified from AOCI into earnings because it is probable that a transaction will not occur, that amount is never reclassified back into AOCI from earnings, even if the likelihood of the transaction occurring changes. [815-30-40-4 – 40-6A]

A pattern of missing forecasts (i.e. determining that it is probable that hedged forecasted transactions will not occur by the end of the originally specified time period or within the two months thereafter) calls 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. [815-30-40-6]

#### Question 6.5.50

**Can amounts be reclassified from AOCI when a hedge is discontinued, even if the forecasted transaction is reasonably possible?**

**Interpretive response:** No. If the forecasted transaction is still reasonably possible, the net derivative gains or losses reported in AOCI (i.e. that arose before the hedge was discontinued) continue to be reported in AOCI and to be reclassified into earnings when the hedged forecasted transaction is reported in earnings.

If it was permissible to immediately reclassify amounts reported in AOCI into earnings when a forecasted transaction no longer is probable but is still reasonably possible, an entity would have the opportunity to manipulate earnings simply by changing its estimate of probability. As a result, net derivative gains or losses reported in AOCI when a hedge is discontinued are immediately reclassified into earnings only when an entity determines it is
probable that the forecasted transaction will not occur in the originally specified time period or within a two-month period thereafter. [FAS 133.BC494]

### Applying the additional two-month period

**Question 6.5.60**

Does an entity consider an additional two-month period when deciding whether to discontinue hedge accounting?

**Interpretive response:** No. An entity should not factor an additional two months into its consideration when determining whether a cash flow hedging relationship must be discontinued; instead, the entity should discontinue the hedging relationship because the hedged forecasted transaction will not occur within the originally specified time period.

The additional two-month period is relevant only after the entity discontinues a cash flow hedging relationship and it is evaluating whether to reclassify amounts related to the discontinued hedging relationship from AOCI into earnings.

However, Topic 815 does provide flexibility for documenting – at inception of the hedging relationship – when the forecasted transaction will occur if the timing of the forecasted transaction involves some uncertainty within a range (see section 5.3.40).

**Question 6.5.70**

May an entity ignore the additional two-month period when deciding whether to immediately reclassify amounts from AOCI into earnings?

**Interpretive response:** No. Once a hedging relationship has been discontinued, an entity is required to evaluate the likelihood of the forecasted transaction occurring within the originally specified time period plus an additional two months. Including the additional two months in this evaluation is not optional. [815-30-40-4]

See Question 6.5.80 regarding how to consider the additional two-month period when an entity has a series of hedging relationships.
Excerpt from ASC 815-30

>> Example 17: Discontinuation of a Cash Flow Hedge

55-100 The following Cases illustrate the application of paragraphs 815-30-40-4 through 40-5 to changes in timing of a forecasted transaction in relation to an originally specified time period:

a. Transactions to occur within two months of end of originally specified time period (Case A)
b. Transactions not to occur within two months of end of originally specified time period (Case B).

55-101 Cases A and B share the following assumptions. On January 1, an entity enters into a hedge of the variability in the total cash flows of a forecasted sale of the first 100 units of a specified product during the 3-month period from February 1 to April 30. Gains and losses on the hedging instrument are accumulated in other comprehensive income and reclassified into earnings as sales occur and are presented in the same income statement line item as the earnings effect of the hedged item. However, as of March 10, only 60 units of the product have been sold and the entity determines that it is probable that the sale of the remaining 40 units will not occur by April 30. As a result, the entity must discontinue cash flow hedge accounting under the originally designated hedging relationship as of March 10 (pursuant to paragraph 815-30-40-1(a)).

>>> Case A: Transactions to Occur within Two Months of End of Originally Specified Time Period

55-102 In this Case, the entity determines that it is probable that the sale of the remaining 40 units will occur by June 20. Based on this new information, the entity is permitted to designate a new cash flow hedge under which subsequent derivative instrument gains and losses would receive cash flow hedge accounting. This Example focuses on the derivative instrument gains and losses that have been accumulated in other comprehensive income at March 10 with respect to the remaining 40 unsold units. The derivative instrument gains or losses accumulated in other comprehensive income related to the sale of the remaining 40 units should not be reclassified into earnings as of March 10 because the entity determined on that date that it is at least reasonably possible that the forecasted transactions will occur within the two-month period following April 30 (the end of the originally specified time period).

>>> Case B: Transactions Not to Occur within Two Months of End of Originally Specified Time Period

55-103 In this Case, the entity determined on March 10 that it is probable that the sale of the remaining 40 units will not occur by June 30 but it was reasonably possible that the sale would occur in July or August.

55-104 In that circumstance, the derivative instrument gains or losses accumulated in other comprehensive income related to the sale of the remaining 40 units must be reclassified into earnings as of March 10 because
the entity would have determined on that date that it is probable that the forecasted transactions will neither occur by the end of the originally specified time period (that is, April 30) nor within the allowable additional two-month period of time (ending on June 30).

55-105 Furthermore, the example indicates no extenuating circumstances that could justify applying the exception related to a forecasted transaction that is probable of occurring on a date beyond the additional two-month period of time.

Excerpt from ASC 815-30

>> Example 21: Effect on Accumulated Other Comprehensive Income from Issuing Debt at a Date That Is Not the Same as Originally Forecasted

55-128 The following Cases illustrate the application of paragraph 815-30-40-5 in determining whether an entity should immediately reclassify into earnings the entire net gain or loss related to the derivative instrument in accumulated other comprehensive income when issuing debt at a date that is not the same as originally forecasted:

a. Amounts are not reclassified immediately into earnings (Case A).
b. Amounts are reclassified immediately into earnings (Case B).

>>> Case A: Amounts Are Not Reclassified Immediately into Earnings

55-129 This Case has the following assumptions:

a. Entity A expects to borrow $100 million over a 10-year period beginning in 6 months.
b. Entity A initially plans to issue $100 million of 10-year fixed-rate debt at or near par at the then-current market interest rate.
c. Entity A will be exposed to variability in cash flows for the future quarterly interest payments on the debt due to changes in credit risk and interest rate risk that occur during this six-month period before issuance.
d. To hedge the risk of changes in these 40 quarterly interest payments attributable to changes in the benchmark interest rate for the 6-month period, Entity A does both of the following:
   1. Enters into a derivative instrument (for example, a forward-starting interest rate swap)
   2. Documents that it is hedging the variability in the 40 future quarterly interest payments, attributable to changes in the benchmark interest rate, over the next 10 years related to its 10-year $100 million borrowing program that begins in 6 months.
e. Entity A documents that it will assess the effectiveness of the hedging relationship semimonthly on a quantitative basis.
f. Six months after inception of the hedging relationship, Entity A decides to delay the issuance of the 10-year debt for 3 months.

55-130 When Entity A decides to delay the issuance of the 10-year debt for 3 months, Entity A should not immediately reclassify into earnings the entire
net gain or loss in accumulated other comprehensive income related to the
derivative instrument. Entity A’s strategy is a cash flow hedge of 40 individual
probable quarterly interest payments. A cash flow hedge of future interest
payments is a hedge of a series of forecasted transactions; consequently,
Entity A must first determine the likelihood of whether and when each
forecasted transaction in the series will occur. If at any time during the
hedging relationship Entity A determines that it is no longer probable that any
of the forecasted transactions in the series will occur by the date (or within the
time period) originally specified, it must terminate the original hedging
relationship for each of those specific nonprobable forecasted transactions—
even if the forecasted transaction will occur within an additional two-month
period of time after that originally specified date. Entity A need not terminate
the original hedging relationship for those specific forecasted transactions that
remain probable of occurring by the date or within the time period originally
specified. After the hedging relationship is terminated, Entity A must
determine whether it is probable that any or all of those specific nonprobable
forecasted transactions will not occur either by the date (or within the time
period) originally specified or within an additional two-month period of time
thereafter (see paragraphs 815-30-40-4 through 40-5). Entity A should reclassify
into earnings from accumulated other comprehensive income the amount of
the net derivative instrument gain or loss related to those specific nonprobable
forecasted transactions for which it is probable they will not occur. That
amount should be equivalent to the present value of the derivative
instrument’s cash flows intended to offset the changes in the original
forecasted transactions for which Entity A has determined it is probable that
they will not occur by the date (or within the time period) originally specified or
within an additional two-month period of time thereafter.

55-131 In this Case, when Entity A originally documented the hedging
relationship, it was hedging 40 forecasted transactions (forecasted interest
payments) that would begin in 6 months’ time and continue over a 10-year
period. Because Entity A did not issue the debt instrument as originally
documented, Entity A would determine that it is probable that the first
forecasted transaction will not occur at the time forecasted; consequently,
Entity A must terminate the original hedging relationship with respect to that
first forecasted transaction. However, Entity A would also determine that it is
probable that the other 39 forecasted transactions will occur at the time
forecasted. After the hedging relationship is terminated for the specific
nonprobable first forecasted transaction, Entity A must determine whether it is
probable that specific nonprobable first forecasted transaction will not occur by
the forecasted date or within an additional two-month period of time
thereafter. In this Case, Entity A determines that it is probable that the first
hedged quarterly interest payment will not occur within two months of its
specified date. The amount reclassified into earnings from accumulated other
comprehensive income is the portion of the interest rate swap’s net gain or
loss equivalent to the present value of the cash flows from the interest rate
swap intended to offset the changes in the first forecasted transaction that is
probable not to occur.

>>> Case B: Amounts Are Reclassified Immediately into Earnings

55-132 This Case has the following assumptions:

a. Entity B expects to issue $100 million of 10-year, 9 percent debt in 6
   months.
b. Because the debt will have a fixed interest rate of 9 percent, Entity B will not be exposed to variability in the future quarterly interest payments at 9 percent, but it will be exposed to variability in the cash flows received as proceeds on the debt due to changes in credit risk and interest rate risk that occur during the 6-month period before issuance.

c. To hedge the risk of changes in the total proceeds attributable to changes in the benchmark interest rate, Entity B does both of the following:
   1. Enters into a derivative instrument (for example, a short position in U.S. Treasury note futures contracts)
   2. Documents that it is hedging the variability in the cash proceeds attributable to changes in the benchmark interest rate to be received from the 9 percent fixed-rate debt it will issue in 6 months and that it will assess effectiveness on a quantitative basis.

d. Because Entity B plans to issue $100 million of 10-year, 9 percent debt regardless of the then-current interest rate environment, the effect of increases or decreases in interest rates will be reflected in issuing the debt at a discount or a premium, respectively.

e. Six months after inception of the hedging relationship, Entity B decides to delay the issuance of the debt for three months.

55-133 This strategy is a cash flow hedge of the variability in proceeds attributable to changes in the benchmark interest rate to be received from the issuance of debt in six months. A cash flow hedge of the proceeds attributable to changes in the benchmark interest rate is a hedge of a single forecasted transaction specified to occur in six months; consequently, when the single forecasted transaction is no longer probable of occurring by the date (or within the time period) originally specified, Entity B must terminate the hedging relationship. After the hedging relationship is terminated, Entity B must determine whether it is probable that the specific nonprobable forecasted transaction will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter. Because Entity B decided to delay the issuance of the debt for a three-month period of time, Entity B concludes that it is probable that the forecasted transaction will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter. Consequently, Entity B should immediately reclassify into earnings the entire net gain or loss related to the derivative instrument in accumulated other comprehensive income. Given the guidance in paragraph 815-30-40-5, the nonoccurrence of the hedged forecasted transactions described in this Case could potentially jeopardize Entity B’s ability to use cash flow hedge accounting in the future for the situation described.

Question 6.5.80

How is the additional two-month period considered when an entity has a series of hedging relationships?

Background: Determining whether a hedged forecasted transaction will occur in the originally specified time period or with an additional two-month period can be complicated. It is particularly complicated when an entity enters into
separate derivative contracts to hedge forecasted transactions that will occur over several periods and – at a later date – some of those forecasted transactions are not expected to occur as originally documented.

For example, an entity initially expects to sell inventory in the amounts specified and on the dates indicated in the following table. To hedge against changes in prices of these forecasted sales, the entity purchases three forward contracts, each having a notional amount and maturing on the date that coincides with the forecasted unit sales. It designates the forward contracts as hedging instruments in three separate hedging relationships.

<table>
<thead>
<tr>
<th>Hedge #</th>
<th>Date</th>
<th>Forecast unit sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>March 31</td>
<td>80</td>
</tr>
<tr>
<td>2</td>
<td>April 30</td>
<td>20</td>
</tr>
<tr>
<td>3</td>
<td>May 31</td>
<td>30</td>
</tr>
</tbody>
</table>

Subsequent to the hedge inception dates, the entity believes that it will have only 60 unit sales on March 31. It determines that Hedge #1 is not highly effective and discontinues hedge accounting for that relationship. The entity continues to believe the forecast unit sales on April 30 and May 31 are probable.

The entity must evaluate the likelihood that the 80 unit sales that were forecast to occur on March 31 will occur on March 31 or within an additional two-month period. If it is probable that they will not occur during that timeframe, amounts in AOCI related to the forecasted sales that it is probable will not occur are immediately reclassified into earnings.

Interpretive response: We believe an entity makes an accounting policy election when it chooses to consider transactions that are expected to occur within the additional two-month period – but that are hedged transactions in separate hedging relationships – in evaluating whether the net derivative gains (losses) in AOCI should be reclassified into earnings immediately. This accounting policy election must be consistently applied.

<table>
<thead>
<tr>
<th>Accounting policy</th>
<th>Summary of effects</th>
</tr>
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<tbody>
<tr>
<td>Future transactions that are designated in separate existing hedging relationships are included when evaluating whether the net derivative gains (losses) in AOCI should be immediately reclassified into earnings</td>
<td>— In the background example, the entity considers all unit sales from March 31 through May 31 (i.e. two months after March 31) – without regard to whether they are hedged in separate existing hedging relationships – when evaluating whether it is probable that the 80 unit sales that were hedged in Hedge #1 will not occur. Because there are 20 unit sales forecast to occur on April 30 and 30 on May 1, the 80 unit sales from Hedge #1 are still at least reasonably possible (i.e. it is not probable that they will not occur) and the amounts in AOCI are not immediately reclassified into earnings.</td>
</tr>
<tr>
<td></td>
<td>— Because the amounts in AOCI related to Hedge #1 under the updated forecast are expected to be reclassified into earnings on March 31 (for 60 units) and on April 30 (i.e. for 20 units), there are no longer 20 unit sales available for Hedge #2. As a result, Hedge #2 is discontinued and the entity determines</td>
</tr>
<tr>
<td>Accounting policy</td>
<td>Summary of effects</td>
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<td></td>
<td>whether amounts in AOCI should be immediately reclassified into earnings. All future transactions – including the 30 sales expected to occur on May 31 – are considered in this analysis.</td>
</tr>
<tr>
<td></td>
<td>– A similar process is applied to Hedge #3 as for Hedge #2.</td>
</tr>
<tr>
<td></td>
<td>– If at any time it is probable that previously hedged forecasted sales will not occur in the originally specified period or an additional two months, net derivative gains or losses reported in AOCI related to those sales are immediately reclassified into earnings. Additionally, this represents a missed forecast that the entity would be required to consider when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions (see also Question 6.5.110).</td>
</tr>
</tbody>
</table>

Future transactions that are designated in separate existing hedging relationships are not included when evaluating whether the net derivative gains (losses) in AOCI should be immediately reclassified into earnings

|                   | In the background example, the entity considers only unhedged unit sales from March 31 through May 31 (i.e. two months after March 31) when evaluating whether it is probable that the 80 unit sales from Hedge #1 will not occur. Because all future projected sales are hedged in separate hedging relationships, there are no sales during the additional two-month period to consider. As a result, the entity would conclude that it is probable that the remaining 20 unit sales will not occur in the originally specified period or an additional two months and immediately reclassify net derivative gains or losses reported in AOCI related to those sales into earnings. Additionally, this represents a missed forecast that the entity would be required to consider when evaluating whether it has a pattern of missing forecasts that calls into question its ability to adequately forecast future transactions (see also Question 6.5.110). Hedge #2 and Hedge #3 would be unaffected by the 20 unit sales that did not occur on March 31, provided the missed forecast did not result in the entity concluding that it could not accurately forecast future transactions. |

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**Extending the two-month period due to extenuating circumstances**

In certain instances, the additional two months may be extended because 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 net derivative gain or loss reported in AOCI related to the discontinued cash flow hedge: [815-30-40-4]

– generally should continue to be reported in AOCI until the hedged forecasted transaction occurs (see section 6.3); or
earlier if 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.

**Question 6.5.90**

**How common are extenuating circumstances that extend the additional two-month period?**

**Interpretive response:** We believe it would be rare for extenuating circumstances to result in the additional two-month period being extended. 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 example, 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. In this example, we believe 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 when evaluating whether net derivative gains or losses reported in AOCI should be immediately reclassified into earnings. However, the period and extenuating circumstances must be documented at inception of the hedging relationship.

**Example 6.5.60**

**Whether a delay in a forecasted transaction is due to extenuating circumstances that extend the additional two-month period**

On January 1, Year 1, ABC Corp. forecasts that it will sell 100 barrels of oil on September 30, Year 1. To hedge the variability in overall changes in cash flows of the forecasted sale, it 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, Year 1. All the cash flow hedging requirements are met at inception of the hedge.

On March 31, Year 1 (the first assessment period), ABC concludes that the hedging relationship was highly effective retrospectively and is expected to continue to be highly effective prospectively. ABC recognizes the change in fair value of the forward (unrealized loss of $100,000) in AOCI.

On June 30, Year 1 (the second assessment period), ABC concludes that the hedging relationship was not highly effective retrospectively and is not expected to be highly effective prospectively; this is because there has been a significant increase in the supply of oil in the marketplace. ABC 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.

On discontinuance of the cash flow hedging relationship, ABC concludes that it is probable that the forecasted sale of 100 barrels of oil will not occur by September 30, Year 1 or within a two-month period thereafter (i.e. by November 30, Year 1) because of the significant projected oversupply of oil in the marketplace during that period.

Although the delay in the final sale of the oil was caused by events outside ABC’s control, 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. Instead, the forecasted sale is delayed because of economic factors that arose after the inception of the hedging relationship. As a result, any derivative gains or losses reported in AOCI are reclassified into earnings on June 30, Year 1.

**Effect of missed forecasts**

**Question 6.5.100**

Where are amounts reclassified from AOCI into earnings in connection with a missed forecast presented in the income statement?

**Interpretive response:** When an entity has a missed forecast, Topic 815 does not provide specific presentation guidance for amounts immediately reclassified from AOCI into earnings. [815-20-45-1B]

Because Topic 815 does not provide specific presentation guidance for missed forecasts, an entity may exercise judgment in determining the income statement classification. We believe an entity should apply a consistent policy for amounts reclassified from AOCI into earnings, including amounts associated with the excluded component. For example, an entity could choose a policy that presents the effect of the hedging instrument in the income statement line item where the missed forecasted transaction would have been recorded.

**Question 6.5.110**

What factors are considered when evaluating whether missed forecasts represent a pattern?

**Interpretive response:** We believe instances in which it is probable that a forecasted transaction will not occur should be rare. We understand that the SEC staff will challenge management’s previous and future assertions about forecasted transactions when a registrant displays a pattern of determining that it is probable that hedged forecasted transactions will not occur.

Determining what constitutes a pattern is a matter of judgment based on individual facts and circumstances. However, we believe the following should be considered when determining whether there is a pattern in which it is probable that forecasted transactions will not occur:
— the business or operating circumstances that led the entity to its conclusion;
— whether the entity experienced other instances with similar forecasted transactions. If so:
  — when and what those business or operating circumstances were; and
  — whether the current circumstances are different from the previous instance(s);
— whether the circumstances or events that led to the conclusion were within the control of the entity; and
— whether the entity anticipates a similar forecasted transaction in the near future.
7. Hedging foreign currency exposures

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7.7.50 Single cash flow hedge with a foreign currency purchased option
7.1 How the standard works

Throughout this chapter, FCD means foreign currency denominated.

Foreign currency risk is the risk of changes in a hedged item’s fair value or functional currency equivalent cash flows attributable to changes in the related foreign currency exchange rates.

Foreign currency hedges use the cash flow, fair value or net investment models. However, there are additional criteria for a hedged item or transaction and hedging instrument to be eligible for designation in a foreign currency hedge.

Eligibility of hedged items or transactions

Eligibility of hedged risk(s)

Eligibility of hedging instruments

Hedge effectiveness

Criterion 5: Formal documentation

There are general qualifying criteria applicable to all foreign currency hedges:

— Hedging instrument. The entity with the foreign currency exposure needs to be a party to the hedging instrument (see section 7.3.20).

— Hedged item or transaction. The hedged transaction needs to be denominated in a currency other than the entity’s functional currency (see section 7.3.30).

In addition, there are qualifying criteria specific to the type of foreign currency hedge. This chapter will focus on the general qualifying criteria and the criteria specific to foreign currency fair value and cash flow hedges. For guidance on qualifying criteria specific to net investment hedges, see chapter 8.

This chapter builds on the previous discussion of qualifying criteria for fair value hedges (see chapter 3) and cash flow hedges (see chapter 5). It also builds on the foreign currency concepts in Topic 830 (foreign currency matters) that are discussed in our Handbook, Foreign currency.

Foreign currency fair value hedge. An entity establishes a foreign currency fair value hedge to hedge against changes in fair value due to changes in:

— foreign currency exchange rates; or
— both foreign currency exchange rates and interest rates (see section 7.4).

Foreign currency cash flow hedge. An entity establishes a foreign currency cash flow hedge to hedge against changes in future cash flows due to changes in foreign currency exchange rates (see section 7.6).
For each type of hedge, there are permitted hedged items and hedging instruments.

<table>
<thead>
<tr>
<th>Foreign currency fair value hedge (section 7.4)</th>
<th>Criterion 1: Eligibility of hedged items or transactions</th>
<th>Criterion 3: Eligibility of hedging instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>FCD asset or liability</td>
<td>Derivative</td>
<td></td>
</tr>
<tr>
<td>Unrecognized FCD firm commitment</td>
<td>Derivative or Nonderivative financial instrument</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Foreign currency cash flow hedge (section 7.6)</th>
<th>Criterion 1: Eligibility of hedged items or transactions</th>
<th>Criterion 3: Eligibility of hedging instruments</th>
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<tr>
<td>FCD asset or liability</td>
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<tr>
<td>Unrecognized FCD firm commitment</td>
<td>Derivative</td>
<td></td>
</tr>
<tr>
<td>FCD forecasted transaction</td>
<td>Derivative</td>
<td></td>
</tr>
</tbody>
</table>

The accounting for foreign currency fair value and cash flow hedges is the same as for all other fair value hedges (see chapter 4) and cash flow hedges (see chapter 6), respectively. However, Topic 815 provides additional guidance for certain items and transactions designated in a fair value (see section 7.5) and cash flow (see section 7.7) hedge of foreign currency risk.
7.2 Basic concepts in foreign currency hedges

A foreign currency hedge is a hedge of a foreign currency exposure. 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. Therefore, an entity whose functional currency is the US dollar has a foreign currency exposure only in instances when it has transactions, assets or liabilities, or a net investment in a foreign operation denominated in a currency other than the US dollar. [815-20-25-24]

Topic 830 states that an entity’s functional currency “is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash.” Topic 830 requires FCD assets and liabilities to be remeasured to the entity’s functional currency at the spot rate through earnings. [830-10 Glossary]

A foreign currency hedging transaction allows an entity to hedge the resulting variability in functional currency. When establishing a foreign currency hedging transaction, an entity can use either the fair value or cash flow hedging models, as explained in sections 7.5 and 7.7, respectively. In a foreign currency hedging transaction, an entity is hedging the risk that foreign currency exchange rate movements could have on its financial statements (i.e. a foreign currency risk).

7.3 General qualifying criteria for foreign currency hedges

7.3.10 Overview

Regardless of the hedging model used in a foreign currency hedge (i.e. fair value, cash flow or net investment model) a foreign currency hedge needs to meet the following criteria: [815-20-25-30]

— the entity with the foreign currency exposure needs to be a party to the hedging instrument (see section 7.3.20); and
— the hedged item or transaction needs to be denominated in a currency other than the entity’s functional currency (see section 7.3.30).

Excerpt from ASC 815-20

>> Hedged Items and Transactions Involving Foreign Exchange Risk

25-26 The functional currency concepts of Topic 830 are relevant if the foreign currency exposure being hedged relates to any of the following:

a. An unrecognized foreign-currency-denominated firm commitment
b. A recognized foreign-currency-denominated asset or liability
c. A foreign-currency-denominated forecasted transaction
d. The forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability
Hedging foreign currency exposures

25-27 Because a parent entity whose functional currency differs from its subsidiary’s functional currency is not directly exposed to the risk of exchange rate changes due to a subsidiary transaction that is denominated in a currency other than a subsidiary’s functional currency, the parent cannot qualify for hedge accounting for a hedge of that risk. Accordingly, a parent entity that has a different functional currency cannot qualify for hedge accounting for direct hedges of a subsidiary’s recognized asset or liability, unrecognized firm commitment or forecasted transaction denominated in a currency other than the subsidiary’s functional currency. Also, a parent that has a different functional currency cannot qualify for hedge accounting for a hedge of a net investment of a first-tier subsidiary in a second-tier subsidiary.

25-28 If the hedged item is denominated in a foreign currency, an entity may designate any of the following types of hedges of foreign currency exposure:

a. A fair value hedge of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale debt security)
b. A cash flow hedge of any of the following:
   1. A forecasted transaction
   2. An unrecognized firm commitment
   3. The forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability
   4. A forecasted intra-entity transaction.
c. A hedge of a net investment in a foreign operation.

25-29 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 815-20-25-15(d) and 815-20-25-43(c). Thus, those criteria are not impediments to either of the following:

a. A foreign currency fair value or cash flow hedge of such a foreign-currency-denominated asset or liability
b. 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 830-20-35-1.

25-30 Both of the following conditions shall be met for foreign currency cash flow hedges, foreign currency fair value hedges, and hedges of the net investment in a foreign operation:

a. For consolidated financial statements, either of the following conditions is met:
   1. The operating unit that has the foreign currency exposure is a party to the hedging instrument.
   2. Another member of the consolidated group that has the same functional currency as that operating unit is a party to the hedging instrument and there is no intervening subsidiary with a different functional currency. See guidance beginning in paragraph 815-20-25-52 for conditions under which an intra-entity foreign currency derivative
Hedging foreign currency exposures

7. Hedging foreign currency exposures

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.

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**Question 7.3.10**

**Can an entity hedge recognized FCD assets and liabilities?**

**Interpretive response:** Yes. An overall limitation on any type of hedging transaction is that the hedged item cannot be remeasured at fair value with changes in fair value recognized in earnings. Therefore, an entity is not permitted to hedge assets and liabilities that are remeasured for changes in fair value attributable to the hedged risk reported currently in earnings (e.g. trading securities) or forecasted transactions that become recognized and subsequently remeasured for changes in fair value attributable to the hedged risk through earnings. [815-20-25-15(d), 25-43(c)(3)]

However, the remeasurement of FCD monetary assets and liabilities to the entity’s functional currency at the spot rate through earnings (in accordance with Topic 830) is not a remeasurement at fair value. Therefore, FCD monetary assets and liabilities can be the hedged item in a foreign currency hedge, if all other hedge criteria are met. In addition, FCD AFS debt securities can also be designated as hedged items even though they are nonmonetary assets (see sections 7.4.40 and 7.6.50) [815-20-25-29]

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**Question 7.3.20**

**What risk(s) may be hedged in FCD assets and liabilities?**

**Interpretive response:** FCD assets and liabilities may be hedged for the following risk(s):

- only for foreign currency risk; or
- for multiple risks simultaneously – e.g. foreign currency risk and interest rate risk; for additional discussion on hedging multiple risks, see section 7.3.40.
7. Hedging foreign currency exposures

7.3.20 Entity with foreign currency risk is party to the hedging instrument

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**Excerpt from ASC 815-20**

>> Hedged Items and Transactions Involving Foreign Exchange Risk

25-23 Under the functional currency concept of Topic 830, exposure to a foreign currency exists only in relation to a specific operating unit’s designated functional currency cash flows. Therefore, exposure to foreign currency risk shall be assessed at the unit level.

25-24 A unit has exposure to foreign currency risk only if it enters into a transaction (or has an exposure) denominated in a currency other than the unit’s functional currency.

25-25 Due to the requirement in Topic 830 for remeasurement of assets and liabilities denominated in a foreign currency into the unit’s functional currency, changes in exchange rates for those currencies will give rise to exchange gains or losses, which results in direct foreign currency exposure for the unit but not for the parent entity if its functional currency differs from its unit’s functional currency.

25-27 Because a parent entity whose functional currency differs from its subsidiary’s functional currency is not directly exposed to the risk of exchange rate changes due to a subsidiary transaction that is denominated in a currency other than a subsidiary’s functional currency, the parent cannot qualify for hedge accounting for a hedge of that risk. Accordingly, a parent entity that has a different functional currency cannot qualify for hedge accounting for direct hedges of a subsidiary’s recognized asset or liability, unrecognized firm commitment or forecasted transaction denominated in a currency other than the subsidiary’s functional currency. Also, a parent that has a different functional currency cannot qualify for hedge accounting for a hedge of a net investment of a first-tier subsidiary in a second-tier subsidiary.

25-30 Both of the following conditions shall be met for foreign currency cash flow hedges, foreign currency fair value hedges, and hedges of the net investment in a foreign operation:

a. For consolidated financial statements, either of the following conditions is met:
   1. The operating unit that has the foreign currency exposure is a party to the hedging instrument.
   2. Another member of the consolidated group that has the same functional currency as that operating unit is a party to the hedging instrument and there is no intervening subsidiary with a different functional currency. See guidance beginning in paragraph 815-20-25-52 for conditions under which an intra-entity foreign currency derivative can be the hedging instrument in a cash flow hedge of foreign exchange risk.

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A required element of a foreign currency hedge is that the entity with the foreign currency exposure is a party to the **hedging instrument**. This criterion
Hedging

7. Hedging foreign currency exposures

is necessary because under Topic 830’s 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. [815-20-25-23]

In consolidated financial statements, foreign currency risk is assessed at the operating unit level. Therefore, the operating unit (e.g. parent, subsidiary) with the foreign currency risk generally needs to be a party to the hedging instrument. In consolidated financial statements, there is an exception that allows another member of the consolidated group to be a party to the hedging instrument in certain circumstances, as illustrated in the following flowchart. [815-20-25-23, 25-30(a)]
Hedging foreign currency exposures

Question 7.3.30
Can a parent entity that has a functional currency different from its subsidiary hedge the subsidiary’s foreign currency risk?

Interpretive response: No. A parent entity whose functional currency differs from that of its subsidiary is not directly exposed to the risk of exchange rate changes for a subsidiary’s foreign currency transactions. Therefore, the parent entity cannot hedge the subsidiary’s foreign currency risk.

Question 7.3.40
How is an operating unit evaluated when determining whether foreign currency exposure can be hedged?

Interpretive response: In consolidated financial statements, the operating unit is evaluated by using a functional currency approach rather than a legal entity approach. Therefore, if the subsidiary has the same functional currency as the parent entity, the parent may enter into a hedging instrument that is designated as the hedge of the subsidiary’s foreign currency risk in the consolidated financial statements. This is because when a subsidiary and its parent have the same functional currency, they also have the same foreign currency exposure.

However, this same foreign currency exposure does not exist if there is an intervening subsidiary with a functional currency different from that of the parent between the parent and the subsidiary that has the foreign currency risk being hedged.

The following illustrates application of this guidance, as does Subtopic 815-20’s Example 11 that follows. For illustrative purposes, the discussion assumes that the subsidiary’s functional currency is not yen and the forecasted transaction is yen-denominated sales.

— **Parent and subsidiary with different functional currencies.** A US dollar functional currency parent 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.

— **Parent and subsidiary with same functional currencies.** If both the parent and subsidiary have the US dollar as their functional currency, the parent can directly hedge the yen-denominated forecasted sales of the subsidiary, provided there is no intervening subsidiary with a different functional currency.

— **Parent and subsidiary with same functional currencies and intervening subsidiary.** If both the parent and second-tier subsidiary have the US dollar as their functional currency, and there is an intervening UK subsidiary with a pound sterling functional currency, the US dollar functional currency parent cannot directly hedge the second-tier US dollar functional currency subsidiary’s yen-denominated forecasted sales.
This analysis also applies if another member of the consolidated group (instead of the parent) enters into the hedging instrument. For example, a first-tier subsidiary and its subsidiary (i.e. a second-tier subsidiary) have the same functional currency. If that is the case, the first-tier subsidiary can hedge the second-tier subsidiary’s foreign currency risk.

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**Excerpt from ASC 815-20**

**Example 11: Identifying an Intervening Subsidiary with a Different Functional Currency**

55-130 This Example illustrates the application of paragraph 815-20-25-30(a)(2). If a dollar- (USD-) functional, second-tier subsidiary has a Euro (EUR) exposure, the USD-functional consolidated parent entity could designate its USD–EUR derivative instrument as a hedge of the second-tier subsidiary’s exposure if the functional currency of the intervening first-tier subsidiary (that is, the parent of the second-tier subsidiary) is also USD. In contrast, if the functional currency of the intervening first-tier subsidiary was the Japanese yen (JPY) (thus requiring the financial statements of the second-tier subsidiary to be translated into JPY before the JPY-denominated financial statements of the first-tier subsidiary are translated into USD for consolidation), the consolidated parent entity could not designate its USD–EUR derivative instrument as a hedge of the second-tier subsidiary’s exposure.

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**Question 7.3.50**

If a parent entity hedges its subsidiary’s foreign currency risk, can the subsidiary recognize the effects of the hedge in its stand-alone financial statements?

**Interpretive response:** No. To recognize the effects of hedge accounting in a subsidiary’s stand-alone financial statements, the subsidiary needs to enter into the hedging instrument. In this case, the parent entered into the hedging instrument to hedge the subsidiary’s foreign currency risk.
7.3.30  Currency other than functional currency

Excerpt from ASC 815-20

>> Hedged Items and Transactions Involving Foreign Exchange Risk

25-30 Both of the following conditions shall be met for foreign currency cash flow hedges, foreign currency fair value hedges, and hedges of the net investment in a foreign operation:…

b. The hedged transaction is denominated in a currency other than the hedging unit’s functional currency.

To apply foreign currency hedge accounting, not only does the entity with the foreign currency risk need to be a party to the hedging instrument, but the hedged transaction needs to be denominated in a currency other than the hedging entity’s functional currency. This is because foreign currency exposure exists in relation to an entity’s functional currency. [815-20-25-30(b)]

Example 7.3.10

Currency other than functional currency

Scenario 1: Functional currency is the same as the transaction currency

ABC Corp. is a euro functional currency entity that enters into euro-denominated transactions. The euro-denominated transactions are not eligible for foreign currency hedging because they do not present a foreign currency exposure in relation to ABC’s functional currency.

Scenario 2: Parent and subsidiary functional currency is the same as the transaction currency

ABC Corp.’s functional currency is the US dollar. It wants to enter into a foreign currency forward contract to hedge the foreign currency risk of a subsidiary’s US dollar purchases. Because ABC’s functional currency is the US dollar and the hedged transaction is denominated in US dollars (i.e. there is no foreign currency exposure for ABC), the hedged transaction does not meet the ‘currency other than functional currency’ requirement. Therefore, ABC may not designate the forward contract as a foreign currency hedge.

Question 7.3.60

Can hedge accounting be applied if the hedged transaction is denominated in the hedging entity’s functional currency but the settlement amount is based on a foreign currency?

Interpretive response: Yes. We believe hedge accounting may be applied for 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 at the time of settlement.

Example 7.3.20
Settlement of hedged transaction is based on a foreign currency

ABC Corp. (which has the US dollar as its functional currency) enters into an agreement with a third party that entitles the third party to produce and distribute one of ABC's products in exchange for quarterly royalty payments based on a percentage of euro-denominated sales.

The calculation of the royalty payment is based on euro-denominated sales, but the royalty payment received by ABC is in US dollars; the euro-denominated sales are converted to US dollars using the average exchange rate for the period. In this case, we believe that in effect the transaction is denominated in a currency other than ABC's functional currency (i.e. payment based on euro). Accordingly, ABC may designate its foreign currency risk on the forecasted cash receipts in euro in a cash flow hedge.

In contrast, ABC may receive royalty payments in euros with the calculation of such payments based on a percentage of US dollar denominated sales converted to euros at the spot rate. In this case, ABC does not have foreign currency exposure and may not designate the forecasted cash receipt in euros in a cash flow hedge.

7.3.40 Other matters relevant to foreign currency hedges

The following topics, discussed in this section, apply to both fair value and cash flow foreign currency hedges, and require special attention:

- intercompany transactions;
- hedging multiple risks; and
- tandem or cross-currency hedges.

Intercompany transactions

Eligibility of hedged items or transactions. An entity is permitted to hedge forecasted intercompany foreign currency transactions and intercompany FCD recognized assets and liabilities. For a discussion of internal derivatives, see sections 7.4.70 (fair value hedges) and 7.6.60 (cash flow hedges). [815-20-25-28]
7. Hedging foreign currency exposures

**Question 7.3.70**
Are there limitations on hedging an intercompany FCD transaction involving a recognized asset or liability?

**Interpretive response:** Yes. In consolidated financial statements, an intercompany FCD transaction involving a recognized asset or liability can be the hedged item as long as only the foreign currency risk is being hedged. Hedging the foreign currency risk associated with an intercompany transaction is permitted because the gain or loss created under Topic 830 when an intercompany FCD transaction is remeasured to the entity’s functional currency is not eliminated in consolidation. Therefore, the risk affects consolidated earnings. [815-20-25-28 – 25-29]

In contrast, in consolidated financial statements, an intercompany FCD transaction 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 within a consolidated group. Therefore, any potential earnings exposure will be eliminated in consolidation.

However, for purposes of the subsidiary’s stand-alone financial statements, any of the previously mentioned risks, including foreign currency risk, presents exposure to that subsidiary’s earnings and are therefore eligible for hedge accounting.

**Question 7.3.80**
Can an intercompany commitment be hedged?

**Excerpt from ASC 815-10**

**20 Glossary**

**Firm Commitment** – 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. The binding provisions of an agreement are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject. 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, a price that is specified in terms of ounces of gold would not be a fixed price if the market price of the item to be purchased or sold under the firm commitment varied with the price of gold.
b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory 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 nonperformance to make performance probable for purposes of applying the definition of a firm commitment.

**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.

**Interpretive response:** Yes, but only under the cash flow hedge model. An unrecognized FCD firm commitment can be the hedged item in either a cash flow hedge or a fair value hedge. However, the definition of a firm commitment states that it must be with an unrelated party. Therefore, an intercompany commitment does not meet the definition of a firm commitment and cannot be hedged under the fair value hedge model. [815-20-25-28, 815-10 Glossary]

Nevertheless, a FCD intercompany commitment or a firm commitment with a related party (e.g. subsidiary to subsidiary within a consolidated group, or entity to related party outside the consolidated financial statements) is eligible to be hedged in a cash flow hedge as a forecasted transaction. This is because the criteria for forecasted transactions do not require the contract to be with an unrelated party – an intercompany and related party commitment exposes an entity to variability in the functional currency equivalent cash flows that could affect reported earnings (see sections 7.6.20 and 7.6.40).

**Hedging multiple risks**

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**Excerpt from ASC 815-20**

**>> Hedged Item Criteria Applicable to Fair Value Hedges Only**

25-12(f) 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 any of the following:

1. The risk of changes in the overall fair value of the entire hedged item…

5. If the risk designated as being hedged is not the risk in paragraph 815-20-25-12(f)(1), two or more of the other risks (interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged.

**>> Hedged Transaction Criteria Applicable to Cash Flow Hedges**

25-15(j) 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 any of the following:
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) …

If the risk designated as being hedged is not the risk in paragraph 815-20-25-15(j)(1), two or more of the other risks (interest rate risk, foreign exchange risk, and credit risk) simultaneously may be designated as being hedged.

**Eligibility of hedged risks.** As discussed in section 2.3.80, for both fair value and cash flow hedges, an entity may simultaneously hedge two or more risks (e.g. foreign currency risk, interest rate risk and credit risk).

The following table summarizes various approaches to hedging foreign currency risk and/or interest rate risk in either a fair value or cash flow model for recognized FCD financial assets or liabilities. The table assumes that the US dollar (USD) is the functional currency and that the interest rate is the benchmark rate for a fair value hedge or the contractually specified interest rate for a cash flow hedge.

<table>
<thead>
<tr>
<th>Hedged item or transaction</th>
<th>Hedge objective</th>
<th>Hedge result</th>
<th>Hedge approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed-rate, FCD instrument</td>
<td>Reduce foreign currency and interest rate risk</td>
<td>USD variable-rate interest and USD principal</td>
<td><strong>Fair value hedge</strong> of foreign currency and interest rate risk</td>
</tr>
<tr>
<td>Fixed-rate, FCD instrument</td>
<td>Fix variability due to foreign currency risk</td>
<td>USD fixed-rate interest and USD principal</td>
<td><strong>Cash flow or fair value hedge</strong>¹ of foreign currency 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><strong>Fair value hedge</strong> of FCD interest rate risk</td>
</tr>
<tr>
<td>FCD trade payable or receivable</td>
<td>Fix variability due to foreign currency risk</td>
<td>USD fixed payment amount</td>
<td><strong>Cash flow or fair value hedge</strong>¹ of foreign currency risk</td>
</tr>
<tr>
<td>Variable-rate, FCD instrument</td>
<td>Fix variability of principal and interest payments due to foreign currency and interest rate risk²</td>
<td>USD fixed interest rate and USD principal</td>
<td><strong>Cash flow hedge</strong> of variability of foreign currency and interest rate risk</td>
</tr>
<tr>
<td>Variable-rate, FCD instrument</td>
<td>Reduce variability of foreign currency risk²</td>
<td>USD variable-rate interest and USD principal</td>
<td><strong>Fair value hedge</strong>³ of foreign currency risk</td>
</tr>
</tbody>
</table>
## Hedging

### 7. Hedging foreign currency exposures

<table>
<thead>
<tr>
<th>Hedged item or transaction</th>
<th>Hedge objective</th>
<th>Hedge result</th>
<th>Hedge approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable-rate, FCD instrument</td>
<td>Reduce variability due to interest rate risk</td>
<td>FCD fixed-rate interest and FCD principal</td>
<td>Cash flow hedge of variability of FCD interest rate risk</td>
</tr>
<tr>
<td>Variable-rate, FCD instrument</td>
<td>Fix variability of principal payment due to foreign currency risk</td>
<td>Fixed USD principal</td>
<td>Cash flow or fair value hedge of foreign currency risk for principal</td>
</tr>
</tbody>
</table>

### Notes:

1. If no components are excluded from the assessment of hedge effectiveness, there may be volatility in earnings for the fair value hedging model due to spot/forward differences or currency basis spreads. Earnings volatility can be reduced if an entity excludes the spot/forward difference or currency basis spreads from its assessment of hedge effectiveness and elects to recognize the initial value of the excluded component using an amortization approach. For additional discussion of excluded components, see section 4.2.20.

2. Alternatively, the hedged item can be designated as the functional currency equivalent cash flows of a specified amount of a variable-rate based foreign currency interest payment(s). For example, if an entity has a 100,000 euro (€) variable-rate loan, it can designate as the hedged item the first €3,000 of a specified variable-rate interest payment(s) if it is probable that the hedged variable interest payment(s) will exceed €3,000. Then the entity can enter into a cash flow hedge with a foreign currency forward contract because all of the variability associated with the first €3,000 of the variable interest payment(s) would be eliminated. For additional discussion, see section 7.6.50. [815-20-25-41]

3. Alternatively, as demonstrated in the last approach in the table, if the hedged item is designated to be the principal payment component only, the cash flow hedging model can be used. As discussed in section 7.6.50, to apply cash flow hedging, all variability of the hedged item’s functional currency cash flows must be eliminated by the effect of the hedge. [815-20-25-39(d) – 25-41]

### Question 7.3.90

**If the hedged item affects more than one income statement line item, where should the effect of the hedging instrument be presented?**

**Interpretive response:** When the earnings effect of the hedged item is presented in more than one line item, the FASB concluded that it is appropriate to present the change in the fair value of the hedging instrument in those same line items. The change in the fair value of the hedging instrument should be appropriately allocated to the different line items. [ASU 2017-12.BC134]

For example, if a hedging relationship involves hedging both the interest rate risk and the foreign currency risk of an interest-earning asset or interest-bearing liability denominated in a currency other than the entity’s functional currency, the earnings effect of the hedged item is typically presented in:

— an interest income or interest expense line item; and
— another line item that the entity uses to present the spot remeasurement of the FCD assets and liabilities under Topic 830 (e.g. foreign currency transaction gain or loss).

The portion of the hedging instrument associated with converting the interest cash flows from fixed-rate to floating-rate and/or from a foreign currency to the entity’s functional currency is presented in interest income or interest expense, except for the portion that the entity determines should be presented in the income statement line item used to present the remeasurement of FCD assets and liabilities. [ASU 2017-12.BC134]

The FASB examples below (paragraphs 815-20-55-79Z to 55-79AD) illustrate one way that an entity might allocate the effect of the hedging relationship between multiple income statement line items.

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Excerpt from Subtopic 815-20

>>> Income Statement Presentation of Hedging Instruments

55-79W Paragraph 815-20-45-1A requires an entity to present the change in the fair value of the hedging instrument included in the assessment of hedge effectiveness and the amount excluded from the assessment of hedge effectiveness in the same income statement line item that is used to present the earnings effect of the hedged item. The following scenarios include implementation guidance on the meaning of the phrase the same income statement line item that is used to present the earnings effect of the hedged item.

>>>> Scenario B

55-79Z Entity B designates a fair value hedge of foreign exchange risk in which the hedged item is an issued variable-rate debt instrument denominated in a currency other than Entity B’s functional currency. The derivative designated as the hedging instrument is a receive-floating-rate (in foreign currency), pay-floating-rate (in functional currency) cross-currency swap that requires an initial and final exchange of notional amounts. In this scenario, Entity B’s objective is to convert the cash flows of the debt instrument (both interest cash flows and the principal cash flow) from a foreign currency to Entity B’s functional currency.

55-79AA The currency swap is a highly effective hedge of the currency risk of both the interest cash flows and the principal cash flows of the debt instrument. Therefore, the change in fair value of the currency swap should be presented in the same income statement line item(s) used to present the earnings effects of the hedged item. Before applying hedge accounting, Entity B presents the earnings effect associated with the hedged item in two income statement line items. That is, interest accruals are presented in an interest expense line item, and the spot remeasurement of the foreign-currency-denominated debt under Topic 830 on foreign currency matters is presented in a foreign currency transaction gain or loss line item. Therefore, in this scenario, because the hedging instrument is highly effective at offsetting changes in fair values associated with the hedged item that are reported in more than one income statement line item, the effects of the hedging...
Hedging foreign currency exposures

Entity B should present all changes in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same interest expense line item that is used to present the earnings effect of the hedged item before applying hedge accounting, except for the change in the fair value of the hedging instrument that the entity determines should be presented in the same foreign currency transaction gain or loss line item used to present the spot remeasurement of the hedged item before applying hedge accounting.

>>>> Scenario C

55-79AB Entity C designates a fair value hedge of interest rate risk and foreign currency risk in which the hedged item is a foreign-currency-denominated fixed-rate available-for-sale debt security. The derivative designated as the hedging instrument is a pay-fixed-rate (in foreign currency), receive-floating-rate (in functional currency) cross-currency interest rate swap. In this scenario, Entity C’s objective is to convert the interest cash flows of the fixed-rate security to floating-rate and also to convert the cash flows of the security (both interest cash flows and the principal cash flow) from a foreign currency to Entity C’s functional currency.

55-79AC The cross-currency interest rate swap is a highly effective hedge of both the interest rate risk and foreign currency risk of the available-for-sale debt security. Therefore, the change in fair value of the cross-currency interest rate swap should be presented in the same income statement line item or items used to present the earnings effect of the hedged item. Before applying hedge accounting, Entity C recognizes the earnings effect of the hedged item (that is, interest accruals on the available-for-sale debt security) in an interest income line item in the income statement and recognizes all other changes in fair value in other comprehensive income in accordance with paragraph 320-10-35-1(b). Entity C should present changes in fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same income statement line item used to present the earnings effect of the hedged item. However, if Entity C’s policy is to present the effect of foreign exchange rate changes on the fair value of the security that are recognized in earnings after applying hedge accounting in accordance with paragraph 815-25-35-6 in a different income statement line item (consistent with its presentation policies when reflecting other foreign exchange rate changes), then the related changes in fair value of the hedging instrument also should be presented in that income statement line item.

55-79AD This scenario illustrates that a single hedging instrument (a cross-currency interest rate swap) may be highly effective at offsetting changes in fair values or cash flows associated with the hedged item in which the earnings effect of the hedged item is presented in more than one income statement line item. If a hedging instrument is highly effective at offsetting changes in fair values or cash flows of the hedged item and the earnings effect of the hedged item is presented in more than one income statement line item, then the earnings effects of the hedging instrument also should be presented in those corresponding income statement line item(s).
Tandem or cross-currency hedging

Excerpt from ASC 815-20

Hedged Items and Transactions Involving Foreign Exchange Risk

25-33 In some instances, it may not be practical or feasible to hedge in the same currency and, therefore, a hedging instrument also may be denominated in a currency for which the exchange rate generally moves in tandem with the exchange rate for the currency in which the hedged item is denominated.

Eligibility of hedging instruments. Topic 815 does not require an entity to use a derivative instrument denominated in the same foreign currency as the hedged item. Instead, a hedging transaction can involve ‘tandem’ currencies – i.e. currencies from two different countries that are highly correlated.

The requirement that a hedging relationship be highly effective also applies to tandem currencies. Therefore, an entity may designate a hedging instrument denominated in a tandem currency if, based on historical experience, it expects that the hedging relationship between the hedged exposure in one currency and the tandem currency will be highly effective. Subtopic 815-20’s Example 10 is a fair value hedge of a FCD firm commitment with a forward to purchase a different currency (see section 7.5.30).

Example 7.3.30
Forecasted purchase in foreign currency

ABC Corp.’s functional currency is the US dollar. It wants to hedge a firmly committed Canadian-dollar sales transaction with an Australian-dollar-denominated foreign currency forward contract.

ABC can use this forward contract as the hedging instrument in this hedge if movements in the fair value of the forward contract are highly effective at offsetting the fair value changes in the foreign currency exposure in a firmly committed Canadian-dollar sales transaction.

7.4 Specific qualifying criteria for foreign currency fair value hedges

7.4.10 Overview

To qualify for foreign currency fair value hedge accounting, a hedging relationship must meet the following qualifying criteria.
This section discusses the specific qualifying criteria for foreign currency fair value hedges related to the eligibility of hedged items and hedging instruments.

**Criterion 1**: Eligibility of hedged items or transactions

**Criterion 2**: Eligibility of hedged risk(s)

**Criterion 3**: Eligibility of hedging instruments

**Criterion 4**: Hedge effectiveness

**Criterion 5**: Formal documentation

Topic 815 permits foreign currency fair value hedges of the following items using the following types of hedging instruments.

**Criterion 1: Items eligible for fair value hedges of foreign currency risk**
- FCD recognized assets and liabilities (section 7.4.30)
- AFS debt securities (section 7.4.40)
- Unrecognized firm commitments (section 7.4.50)

**Criterion 3: Hedging instruments eligible for fair value hedges of foreign currency risk**
- Derivative
- Derivative or Nonderivative financial instrument (section 7.4.60)

Hedged items continue to be subject to other applicable US GAAP, including for assessing impairment.
7.4.20 Eligibility of hedged items and hedging instruments in a fair value hedge of foreign currency risk

Excerpt from ASC 815-20

>>> Items in Fair Value Hedges of Foreign Exchange Risk

25-37 This paragraph identifies possible hedged items in fair value hedges of foreign exchange risk. If every applicable criterion is met, all of the following are eligible for designation as a hedged item in a fair value hedge of foreign exchange risk:

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 earnings under the provisions of paragraph 830-20-35-1. All recognized foreign-currency-denominated assets or liabilities for which a foreign currency transaction gain or loss is recorded in earnings shall qualify for the accounting specified in Subtopic 815-25 if all the fair value hedge criteria in this Section (including the conditions in paragraph 815-20-25-30(a) through (b)) are met.

b. Available-for-sale debt 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 Subtopic 815-25 if all the fair value hedge criteria in this Section (including the conditions in paragraph 815-20-25-30(a) through (b)) are met.

c. Subparagraph superseded by Accounting Standards Update No. 2016-01.

d. Unrecognized firm commitment. Paragraph 815-20-25-58 states that a derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Topic 830 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.

Hedged items. If the general criteria for all fair value hedges and general criteria for all foreign currency hedges are met, the following items (or a specific portion thereof) can be hedged items in a fair value hedge of foreign currency risk: [815-20-25-37]

- recognized assets or liabilities for which transaction gains or losses are recognized in earnings (section 7.4.30);
- AFS debt securities (section 7.4.40); and
- unrecognized firm commitments (section 7.4.50).

See section 3.3.60 for additional information about hedging portions of a hedged item.

Absent from this list is a forecasted transaction. A forecasted transaction can be the hedged item in a foreign currency cash flow hedge but not in a foreign currency fair value hedge.
Hedging instruments. A derivative may be designated as the hedging instrument for FCD recognized assets or liabilities, AFS debt securities and unrecognized firm commitments. A nonderivative financial instrument can also be designated as the hedging instrument for unrecognized firm commitments (see section 7.4.60).

In addition, Topic 815 allows internal derivatives to be designated as hedging instruments for fair value hedges of FCD recognized assets or liabilities if certain conditions are met (see section 7.4.70).

7.4.30 Hedged item: Recognized assets or liabilities for which transaction gains or losses are recognized in earnings

If an item gives rise to foreign currency transaction gains or losses in earnings under Topic 830 it may be a hedged item in a foreign currency fair value hedge. Recognized FCD monetary assets and liabilities are remeasured into the functional currency based on spot exchange rates. The remeasurement represents a foreign currency transaction gain or loss that is recognized in earnings. [830-20-35-1]

<table>
<thead>
<tr>
<th>FCD asset/liability</th>
<th>Hedged item?</th>
<th>Why?</th>
</tr>
</thead>
<tbody>
<tr>
<td>HTM debt securities</td>
<td>Yes</td>
<td>The remeasurement of FCD HTM securities, loans and debt obligations represent foreign currency transaction gains or losses that are recognized in earnings.</td>
</tr>
<tr>
<td>Loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt obligations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trading debt securities</td>
<td>No</td>
<td>FCD trading securities are measured at fair value each reporting period with all fair value changes recognized in earnings. An entity is not permitted to hedge assets or liabilities that are measured at fair value with changes in fair value recognized in earnings.</td>
</tr>
</tbody>
</table>

FCD recognized assets or liabilities may be hedged with a derivative instrument.

7.4.40 Hedged item: AFS debt securities

AFS debt securities are nonmonetary assets for which the change in fair value is expressed in an entity’s functional currency as the total of the changes in: [320-10-35-36 – 35-37]

— the market price of the security expressed in the foreign currency due to factors such as changes in interest rates and credit risk; and
— the currency exchange rates between the foreign currency and the entity’s functional currency.

Although AFS debt securities do not give rise to transaction gains and losses, a FCD AFS debt security (or specific portion thereof) may be the hedged item in a foreign currency fair value hedge because it embodies cash flows denominated
Hedging foreign currency exposures

7. Hedging foreign currency exposures

7.4.50 Hedged item: Unrecognized firm commitments

Excerpt from ASC 815-20

>>> Hedging Instruments in Fair Value Hedges Involving Foreign Exchange Risk

25-58 A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Topic 830 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 Subtopic 815-25 if all the fair value hedge conditions in this Section and the conditions in paragraph 815-20-25-30 are met.

25-59 The carrying basis for a nonderivative financial instrument that gives rise to a foreign currency transaction gain or loss under Subtopic 830-20 is not addressed by this Subtopic.

25-60 An entity may designate an intra-entity loan or other payable 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. That designation is consistent with the ability under paragraphs 815-20-25-58 through 25-59 to designate nonderivative instruments as hedging instruments in foreign currency fair value hedges of firm commitments. However, hedge accounting in the consolidated financial statements shall only be applied if the member of the consolidated entity that is the counterparty to the intra-entity loan has entered into a third-party contract that offsets the foreign exchange exposure of that entity’s intra-entity loan receivable. That is, the requirement in paragraphs 815-20-25-28 through 25-29 that an intra-entity derivative instrument designated as a hedging instrument in a foreign currency fair value hedge be offset by a third-party contract would also apply to intra-entity nonderivative instruments designated as hedging instruments. To remain consistent with the notion that the intra-entity contract is simply a conduit for the third-party exposure, an intra-entity loan designated as a hedging instrument shall be offset by a third-party loan (that is, it shall not be offset by a derivative instrument). Hedge accounting shall be applied in consolidation only to those gains and losses occurring during the period that the offsetting third-party loan is in place.

The definition of firm commitment for foreign currency hedges is used in the same manner as for other fair value hedges. An unrecognized FCD firm commitment (or specific portion thereof) is eligible to be a hedged item in a fair value hedge of foreign currency exposure if its price is expressed in a specified amount of currency. For additional discussion of whether a transaction meets the definition of a firm commitment, see section 3.3.20. [815-20 Glossary]
In a foreign currency fair value hedge, an unrecognized FCD firm commitment may be hedged with a derivative or a nonderivative financial instrument (e.g. FCD debt). [815-20-25-58]

Question 7.4.10
Can an entity hedge future interest payments of FCD debt as an unrecognized firm commitment in a fair value hedge?

Excerpt from ASC 815-20

>>>> Foreign-Currency Denominated Interest Payments

55-35 An entity may not treat foreign-currency-denominated fixed-rate interest coupon payments arising from an issuance of foreign-currency-denominated fixed-rate debt as an unrecognized firm commitment that may be designated as a hedged item in a foreign currency fair value hedge. (See paragraph 815-20-25-23.) The foreign-currency exposure of the future interest payments would not meet this Subtopic’s definition of an unrecognized firm commitment because the obligation is recognized on the balance sheet—that is, the carrying amount of the foreign-currency-denominated fixed-rate debt incorporates the entity’s obligation to make those future interest payments as well as the repayment of principal. However, those fixed-rate interest payments could be designated as the hedged transaction in a cash flow hedge.

55-36 Those fixed-rate interest payments might arise as follows. An entity whose functional currency is the U.S. dollar issues fixed-rate debt denominated in a foreign currency. The debt has a fixed interest coupon that is payable semiannually in that foreign currency. The entity wishes to lock in, in U.S. dollar functional currency terms, the future interest expense that will result from the debt and enters into a derivative instrument to hedge the foreign currency risk of the fixed foreign-currency-denominated interest coupon payments. For example, the entity may enter into a foreign currency swap to receive an amount of the foreign currency required to satisfy the interest coupon obligation in exchange for U.S. dollars at each coupon date, or, alternatively, it may enter into a strip of foreign currency forward contracts that provide for receipt of an amount of foreign currency required to satisfy the interest coupon obligation in exchange for the payment of U.S. dollars at each coupon date.

55-37 This guidance also applies to dual-currency bonds that provide for repayment of principal in the functional currency and periodic fixed-rate interest payments denominated in a foreign currency. Subtopic 830-20 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.
**Interpretive response:** No. Future interest payments on existing FCD debt do not meet the definition of an unrecognized firm commitment because the obligation is recognized on the balance sheet. Therefore, the coupon payments cannot be hedged in a foreign currency fair value hedge. However, the fixed-rate interest payments may be designated as the hedged transaction in a **cash flow hedge**. [815-20-55-35 – 55-36]

This guidance also applies to a dual-currency bond, which is a bond in which principal and interest payments are denominated in different currencies. [815-20-55-37]

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**Question 7.4.20**

If a commitment to sell is based on the market price at the time of shipment, can a portion of the price of each unit to be sold be designated as the hedged item in a fair value hedge?

**Interpretive response:** No. The definition of a firm commitment states, among other things, that there must be a fixed price. If the price is the market price at the time of shipment, it is not fixed until the time of shipment and therefore would not qualify as a firm commitment. Therefore, it cannot be designated as the hedged item in a fair value hedge.

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**Example 7.4.10**

**Commitment to sell at fair value – hedging a portion of the price of each unit**

ABC Corp. is a manufacturing company. Its functional currency is the US dollar. ABC enters into a contract with a foreign customer to sell 10,000 units of product each month. The price of the product is denominated in a foreign currency 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 80 to 90 euros (€) per unit. ABC wishes to hedge the currency exposure as a hedge of a firm commitment and has proposed hedging the first €50 on each of its fixed quantity of units to be sold. This means ABC’s hedging transaction is designed to protect ABC on currency exposure on €50 per unit.

ABC contends that sales below €50 per unit are remote, as that term is used in Topic 450 (contingencies). Therefore, effectively at least €500,000 (10,000 units × €50 per unit) is fixed.

ABC cannot designate the first €50 on each unit sold as the hedged item in a fair value hedge. The definition of a firm commitment is not met because the price is the market price at the time of shipment; therefore, it is not fixed until the time of shipment.
Foreign currency cash flow hedge as an alternative

However, the transaction can be structured as a cash flow hedge if ABC’s transaction meets the requirements for a forecasted transaction. To be able to designate the forecasted sales as the hedged item in a cash flow hedge, ABC should be able to support that the specified currency amount of sales is probable.

ABC determined it is probable that it will sell 10,000 units and the sales price will be €80 per unit. Therefore, the foreign currency hedge may cover sales up to €800,000 (10,000 units × €80 per unit).

7.4.60 Hedging instrument: Nonderivative financial instrument

In a foreign currency fair value hedge, an unrecognized FCD firm commitment may be hedged with a derivative or nonderivative financial instrument (e.g. FCD debt). [815-20-25-58]

Question 7.4.30
Can a nonderivative financial instrument be used to hedge an unrecognized firm commitment?

Interpretive response: Yes, as long as the nonderivative financial instrument gives rise to foreign currency transaction gains or losses under Topic 830 – i.e. the nonderivative instrument must be remeasured to the entity’s functional currency at the spot rate through earnings. [815-20-25-58]

An instrument reported at fair value cannot be a hedging instrument. Therefore, a financial instrument for which an entity elects the fair value option under Topic 825 cannot be a hedging instrument because it does not give rise to a foreign currency transaction gain or loss.

Question 7.4.40
In the consolidated financial statements, can an intercompany nonderivative financial instrument be used to hedge an unrecognized firm commitment?

Interpretive response: It depends. An intercompany FCD nonderivative financial instrument (e.g. intercompany borrowing or receivable) can be a hedging instrument in a foreign currency fair value hedge in the consolidated financial statements if: [815-20-25-60]

— the nonderivative instrument gives rise to foreign currency transaction gains or losses; and
— the counterparty to the intercompany 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.

Subtopic 815-20’s Example 17 below illustrates these concepts.

The requirement to enter into an offsetting instrument with a third party in this situation is also a requirement when the hedging instrument is an internal derivative, rather than a nonderivative, as explained in section 7.4.70.

**FASB Example: Nonderivative hedging instrument designated in a fair value hedge of an unrecognized firm commitment**

Excerpt from ASC 815-20

>> Example 17: Designation of an Intra-Entity Loan or Other Payable as the Hedging Instrument in a Fair Value Hedge of an Unrecognized Firm Commitment

55-167 This Example illustrates the application of paragraph 815-20-25-60.

55-168 A parent entity (Parent A) with the U.S. dollar (USD) as both its functional currency and reporting currency has a subsidiary with a Euro (EUR) functional currency (Subsidiary B). Subsidiary B enters into an unrecognized firm commitment with a third party that will result in Japanese yen (JPY) cash inflows. Concurrent with Subsidiary B entering into the firmly committed contract, Parent A extends a loan to Subsidiary B denominated in JPY, which is funded by a third-party, JPY-denominated borrowing by Parent A. Subsidiary B wishes to designate its JPY-denominated intra-entity loan payable as the hedging instrument in consolidated financial statements in a fair value hedge of foreign currency exposure related to its JPY-denominated unrecognized firm commitment to a third party.

55-169 In accordance with paragraph 830-20-35-1, at each balance sheet date, Subsidiary B’s JPY-denominated intra-entity loan payable would be remeasured from the foreign currency (JPY) into Subsidiary B’s functional currency (EUR) at the current EUR/JPY spot rate. Similarly, Parent A’s intra-entity JPY-denominated receivable and its third-party JPY-denominated loan payable are remeasured from the foreign currency (JPY) into Parent A’s functional currency (USD) at the current USD/JPY spot rate. The transaction gains or losses that are generated from remeasurement into functional currency are recorded in net income. If Subsidiary B designates its JPY-denominated intra-entity loan payable as the hedging instrument in consolidated financial statements, the transaction gains and losses related to the intra-entity loan payable would offset the change in fair value of the firm commitment attributable to changes in foreign exchange rates in the consolidated income statement.

55-170 In this Example, Subsidiary B’s JPY-denominated intra-entity payable may be designated as a fair value hedge of the foreign exchange exposure arising from the third-party JPY-denominated firm commitment. Parent A has in place a third-party JPY-denominated borrowing that offsets the exposure of
its JPY-denominated intra-entity receivable from Subsidiary B during the period the intra-entity loan receives hedge accounting.

**Question 7.4.50**

What are the practical implications of using a nonderivative instrument to hedge an unrecognized firm commitment?

**Interpretive response:** 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 on a nonderivative hedging instrument is measured by reference to changes in spot exchange rates under Topic 830. [830-20-35-1 – 35-2]

Therefore, 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. See the KPMG observation in section 7.5.20 relating to calculating the fair value of a hedged unrecognized firm commitment.

**7.4.70 Hedging instrument: Internal derivatives**

**Excerpt from ASC 815-20**

**20 Glossary**

**Internal Derivative** – A foreign currency derivative instrument that has been entered into with another member of a consolidated group (such as a treasury center).

**Intra-entity Derivative** – A derivative instrument contract between two members of a consolidated group.

**>> Hedged Items and Transactions Involving Foreign Exchange Risk**

25-31 However, a subsidiary may enter into an intra-entity hedging instrument with the parent entity, and that contract can be a hedging instrument in the consolidated financial statements if the parent entity enters into an offsetting contract (pursuant to paragraph 815-20-25-52 for the appropriate hedging relationship) with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the subsidiary that initiated the hedge.

25-32 If a subsidiary has the same functional currency as the parent entity or other member of the consolidated group, the parent entity or that other member of the consolidated group may, subject to certain restrictions, enter into a derivative instrument or nonderivative instrument that is designated as the hedging instrument in a hedge of that subsidiary’s foreign exchange risk in consolidated financial statements.
Hedging Instruments in Hedges of Foreign Exchange Risk

25-51A The guidance on hedging instruments in hedges of foreign exchange risk is organized as follows:

- A. Intra-entity derivatives
- B. Hedging instruments in fair value hedges involving foreign exchange risk
- C. Internal derivatives as hedging instruments in cash flow hedges of foreign exchange risk
- D. Hedging instruments in net investment hedges.

Intra-Entity Derivatives

25-52 A foreign currency derivative instrument that has been entered into with another member of a consolidated group can be a hedging instrument in any of the following hedging relationships only if that other member of the consolidated group 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:

- A. A fair value hedge
- B. A cash flow hedge of a recognized foreign-currency-denominated asset or liability
- C. A net investment hedge in the consolidated financial statements.

25-53 Paragraph 815-20-25-46A states that there is no requirement in this Subtopic that the operating unit with the interest rate, market price, or credit risk exposure be a party to the hedging instrument and provides related guidance.

25-54 An intra-entity derivative can be designated as a hedging instrument in consolidated financial statements if condition (a) is met and either condition (b) or (c) is met:

- A. The hedged risk is either of the following:
  1. The risk of changes in fair value or cash flows attributable to changes in a foreign currency exchange rate
  2. The foreign exchange risk for a net investment in a foreign operation.

- B. 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 the counterparty (that is, the other member of the consolidated group) has entered into a contract with an unrelated third party that offsets the intra-entity derivative completely, thereby hedging the exposure it acquired from issuing the intra-entity derivative to the affiliate that designated the hedge.

- C. In a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment the counterparty has entered into a derivative instrument with an unrelated third party to offset the exposure that results from that internal derivative or, if the conditions in paragraphs 815-20-25-62 through 25-63 are met, entered into derivative instruments with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative instruments.

25-55 The designation of intra-entity derivatives as hedging instruments for hedges of foreign exchange risk enables entities to continue using a central treasury function for derivative instruments with third parties and still comply
Hedging

7. Hedging foreign currency exposures

with the requirement in paragraph 815-20-25-30(a) that the operating unit with the foreign currency exposure be a party to the hedging instrument.

Topic 815 makes a distinction between intra-entity derivatives and internal derivatives. While both derivatives are between members of a consolidated group, the definition of internal derivative is used for foreign currency derivatives. For purposes of this chapter, both intra-entity and internal derivatives are referred to as internal derivatives.

An internal derivative can be designated as a hedging instrument in a fair value hedge of a FCD recognized asset or liability. However, an internal derivative 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.

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.

Generally, for an internal derivative to qualify as a hedging instrument in the consolidated financial statements, it has to be offset by an unrelated third-party contract on an individual basis. Topic 815 permits a limited exception to offset the net foreign currency exposure of internal derivatives used in a treasury center with an unrelated third party for certain cash flow hedges (see section 7.6.70). [815-20-25-52]

Example 7.4.20

Internal derivative with no offsetting third-party derivative contract

Subsidiary has the euro (€) as its functional currency and is exposed to $/€ currency fluctuations on a $1,000,000 debt security. Subsidiary enters into a foreign currency forward contract with Parent to sell $1,000,000 in three months to hedge the impact of foreign currency fluctuations on the debt security over the next three months. Subsidiary designates the forward as a fair value hedge.

The forward contract eliminates Subsidiary’s foreign currency risk. However, because the forward contract is an internal derivative, it does not offset the foreign currency exposure on a consolidated basis. It merely transfers the exposure so that Parent now has a $/€ currency exposure.

In the consolidated financial statements, the internal derivative cannot be accounted for as a hedging instrument because it does not reduce the variability of functional currency equivalent fair value on a consolidated basis. In consolidation, the internal derivative is eliminated and Subsidiary’s original exposure to foreign currency fluctuations exposure continues to exist.

In contrast, the internal derivative can qualify as a derivative hedging instrument in Subsidiary’s stand-alone financial statements. If Subsidiary accounts for the
internal derivative using hedge accounting for purposes of its stand-alone financial statements and Parent does not enter into an offsetting contract with a third party, Parent will need to eliminate the hedge accounting entries made at the subsidiary level when preparing the consolidated financial statements.

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Example 7.4.30

**Internal derivative with offsetting third-party derivative contract**

Assume the same facts as in Example 7.4.20 except that Parent enters into a foreign currency forward contract with an unrelated third party to offset the exposure it acquires from entering into the internal derivative with Subsidiary. Specifically, Parent enters into a foreign currency forward contract to sell US dollars with an unrelated third party and documents that the unrelated third-party contract has been entered into to offset the specific contract entered into with Subsidiary.

Parent has offset the exposure acquired from Subsidiary and on a consolidated basis has eliminated its exposure to the variability in the functional currency equivalent fair value of the US dollar security. Therefore, fair value hedge accounting at the subsidiary level carries forward into the consolidated financial statements as long as the hedge documentation is maintained at both the subsidiary and parent levels linking the hedged exposure with the unrelated third-party derivative contract. In Parent’s stand-alone financial statements before consolidation, the internal derivative and the unrelated third-party derivative contract are 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.

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7.5 Accounting for foreign currency fair value hedges

7.5.10 Overview

The accounting for foreign currency fair value hedges is the same as it is for all other fair value hedges (see chapter 4). The following shows the general accounting and presentation for a highly effective fair value hedge (not including excluded components).
In general, the fair value foreign currency hedge accounting model comprises the following.

| **Derivative hedging instrument** | Recognized at fair value on the balance sheet with changes in fair value recognized in earnings, other than amounts related to excluded components. For additional discussion of excluded components, see section 4.2.20. |
| **Nonderivative hedging instrument** | Foreign currency transaction gains or losses under Topic 830 reported in earnings. The foreign currency transaction gain or loss is determined as the change 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. |
| **Hedged item** | FCD assets or liabilities are remeasured to functional currency based on spot exchange rates through earnings. If multiple risks are being hedged, the carrying amount of the hedged item is adjusted for each of the risks (discussed below). |

**Hedges of multiple risks**

In addition to hedging only foreign currency risk, an entity can hedge the combination of foreign currency risk and other risks (see section 2.3.80). For example, to mitigate the earnings volatility caused by entering into a foreign currency fair value hedging relationship for a recognized interest-bearing financial asset or liability, an entity could hedge the combination of foreign currency risk and the benchmark interest rate risk.

Hedging the change in fair value attributable to changes in both the benchmark interest rate and foreign currency exchange rate of a recognized FCD financial asset or liability requires a two-step approach to adjust the basis of the hedged item.
7. Hedging foreign currency exposures

Step 1
The hedged item is adjusted through earnings for the change in fair value attributable to a change in the foreign benchmark interest rate.

Step 2
The basis-adjusted (for changes in foreign benchmark interest rates) FCD asset or liability is remeasured to the functional currency at the spot rate through earnings.

If an entity excludes the cross-currency basis spread from its assessment of hedge effectiveness (see section 9.2.70), the above approach effectively eliminates any difference that will be reflected in earnings related to the volatility in the cross-currency basis spread that is included in the measurement of the hedging instrument. For additional discussion about the accounting for the excluded component, see section 4.2.20.

Observation
Hedging variable-rate FCD instruments

If an entity is hedging the foreign currency risk of a variable-rate FCD instrument and no components are excluded from the assessment of hedge effectiveness, there may be volatility in earnings for the fair value hedging model due to spot-forward differences or currency basis spreads.

Earnings volatility can be reduced if an entity excludes the spot-forward difference or currency basis spreads from its assessment of hedge effectiveness and elects to recognize the initial value of the excluded component using an amortization approach. For additional discussion of excluded components, see section 4.2.20.

7.5.20 Changes involving foreign currency risk

Excerpt from ASC 815-25

>> Changes Involving Foreign Exchange Risk

35-15 Gains and losses on a qualifying foreign currency fair value hedge shall be accounted for as specified in Section 815-25-40 and paragraphs 815-25-35-1 through 35-10.

35-16 If a nonderivative instrument qualifies as a hedging instrument under paragraph 815-20-25-58, the gain or loss on the nonderivative hedging instrument attributable to foreign currency risk shall be the foreign currency transaction gain or loss as determined under Subtopic 830-20. The foreign currency transaction gain or loss on a hedging instrument shall be determined, consistent with paragraph 830-20-35-1, 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. 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.

35-17 Paragraph Not Used

35-18 Remeasurement of hedged foreign-currency-denominated assets and liabilities is based on the guidance in Subtopic 830-20, which requires remeasurement based on spot exchange rates, regardless of whether a fair value hedging relationship exists.

**Observation**

Calculating the fair value of a hedged unrecognized firm commitment

How an entity calculates the changes in fair value related to foreign currency risk when the hedged item is an unrecognized firm commitment depends on the nature of the hedging instrument.

**Hedging instrument is a derivative forward contract**

If the hedging instrument is a derivative forward contract, an entity would not have volatility in the income statement if the changes in fair value of the hedged item are based on forward foreign currency exchange rates. Otherwise, if the spot exchange rate were used to calculate the change in fair value of the firm commitment due to changes in the foreign currency exchange rates, there would be volatility in earnings. The volatility is because the change in fair value of the derivative hedging instrument (which is calculated based on forward rates) would not equal the change in the hedged firm commitment (which is based on spot exchange rates).

**Hedging instrument is a nonderivative financial instrument**

When a FCD nonderivative financial instrument is the hedging instrument, an entity would not have volatility in the income statement if the change in the fair value of the hedged item is based on spot rates. Otherwise, if the forward exchange rate were used to calculate the change in fair value of the firm commitment due to changes in foreign currency exchange rates, there would be volatility in earnings. The volatility is because the change in the nonderivative hedging instrument (which is calculated based on spot rates) would not equal the change in the hedged firm commitment (which is based on forward rates).

**Question 7.5.10**

What model will result in less earnings volatility when hedging only the foreign currency exposure of a recognized financial asset or liability?

**Interpretive response:** It depends.

If an entity is hedging a recognized FCD monetary financial asset or liability, the assessment of effectiveness of the fair value hedging relationship due to
changes in foreign currency rates is affected by the interaction of Topics 815 and 830.

Topic 830 requires such assets and liabilities to be remeasured to functional currency based on spot exchange rates. Therefore, the adjustment of these assets and liabilities for changes in fair value due to changes in foreign currency exchange rates is limited to the changes based on spot rates; however the change in fair value of the derivative hedging instrument is based on forward rates. If an entity does not exclude any components from its assessment of hedge effectiveness, there will be earnings volatility for the spot-forward rate difference. [830-20-35-1 – 35-2]

**Cash flow hedges.** If an entity does not exclude any components from its assessment of hedge effectiveness and wants less earnings volatility, it may elect to use the foreign currency cash flow hedging model.

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**Question 7.5.20**

Is a partial-term fair value hedge of foreign currency risk permitted?

**Interpretive response:** It depends.

— If **effectiveness is based on changes in the spot rates** of the hedging instrument, an entity is permitted to enter into a partial-term fair value hedge of foreign currency risk. Therefore, it does not need to hedge all of the foreign currency exposure throughout the life of the hedged item. This is because if the effectiveness of the hedging relationship is based solely on changes in spot rates, it is not affected by the maturity date of the hedging instrument or the hedged item. If an entity excludes the time value of option and forward points (spot-forward difference) from its assessment of hedge effectiveness, the excluded component should be accounted for using either the mark-to-market approach or the amortization approach (see section 4.2.20).

— If **effectiveness is based on changes in the forward rates** of the hedging instrument, an entity is not permitted to enter into a partial-term fair value hedge of foreign currency risk. We do not believe the guidance in paragraph 815-25-35-13B that permits partial-term hedges of interest rate risk (or interest rate risk and foreign currency risk) permits an entity to enter into a partial-term hedge of only foreign currency risk when effectiveness is based on forward rates.

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**Example 7.5.10**

Partial-term foreign currency fair value hedge

If a US dollar functional currency entity has a 1,000,000 yen (¥) receivable with a maturity of 60 days, it may enter into a forward contract to pay yen and receive US dollars to hedge the risk of changes in fair value of that receivable due to changes in the ¥/$ 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 60 days because the entity need not hedge all of the foreign currency exposure throughout the hedged item’s life. The excluded component should be accounted for using either the mark-to-market approach or the amortization approach (see section 4.2.20).

### Question 7.5.30

**If a cross-currency interest rate swap is used to hedge only foreign currency risk, what can be excluded from hedge effectiveness?**

**Background:** An entity is permitted to exclude certain items from its assessment of hedge effectiveness including: [815-20-25-82]

- for forward or future contracts, the change in fair value of the contract related to the spot-forward difference; and
- the portion of the change in fair value of a currency swap attributable to the cross-currency basis spread.

Entities often use either a fixed-for-fixed or a floating-for-floating cross-currency interest rate swap to hedge their exposure to foreign currency risk. For further discussion on cross-currency interest rate swaps, see section 2.6.20, and for the accounting for the cross-currency basis spread as an excluded component, see section 4.2.20.

**Interpretive response:** We believe an entity may exclude the entire spot-forward difference from its assessment of hedge effectiveness when using either a fixed-for-fixed or a floating-for-floating cross-currency interest rate swap to hedge its exposure to foreign currency risk.

We believe the guidance for net investment hedges in which only foreign currency risk is hedged may be considered by analogy. An entity is permitted to use a fixed-for-fixed or a floating-for-floating cross-currency interest rate swap for a net investment hedge but is not permitted to use a fixed-for-floating interest rate swap. See chapter 8 for additional information on net investment hedges. [815-25-25-67 – 25-68A]

An entity is not permitted to use a compound derivative that has multiple underlyings as a hedging instrument in a net investment hedge. A fixed-for-fixed or a floating-for-floating cross-currency interest rate swap is not a compound derivative because foreign currency rate changes primarily affect changes in its fair value. These types of derivatives are economically similar to foreign currency forward contracts. Therefore, similar to forward contracts, we believe an entity may exclude the entire spot-forward difference from the assessment of hedge effectiveness.

### 7.5.30 Examples of foreign currency fair value hedges

This section contains three examples illustrating the application of the foreign currency fair value hedging principles to the following hedging relationships.
— Fair value hedge of a firm FCD purchase commitment with a forward contract (Example 7.5.20);
— Fair value hedge of a FCD AFS debt security with a forward contract (Example 7.5.30); and
— Fair value hedge of a firm commitment denominated in a foreign currency with a forward to purchase a different currency (Subtopic 815-25’s Example 10).

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 7.5.20

**Fair value hedge of a firm FCD purchase commitment with a forward contract**

ABC Corp’s functional currency is the US dollar ($). On October 1, Year 1, ABC enters into a firm commitment to purchase equipment for delivery on March 31, Year 2 in pounds sterling (£). The price of the equipment is fixed at £10,000 with payment due on delivery.

Also on October 1, Year 1, ABC enters into a foreign currency forward contract to buy £10,000 on March 31, Year 2. ABC will exchange $11,000 for £10,000 on that date (forward rate $1.10 per £1).

ABC 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.

Spot rates, forward rates and fair value of the foreign currency forward contract are as follows.

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<th>Forward $/£</th>
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<td>£1 = $1.10</td>
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</tr>
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</tr>
</tbody>
</table>

Note:
1. The fair value is determined using the change in forward rates (1.40 - 1.10 × £10,000) discounted at an appropriate rate.

**Hedge effectiveness.** ABC assesses hedge effectiveness 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; this is because both are
denominated in the same currency and have the same terms. It is assumed that the hedge is highly effective at inception and throughout the term.

**Journal entries**

ABC makes a memorandum entry on October 1, Year 1 to document the existence of the hedging relationship. There is no entry for the foreign currency forward contract because the contract is at market rates (i.e., fair value is zero).

**Journal entries – December 31, Year 1**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense¹</td>
<td>2,857</td>
</tr>
<tr>
<td>Firm commitment</td>
<td>2,857</td>
</tr>
<tr>
<td><strong>To record change in fair value of foreign currency firm commitment.</strong></td>
<td></td>
</tr>
<tr>
<td>Forward contract</td>
<td>2,857</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>2,857</td>
</tr>
<tr>
<td><strong>To record change in fair value of foreign currency forward contract.</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Note:**

¹. The change in fair value of the foreign currency firm commitment is recorded in the same income statement line item that is used to present the earnings effect of the hedged equipment (depreciation expense).

**Journal entries – March 31, Year 2**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm commitment</td>
<td>2,357</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>2,357</td>
</tr>
<tr>
<td><strong>To record change in fair value of foreign currency firm commitment.</strong></td>
<td></td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>2,357</td>
</tr>
<tr>
<td>Forward contract</td>
<td>2,357</td>
</tr>
<tr>
<td><strong>To record change in fair value of foreign currency forward contract.</strong></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>11,500</td>
</tr>
<tr>
<td>Cash</td>
<td>11,500</td>
</tr>
<tr>
<td><strong>To record purchase of equipment from UK supplier at March 31, Year 2 spot rate (£1 = $1.15).</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>500</td>
</tr>
<tr>
<td>Forward contract</td>
<td>500</td>
</tr>
<tr>
<td><strong>To record settlement of foreign currency forward contract.</strong></td>
<td></td>
</tr>
</tbody>
</table>
7. Hedging foreign currency exposures

ABC’s hedging objective was to lock in the purchase price of the equipment at the US dollar price based on the £ forward rate on October 1, Year 1. During the period the hedge was in place, the US dollar weakened against 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, ABC limits its net cash outflow to $11,000. The equipment is also recorded at $11,000.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm commitment</td>
<td>500</td>
</tr>
<tr>
<td>Equipment</td>
<td>500</td>
</tr>
</tbody>
</table>

*To adjust carrying amount of the equipment to reflect hedge of firm commitment.*

Example 7.5.30

**Fair value hedge of a FCD AFS debt security with a forward contract**

ABC Corp.’s functional currency is the US dollar ($). On April 1, Year 1, ABC purchases a debt security for 1,000,000 pounds sterling (£) and classifies it as an AFS security.

To hedge the fair value of its investment in the debt security against adverse changes in the $/£ exchange rate, on April 1, Year 1 ABC purchases a forward contract to sell £1,000,000 on June 30. ABC designates the forward as a hedge of its risk of changes in fair value of its AFS debt security (for £1,000,000) resulting from changes in the $/£ exchange rate between April 1 and June 30.

ABC determines that the change in fair value of the derivative is highly effective at offsetting changes in fair value of the hedged AFS debt securities. ABC elects to exclude the spot-forward difference for the effectiveness assessment and account for the excluded component using the mark-to-market approach.

Bond prices, foreign currency exchange rates and fair value of ABC’s investment are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Value in £</th>
<th>Spot $/£</th>
<th>Value in $</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1</td>
<td>£1,000,000</td>
<td>£1 = $1.00</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>June 30</td>
<td>1,050,000</td>
<td>£1 = $0.90</td>
<td>945,000</td>
</tr>
</tbody>
</table>

The change in fair value of the bond is attributable to both changes in the exchange rates and market prices. The following are the changes attributable to each.
7. Hedging foreign currency exposures

<table>
<thead>
<tr>
<th>Date</th>
<th>Total change in bond fair value USD</th>
<th>Fair value change due to exchange rates</th>
<th>Fair value change due to changes in market price of bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30</td>
<td>$(55,000)</td>
<td>$(100,000)$</td>
<td>$45,000$</td>
</tr>
</tbody>
</table>

Notes:
1. £1,000,000 × ($1.00 - $0.90).
2. £50,000 increase in value (£1,050,000 - £1,000,000) converted at the spot rate on June 30 ($0.90).

The foreign currency exchange rates and fair value of the forward contracts are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot $/£</th>
<th>Forward rate $/£</th>
<th>Fair value of forward contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1</td>
<td>£1 = $1.00</td>
<td>£1 = $0.95</td>
<td>N/A</td>
</tr>
<tr>
<td>June 30</td>
<td>£1 = $0.90</td>
<td>N/A</td>
<td>$50,000$</td>
</tr>
</tbody>
</table>

Note:
1. £1,000,000 × ($0.95 - $0.90).

Journal entries – April 1, Year 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in AFS security</td>
<td>1,000,000</td>
<td>To record purchase of AFS debt security at spot rate of £1 = $1.00.</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000,000</td>
<td></td>
</tr>
</tbody>
</table>

Journal entries – June 30, Year 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward contract</td>
<td>100,000</td>
<td>To record change in fair value of forward contract due to changes in spot rate in same line item as hedged item.</td>
</tr>
<tr>
<td>Gains/losses on AFS security</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Forward contract</td>
<td>50,000</td>
<td>To record mark-to-market on excluded component (spot-forward difference).</td>
</tr>
<tr>
<td>Gains/losses on AFS security</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Investment in AFS security</td>
<td>100,000</td>
<td>To record change in fair value of AFS debt security attributable to changes in exchange rates.</td>
</tr>
</tbody>
</table>
### Hedging foreign currency exposures

#### Debit Credit

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in AFS security</td>
<td>45,000</td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td></td>
<td>45,000</td>
</tr>
<tr>
<td>To record change in fair value of AFS debt security attributable to risk not being hedged.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Forward contract</td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>To record settlement of forward contract.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

**FASB Example: Firm commitment denominated in foreign currency with a forward to purchase a different currency**

**Excerpt from ASC 815-25**

**Example 10: Fair Value Hedge of a Firm Commitment Denominated in a Foreign Currency with a Forward to Purchase a Different Currency**

**55-62** This Example illustrates application of the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 to a fair value hedge of a firm commitment to purchase an asset for a price denominated in a foreign currency. In this Example, the hedging instrument and the firm commitment are denominated in different foreign currencies. Consequently, although the hedge is highly effective at achieving offsetting changes in fair value, the hedge is not perfectly effective, and there will be an earnings effect. (The entity in the Example could have designed a perfectly effective hedge by using a hedging instrument denominated in the same foreign currency as the firm commitment with terms that match the appropriate terms in the firm commitment.) For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

**55-63** Entity MNO’s functional currency is the U.S. dollar (USD). On February 3, 20X7, Entity MNO enters into a firm commitment to purchase a machine for delivery on May 1, 20X7. The price of the machine will be 270,000 Swiss francs (CHF 270,000). Also on February 3, 20X7, Entity MNO enters into a forward contract to purchase 240,000 Euros (EUR 240,000) on May 1, 20X7. Entity MNO will pay USD 0.6125 per EUR 1 (a total of USD 147,000), which is the current forward rate for an exchange on May 1, 20X7. Entity MNO designates the forward contract as a hedge of its risk of changes in the fair value of the firm commitment resulting from changes in the USD–CHF forward exchange rate.

**55-64** Entity MNO will assess effectiveness by comparing the overall changes in the fair value of the forward contract to the changes in fair value in USD of the firm commitment due to changes in USD–CHF forward exchange rates.
Entity MNO expects the forward contract to be highly effective as a hedge because all of the following conditions exist:

a. EUR 240,000 is approximately equal to CHF 270,000 at the May 1, 20X1, forward exchange rate in effect on February 3, 20X7.

b. Settlement of the forward contract and the firm commitment will occur on the same date.

c. In recent years, changes in the value in USD of EUR over three-month periods have been highly correlated with changes in the value in USD of CHF over those same periods.

Although the hedging relationship has been determined to be highly effective at achieving offsetting changes in fair value, the hedge will not be perfectly effective and the difference between changes in the USD equivalent of EUR 240,000 (the notional amount of the forward contract) and changes in the USD equivalent of CHF 270,000 (the amount to be paid for the machine) will affect earnings. The difference between the spot rate and the forward exchange rate is not excluded from the assessment of hedge effectiveness because changes in the fair value of the firm commitment are being measured using forward exchange rates. Therefore, the entire change in the fair value of the hedging instrument will be presented in earnings in the same income statement line item as the earnings effect of the hedged item. If the hedged item were a foreign-currency-denominated available-for-sale debt security instead of a firm commitment, Topic 830 would have required its carrying value to be measured using the spot exchange rate. In that case, the spot-forward difference would have been recognized currently in earnings in the same income statement line item as the earnings effect of the hedged item if it was included in the assessment of effectiveness. The spot-forward difference also may be excluded from the assessment of effectiveness and accounted for through either an amortization approach or a mark-to-market approach in accordance with paragraph 815-20-25-83A or paragraph 815-20-25-83B.

The forward exchange rates in effect on certain key dates are assumed to be as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>USD-EUR Forward Exchange Rate for Settlement on 5/1/X7</th>
<th>USD-CHF Forward Exchange Rate for Settlement on 5/1/X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inception of the hedge—2/3/X7</td>
<td>USD 0.6125 = EUR 1</td>
<td>USD 0.5454 = CHF 1</td>
</tr>
<tr>
<td>Quarter end—3/31/X7</td>
<td>USD 0.5983 = EUR 1</td>
<td>USD 0.5317 = CHF 1</td>
</tr>
<tr>
<td>Machine purchase—5/1/X7</td>
<td>USD 0.5777 = EUR 1</td>
<td>USD 0.5137 = CHF 1</td>
</tr>
</tbody>
</table>

The USD equivalent and changes in the USD equivalent of the forward contract and the firm commitment, the changes in fair value of the forward contract and the firm commitment, and the earnings effect of the hedge on those same key dates are shown in the following table. A 6 percent discount rate is used in this Example.
7. Hedging foreign currency exposures

**Forward contract**

<table>
<thead>
<tr>
<th>2/3/X7</th>
<th>3/31/X7</th>
<th>5/1/x7</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD-EUR forward exchange rate for settlement on May 1, 20X7</td>
<td>USD 0.61</td>
<td>USD 0.60</td>
</tr>
<tr>
<td>Units of currency (EUR)</td>
<td>x 240,000</td>
<td>x 240,000</td>
</tr>
<tr>
<td>Forward price of EUR 240,000 in USD</td>
<td>147,000</td>
<td>143,592</td>
</tr>
<tr>
<td>Contract price in USD</td>
<td>(147,000)</td>
<td>(147,000)</td>
</tr>
<tr>
<td>Difference</td>
<td>USD -</td>
<td>USD (3,408.00)</td>
</tr>
<tr>
<td>Fair value (present value of the difference)</td>
<td>USD -</td>
<td>USD (3,391.00)</td>
</tr>
<tr>
<td>Change in fair value during the period</td>
<td>USD (3,391.00)</td>
<td>USD -</td>
</tr>
</tbody>
</table>

**Firm commitment**

<table>
<thead>
<tr>
<th>2/3/X7</th>
<th>3/31/X7</th>
<th>5/1/x7</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD-CHF forward exchange rate for settlement on May 1, 20X7</td>
<td>USD 0.55</td>
<td>USD 0.53</td>
</tr>
<tr>
<td>Units of currency (CHF)</td>
<td>x 270,000</td>
<td>x 270,000</td>
</tr>
<tr>
<td>Forward price of CHF 270,000 in USD</td>
<td>(147,258)</td>
<td>(143,559)</td>
</tr>
<tr>
<td>Initial forward price in USD</td>
<td>147,258</td>
<td>147,258</td>
</tr>
<tr>
<td>Difference</td>
<td>USD -</td>
<td>USD 3,699.00</td>
</tr>
<tr>
<td>Fair value (present value of the difference)</td>
<td>USD -</td>
<td>USD 3,681.00</td>
</tr>
<tr>
<td>Change in fair value during the period</td>
<td>USD 3,681.00</td>
<td>USD -</td>
</tr>
<tr>
<td>Difference between changes in fair values of the forward contract denominated in EUR and the firm commitment denominated in CHF</td>
<td>USD 290.00</td>
<td>USD -</td>
</tr>
</tbody>
</table>

55-68 This Subtopic requires that Entity MNO recognize currently in earnings all changes in fair values of the forward contract. Because Entity MNO is hedging the risk of changes in fair value of the firm commitment attributable to changes in the forward exchange rates, this Subtopic also requires recognizing those changes currently in earnings. Section 815-20-45 requires that those changes be presented in earnings in the same income statement line item as the earnings effect of the hedged item.

55-69 On May 1, 20X7, Entity MNO fulfills the firm commitment to purchase the machine and settles the forward contract. The entries illustrating fair value hedge accounting for the hedging relationship and the purchase of the machine are summarized in the following table.
### Hedging foreign currency exposures

#### March 31, 20X7
- **Recognize change in fair value of firm commitment**: USD 3,681, USD (3,861)
- **Recognize change in fair value of forward contract**: USD (3,391), 3,391

#### April 30, 20X7
- **Recognize change in fair value of firm commitment**: 4,878, (4,878)
- **Recognize change in fair value of forward contract**: (4,961), 4,961

#### May 1, 20X7
- **Recognize settlement of forward contract**: USD 8,352, 8,352
- **Recognize purchase of machine**: (138,699), (8,559), USD 147,258

#### Total
- **Cash**: USD (147,051)
- **Firm Commitment**: USD -
- **Forward Contract**: USD -
- **Machine**: USD 147,258
- **Earnings**: USD -

**55-70** To simplify this Example and focus on the effects of the hedging relationship, other amounts that would be involved in the purchase of the machine by Entity MNO (for example, shipping costs and installation costs) have been ignored.

**55-71** The effect of the hedge is to recognize the machine at its price in CHF (CHF 270,000) translated at the forward rate in effect at the inception of the hedge (USD 0.5454 per CHF 1).
7.6 Specific qualifying criteria for foreign currency cash flow hedges

7.6.10 Overview

To qualify for foreign currency cash flow hedge accounting, a hedging relationship must meet the following qualifying criteria.

General hedging requirements
Chapter 2

Qualifying criteria for all cash flow hedges
Chapter 5
However, the criteria in paragraph 815-20-25-15(c) (which requires that the transaction be with a party external to the entity) does not have to be met.

General qualifying criteria for all foreign currency hedges
Section 7.3

Specific qualifying criteria for foreign currency cash flow hedges
Section 7.6

This section discusses the specific qualifying criteria for foreign currency cash flow hedges related to the eligibility of hedged transactions and hedging instruments.

Criterion 1: Eligibility of hedged items or transactions
Criterion 2: Eligibility of hedged risk(s)
Criterion 3: Eligibility of hedging instruments
Criterion 4: Hedge effectiveness
Criterion 5: Formal documentation

Topic 815 permits foreign currency cash flow hedges of FCD forecasted transactions (including forecasted intercompany transactions), unrecognized firm commitments and recognized assets and liabilities. Only a derivative may be designated as the hedging instrument in a foreign currency cash flow hedge.

Criterion 1: Items eligible for cash flow hedges of foreign currency risk
- Forecasted transaction (including an intercompany forecasted transaction) (section 7.6.30)
- Unrecognized firm commitments (section 7.6.40)
- Recognized asset or liability (section 7.6.50)

Criterion 3: Hedging instruments eligible for cash flow hedges of foreign currency risk
- Derivative
Hedging foreign currency exposures

Hedged items continue to be subject to other applicable US GAAP, including for assessing impairment.

7.6.20 Eligibility of hedged transactions and hedging instruments in a cash flow hedge of foreign currency risk

Excerpt from ASC 815-20

>>> Items and Transactions in Cash Flow Hedges of Foreign Exchange Risk

25-38 The conditions in the following paragraph relate to a derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with any of the following:

a. A forecasted transaction (for example, a forecasted export sale to an unaffiliated entity with the price to be denominated in a foreign currency)

b. A recognized asset or liability

c. An unrecognized firm commitment

d. A forecasted intra-entity transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary).

25-39 A hedging relationship of the type described in the preceding paragraph qualifies for hedge accounting if all the following criteria are met:

a. The criteria in paragraph 815-20-25-30(a) through (b) are met.

b. All of the cash flow hedge criteria in this Section otherwise are met, except for the criterion in paragraph 815-20-25-15(c) that requires that the forecasted transaction be with a party external to the reporting entity.

c. 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.

d. 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 shall be eliminated by the effect of the hedge.

Hedged transaction. A foreign currency cash flow hedge is designed to hedge the foreign currency exposure to variability in functional currency equivalent cash flows generated by a hedged transaction. This exposure to cash flows generated by the following transactions can be hedged in foreign currency cash flow hedges: [815-20-25-38]

— forecasted transaction, including an intercompany forecasted transaction (section 7.6.30);
— unrecognized firm commitment (section 7.6.40); and
— recognized asset or liability (section 7.6.50).
Hedging instruments. Only a derivative may be designated as the hedging instrument in a foreign currency cash flow hedge.

Topic 815 allows internal derivatives to be designated as hedging instruments for cash hedges of foreign exchange risk if certain conditions are met; for further discussion, see section 7.6.60.

7.6.30 Hedged transaction: Forecasted FCD transaction

The cash flows associated with a forecasted FCD transaction can be hedged in a cash flow hedge (but not a fair value hedge). The forecasted transaction may be with an unrelated or a related party (e.g. an intercompany transaction).

This section also discusses items related to when the following forecasted transactions are the hedged transactions:
— forecasted intercompany transaction; and
— forecasted sales or purchases on credit.

Question 7.6.10
Can a group of forecasted transactions be hedged in a single cash flow hedge?

Interpretive response: Yes. A group of similar forecasted transactions can be hedged as one transaction. However, the group cannot include both forecasted foreign currency inflows and outflows. An entity that forecasts sales and purchases in the same foreign currency cannot net the forecasted sales and purchases and hedge the net foreign currency exposure. The entity has to separately hedge the forecasted sales and the forecasted purchases. [815-20-25-39(c)]

Although an entity is not permitted to hedge the net foreign currency exposure, it can hedge a gross exposure (that equals the net exposure) and qualify for hedge accounting.

Example 7.6.10
Forecasted cash inflows and outflows in foreign currency

ABC Corp. has a US dollar functional currency and forecasts that it will (1) receive €1,000,000 (related to sales of its product) on May 15, Year 1 and (2) pay €700,000 (related to purchases of inventory) on that day. Therefore, ABC has a net receive position of €300,000.

ABC is not permitted to designate that net position as the hedged transaction because it includes forecasted inflows and outflows. Instead, it may hedge the foreign currency risk related to the forecasted receipt of €300,000 (related to sales of its products) on May 15, Year 1 if all of the requirements for a cash flow hedge are met.
Question 7.6.20
Can the foreign currency exposure in a forecasted issuance of FCD debt be hedged?

Interpretive response: No. The foreign currency exposure associated with the forecasted issuance of FCD debt cannot be hedged as a forecasted transaction because it does not affect earnings. The change in the functional currency equivalent proceeds an entity will receive on issuance of debt does not affect earnings because changes in exchange rates from hedge inception to the borrowing date will only affect the initial measurement of the liability.

Question 7.6.30
Can the foreign currency exposure in forecasted earnings of a foreign subsidiary be hedged?

Interpretive response: No. An entity is not permitted to designate forecasted earnings of a foreign subsidiary as a hedged transaction in a foreign currency cash flow hedge because hedges of future earnings are not permitted. However, an entity may designate the net investment in a foreign operation as the hedged item. For additional discussion of net investment hedges, see chapter B. [FAS 133.BC485]

**Forecasted intercompany transaction**

Hedging a forecasted intercompany transaction is permitted because when an intercompany transaction denominated in a currency other than an entity’s functional currency is remeasured under Topic 830 it affects consolidated earnings. Therefore, a forecasted intercompany transaction presents an exposure to foreign currency risk. [815-20-25-28 – 25-29]

Question 7.6.40
Can forecasted intercompany dividends be hedged?

Interpretive response: No. Forecasted intercompany dividends either in foreign or functional currency cannot be hedged as a forecasted transaction because intercompany dividends do not affect earnings. A hedge of forecasted intercompany dividends expected to be paid from future earnings is a hedge of those future earnings. Hedges of future earnings are not permitted. [FAS 133.BC485]

However, once FCD dividends are declared by the subsidiary and recognized as dividends receivable/payable by the parent/subsidiary, they can be hedged as recognized FCD assets/liabilities for changes in foreign currency exchange rates.
Can an intercompany FCD transaction be hedged for overall changes in fair value or cash flows?

**Interpretive response:** No. An intercompany FCD transaction cannot be hedged for overall changes in fair value or cash flows (e.g. price risk), 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. Therefore, any potential earnings exposure will be eliminated in consolidation.

However, from the perspective of a subsidiary’s stand-alone financial statements, any of the previously mentioned risks (that is, interest rate or credit risk), as well as foreign currency risk, presents exposure to that subsidiary’s earnings and therefore are eligible for hedge accounting solely for purposes of the subsidiary’s stand-alone financial statements.

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**Forecasted purchases or sales on credit**

**Excerpt from ASC 815-20**

>>> Sale or Purchase on Credit as a Hedged Item Involving Foreign Exchange Risk

25-34 The provisions of this Section (including paragraph 815-20-25-28) 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. Specifically, an entity may choose to designate either of the following:

a. 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

b. Both of the following separate hedges:
   1. 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
   2. A foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable.

25-35 If two separate hedges are designated, the cash flow hedge would terminate (that is, be dedesignated) when the hedged sale or purchase occurs and the foreign-currency-denominated receivable or payable is recognized.
An entity can designate a cash flow hedge of the variability of functional currency-equivalent cash flows attributable to foreign currency risk related to a forecasted FCD sale or purchase on credit. In a forecasted FCD purchase or sale on credit, an entity can choose to hedge foreign currency risk to the date:

— the purchase or sale will occur; or
— the FCD payable or receivable will be settled.

If an entity chooses to hedge the risk to the date the payable or receivable is settled, it may use the same derivative instrument and designate either a single cash flow hedge or two separate hedges. [815-20-25-34]

— **Single cash flow hedge with a dual purpose.** This alternative hedges the foreign currency risk related to both the forecasted purchase or sale and settlement of the FCD payable or receivable resulting from the forecasted purchase or sale. [815-20-25-34(a), 815-30-35-9]

— **Two separate hedges with the same hedging instrument.** The first hedge is a cash flow hedge that hedges the foreign currency risk related to the forecasted purchase or sale. The first hedge is dedesignated when the purchase or sale occurs. The second hedge is a fair value hedge of the resulting payable or receivable. [815-20-25-34(b) – 25-36]

Generally, entities use a single cash flow hedge with a dual purpose to avoid operational issues associated with using two separate hedges.

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**Example 7.6.20**

**Forecasted purchase in foreign currency**

ABC Corp.’s functional currency is the US dollar. It forecasts that it will purchase equipment from a supplier in Mexico for 100 Mexican pesos in six months. It anticipates purchasing the equipment on credit and settling the payable three months after purchase.

**Single cash flow hedge with a dual purpose**

To hedge the foreign currency risk inherent in this transaction for the hedge term of nine months, ABC uses as the hedging instrument a forward contract that matures in nine months (i.e. when it anticipates settling the payable). This one instrument hedges the variability of functional currency cash flows attributable to foreign currency risk related to the settlement of the FCD payable resulting from a forecasted purchase on credit.

**Two separate hedges with the same hedging instrument**

To hedge the foreign currency risk inherent in this transaction, ABC establishes a cash flow hedge by using a forward contract that matures in nine months to hedge any foreign currency risk related to the forecasted purchase of equipment. It also establishes a fair value hedge when the payable is recognized with the same forward contract to hedge any change in the fair value of the resulting liability due to foreign currency exchange rate fluctuations.
In this transaction, ABC dedesignates the cash flow hedge when it purchases the equipment in six months.

Observation
Two separate hedges for a forecasted purchase on credit with the same hedging instrument

For a forecasted FCD purchase or sale on credit, an entity may choose to hedge the foreign currency risk to the date the payable or receivable is settled. An entity may elect to hedge this risk by designating two separate hedges with the same hedging instrument.

**Hedge effectiveness.** If the entity uses a single hedging instrument and designates two separate hedges, the entity’s assessment of hedge effectiveness using forward rates will need to consider the mismatch due to the hedging instrument’s fair value being based on a time period to the settlement date, while the change in forecasted cash flows is calculated based on a shorter time period (through the sale or purchase date).

If the entity’s assessment of hedge effectiveness uses spot rates, the timing mismatch will not impact hedge effectiveness.

Question 7.6.60
Can an entity apply hedge accounting once the forecasted transaction to purchase a FCD nonfinancial asset has occurred?

**Interpretive response:** Yes. If an entity has a foreign currency cash flow hedge and is hedging the cash settlement of the forecasted acquisition of a FCD nonfinancial asset (e.g. inventory) and the forecasted transaction occurs, it may continue to apply hedge accounting. However, the entity no longer has a forecasted transaction. Instead, it has a FCD monetary liability (i.e. payable) that would separately be eligible to be designated as a *fair value hedge* of foreign currency risk or continue to be eligible as a cash flow hedge of foreign currency risk.

7.6.40 Hedged transaction: Unrecognized firm commitments

Excerpt from ASC 815-20

>>> Foreign Exchange Risk of a Firm Commitment as Hedged Transaction in a Cash Flow Hedge

25-42 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 does not preclude a cash flow hedge of the variability in functional-currency-equivalent cash flows if the commitment’s fixed price is denominated in a foreign currency. Although that definition of a firm commitment requires a fixed price, it permits the fixed price to be denominated in a foreign currency. A firm commitment can expose the parties to variability in their functional-currency-equivalent cash flows. 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 (that is, current exchange rate). Example 14 (see paragraph 815-20-55-136) illustrates the application of this guidance.

>> Example 14: Hedging a Firm Commitment or Fixed-Price Agreement Denominated in a Foreign Currency

55-136 The following Cases illustrate hedging foreign exchange risk under the cash flow hedging model as discussed in paragraph 815-20-25-42 and others:

a. Firm commitment (Case A)
b. Fixed-price agreement (Case B).

>>> Case A: Firm Commitment

55-137 On January 1, an entity enters into an agreement to sell 1,000 tons of a nonfinancial asset to an unrelated party on June 30. The agreement meets the definition of a firm commitment. The firm commitment is denominated in the buyer’s functional currency, which is not the seller’s functional currency. Accordingly, the firm commitment exposes the seller to foreign currency risk. The seller may hedge the foreign currency exposure arising from the firm commitment under the fair value hedging model.

55-138 The seller may hedge its exposure to foreign currency risk under the cash flow hedging model even though the agreement meets the definition of a firm commitment. Accordingly, the seller may hedge the foreign currency exposure arising from the firm commitment to sell 1,000 tons of the nonfinancial asset under the cash flow hedging model, even though the seller has previously hedged its foreign currency exposure arising from another similar firm commitment under the fair value hedging model.

>>> Case B: Fixed-Price Agreement

55-139 On January 1, an entity enters into an agreement to sell 1,000 tons of a nonfinancial asset to an unrelated party on June 30. Although the agreement in this Case does not meet the definition of a firm commitment, the seller’s assessment of the observable facts and circumstances is that performance under the agreement is probable. The agreement is denominated in the buyer’s functional currency, which is not the seller’s functional currency. Accordingly, the foreign-currency-denominated fixed-price agreement exposes the seller to foreign currency risk.

55-140 If the agreement does not meet the definition of a firm commitment, but contains a fixed foreign-currency-denominated price, the seller may not hedge the foreign currency risk relating to the agreement to sell the nonfinancial asset under the fair value hedging model because the agreement is not a recognized asset, a recognized liability, or a firm commitment, which
Hedging foreign currency exposures

are the only items that can be designated as the hedged item in a fair value hedge. However, the seller may hedge the foreign currency risk relating to the agreement under the cash flow hedging model. The agreement is by definition a forecasted transaction because the sale of the nonfinancial assets will occur at the prevailing market price, that is, the fixed foreign-currency-denominated market price converted into the seller’s functional currency at the prevailing exchange rate when the transaction occurs. Therefore, because the agreement includes a fixed foreign-currency-denominated price, the agreement exposes the seller to variability in the functional-currency-equivalent cash flows. Accordingly, the seller may not hedge the foreign currency risk relating to the agreement to sell 1,000 tons of the nonfinancial asset under the fair value hedging model but may hedge the foreign currency risk under the cash flow hedging model.

An unrecognized FCD firm commitment (or specific portion thereof) is eligible to be a hedged transaction in a cash flow hedge of foreign currency exposure if its price is expressed in a specified amount of currency. It does not matter whether that currency is the entity’s functional currency or a foreign currency as long as the commitment exposes the entity to variability in its functional currency equivalent cash flows. [815-20 Glossary]

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 does not preclude a cash flow hedge of the variability in functional currency equivalent cash flows when the commitment’s price is denominated in a foreign currency, [815-20 Glossary, 815-20-25-42]

Question 7.6.70

Can an unrecognized FCD commitment with a related party be hedged?

Interpretive response: Yes. FCD commitments with related parties 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 (see Question 5.3.40); and
— the intercompany or related party commitment exposes an entity to variability in functional currency equivalent cash flows that could affect reported earnings.

A related party can be another entity within the entity’s consolidated group (e.g. a subsidiary-to-subsidiary firm commitment). Alternatively, it can be with another entity that is not within the entity’s consolidated group but is nonetheless related to the entity.

However, a commitment with a related party cannot be the hedged item in a fair value hedge because the definition of a firm commitment requires that the commitment be with an unrelated party (see section 3.3.20).
Can a commitment to sell in the future based on the market price at the time of shipment be hedged in a cash flow hedge?

Interpretive response: Yes. An entity may hedge the foreign currency risk related to a commitment to sell a nonfinancial asset that is denominated in the buyer’s functional currency, which is not the seller’s functional currency, under the cash flow hedge model.

The agreement is by definition a forecasted transaction because the sale of the nonfinancial asset will occur at the prevailing market price. Therefore, because the agreement includes a fixed foreign currency denominated price, the agreement exposes the entity to variability in the functional currency equivalent cash flows. Therefore, the entity may hedge the foreign currency risk under the cash flow hedge model [815-20-25-42, 55-139 – 55-140]

Example 7.4.10 is an example of a commitment to sell at fair value.

7.6.50 Hedged transaction: Recognized assets and liabilities

Excerpt from ASC 815-20

>>> Items and Transactions in Cash Flow Hedges of Foreign Exchange Risk

25-39 A hedging relationship of the type described in the preceding paragraph qualifies for hedge accounting if all the following criteria are met: ...

d. 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 shall be eliminated by the effect of the hedge.

25-40 For purposes of item (d) in the preceding paragraph, an entity shall not specifically exclude a risk from the hedge that will affect the variability in cash flows. For example, a cash flow hedge cannot be used with a variable-rate foreign-currency-denominated asset or liability and a derivative instrument based solely on changes in exchange rates because the derivative instrument does not eliminate all the variability in the functional currency cash flows. As long as no element of risk that affects the variability in foreign-currency-equivalent 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 (d) in the preceding paragraph. That criterion does not require that the derivative instrument used to hedge the foreign currency exposure of the forecasted foreign-currency-equivalent cash flows associated with a recognized asset or liability be perfectly effective, rather it is intended to ensure that the hedging relationship is highly effective at offsetting all risks that impact the variability of cash flows.
7. Hedging foreign currency exposures

If all of the variability of the functional-currency-equivalent cash flows is eliminated as a result of the hedge (as required by paragraph 815-20-25-39(d)), an entity can use cash flow hedge accounting to hedge the variability in the functional-currency-equivalent cash flows associated with any of the following:

a. All of the payments of both principal and interest of a foreign-currency-denominated asset or liability
b. All of the payments of principal of a foreign-currency-denominated asset or liability
c. All or a fixed portion of selected payments of either principal or interest of a foreign-currency-denominated asset or liability
d. Selected payments of both principal and interest of a foreign-currency-denominated asset or liability (for example, principal and interest payments on December 31, 20X1, and December 31, 20X3).

The cash flows associated with a FCD recognized asset or liability can be hedged in a foreign currency cash flow hedge if the hedge eliminates all of the variability in the functional currency equivalent cash flows. [815-20-25-39(d)]

An entity can designate all or part of the cash flows of a FCD recognized asset or liability as a hedged transaction. Specifically, for either fixed- or variable-rate assets or liabilities, an entity is permitted to hedge the variability in functional currency equivalent cash flows for the following: [815-20-25-41]

— 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.

When a cash flow hedge will not eliminate all of a hedged transaction’s variability, the entity can designate the asset or liability as the hedged item in a foreign currency fair value hedge if all of the criteria for the hedge are met (see section 7.4).

See section 7.7.40 for an example of a foreign currency cash flow hedge of portions of a FCD financial asset or liability as the hedged transaction (Subtopic 815-20’s Example 15).

Question 7.6.90

Does the requirement that all variability in cash flows be eliminated mean that the hedging instrument needs to be perfectly effective?

Interpretive response: No. The requirement to eliminate all variability in cash flows is not intended to require that the hedging instrument be perfectly effective. Rather, this requirement is intended to ensure that the hedging relationship is highly effective at offsetting all risks that affect the variability of cash flows. Therefore, as long as no element of risk from a hedge that will affect the variability in cash flows has been specifically excluded from the hedge, a less than perfect (but highly effective) hedge meets the requirement to eliminate all variability in cash flows. [815-20-25-40]
Subtopic 815-20’s Example 13 (reproduced in this section) includes three different fact patterns to illustrate whether all variability in a hedged transaction’s functional currency equivalent cash flows are eliminated by the effect of the hedging instrument when the hedging instrument is not perfectly effective.

Example 7.6.30
Applying the requirement to eliminate variability in all cash flows

Non-interest bearing assets and liabilities
ABC Corp. has a non-interest bearing FCD asset (e.g. an account receivable). ABC wants to hedge the foreign currency risk with a forward currency contract. Because this asset is non-interest bearing, all of the variability in its functional currency equivalent cash flows is attributable to foreign currency exchange rate changes.

Therefore, all of the variability will be eliminated by the forward currency contract, meaning the asset is eligible for a foreign currency cash flow hedge. The same result would apply to a non-interest bearing liability, such as an account payable.

Fixed-rate interest bearing assets and liabilities
ABC has a fixed-rate yen-denominated loan and wants to hedge the foreign currency risk with a forward currency contract. Because the yen interest payments are fixed and the forward currency contract eliminates the remaining variability in the loan’s functional currency equivalent cash flows, the loan is eligible for a foreign currency cash flow hedge.

Variable-rate interest bearing assets and liabilities
ABC has a variable-rate yen-denominated loan. ABC wants to hedge the foreign currency risk for both the principal and interest. For a hedge in this example to be a foreign currency cash flow hedge, the hedging instrument needs to offset the variability in cash flows for both foreign currency risk and interest rate risk. ABC may use a floating-to-fixed cross-currency interest rate swap to hedge the foreign exchange and interest rate risks. ABC is not able to use a forward contract because it only eliminates the variability due to foreign currency exchange rates.

Alternatively, ABC may designate as the hedged transaction the present value of the principal amount of the variable-rate yen-denominated loan. ABC may use a forward contract because it eliminates all of the hedged transaction’s variability. This is because the interest payment component of the loan, whose variability is not eliminated, is not part of the designated hedged transaction.
Question 7.6.100

May the fixed-rate interest payments denominated in a foreign currency in a dual-currency bond be designated as the hedged transaction?

Interpretive response: Yes, such interest payments may be designated as the hedged transaction in a cash flow hedge of foreign currency risk. 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. Therefore, those fixed-rate interest payments on a dual-currency bond could be designated as the hedged transaction in a cash flow hedge of foreign currency risk.

Example 7.6.40

Hedging fixed-rate interest payments in a dual-currency bond

ABC Corp., whose functional currency is the US dollar, issues dual-currency bonds that provide for repayment of principal in US dollars and periodic fixed-rate interest payments denominated in a foreign currency. ABC wishes to lock in the US dollar functional currency future interest expense.

To hedge the foreign currency risk of the fixed FCD interest coupon payments, ABC enters 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 US dollars at each coupon date. The fixed-rate interest payments on the dual-currency bond could be designated as the hedged transaction in a cash flow hedge of foreign currency risk.

FASB Example: Eliminating all variability in cash flows

Excerpt from ASC 815-20

>> Example 13: Eliminating All Variability in Cash Flows

55-132 The following Cases illustrate the application of paragraph 815-20-25-39(d) regarding whether all the variability in a hedged item’s functional-currency-equivalent cash flows are eliminated by the effect of the hedge:

a. Difference in optionality (Case A)
b. Difference in reset dates (Case B)
c. Difference in notional amounts (Case C).

>>> Case A: Difference in Optionality

55-133 An entity has issued a fixed-rate foreign-currency-denominated debt obligation that is callable (that is, by that entity) and desires to hedge its foreign
currency exposure related to that obligation with a fixed-to-fixed cross-currency
swap. A fixed-to-fixed currency swap could be used to hedge the fixed-rate
foreign-currency-denominated debt instrument that is callable even though the
swap does not contain a mirror-image call option 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.

>>> Case B: Difference in Reset Dates

55-134 An entity has issued a variable-rate foreign-currency-denominated debt
obligation and desires to hedge its foreign currency exposure related to that
obligation. The entity uses a variable-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. If the swap would otherwise meet this Subtopic's definition of
providing high effectiveness in hedging the foreign currency exposure of the
debt instrument, but there is a one day difference between the reset dates in
the debt obligation and the swap (that is, the one day difference in reset dates
results in the hedge being highly effective, but not perfectly effective), the
variable-to-fixed cross-currency interest rate swap could be used to hedge the
variable-rate foreign-currency-denominated debt instrument even though there
is a one-day difference between the reset dates or a slight difference in the
notional amounts in the debt instrument and the swap. This would be true as
long as the difference in reset dates or notional amounts is not significant
enough to cause the hedge to fail to be highly effective at providing offsetting
cash flows.

>>> Case C: Difference in Notional Amounts

55-135 This Case involves the same facts as in Case B, except that there is no
difference in the reset dates. However, there is a slight difference in the
notional amount of the swap and the hedged item. If the swap would
otherwise meet this Subtopic’s definition of providing high effectiveness in
hedging the foreign currency exposure of the debt instrument, paragraph 815-
20-25-39(d) does not preclude the swap from qualifying for hedge accounting
simply because the notional amounts do not exactly match. The mismatch
attributable to the slight difference in the notional amount of the swap and the
hedged item could be eliminated by designating only a portion of the contract
with the larger notional amount as either the hedging instrument or hedged
item, as appropriate.
Hedging instrument: Internal derivatives

Excerpt from ASC 815-20

>>> Intra-Entity Derivatives

25-52 A foreign currency derivative instrument that has been entered into with another member of a consolidated group can be a hedging instrument in any of the following hedging relationships only if that other member of the consolidated group 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:

a. A fair value hedge
b. A cash flow hedge of a recognized foreign-currency-denominated asset or liability
c. A net investment hedge in the consolidated financial statements.

25-53 Paragraph 815-20-25-46A states that there is no requirement in this Subtopic that the operating unit with the interest rate, market price, or credit risk exposure be a party to the hedging instrument and provides related guidance.

25-54 An intra-entity derivative can be designated as a hedging instrument in consolidated financial statements if condition (a) is met and either condition (b) or (c) is met:

a. The hedged risk is either of the following:
   1. The risk of changes in fair value or cash flows attributable to changes in a foreign currency exchange rate
   2. The foreign exchange risk for a net investment in a foreign operation.

b. 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 the counterparty (that is, the other member of the consolidated group) has entered into a contract with an unrelated third party that offsets the intra-entity derivative completely, thereby hedging the exposure it acquired from issuing the intra-entity derivative to the affiliate that designated the hedge.

c. In a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment the counterparty has entered into a derivative instrument with an unrelated third party to offset the exposure that results from that internal derivative or, if the conditions in paragraphs 815-20-25-62 through 25-63 are met, entered into derivative instruments with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative instruments.

25-55 The designation of intra-entity derivatives as hedging instruments for hedges of foreign exchange risk enables entities to continue using a central treasury function for derivative instruments with third parties and still comply with the requirement in paragraph 815-20-25-30(a) that the operating unit with the foreign currency exposure be a party to the hedging instrument.
As noted in section 7.4.70, Topic 815 makes a distinction between intra-entity derivatives and internal derivatives. While both derivatives are between members of a consolidated group, the term internal derivative is used for foreign currency derivatives entered into between entities within a consolidated group. For purposes of this chapter, both intra-entity and internal derivatives are referred to as internal derivatives.

An internal derivative can be designated as a hedging instrument in a cash flow hedge of a FCD recognized asset or liability, a forecasted borrowing, purchase or sale, or an unrecognized firm commitment.

However, an internal derivative cannot be considered a derivative hedging instrument in consolidated financial statements unless the risk acquired through the internal derivative has been offset with an unrelated third-party derivative contract. This is because 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. [815-20-25-52, 25-54]

Generally, for an internal derivative to qualify as a hedging instrument in the consolidated financial statements, it has to be offset by an unrelated third-party contract on an individual basis. As described in section 7.6.70, Topic 815 permits a limited exception that cash flow hedges of a forecasted borrowing, purchase or sale, or an unrecognized firm commitment can be hedged on a net basis with contracts entered into with unrelated third parties. [815-20-25-52, 25-54(c)]

Example 7.6.50
Hedging the net exposure from internal derivatives

Finance Co.’s functional currency is the US dollar. As the parent entity, 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 in three months.

As a result of these internal derivative contracts, Finance has a net position to pay £75 and receive ¥15,000 in three months and therefore has an exposure to both fluctuations in the $/£ exchange rate and the $/¥ exchange rate. Finance offsets these two exposures by entering into two foreign currency forward contracts with Bank, an unrelated third party, to buy £75 for $100 and to sell ¥15,000 for $150 in three months.

London and Tokyo can apply cash flow hedge accounting in their stand-alone financial statements. London and Tokyo have foreign currency exposure as a result of the forecasted transactions and have entered into the hedging
transaction with their parent. A derivative instrument used in a cash flow hedge of a forecasted transaction may be between a parent and subsidiary. [815-20-25-30(a), 815-20-25-61]

Finance cannot apply cash flow hedge accounting in its stand-alone financial statements. The risks acquired from the subsidiaries by Finance were acquired in the form of derivative instruments. The internal derivatives entered into by Finance with London and Tokyo will be remeasured at fair value through earnings. Items that are recorded at fair value with adjustments recognized currently through earnings are not permitted to be designated as hedged transactions (see section 2.5.70). The derivative contract entered into with Bank 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.

The consolidated group may apply cash flow hedge accounting. Finance entered into two derivatives with an unrelated third party (Bank) to offset the exposures that resulted from the internal derivatives. [815-20-25-61(b)(1)]

7.6.70 Limitation on internal derivatives as hedging instruments: Hedging on a net basis

Excerpt from ASC 815-20

>>> Internal Derivatives as Hedging Instruments in Cash Flow Hedges of Foreign Exchange Risk

25-61 An internal derivative 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 both of the following conditions are satisfied:

a. From the perspective of the member of the consolidated group using the derivative instrument as a hedging instrument (the hedging affiliate), the criteria for foreign currency cash flow hedge accounting otherwise specified in this Section are satisfied.

b. The member of the consolidated group not using the derivative instrument as a hedging instrument (the issuing affiliate) either:
   1. Enters into a derivative instrument with an unrelated third party to offset the exposure that results from that internal derivative
   2. If the conditions in paragraphs 815-20-25-62 through 25-63 are met, enters into derivative instruments with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative instruments. In complying with this guidance the issuing affiliate could enter into a third-party position with neither leg of the third-party position being the issuing affiliate’s functional currency to offset its exposure if the amount of the respective currencies of each leg are equivalent with respect to each other based on forward exchange rates.

25-62 If an issuing affiliate chooses to offset exposure arising from multiple internal derivatives on an aggregate or net basis, the derivative instruments
issued to hedging affiliates shall 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 instrument with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivatives.

b. The derivative instrument 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 instruments issued to affiliates.

c. 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 instrument. Nonderivative contracts shall not be used as hedging instruments to offset exposures arising from internal derivatives.

d. Foreign currency exposure that is offset by a single net third-party contract arises from internal derivatives that mature within the same 31-day period and that involve the same currency exposure as the net third-party derivative instrument. The offsetting net third-party derivative instrument related to that group of contracts shall meet all of the following criteria:
   1. It offsets the aggregate or net exposure to that currency.
   2. It matures within the same 31-day period.
   3. It is entered into within three business days after the designation of the internal derivatives as hedging instruments.

e. The issuing affiliate meets both of the following conditions:
   1. It tracks the exposure that it acquires from each hedging affiliate.
   2. It maintains documentation supporting linkage of each internal derivative and the offsetting aggregate or net derivative instrument with an unrelated third party.

f. The issuing affiliate does not alter or terminate the offsetting derivative instrument with an unrelated third party unless the hedging affiliate initiates that action.

25-63 If the issuing affiliate alters or terminates any offsetting third-party derivative (which should be rare), the hedging affiliate shall prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative instrument.

25-64 A member of a consolidated group cannot meet the offsetting criteria by offsetting 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.

25-65 A qualifying foreign currency cash flow hedge shall be accounted for as specified in Subtopic 815-30.

Foreign currency risk of multiple internal derivatives can be hedged on a net basis with contracts entered into by the issuing entity with unrelated third parties if certain conditions are met. This type of hedge is permitted only for a
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A cash flow hedge associated with a forecasted borrowing, purchase or sale or an unrecognized firm commitment.

The issuing entity is the member of the consolidated group that is not using the derivative as a hedging instrument. The entities that may be involved when internal derivatives are used are illustrated in the following diagram.

The ability to offset risk on a net basis is intended to accommodate the practice used by many organizations that manage risk on a centralized basis using a treasury center function. The entity with the foreign currency risk to be hedged enters into an internal derivative with the treasury center and designates the internal derivative as the hedging instrument. The treasury center then offsets the risk exposure it receives through the internal derivative by entering into a derivative with a third party for the net exposure. To apply hedge accounting at the consolidated group, a derivative needs to be entered into with a third party for the net exposure.

Neither leg of the derivative with the third party is required to be in the issuing entity’s functional currency (see Question 7.6.110). [815-20-25-61, 25-62]

If the issuing entity enters into offsetting third-party derivative contracts on an aggregate or net basis for each currency, the following additional requirements need to be met.
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Do 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?

Yes → Do the internal derivatives mature within the same 31-day period as the offsetting third-party derivative?

Yes → Is the offsetting third-party derivative entered into within three business days after the internal derivatives are designated as hedging instruments?

Yes → Does the issuing entity track the exposure from affiliates and document linkage between internal derivative and offsetting net derivative with unrelated third party?

Yes → Cash flow hedge accounting permitted

No → Cash flow hedge accounting not permitted

No → No

No → No

No → No

No → Yes

An issuing entity may not alter or terminate the offsetting third-party derivative unless the hedging entity initiates the action. If the issuing entity alters or terminates the offsetting instrument with a third party, hedge accounting would prospectively cease for the internal derivatives that are offset by the third-party derivative. [815-20-25-63]
Observation

Internal derivatives used for different hedging relationship

Treasury centers that issue internal derivatives 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) from internal derivatives issued for cash flow hedges of forecasted transactions or unrecognized firm commitments (which can be aggregated or netted).

This segregation creates system and tracking issues for a treasury center that issues internal derivatives for various hedging purposes. It will require the treasury center to know the hedging relationship that the entity is establishing with the internal derivative.

Question 7.6.110

Can the treasury center enter into a third-party derivative with neither leg being its functional currency?

Interpretive response: Yes. To achieve hedge accounting on a consolidated basis, a treasury center can aggregate or net foreign currency exposures from multiple internal derivatives and enter into one third-party derivative contract to offset those exposures. The legs of the third-party contract do not need to be denominated in the treasury center’s functional currency. In other words, the treasury center does not need to enter into two derivatives, each of which has the center’s functional currency as one of its legs.

Subtopic 815-20’s Example 18 (reproduced below) provides an example of a subsidiary offsetting its exposure on a net basis. [815-20-25-61(b)(2)]

Excerpt from ASC 815-20

>> Example 18: Offsetting a Subsidiary’s Exposure on a Net Basis

55-171 This Example illustrates the application of paragraph 815-20-25-61(b)(2) in offsetting a subsidiary’s exposure on a net basis in which neither leg of the third-party position is in the treasury center’s functional currency.

55-172 If a U.S. dollar (USD) functional currency treasury center was short 390 Euros (EUR) and long 40,684.80 yen (JPY) after netting its exposures obtained from internal derivatives and the forward exchange rate between EUR and JPY was EUR 1.00 = JPY 104.32, then the treasury center could enter into a third-party receive EUR 390, pay JPY 40,684.80 contract to offset the exposures. In contrast, if the treasury center was short EUR 390 and long JPY 51,000, then the treasury center would need to enter into 2 third-party contracts with the receive leg of the second third-party position being the treasury center’s functional currency. For example, the treasury center could...
enter into a third-party receive EUR 390, pay JPY 40,684.80 contract to offset the EUR exposure and partially offset the JPY exposure. It would then need to enter into a receive functional currency, pay JPY contract to hedge the remainder of its JPY exposure.

Question 7.6.120

**How does an entity determine if third-party derivatives generate closely approximating gains/losses compared with the net gains/losses generated by the internal derivatives?**

**Background:** When internal derivatives are offset on a net basis by third-party derivatives, those derivatives must generate closely approximating gains and losses when compared with the net gains and losses generated by the internal derivatives. [815-20-25-62(b)]

**Interpretive response:** Topic 815 does not specify how to determine whether third-party derivatives generate closely approximating gains and losses when compared with the net gains and losses generated by the internal derivatives. However, we believe this requirement is much more stringent than the 80%–125% range used to test if a hedge is highly effective.

Question 7.6.130

**Can internal derivatives that are not designated as hedging instruments be included in determining the foreign currency exposure to be offset on a net basis?**

**Interpretive response:** No. 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 an entity, through the treasury center, is permitted to decide which internal derivatives will be designated as a hedging instrument and the level or amount of the offsetting contract it enters into with an unrelated third party. [815-20-25-62(c)]

For example, an entity can decide the level of foreign currency exposure it wants to hedge (or not hedge) by identifying which internal derivatives are to be offset with a third-party derivative and designated as hedging instruments for consolidated financial statement purposes. Even if an internal derivative is not designated as a hedging instrument for the consolidated financial statements, a hedging entity may still be able to apply hedge accounting for that derivative in its stand-alone financial statements.

The approach of deciding the level or amount of the offsetting contract appears simple, but if a large number of internal derivatives exist, applying of this approach could become very complex.
Question 7.6.140
Does the linkage between each internal derivative and the offsetting third-party derivative have to be documented at the third-party derivative’s initiation?

Interpretive response: Yes, we believe the treasury center is required to document the linkage of each internal derivative and the offsetting net third-party derivative when it enters into the offsetting third-party derivative.

Question 7.6.150
Can the provisions for netting foreign currency risks be used to offset exposures to FCD assets or liabilities or net investment hedges?

Interpretive response: No. The provisions for aggregating or netting foreign currency risk cannot be used to offset exposures arising from internal derivatives related to recognized FCD assets or liabilities or net investment hedges. [815-20-25-64]

Question 7.6.160
If a forecasted transaction or firm commitment is being hedged using an internal derivative, what is the effect when the transaction or firm commitment occurs?

Interpretive response: As noted in Question 7.6.110, for cash flow hedges of forecasted transactions and unrecognized firm commitments, a treasury center may designate an internal derivative as the hedging instrument and offset it on an aggregate or net basis with an unrelated third-party derivative.

There may be instances in which the designated internal derivative has not yet matured when the hedged transaction occurs and becomes a recognized asset or liability. At the point a forecasted transaction or firm commitment occurs, the designated internal derivative that the treasury center aggregated or netted (for purposes of entering into third-party derivative contracts) no longer qualifies for hedge accounting in the consolidated financial statements. Therefore, the internal derivative cannot be used to hedge the newly recognized asset or liability.

Additionally, the treasury center would have to update the hedge documentation that links the third-party derivative to the aggregate or net remaining internal derivatives. If the conditions for netting foreign currency risks in paragraphs 815-20-25-61 and 25-62 were initially met, the remaining internal derivatives from this linked hedging relationship can continue to receive hedge accounting in the consolidated financial statements.
If a hedging entity modifies the internal derivative (resulting in a dedesignation) or dedesignates the hedging relationship, the treasury center has to reassess compliance with the requirements in paragraphs 815-20-25-61 and 25-62 for hedging the entity’s internal derivatives on a net basis. The treasury center also has to update the hedging documentation that links the third-party derivative to the aggregate or net internal derivatives being hedged.

The treasury center can enter into a third-party derivative to offset the effect for the changed internal derivative and 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.

**Question 7.6.170**

What is the effect of an issuing entity altering or modifying an offsetting third-party derivative?

**Excerpt from ASC 815-30**

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> Alterations or Terminations of Offsetting Third-Party Derivative Instruments

40-7 Paragraph 815-20-25-62 provides guidance on internal derivatives as hedging instruments in cash flow hedges of foreign exchange risk. Paragraph 815-20-25-63 states that, if an issuing affiliate alters or terminates any offsetting third-party derivative instrument (which should be rare), the hedging affiliate prospectively shall cease hedge accounting for the internal derivatives that are offset by that third-party derivative instrument.

**Interpretive response:** If an issuing entity alters or modifies a third-party derivative that is being used to offset the exposure it receives through the internal derivative, the hedging entity discontinues hedge accounting for the internal derivative prospectively. Topic 815 indicates that instances in which the issuing affiliate alters or terminates the offsetting third-party derivative should be rare. [815-30-40-7]

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**FASB Example: Hedging on a net basis**

The following FASB example illustrates the appropriate accounting for an internal derivative that has been offset on a net basis by a third-party derivative.
Hedging foreign currency exposures

55-113 This Example illustrates the application of paragraphs 815-20-25-61 through 25-63, specifically, 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 as such makes certain simplifying assumptions.

55-114 Entity XYZ is a U.S. entity with the U.S. dollar (USD) as both its functional currency and its reporting currency. Entity XYZ has three subsidiaries: Subsidiary A is located in Germany and has the Euro (EUR) as its functional currency, Subsidiary B is located in Japan and has the Japanese yen (JPY) as its functional currency, and Subsidiary C is located in the United Kingdom and has the pound sterling (GBP) as its functional currency. Entity XYZ uses its Treasury Center to manage foreign exchange risk on a centralized basis. Foreign exchange risk assumed by Subsidiaries A, B, and C through transactions with external third parties is transferred to the Treasury Center via internal contracts. The Treasury Center then offsets that exposure to foreign currency risk via third-party contracts. To the extent possible, the Treasury Center offsets exposure to each individual currency on a net basis with third-party contracts.

55-115 On January 1, Subsidiaries A, B, and C decide 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 A, B, and C 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 entity (USD).

55-116 Subsidiaries A, B, and C have the following foreign currency exposures and enter into the following internal contracts with the Treasury Center.

<table>
<thead>
<tr>
<th>Subsidiary</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>A (German)</td>
<td>EUR</td>
<td>JPY payable 12,000</td>
<td>Jun 1</td>
<td>JPY 12,000</td>
<td>EUR 115&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>GBP receivable 50</td>
<td>Jun 1</td>
<td>EUR 80&lt;sup&gt;a&lt;/sup&gt;</td>
<td>GBP 50</td>
</tr>
<tr>
<td>B (Japanese)</td>
<td>JPY</td>
<td>USD payable 100</td>
<td>Jun 15</td>
<td>USD 100</td>
<td>JPY 10,160&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>EUR receivable 100</td>
<td>Jun 15</td>
<td>JPY 10,432&lt;sup&gt;a&lt;/sup&gt;</td>
<td>EUR 100</td>
</tr>
<tr>
<td>C (UK)</td>
<td>GBP</td>
<td>USD receivable 330</td>
<td>Jun 30</td>
<td>GBP 201&lt;sup&gt;a&lt;/sup&gt;</td>
<td>USD 330</td>
</tr>
</tbody>
</table>

<sup>a</sup> Computed based on forward exchange rates as of January 1.

55-117 Subsidiaries A, B, and C designate the internal contracts with the Treasury Center as cash flow hedges of their foreign currency forecasted purchases and sales. Those internal contracts may be designated as hedging
instruments in the consolidated financial statements if the requirements of this Subtopic are met. From the subsidiaries’ perspectives, the requirements of 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 paragraphs 815-20-25-30 and 815-20-25-39 through 25-41 for cash flow hedge accounting. Subsidiaries A, B, and C 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 Section 815-20-25 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 based on the internal derivatives designated as hedging instruments.

b. The affiliate that issues the hedge must offset the internal derivative either individually or on a net basis. The Treasury Center determines that it will offset the exposure arising from the internal derivatives with Subsidiaries A, B, and C 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.

55-118 To determine the net currency exposure arising from the internal contracts with Subsidiaries A, B, and C, the Treasury Center performs the following analysis.

### Subsidiary Perspective—Internal Contracts with the Treasury Center

<table>
<thead>
<tr>
<th>Subsidiary</th>
<th>Contract with Treasury Center</th>
<th>CurrencyReceived (CurrencyPaid)</th>
<th>EUR</th>
<th>JPY</th>
<th>GBP</th>
<th>USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>A (German)</td>
<td>Internal Contract 1</td>
<td></td>
<td>(115)</td>
<td>12,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Internal Contract 2</td>
<td></td>
<td>80</td>
<td>(50)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B (Japanese)</td>
<td>Internal Contract 3</td>
<td></td>
<td>(10,160)</td>
<td>100</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Internal Contract 4</td>
<td></td>
<td>(100)</td>
<td>10,432</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C (UK)</td>
<td>Internal Contract 5</td>
<td></td>
<td>201</td>
<td>(330)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net exposure</strong></td>
<td></td>
<td></td>
<td>(135)</td>
<td>(12,272)</td>
<td>(151)</td>
<td>(230)</td>
</tr>
</tbody>
</table>

### Treasury Center Perspective—Internal Contracts with the Subsidiaries

<table>
<thead>
<tr>
<th>Subsidiary</th>
<th>Contract with Treasury Center</th>
<th>Currency Received (Currency Paid)</th>
<th>EUR</th>
<th>JPY</th>
<th>GBP</th>
<th>USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>A (German)</td>
<td>Internal Contract 1</td>
<td></td>
<td>115</td>
<td>(12,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Internal Contract 2</td>
<td></td>
<td>(80)</td>
<td>50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B (Japanese)</td>
<td>Internal Contract 3</td>
<td></td>
<td>10,160</td>
<td>(100)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Internal Contract 4</td>
<td></td>
<td>100</td>
<td>(10,432)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C (UK)</td>
<td>Internal Contract 5</td>
<td></td>
<td>(201)</td>
<td>330</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net exposure</strong></td>
<td></td>
<td></td>
<td>135</td>
<td>(12,272)</td>
<td>(151)</td>
<td>230</td>
</tr>
</tbody>
</table>
For Subsidiaries A, B, and C to designate the internal contracts as hedging instruments in the consolidated financial statements, the Treasury Center must meet certain required criteria outlined in paragraphs 815-20-25-62 through 25-63 in determining how it will offset exposure arising from multiple internal derivatives that it has issued. Based on a determination that those requirements are satisfied (see the following paragraph, the Treasury Center determines the net exposure in each currency with respect to USD (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.

<table>
<thead>
<tr>
<th>Currency Brought (Currency Sold)</th>
<th>EUR</th>
<th>JPY</th>
<th>BP</th>
<th>USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Third-Party Contract 1</td>
<td>(135)</td>
<td></td>
<td>138</td>
<td>(a)</td>
</tr>
<tr>
<td>Third-Party Contract 2</td>
<td></td>
<td>12,272</td>
<td></td>
<td>(121) (a)</td>
</tr>
<tr>
<td>Third-Party Contract 3</td>
<td></td>
<td></td>
<td>151</td>
<td>(247) (a)</td>
</tr>
<tr>
<td>Net exposure</td>
<td>(135)</td>
<td>12,272</td>
<td>151</td>
<td>(230)</td>
</tr>
</tbody>
</table>

(a) Computed based on forward exchange rates as of January 1.

From the Treasury Center’s perspective, the required criteria in paragraphs 815-20-25-62 through 25-63 are satisfied as follows:

a. The issuing affiliate enters into a derivative instrument with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivatives, and the derivative instrument 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 instruments issued to affiliates. The Treasury Center enters into third-party derivative instruments to offset the exposure of each foreign currency on a net basis. The Treasury Center offsets 100 percent of the net exposure to each currency; that is, the Treasury Center does not selectively keep any portion of that exposure. In this Example, the Treasury Center’s third-party contracts generate losses that are equal to the losses on internal contracts designated as hedging instruments by Subsidiaries A, B, and C (see analysis beginning in the following paragraph).

b. Internal derivatives that are not designated as hedging instruments and all nonderivative instruments are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative instrument. The Treasury Center does not include in the determination of net exposure any internal derivatives not designated as hedging instruments or any nonderivative instruments.

c. Foreign currency exposure that is offset by a single net third-party contract arises from internal derivatives that involve the same currency and that mature within the same 31-day period. The offsetting net third-party derivative instrument 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. The Treasury Center’s third-party net contracts involve the same currency (that is, not a tandem currency) as the net exposure arising from the internal
derivatives issued to Subsidiaries A, B, and C. The Treasury Center’s third-party derivative instruments mature within the same 31-day period as the internal contracts that involve currencies that are offset on a net basis. In this Example, for simplicity, all internal contracts and third-party derivative instruments are entered into on the same date.

d. The issuing affiliate tracks the exposure that it acquires from each hedging affiliate and maintains documentation supporting linkage of each derivative instrument and the offsetting aggregate or net derivative instrument with an unrelated third party. The Treasury Center maintains documentation supporting linkage of third-party contracts and internal contracts throughout the hedge period.

e. The issuing affiliate does not alter or terminate the offsetting derivative instrument 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. Based on Entity XYZ’s policy, the Treasury Center may not alter or terminate the offsetting derivative instrument with an unrelated third party unless the hedging affiliate initiates that action.

f. If an internal derivative that is included in determining the foreign currency exposure on a net basis is modified or dedesignated as a hedging instrument, compliance must be reassessed. For simplicity, this Example does not involve a modification or redesignation of an internal derivative.

55-121 At the end of the quarter, each subsidiary determines the functional currency gains and losses for each contract with the Treasury Center.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A (German)</td>
<td>Internal Contract 1</td>
<td>(115)</td>
<td>(115)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>Internal Contract 2</td>
<td>80</td>
<td>83</td>
<td>(3)</td>
<td>(3)</td>
</tr>
<tr>
<td>B (Japanese)</td>
<td>Internal Contract 3</td>
<td>(10,160)</td>
<td>(10,738)</td>
<td>578</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>Internal Contract 4</td>
<td>10,432</td>
<td>10,421</td>
<td>11</td>
<td>-</td>
</tr>
<tr>
<td>C (UK)</td>
<td>Internal Contract 5</td>
<td>201</td>
<td>204</td>
<td>(3)</td>
<td>(5)</td>
</tr>
</tbody>
</table>

Net USD Gain (Loss) (3)

<table>
<thead>
<tr>
<th>Subsidiary</th>
<th>Contract with Third Party</th>
<th>Beginning of Period USD Amount Receive (Pay)</th>
<th>End of Period USD Amount Receive (Pay)</th>
<th>USD Gain (Loss)</th>
</tr>
</thead>
</table>

55-122 At the end of the quarter, the Treasury Center determines its gains or losses on third-party contracts.
a. Computed based on forward exchange rates as of January 1 and March 31.
b. For simplicity, gains or losses are not discounted in this Example.

55-123 Journal Entries at March 31 (Note: All journal entries are in USD.)

### Subsidiaries’ Journal Entries

#### German Subsidiary A
- There is no entry for Contract 1 because the USD gain or loss is zero.
- Other comprehensive income $3
- Derivative liability $3

To record the loss on Internal Contract 2.

#### Japanese Subsidiary B
- Derivative asset $5
- Other comprehensive income $5

To record the gain on Contract 3.

There is no entry for Internal Contract 4 because the USD gain or loss is zero.

#### UK Subsidiary C
- Other comprehensive income $5
- Derivative liability $5

To record the loss on Internal Contract 5.

### Treasury Center’s Journal Entries

#### Journal Entries for Internal Contracts with Subsidiaries
- There is no entry for Internal Contract 1 because the USD gain or loss is zero.
- Derivative asset $3

Earnings $3

To record the gain on Internal Contract 2 with German Subsidiary A.

Earnings $5
- Derivative liability $5

To record the gain on Internal Contract 3 with Japanese Subsidiary B.

There is no entry for Internal Contract 4 because the USD gain or loss is zero.

- Derivative asset $5

Earnings $5

To record the gain on Internal Contract 5 with UK Subsidiary C.

#### Journal Entries for Third-Party Contracts
- Derivative asset $7

Earnings $7

To record the gain on Third-Party Contract 1.

Earnings $7
Hedging

7. Hedging foreign currency exposures

### 7.7 Accounting for foreign currency cash flow hedges

#### 7.7.10 Overview

Excerpt from ASC 815-30

> **Subsequent Recognition and Measurement of Gains and Losses on Hedging Instrument**

35-3 When the relationship between the hedged item and hedging instrument is highly effective at achieving offsetting changes in cash flows attributable to the hedged risk, an entity shall record in **other comprehensive income** the entire change in the fair value of the designated hedging instrument that is included in the assessment of hedge effectiveness. More specifically, a qualifying **cash flow hedge** shall be accounted for as follows: ...

a. An entity’s defined risk management strategy for a particular hedging relationship may exclude 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 paragraphs 815-20-25-81 through 25-83B). That excluded component of the gain or loss shall be recognized in earnings either through an amortization approach in accordance with paragraph 815-20-25-83A or through a mark-to-market approach in accordance with paragraph 815-20-25-83B. Under either approach, the amount recognized in earnings for an excluded component shall be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A. For example, if the effectiveness of a hedging relationship with an option is assessed based on changes in the option’s intrinsic value, the changes in the option’s **time value** would be excluded from the assessment of hedge effectiveness and either may be recognized in earnings through an amortization approach in accordance with paragraph 815-20-25-83A or currently in earnings in accordance with paragraph 815-20-25-83B.

b. Amounts in accumulated other comprehensive income related to the derivative designated as a hedging instrument included in the assessment of hedge effectiveness are reclassified to earnings in the same period or periods during which the hedged forecasted transaction affects earnings in accordance with paragraphs 815-30-35-38 through 35-41 and presented in...
the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A. The balance in accumulated other comprehensive income associated with the hedged transaction shall be the cumulative gain or loss on the derivative instrument from inception of the hedge less all of the following:

1. Subparagraph superseded by Accounting Standards Update No. 2017-12.
   a. The derivative instrument’s gains or losses previously reclassified from accumulated other comprehensive income into earnings pursuant to paragraphs 815-30-35-38 through 35-41.
   b. The cumulative amount amortized to earnings related to excluded components accounted for through an amortization approach in accordance with paragraph 815-20-25-83A.
   c. The cumulative change in fair value of an excluded component for which changes in fair value are recorded currently in earnings in accordance with paragraph 815-20-25-83B.

2. Subparagraph superseded by Accounting Standards Update No. 2017-12.

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 (b) would exclude the gains or losses occurring during that period. 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 would be highly effective in future periods. Consequently, the hedging relationship continued even though hedge accounting was not permitted for a specific previous effectiveness assessment period.

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 830-20-35-1, 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 is 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 830-20-35-1 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 is 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—itself entire gain or loss), an amount that adjusts earnings for the
Hedging foreign currency exposures

amortization of the cost of the option on a rational basis shall be reclassified each period from other comprehensive income to earnings. This guidance is limited to foreign currency hedging relationships because of their unique attributes and is an exception for foreign currency hedging relationships.

35-6 Remeasurement of the hedged foreign-currency-denominated assets and liabilities is based on the guidance in Topic 830, which requires remeasurement based on spot exchange rates, regardless of whether a cash flow hedging relationship exists.

The accounting for foreign currency cash flow hedges is the same as for all other cash flow hedges (see chapter 6). The following shows the general accounting and presentation for a highly effective cash flow hedge (not including excluded components).

<table>
<thead>
<tr>
<th>Hedging instrument</th>
<th>Hedged transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entire change in fair value recorded in OCI</td>
<td>Continue to apply otherwise applicable GAAP based on the nature of the hedged transaction</td>
</tr>
<tr>
<td>Reclassified from AOCI into earnings when hedged transaction affects earnings</td>
<td>Hedged transaction affects earnings</td>
</tr>
<tr>
<td>Offset of hedging instrument in same income statement line item as earnings impact of hedged item</td>
<td></td>
</tr>
</tbody>
</table>

Derivative hedging instrument

Recognized at fair value on the balance sheet with changes in fair value recognized in OCI, other than amounts related to excluded components. For a discussion of excluded components, see section 6.2.20. The amount in AOCI is reclassified into earnings in the same periods during which the hedged transaction affects earnings.

Hedged transaction

FCD monetary assets or liabilities are remeasured to the functional currency based on spot exchange rates through earnings. Therefore, the adjustment for these instruments for changes in foreign currency exchange rates is limited to changes based on spot rates.

The general cash flow hedging model requires amounts in AOCI to be reclassified into earnings in the same period(s) during which the forecasted
transaction affects earnings. Such guidance also applies for cash flow hedges of forecasted FCD intercompany transactions. However, the period of reclassification may be different for stand-alone versus consolidated financial statements (see Question 7.7.10).

The following topics specific to accounting for foreign currency cash flow hedges are discussed in this section:

— hedges of recognized FCD assets and liabilities (section 7.7.20); and
— forecasted purchases or sales on credit (section 7.7.30).

**Question 7.7.10**

*When are amounts in AOCI reclassified into earnings in a hedge of a forecasted intercompany transaction?*

**Interpretive response:** The general cash flow hedging model requires amounts in AOCI to be reclassified into earnings in the same period(s) during which the forecasted transaction affects earnings.

If a subsidiary is hedging the functional currency equivalent cash flows of a forecasted FCD intercompany transaction, the subsidiary reclassifies 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 are not reclassified into earnings unless and until the forecasted transaction affects the consolidated earnings. An entity that hedges forecasted FCD intercompany transactions under the cash flow hedge model needs to track these differences.

Subtopic 815-30’s [Example 14](#) illustrates the reclassification of amounts from AOCI.

**Excerpt from ASC 815-30**

**Example 14: Reclassifying Amounts from a Cash Flow Hedge of a Forecasted Foreign-Currency-Denominated Intra-Entity Sale**

This Example illustrates the application of paragraphs 815-20-25-30 and 815-20-25-39 through 25-41. This Example has the following assumptions:

a. Parent A is a multinational corporation that has the U.S. dollar (USD) as its functional currency.
b. Parent A has the following two subsidiaries:
   1. Subsidiary B, which has the Euro (EUR) as its functional currency
   2. Subsidiary C, which has the Japanese yen (JPY) as its functional currency.
c. Subsidiary B manufactures a product and has a forecasted sale of the product to Subsidiary C that will be transacted in JPY.
Eventually, Subsidiary C will sell the product to an unrelated third party in JPY. Subsidiary B enters into a forward contract with an unrelated third party to hedge the cash flow exposure of its forecasted intra-entity sale in JPY to changes in the EUR-JPY exchange rate.

The transaction in this Example meets the hedge criteria of paragraphs 815-20-25-30 and 815-20-25-39 through 25-41, which permits a derivative instrument to be designated as a hedge of the foreign currency exposure of variability in the functional-currency-equivalent cash flows associated with a forecasted intra-entity foreign-currency-denominated transaction if certain criteria are met. Specifically, the operating unit having the foreign currency exposure (Subsidiary B) is a party to the hedging instrument; the hedged transaction is denominated in JPY, which is a currency other than Subsidiary B’s functional currency; and all other applicable criteria in Section 815-20-25 are satisfied.

Subsidiary B measures the derivative instrument at fair value and records the gain or loss on the derivative instrument in accumulated other comprehensive income. In the consolidated financial statements, the amount in other comprehensive income representing the gain or loss on a derivative instrument designated in a cash flow hedge of a forecasted foreign-currency-denominated intra-entity sale should be reclassified into earnings in the period that the revenue from the sale of the manufactured product to an unrelated third party is recognized and presented in earnings in the same income statement line item as the earnings effect of the hedged item. The reclassification into earnings in the consolidated financial statements should occur when the forecasted sale affects the earnings of Parent A. Because the consolidated earnings of Parent A will not be affected until the sale by Subsidiary C to the unrelated third party occurs, the reclassification of the amount of derivative gain or loss from other comprehensive income into earnings in the consolidated financial statements should occur upon the sale by Subsidiary C to an unrelated third party.

This guidance is relevant only with respect to the consolidated financial statements. In Subsidiary B’s separate entity financial statements, the reclassification of the amount of the derivative instrument gain or loss from other comprehensive income into earnings should occur in the period the forecasted intra-entity sale is recorded because Subsidiary B’s earnings are affected by the change in the EUR-JPY exchange rate when the sale to Subsidiary C occurs.

Question 7.7.20

How are gains and losses on a hedging instrument recognized if an entity assesses effectiveness on an after-tax basis?
Excerpt from ASC 815-30

> Subsequent Recognition and Measurement of Gains and Losses on Hedging Instrument

If an entity has designated and documented that it will assess effectiveness and measure hedge results of a cash flow hedge of foreign currency risk on an after-tax basis as permitted by paragraph 815-20-25-3(b)(2)(vi), the portion of the gain or loss on the hedging instrument that exceeded the loss or gain on the hedged item shall be included as an offset to the related tax effects in the period in which those tax effects are recognized.

Interpretive response: If an entity assesses effectiveness on an after-tax basis, the portion of the gain or loss on the hedging instrument that exceeds the loss or gain on the hedged item is included as an offset to the related tax effect in the period in which the tax effects are recognized.

Question 7.7.30

Is a partial-term cash flow hedge of foreign currency risk permitted?

Interpretive response: It depends.

If effectiveness is based on changes in the spot rates of the hedging instrument, an entity is permitted to enter into a partial-term cash flow hedge of foreign currency risk. Therefore, an entity does not need to hedge all of the foreign currency exposure throughout the life of the hedged item.

Because the effectiveness is based on changes in the spot value, any changes in the time value of the hedging instrument would be recognized in earnings immediately (if the mark-to-market approach is elected) or amortized into earnings (if the amortization approach is elected).

Example 7.7.10

Different maturities for hedged item and hedging instrument

A US dollar functional currency entity expects to sell a product in 60 days for 1,000,000 yen (¥). It enters into a forward contract to pay yen and receive US dollars to hedge the risk of changes in cash flows of that sale due to changes in the ¥/$ 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 60 days. The excluded component should be accounted for using either the mark-to-market approach or the amortization approach (see section 6.2.20).
Similarly, 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 60 days. Before such relationship is entered into, the entity needs to consider the effect on its assessment of hedge effectiveness due to the timing of the expected cash flows on the forecasted transaction versus the timing of the cash flows for the forward contract.

### 7.7.20 Recognized FCD assets and liabilities

**Excerpt from ASC 815-30**

> **Subsequent Recognition and Measurement of Gains and Losses on Hedging Instrument**

35-3 When the relationship between the hedged item and hedging instrument is highly effective at achieving offsetting changes in cash flows attributable to the hedged risk, an entity shall record in **other comprehensive income** the entire change in the fair value of the designated hedging instrument that is included in the assessment of hedge effectiveness. More specifically, a qualifying cash flow hedge shall be accounted for as follows: …

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 830-20-35-1, 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 is 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 830-20-35-1 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 is 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. This guidance is limited to foreign currency hedging relationships because of their unique attributes and is an exception for foreign currency hedging relationships.
Hedging recognized FCD monetary assets and liabilities is affected by the interaction of Topic 815 and Topic 830. Topic 830 requires recognized FCD monetary assets and liabilities to be remeasured to the functional currency based on the spot exchange rate through earnings; therefore, the adjustment of these recognized assets and liabilities for foreign exchange rates is limited to the changes based on spot rates. A derivative used to hedge the foreign currency risk (such as a foreign currency forward contract) on the FCD monetary assets and liabilities is recognized on the balance sheet at fair value. If the cash flow hedge is highly effective, the change in fair value of the derivative is recognized in OCI while the remeasurement gain/loss of the monetary assets and liabilities is recognized in earnings. This would result in earnings volatility.

Therefore, an exception to the general hedging guidance was provided for cash flow hedges of recognized FCD assets and liabilities when an entity assesses effectiveness based on total changes in the hedging instrument’s cash flows. The FASB decided to permit this exception because it believes it is consistent with its general principle of providing special hedge accounting to mitigate the effects in earnings of different existing measurement criteria for FCD transactions.

The following table describes this exception, which may not be applied by analogy to other hedging relationships.

<table>
<thead>
<tr>
<th>Hedging instrument</th>
<th>Assessment of hedge effectiveness</th>
<th>Amount to be reclassified from AOCI into earnings</th>
</tr>
</thead>
</table>
| Non-option contract | Based on total changes in cash flows of the non-option contract | — Gain or loss to offset transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates.  
— Portion of cost attributable to spot-forward difference amortized in earnings using the interest method. |
| Option contract | Based on total changes in cash flows of the option contract | — Gain or loss to offset transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates limited to the change in the underlying that results in a change in the option contract’s intrinsic value.  
— Portion of cost of the option amortized in earnings on a rational basis. |

The following table describes the reclassification from AOCI into earnings if the assessment of hedge effectiveness is not based on the hedging instrument’s total change in cash flows.

<table>
<thead>
<tr>
<th>Hedging instrument</th>
<th>Assessment of hedge effectiveness</th>
<th>Amount to be reclassified from AOCI into earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-option contract</td>
<td>Spot-forward difference excluded from</td>
<td>— Gain or loss to offset transaction gain or loss from remeasuring</td>
</tr>
<tr>
<td>Hedging foreign currency exposures</td>
<td>the asset/liability to functional currency based on spot rates.</td>
<td></td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>---------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td>assessment of hedge effectiveness</td>
<td>As discussed in section 6.2.20, an entity can recognize the initial value of the excluded component in earnings using either:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- <strong>Amortization approach.</strong> A systematic and rational method over the life of the hedging instrument; or</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- <strong>Mark-to-market approach.</strong> A method that recognizes all fair value changes of the excluded component currently in earnings</td>
<td></td>
</tr>
<tr>
<td>Option contract</td>
<td>Gain or loss to offset transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates limited to the change in the underlying that results in a change in the option contract’s intrinsic value</td>
<td></td>
</tr>
<tr>
<td>Based on changes in intrinsic value of the option contract</td>
<td>As discussed in section 6.2.20, an entity can recognize the initial value of the excluded component in earnings using either:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- <strong>Amortization approach.</strong> A systematic and rational method over the life of the hedging instrument; or</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- <strong>Mark-to-market approach.</strong> A method that recognizes all fair value changes of the excluded component currently in earnings</td>
<td></td>
</tr>
</tbody>
</table>

The initial spot-forward difference for a forward contract or the premium paid for an option contract represents the cost to the purchaser or income to the seller of the hedging instrument.

**Question 7.7.40**

For non-option contracts, how are amounts reclassified from AOCI when hedge effectiveness is based on a hedging instrument’s total change in cash flows?
Interpretive response: If a non-option contract is the hedging instrument, two reclassifications from AOCI are required when hedge effectiveness is based on the hedging instrument’s total change in cash flows.

— First, an amount is reclassified from AOCI each period to offset the transaction gain or loss arising from the Topic 830 remeasurement of the FCD asset or liability at the spot exchange rate.
— Second, an amount is reclassified from AOCI each period representing the cost attributable to the spot-forward difference of the hedging derivative.

The cash flow hedging model for recognized FCD 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 non-option contract.

Example 18 in Subtopic 815-30 (reproduced in this section) illustrates a method of ascribing the amount of cost or income to each period using a pro rata method based on the number of days in the hedging relationship. Such method is based on the daily interest implicit in the forward contract. This is done by dividing the forward-to-spot premium or discount by the number of days in the non-option contract. The amount of daily interest is recognized for the number of days in the period.

Question 7.7.50

For option contracts, how are amounts reclassified from AOCI when hedge effectiveness is based on a hedging instrument’s total change in cash flows?

Interpretive response: If the hedging instrument is a currency option-based derivative and effectiveness is based on the total change in cash flows, an amount is 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.

In-the-money option

When the option is in the money, this change parallels the guidance in Topic 830 that requires the recognized asset or liability to be remeasured using the spot rate. 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 Topic 830 transaction gain or loss.

Out-of-the-money option

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 are reclassified to AOCI.

The cost of the currency option is amortized to earnings on a rational basis. The amortization method is used 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. In our experience, most entities use a straight-line
amortization method for simplicity. The amount of daily cost is recognized for the number of days in the period.

If the assessment of effectiveness is not based on the total change in cash flows of an option contract, an amount is 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. However, the changes in the option’s time value are recognized in earnings using either an amortization approach or a mark-to-market approach.

7.7.30 Forecasted purchases and sales on credit

Excerpt from ASC 815-30

> Application to Single Cash Flow Hedge of a Forecasted Sales or Purchase on Credit for Foreign Exchange Risk

35-9 For a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of a foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit, the guidance in paragraph 815-30-35-3 is applied as follows:

a. The gain or loss on the derivative instrument that is included in the assessment of hedge effectiveness is reported in other comprehensive income during the period before the forecasted purchase or sale.

b. The functional currency interest rate implicit in the hedging relationship as a result of entering into the forward contract is used to determine the amount of cost or income to be ascribed to each period of the hedging relationship. 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 relevant period of the hedging relationship. However, for simplicity, in hedging relationships in which the hedged item is a short-term non-interest-bearing account receivable or account payable, the amount of cost or income to be ascribed each period can also be determined using a pro rata method based on the number of days or months of the hedging relationship. In addition, in a short-term single cash flow hedging relationship that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of a foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit, the amount of cost or income to be ascribed each period can also be determined using a pro rata method or a method that uses two foreign currency forward exchange rates. The first foreign currency forward exchange rate would be based on the maturity date of the forecasted purchase or sale transaction. The second foreign currency forward exchange rate would be based on the settlement date of the resulting account receivable or account payable.

c. For forecasted sales on credit, the amount of cost or income ascribed to each forecasted period is reclassified from other comprehensive income to
earnings on the date of the sale. For forecasted purchases on credit, the amount of cost or income ascribed to each forecasted period is reclassified from other comprehensive income to earnings in the same period or periods during which the asset acquired affects earnings. The reclassification from other comprehensive income to earnings of the amount of cost or income ascribed to each forecasted period is based on the guidance in paragraphs 815-30-35-38 through 35-41.

d. The income or cost ascribed to each period encompassed within the periods of the recognized foreign-currency-denominated receivable or payable is reclassified from other comprehensive income to earnings at the end of each reporting period.

As discussed in section 7.6.30, an entity can designate a single cash flow hedge that encompasses the variability of functional currency equivalent cash flows attributable to foreign currency risk related to settlement of the FCD receivable or payable resulting from a forecasted sale or purchase on credit.

The accounting from the time the hedge is designated to the time the receivable or payable is cash settled, can be summarized as follows.

| Forecast period (before sale/purchase date) | — The gain or loss on the hedging instrument included in the assessment of effectiveness is reported in OCI during the period before the purchase or sale date of a forecasted foreign currency transaction.  
— 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 to be ascribed each period can be determined using a pro rata method based on the number of days in the hedging relationship. |
| On the sale/purchase date | — 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 into 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 into earnings in the same period(s) during which the asset acquired affects earnings. |
| After sale/purchase date (during life of FCD receivable/payable) | — The income or cost ascribed to each period encompassed during the periods of the recognized FCD receivable or payable that results from the forecasted sale or purchase is reclassified from AOCI into earnings at the end of each reporting period.  
— During the period in which the FCD 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 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, any gain or loss to offset the transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates limited to the changes in... |
The following FASB example illustrates these accounting requirements.

**Excerpt from ASC 815-30**

>> Example 18: Cash Flow Hedge of Forecasted Purchase or Sale on Credit

**55-106** This Example illustrates the application of paragraphs 815-30-35-9 and 815-20-25-34 through 25-36, which permit an entity to designate a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of a foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit.

**55-107** This Example has the following assumptions:

a. Entity A, a U.S. dollar (USD) functional currency entity, forecasts the purchase of inventory on credit for FC 100,000 in 182 days with settlement of the payable in 227 days. The purchase will occur July 15 on credit; the resulting payable will settle August 29.

b. Entity A enters into a forward contract to purchase FC 100,000 in 227 days at the forward rate of USD \(0.6614 = FC 1\).

c. Entity A designates a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of the foreign-currency-denominated payable resulting from the forecasted purchase on credit.

d. After the initial quantitative effectiveness test, Entity A elects to assess effectiveness on a quantitative basis based on forward rates.

**55-108** Exchange rates are as follows.

<table>
<thead>
<tr>
<th>Period</th>
<th>Spot</th>
<th>8/29 Forward</th>
<th>7/15 Forward</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/14</td>
<td>0.6575</td>
<td>0.6614</td>
<td>0.6605</td>
</tr>
<tr>
<td>3/31</td>
<td>0.6757</td>
<td>0.6793</td>
<td></td>
</tr>
<tr>
<td>6/30</td>
<td>0.6669</td>
<td>0.6734</td>
<td></td>
</tr>
<tr>
<td>7/15</td>
<td>0.6761</td>
<td>0.6767</td>
<td></td>
</tr>
<tr>
<td>8/29</td>
<td>0.6798</td>
<td>0.6798</td>
<td></td>
</tr>
</tbody>
</table>

**55-109** Entity A would record the following journal entries.

<table>
<thead>
<tr>
<th>Debit (Credit)</th>
<th>Cash</th>
<th>Inventory</th>
<th>Forward Contract</th>
<th>Accounts Payable</th>
<th>Earnings</th>
<th>Accum. Other Comprehensive Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inception 1/14</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>March 31 entry (76 days):</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mark forward to fair value</td>
<td>$1,703</td>
<td>$1,703</td>
<td>$1,703</td>
<td>$1,703</td>
<td>$1,703</td>
<td>$1,703</td>
</tr>
</tbody>
</table>
June 30 entry (91 days):
Mark forward to fair value (526) 526

July 15 entries (15 days):
Inventory purchase $67,610 $ (67,610)

August 29 entries (45 days):
Mark forward to fair value 663 (663)
Functional currency transaction loss on payable (370) 370
Adjustment for paragraph 815-30-35-3(d)—offset the functional currency transaction loss (370) 370
Adjustment for paragraph 815-30-35-3(d)—effect of hedge (based on implicit interest rate; see paragraph 815-30-55-112) 78 (78)
Settlement of payable $ (67,980) 67,980
Settlement of forward 1,840 (1,840)

<table>
<thead>
<tr>
<th>Date</th>
<th>PV</th>
<th>FV</th>
<th>Daily Interest</th>
<th>1/14</th>
<th>3/31</th>
<th>6/30</th>
<th>7/15</th>
<th>8/29</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/14</td>
<td>$65,750</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3/31</td>
<td>65,880</td>
<td></td>
<td>$130</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6/30</td>
<td>66,036</td>
<td></td>
<td>$156</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7/15</td>
<td>66,062</td>
<td></td>
<td>26</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8/29</td>
<td>66,140</td>
<td></td>
<td>78</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

$390

Method using two foreign currency forward exchange rates:

From 1/14 to 7/15
7/15 Forward Rate .6605
$66,050 – $65,750 = $300

From 7/16 to 8/29
8/29 Forward Rate .6614
7.7.40 Examples of foreign currency cash flow value hedges

This section contains seven examples illustrating the application of the foreign currency cash flow hedging principles to the following hedging relationships.

— Cash flow hedge of variable-rate FCD debt with a variable to fixed cross-currency interest rate swap (variable-to-fixed scenario) (Example 7.7.20)
— Cash flow hedge of a forecasted FCD purchase with a forward contract (Example 7.7.30)
— Cash flow hedge of recognized FCD payable with a forward contract (Example 7.7.40)
— Single cash flow hedge with a foreign currency purchased option (Example 7.7.50)
— Cash flow hedge of foreign currency exposure in a royalty arrangement (Subtopic 815-30’s Example 11);
— Cash flow hedge of a fixed-rate FCD loan eliminating variability in the functional currency equivalent cash flows (fixed-to-fixed scenario) (Subtopic 815-30’s Example 13);
— Portions of a FCD financial asset or liability as hedged item (Subtopic 815-20’s Example 15).

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 7.7.20
Cash flow hedge of variable-rate FCD debt with a variable to fixed cross-currency interest rate swap (variable-to-fixed scenario)

ABC Corp.’s functional currency is the US dollar. On January 1, Year 1, ABC borrows 100,000 euro (€) at a variable rate of Euribor plus 50 basis points (bps). The debt is due on December 31, Year 1. Also on January 1, Year 1, ABC enters into a variable-to-fixed cross-currency interest rate swap (cross-currency swap) in which it will receive Euribor plus 50 bps on €100,000 and pay fixed US dollars at 6.373% on $102,000.
The swap matures on December 31, Year 1. There will be a final exchange of principal at maturity of the cross-currency swap (ABC will receive €100,000 and pay $102,000). The debt and the cross-currency swap will pay interest quarterly on March 31, June 30, September 30 and December 31.

ABC 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 currency exchange rates ($/€).

**Hedge effectiveness.** ABC assesses hedge effectiveness using the hypothetical derivative method. Because 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, ABC concludes that the hedge is highly effective. On an ongoing basis, ABC will ascertain and document that the critical terms of the cross-currency swap and the debt have not changed, including that there have been no adverse developments concerning the risk of default by the counterparty to the cross-currency swap or its own nonperformance risk, therefore not causing a different conclusion about hedge effectiveness.

The spot exchange rate for $/€, flat Euribor swap rate, and US LIBOR rate over the life of the hedge are as follows.

<table>
<thead>
<tr>
<th></th>
<th>January 1</th>
<th>March 31</th>
<th>June 30</th>
<th>September 30</th>
<th>December 31</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>
</tr>
<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>US LIBOR</td>
<td>6.000%</td>
<td>5.500%</td>
<td>6.000%</td>
<td>6.500%</td>
<td>7.000%</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></th>
<th>January 1</th>
<th>March 31</th>
<th>June 30</th>
<th>September 30</th>
<th>December 31</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>
</tr>
<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>

Note:  
1. €100,000 × spot rate.

The income statement effect of the debt and the cross-currency swap are as follows for each quarter ended period.
### Hedging foreign currency exposures

**March 31**  |  **June 30**  |  **September 30**  |  **December 31**
---|---|---|---
Interest expense\(^1\) (in €)  | €(1,415)  | €(1,413)  | €(1,385)  | €(1,339)
Interest expense\(^2\) (in $)  | $(1,517)  | $(1,515)  | $(1,561)  | $(1,587)
Swap interest settlement  | (108)  | (110)  | (64)  | (38)
Net interest expense\(^3\)  | $(1,625)  | $(1,625)  | $(1,625)  | $(1,625)

**Notes:**
1. Based on Euribor plus 50bps on €100,000. For example, interest for the period ended March 31 is \((5.160\% + 50 \text{ bps}) / 100 \times \frac{1}{4} \times €100,000 = €1,415\).
2. For simplicity, the variable euro interest expense is remeasured into the functional currency ($) at the spot exchange rate at the end of the quarter.
3. Interest expense + swap interest settlement.

### Journal entries – January 1, Year 1

ABC makes a memorandum entry on January 1, Year 1 to document the existence of the hedging relationship. There is no entry for the cross-currency swap because the contract is at market rates (i.e. fair value is zero).

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>102,000</td>
</tr>
<tr>
<td>Debt obligation</td>
<td>102,000</td>
</tr>
<tr>
<td><strong>To record €100,000 debt at spot rate of €1 = $1.02.</strong></td>
<td></td>
</tr>
</tbody>
</table>

### Journal entries – March 31, Year 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>1,517</td>
</tr>
<tr>
<td>Cash</td>
<td>1,517</td>
</tr>
<tr>
<td><strong>To record interest payment on euro debt at Euribor plus 50 bps. Remeasured at period end spot rates for simplicity.</strong></td>
<td></td>
</tr>
<tr>
<td>Other income/expense</td>
<td>5,230</td>
</tr>
<tr>
<td>Debt obligation</td>
<td>5,230</td>
</tr>
<tr>
<td><strong>To record spot remeasurement of debt to functional currency.</strong></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>108</td>
</tr>
<tr>
<td>Cash</td>
<td>108</td>
</tr>
<tr>
<td><strong>To record net interest cash payment on cross-currency swap.</strong></td>
<td></td>
</tr>
<tr>
<td>Cross-currency swap</td>
<td>4,911</td>
</tr>
<tr>
<td>OCI</td>
<td>4,911</td>
</tr>
</tbody>
</table>
### Hedging foreign currency exposures

#### Journal entries – June 30, Year 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>To record change in fair value of cross-currency swap.</td>
<td></td>
<td>AOCI</td>
<td>5,230</td>
</tr>
<tr>
<td>Other income/expense</td>
<td>5,230</td>
<td>Other income/expense</td>
<td></td>
</tr>
<tr>
<td>To reclassify amount out of AOCI to offset spot remeasurement loss on debt obligation.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>1,515</td>
</tr>
<tr>
<td>Cash</td>
<td>1,515</td>
</tr>
<tr>
<td>To record interest payment on euro debt at Euribor plus 50 bps. Remeasured at period end spot rates for simplicity.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>110</td>
</tr>
<tr>
<td>Cash</td>
<td>110</td>
</tr>
<tr>
<td>To record net interest cash payment on cross-currency swap.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cross-currency swap</td>
<td>376</td>
</tr>
<tr>
<td>OCI</td>
<td>376</td>
</tr>
<tr>
<td>To record change in fair value of cross-currency swap.</td>
<td></td>
</tr>
</tbody>
</table>

#### Journal entries – September 31, Year 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>1,561</td>
</tr>
<tr>
<td>Cash</td>
<td>1,561</td>
</tr>
<tr>
<td>To record interest payment on euro debt at Euribor plus 50 bps. Remeasured at period end spot rates for simplicity.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other income/expense</td>
<td>5,500</td>
</tr>
<tr>
<td>Debt obligation</td>
<td>5,500</td>
</tr>
<tr>
<td>To record spot remeasurement of debt to functional currency.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>64</td>
</tr>
<tr>
<td>Cash</td>
<td>64</td>
</tr>
<tr>
<td>To record net interest cash payment on cross-currency swap.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cross-currency swap</td>
<td>5,618</td>
</tr>
<tr>
<td>OCI</td>
<td>5,618</td>
</tr>
</tbody>
</table>
Hedging foreign currency exposures

### Journal entries – December 31, Year 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Interest expense</strong></td>
<td>1,587</td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td>1,587</td>
</tr>
<tr>
<td>To record interest payment on euro debt at Euribor plus 50 bps. Remeasured at period end spot rates for simplicity.</td>
<td></td>
</tr>
<tr>
<td><strong>Other income/expense</strong></td>
<td>5,780</td>
</tr>
<tr>
<td><strong>Debt obligation</strong></td>
<td>5,780</td>
</tr>
<tr>
<td>To record spot remeasurement of debt to functional currency.</td>
<td></td>
</tr>
<tr>
<td><strong>Interest expense</strong></td>
<td>38</td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td>38</td>
</tr>
<tr>
<td>To record net interest cash payment on cross-currency swap.</td>
<td></td>
</tr>
<tr>
<td><strong>Cross-currency swap</strong></td>
<td>5,605</td>
</tr>
<tr>
<td><strong>OCI</strong></td>
<td>5,605</td>
</tr>
<tr>
<td>To record change in fair value of cross-currency swap.</td>
<td></td>
</tr>
<tr>
<td><strong>AOCI</strong></td>
<td>5,780</td>
</tr>
<tr>
<td><strong>Other income/expense</strong></td>
<td>5,780</td>
</tr>
<tr>
<td>To reclassify amount out of AOCI to offset spot remeasurement loss on debt obligation.</td>
<td></td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td>16,510</td>
</tr>
<tr>
<td><strong>Cross-currency swap</strong></td>
<td>16,510</td>
</tr>
<tr>
<td>To record cash receipt on settlement of notional exchange of cross-currency swap.</td>
<td></td>
</tr>
<tr>
<td><strong>Debt obligation</strong></td>
<td>118,510</td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td>118,510</td>
</tr>
<tr>
<td>To record payment of €100,000 debt on maturity at spot rate of €1 = $1.1851.</td>
<td></td>
</tr>
</tbody>
</table>

**Note:**
1. Receive $118,510 (€100,000 x spot rate of €1 = $1.1851) and pay $102,000.
By using a cross-currency swap, ABC eliminates its foreign exchange and interest rate risk by locking in a forward rate on €100,000 at €1 = $1.02. This enables ABC to effectively settle its euro-denominated debt for a fixed US dollar amount ($102,000). ABC’s net cash payment at maturity of the debt is $102,000 ($118,510 - gain on the swap of $16,510).

ABC also converts the variable Euribor interest payments into a fixed US dollar amount based on 6.373% of $102,000, thereby hedging its exposure to changes in interest rates. As a result, the interest expense on the €100,000 debt, adjusted for the period swap interest settlement, totals $1,625 each quarter.

Example 7.7.30
Cash flow hedge of a forecasted FCD purchase with a forward contract

ABC Corp.’s functional currency is the US dollar. On January 14, Year 1 ABC forecasts the purchase of inventory on credit for 100,000 Swiss francs (CHF). The purchase is expected to occur July 15, Year 1. ABC enters into a foreign currency forward contract to purchase CHF100,000 at $0.6614 = CHF1. ABC designates a cash flow hedge of the functional currency equivalent cash flows from the date the purchase is forecasted to be probable through the purchase date.

Hedge effectiveness. ABC expects this hedging relationship to be perfectly effective since the critical terms of the forecasted transaction match the foreign currency forward contract. On an ongoing basis, ABC will ascertain and document that the critical terms of the forward contract and the forecasted purchase 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, therefore not causing a different conclusion about hedge effectiveness.

The spot and forward exchange rates for $/CHF over the life of the hedge are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot rate</th>
<th>July 15 forward rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 14</td>
<td>0.6575</td>
<td>0.6614</td>
</tr>
<tr>
<td>March 31</td>
<td>0.6757</td>
<td>0.6793</td>
</tr>
<tr>
<td>June 30</td>
<td>0.6689</td>
<td>0.6734</td>
</tr>
<tr>
<td>July 15</td>
<td>0.6761</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Journal entries – January 14, Year 1

ABC makes a memorandum entry on January 14, Year 1 to document the existence of the hedging relationship. There is no entry for the foreign currency forward because the contract is at market rates (i.e. fair value is zero).
### Journal entries – March 31, Year 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward contract¹</td>
<td>1,703</td>
</tr>
<tr>
<td>OCI</td>
<td>1,703</td>
</tr>
</tbody>
</table>

*To record change in fair value of foreign currency forward contract.*

**Note:**
1. CHF100,000 × (change in forward rates (0.6793 - 0.6614)) = $1,790 discounted to March 31 at an appropriate rate.

### Journal entries – June 30, Year 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI¹</td>
<td>526</td>
</tr>
<tr>
<td>Forward contract</td>
<td>526</td>
</tr>
</tbody>
</table>

*To record change in fair value of foreign currency forward contract.*

**Note:**
1. Current quarter fair value of $1,177 - prior quarter fair value of $1,703. Current quarter fair value is calculated as CHF100,000 × (change in forward rates (0.6734 - 0.6614)) = $1,200 discounted to June 30 at an appropriate rate.

### Journal entries – July 15, Year 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>67,610</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>67,610</td>
</tr>
</tbody>
</table>

*To record purchase of inventory at spot rate of CHF1 = $0.6761.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward contract¹</td>
<td>293</td>
</tr>
<tr>
<td>OCI</td>
<td>293</td>
</tr>
</tbody>
</table>

*To record change in fair value of foreign currency forward contract.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,470</td>
</tr>
<tr>
<td>Forward contract</td>
<td>1,470</td>
</tr>
</tbody>
</table>

*To record payment received by ABC to settle gain on foreign currency forward contract.*

**Note:**
1. Current quarter fair value of $1,470 - prior quarter fair value of $1,177. Current quarter fair value is calculated as CHF100,000 × (change in forward rates (0.6761 - 0.6614)) = $1,470.

ABC recorded inventory of $67,610 (based on the July 15, Year 1 spot rate). The amount at July 15, Year 1 in AOCI of $1,470 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 rate of $0.6614 = CHF1 that ABC locked in at January 14, Year 1.

Example 7.7.40
Cash flow hedge of recognized FCD payable with a forward contract

ABC Corp.’s functional currency is the US dollar. On January 1, Year 1 ABC purchases inventory on credit for 100,000 Swiss francs (CHF). The payment is due April 30, Year 1. ABC enters into a forward contract to purchase CHF100,000 at CHF1 = $0.6614. ABC designates a cash flow hedge of the functional currency equivalent cash flows through the payment date of April 30, Year 1.

Hedge effectiveness. ABC expects this hedging relationship to be perfectly effective because the critical terms of the FCD payable match the foreign currency forward contract. ABC assesses effectiveness by verifying and documenting that the critical terms have not changed during the review period.

ABC will recognize the spot-forward premium (cost) of $390 on the forward contract based on the implicit interest rate of the forward contract recognized on a pro rata basis over the hedging relationship.

The spot and forward rates for $/CHF over the life of the hedge are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot rate</th>
<th>April 30 forward rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1</td>
<td>0.6575</td>
<td>0.6614</td>
</tr>
<tr>
<td>March 31</td>
<td>0.6757</td>
<td>0.6793</td>
</tr>
<tr>
<td>April 30</td>
<td>0.6761</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Journal entries – January 1, Year 1

ABC makes a memorandum entry on January 1, Year 1 to document the existence of the hedging relationship. There is no entry for the foreign currency forward because the contract is at market rates (i.e. fair value is zero).

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>65,750</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>65,750</td>
</tr>
</tbody>
</table>

To record purchase of inventory at spot rate of CHF1 = $0.6565

Journal entries – March 31, Year 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other income/expense¹</td>
<td>1,820</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>1,820</td>
</tr>
</tbody>
</table>

To record spot remeasurement of accounts payable to functional currency.
### 7. Hedging foreign currency exposures

**Hedging**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward contract²</td>
<td>1,780</td>
</tr>
<tr>
<td>OCI</td>
<td>1,780</td>
</tr>
</tbody>
</table>

*To record change in fair value of foreign currency forward contract.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI</td>
<td>1,820</td>
</tr>
<tr>
<td>Other income/expense</td>
<td>1,820</td>
</tr>
</tbody>
</table>

*To reclassify amount out of AOCI to offset spot remeasurement adjustment.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI</td>
<td>292</td>
</tr>
<tr>
<td>Other income/expense³</td>
<td>292</td>
</tr>
</tbody>
</table>

*To reclassify portion of forward premium on foreign currency forward contract attributable to hedging period (rounded).*

**Notes:**
1. CHF100,000 × (change in spot rates (0.6757 - 0.6575)).
2. CHF100,000 × (change in forward rates (0.6793 - 0.6614)) = $1,790 discounted to March 31 at an appropriate rate.
3. $390 premium × 90/120 days.

### Journal entries – April 30, Year 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other income/expense¹</td>
<td>40</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>40</td>
</tr>
</tbody>
</table>

*To record spot remeasurement of accounts payable to functional currency.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI²</td>
<td>310</td>
</tr>
<tr>
<td>Forward</td>
<td>310</td>
</tr>
</tbody>
</table>

*To record change in fair value of foreign currency forward contract.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI</td>
<td>40</td>
</tr>
<tr>
<td>Other income/expense</td>
<td>40</td>
</tr>
</tbody>
</table>

*To reclassify amount out of AOCI to offset spot remeasurement adjustment.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other income/expense³</td>
<td>98</td>
</tr>
<tr>
<td>OCI</td>
<td>98</td>
</tr>
</tbody>
</table>

*To reclassify portion of forward premium on foreign currency forward contract attributable to the hedging period (rounded).*
### Example 7.7.50

**Single cash flow hedge with a foreign currency purchased option**

ABC Corp.'s functional currency is the US dollar. On December 31, Year 1, ABC forecasts the sale of inventory on credit for 10,000,000 Australian dollars (A$) on February 15, Year 2 with settlement of the receivable on April 15, Year 2.

ABC purchases a foreign currency European style put option that gives it the right to sell A$10,000,000 on April 15, Year 2, for $5,000,000. The terms of the purchased put option are as follows.

<table>
<thead>
<tr>
<th>Contract amount</th>
<th>A$10,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expiration date</td>
<td>April 15, Year 2</td>
</tr>
<tr>
<td>Put option strike price</td>
<td>A$2 = $1</td>
</tr>
<tr>
<td>Spot rate</td>
<td>A$2 = $1</td>
</tr>
<tr>
<td>Premium</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Because the option is purchased at the money, the premium on December 31, Year 1 reflects the option's time value only. The option can be exercised only on its expiration date. It is designated as a single cash flow hedge that encompasses the variability of functional currency equivalent cash flows attributable to foreign currency exchange risk related to:

— forecasted sale of inventory on credit on February 15, Year 2; and
Hedging foreign currency exposures

ABC defines its foreign currency risk as being in one direction because it wishes to preserve its functional currency equivalent cash flows when the exchange rate increases above A$2.00 = $1 – that is, the option will be exercised if the A$/US$ rate increases above the strike price of A$2.00 = $1. Specifically, as the functional currency equivalent cash flows of $5,000,000 decrease, the pay-off amount of the option will compensate ABC for the difference.

ABC ascertains that the conditions in paragraph 815-20-25-129 have been met such that the hedging relationship is considered perfectly effective (see section 9.7.20).

The assumed spot exchange rates and fair value of the option are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot rate (A$/US$)</th>
<th>Fair value</th>
<th>Change in fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, Year 1</td>
<td>2.00</td>
<td>$20,000</td>
<td>$</td>
</tr>
<tr>
<td>January 31, Year 1</td>
<td>2.10</td>
<td>253,095</td>
<td>233,095</td>
</tr>
<tr>
<td>February 15, Year 2</td>
<td>2.05</td>
<td>133,951</td>
<td>(119,144)</td>
</tr>
<tr>
<td>March 31, Year 2</td>
<td>1.90</td>
<td>3,000</td>
<td>(130,951)</td>
</tr>
<tr>
<td>April 15, Year 2</td>
<td>2.30</td>
<td>652,174</td>
<td>649,174</td>
</tr>
</tbody>
</table>

**Journal entries – December 31, Year 1**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchased put option</td>
<td>20,000</td>
</tr>
<tr>
<td>Cash</td>
<td>20,000</td>
</tr>
</tbody>
</table>

*To record purchase of put option at fair value.*

**Journal entries – January 31, Year 2**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchased put option</td>
<td>233,095</td>
</tr>
<tr>
<td>OCI</td>
<td>233,095</td>
</tr>
</tbody>
</table>

*To record change in fair value of put option.*

**Journal entries – February 15, Year 2**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI</td>
<td>119,144</td>
</tr>
<tr>
<td>Purchased put option</td>
<td>119,144</td>
</tr>
</tbody>
</table>

*To record change in fair value of put option.*
### 7. Hedging foreign currency exposures

**Debit** | **Credit**
---|---
Accounts receivable | 4,878,049
Revenue | 4,878,049

*To record sale of inventory on credit at spot rate of A$2.05 = $1 (rounded).*

**AOCI\(^1\)** | **Revenue**
---|---
121,951 | 121,951

*To reclassify amount out of AOCI for portion of change in fair value of put option to effectively lock in the hedge level (rounded).*

**Revenue\(^2\)** | **AOCI**
---|---
8,762 | 8,762

*To reclassify portion of put option premium attributable to forecast period (rounded).*

**Notes:**
1. \((A$10,000,000 \div A$2.00) - (A$10,000,000 \div A$2.05).\)
2. Put option premium of $20,000 × (46 day forecast period ÷ 105 day option term).

#### Journal entries – March 31, Year 2

**Debit** | **Credit**
---|---
OCI | 130,951
Purchased put option | 130,951

*To record change in fair value of put option.*

**Accounts receivable\(^1\)** | **Other income/expense**
---|---
385,109 | 385,109

*To record spot remeasurement of accounts receivable to functional currency (rounded).*

**Other income/expense\(^2\)** | **AOCI**
---|---
121,951 | 121,951

*To reclassify amount out of AOCI for portion of change in fair value of put option to offset spot remeasurement adjustment. Amount limited to defined hedge exchange rate of A$2.00 = $1 (rounded).*

**Other income/expense\(^3\)** | **AOCI**
---|---
8,381 | 8,381

*To reclassify portion of put option premium attributable to period of recognized receivable (rounded).*

**Notes:**
1. \((A$10,000,000 \div A$1.90) - (A$10,000,000 \div A$2.05).\)
Hedging foreign currency exposures

2. \((\text{A}\$10,000,000 \div \text{A}\$2.05) - (\text{A}\$10,000,000 \div \text{A}\$2.00)\). This amount is limited to the defined hedged exchange rate of \(\text{A}\$2.00 = \$1\) because ABC is only hedging against an increase in the rate – i.e. if the rate exceeds \(\text{A}\$2.00\). Because the exchange rate changes from \(\text{A}\$2.05 = \$1\) to \(\text{A}\$1.90 = \$1\), this adjustment only offsets the movement from \(\text{A}\$2.05\) to \(\text{A}\$2.00\) per \$1.

3. Put option premium of \(\$20,000 \times (44 \text{ days} \div 105 \text{ day option term})\).

### Journal entries – April 15, Year 2

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchased put option</td>
<td>649,174</td>
</tr>
<tr>
<td>OCI</td>
<td>649,174</td>
</tr>
<tr>
<td>To record change in fair value of put option.</td>
<td></td>
</tr>
<tr>
<td>Other income/expense(^1)</td>
<td>915,332</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>915,332</td>
</tr>
<tr>
<td>To record spot remeasurement of accounts receivable to functional currency (rounded).</td>
<td></td>
</tr>
<tr>
<td>AOCI(^2)</td>
<td>652,174</td>
</tr>
<tr>
<td>Other income/expense</td>
<td>652,174</td>
</tr>
<tr>
<td>To reclassify amount out of AOCI for portion of change in fair value of put option to offset spot remeasurement adjustment.</td>
<td></td>
</tr>
<tr>
<td>Other income/expense(^3)</td>
<td>2,857</td>
</tr>
<tr>
<td>AOCI</td>
<td>2,857</td>
</tr>
<tr>
<td>To reclassify portion of put option premium attributable to period of recognized receivable (rounded).</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>4,347,826</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>4,347,826</td>
</tr>
<tr>
<td>To record settlement of FCD receivable at spot rate of (\text{A}$2.30 = $1).</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>652,174</td>
</tr>
<tr>
<td>Purchased put option</td>
<td>652,174</td>
</tr>
<tr>
<td>To record cash receipt on exercise of put option by ABC.</td>
<td></td>
</tr>
</tbody>
</table>

### Notes:

1. \((\text{A}\$10,000,000 \div \text{A}\$2.30) - (\text{A}\$10,000,000 \div \text{A}\$1.90)\).

2. \((\text{A}\$10,000,000 \div \text{A}\$2.30) - (\text{A}\$10,000,000 \div \text{A}\$2.00)\). This amount is limited to the increase above the defined hedged exchange rate of \(\text{A}\$2.00 = \$1\) because ABC is only hedging against an increase in the rate. Even though the rate changed from \(\text{A}\$1.90 = \$1\) to \(\text{A}\$2.30 = \$1\), the change in the fair value of the put option that is considered effective is the change from \(\text{A}\$2.00\) to \(\text{A}\$2.30\) per \$1.

3. Put option premium of \(\$20,000 \times (15 \text{ days} \div 105 \text{ day option term})\).
A single cash flow hedge of a forecasted sale on credit hedges two items: the forecasted sale until the date of sale, and the FCD receivable until settlement. Therefore, the gain or loss on the put option is recognized in revenue during the forecast period and in other income/expense when the FCD receivable is outstanding.

Upon sale of the inventory, ABC records revenue of $4,878,049 (based on the February 15, Year 1 spot rate) and reclassifies $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 is also recognized in earnings at this time.

The net effect in ABC’s income statement for this sale in Australian dollars, collection of the Australian dollar-denominated receivable and related hedging option is $4,980,000. This amount is based on the put option’s exchange rate of A$2.00 = $1, which fixes the functional currency amount of the A$10,000,000 sale and collection at $5,000,000 less the option’s premium of $20,000. ABC is not exposed to the increase in the A$/$/ exchange rate above A$2.00 = $1 because it effectively hedged its exposure.

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**Excerpt from ASC 815-30**

**Example 11: Cash Flow Hedge of the Foreign Currency Exposure in a Royalty Arrangement**

This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to a hedging relationship involving a single hedging derivative and three separate forecasted transactions. The three transactions occur on three separate dates, but the payment on receivables related to all three occurs on the same date. The settlement of the hedging derivative will occur on the date the receivable is paid. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

Entity DEF’s functional currency is the U.S. dollar (USD). Entity ZYX’s functional currency is the euro (EUR). Effective January 1, 20X1, Entity DEF enters into a royalty agreement with Entity ZYX that gives Entity ZYX the right to use Entity DEF’s technology in manufacturing Product X. On April 30, 20X1, Entity ZYX will pay Entity DEF a royalty of EUR 1 million for each unit of Product X sold by that date. Entity DEF expects Entity ZYX to sell one unit of Product X on January 31, one on February 28, and one on March 31. The forecasted royalty is probable because Entity ZYX has identified a demand for Product X and no other supplier has the capacity to fill that demand.

Also on January 1, 20X1, Entity DEF enters into a forward contract to sell EUR 3 million on April 30, 20X1, for a price equal to the forward price of USD 0.6057 per EUR. Entity DEF designates the forward contract as a hedge of the risk of changes in its functional-currency-equivalent cash flows attributable to changes in the EUR-USD exchange rates related to the forecasted receipt of EUR 3 million from the royalty agreement. The spot price and forward price of
Hedging foreign currency exposures

EUR at January 1, 20X1, and the USD equivalent of EUR 3 million at those prices are assumed to be as follows.

<table>
<thead>
<tr>
<th>Prices at January 1, 20X1</th>
<th>USD per EUR</th>
<th>USD Equivalent of EUR 3 Million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spot price</td>
<td>USD 0.6019</td>
<td>USD 1,805,700</td>
</tr>
<tr>
<td>4-month forward price</td>
<td>USD 0.6057</td>
<td>1,817,100</td>
</tr>
</tbody>
</table>

55-70 Entity DEF will exclude from its assessment of effectiveness the portion of the fair value of the forward contract attributable to the spot-forward difference (the difference between the spot exchange rate and the forward exchange rate). Entity DEF elects to recognize changes in that portion of the derivative instrument’s fair value currently in earnings in accordance with paragraph 815-20-25-83B. Entity DEF will estimate the cash flows on the forecasted transactions based on the current spot exchange rate and will discount that amount. Thus, Entity DEF will assess effectiveness by comparing the following amounts:

a. Changes in the fair value of the forward contract attributable to changes in the USD spot price of EUR
b. Changes in the present value of the forecasted cash flows based on the current spot exchange rate.

55-71 Those two changes will exactly offset because the currency and the notional amount of the forward contract match the currency and the total of the expected foreign currency amounts of the forecasted transactions. Thus, if Entity DEF dedesignates a proportion of the forward contract each time a royalty is recognized (as described in the following paragraph), the hedging relationship will meet the highly effective criterion.

55-72 As each royalty is recognized, Entity DEF recognizes a receivable and royalty income. The forecasted transaction (the recognition of royalty income) has occurred. The receivable is an asset, not a forecasted transaction, and would separately be eligible to be designated as a fair value hedge of foreign exchange risk or continue to be eligible as a cash flow hedge of foreign exchange risk. Consequently, if the variability of the functional currency cash flows related to the royalty receivable is not being hedged, Entity DEF will dedesignate a proportion of the hedging instrument in the original hedging relationship with respect to the proportion of the forward contract corresponding to the recognized royalty. As the royalty is recognized in earnings and each proportion of the derivative instrument is dedesignated, the related derivative instrument gain or loss in accumulated other comprehensive income is reclassified into earnings and presented in the same income statement line item as the earnings effect of the hedged item. After that date, any gain or loss on the dedesignated proportion of the derivative instrument and any transaction loss or gain on the royalty receivable will be recognized in earnings and may substantially offset each other.

55-73 Subtopic 830-20 requires immediate recognition in earnings of any foreign currency transaction gain or loss on a foreign-currency-denominated receivable that is not designated as a hedging instrument. Therefore, the effect of changes in spot prices on the royalty receivable must be recognized immediately in earnings.
The spot prices and forward prices for settlement on April 30, 20X1, in effect at inception of the hedge (January 1, 20X1) and at the end of each month between inception and April 30, 20X1, are assumed to be as follows.

<table>
<thead>
<tr>
<th>USD per EUR</th>
<th>Spot Price</th>
<th>Forward Price for Settlement on 4/30/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1</td>
<td>USD 0.6019</td>
<td>USD 0.6057</td>
</tr>
<tr>
<td>January 31</td>
<td>0.5970</td>
<td>0.6000</td>
</tr>
<tr>
<td>February 28</td>
<td>0.5909</td>
<td>0.5926</td>
</tr>
<tr>
<td>March 31</td>
<td>0.5847</td>
<td>0.5855</td>
</tr>
<tr>
<td>April 30</td>
<td>0.5729</td>
<td>0.5729</td>
</tr>
</tbody>
</table>

The changes in fair value of the forward contract that are recognized each month in earnings and other comprehensive income are shown in the following table. Amounts reclassified from accumulated other comprehensive income to earnings and amounts excluded from the assessment of hedge effectiveness are presented in the same income statement line item as the earnings effect of the hedged item. The fair value of the forward is the present value of the difference between the USD to be received on the forward (USD 1,817,100) and the USD equivalent of EUR 3 million based on the current forward rate. A 6 percent discount rate is used in this Example.

<table>
<thead>
<tr>
<th>Debit (Credit)</th>
<th>Forward Contract</th>
<th>Earnings</th>
<th>Other Comprehensive Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value on January 1</td>
<td>$ -</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Period ended January 31:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in spot-forward difference</td>
<td>2,364</td>
<td>$ (2,364)</td>
<td></td>
</tr>
<tr>
<td>Change in fair value of dedesignated proportion</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Change in fair value of designated proportion</td>
<td>14,482</td>
<td>$ (14,482)</td>
<td>4,827</td>
</tr>
<tr>
<td>Reclassification of gain</td>
<td>-</td>
<td>(4,827)</td>
<td>4,827</td>
</tr>
<tr>
<td>Fair value on January 31</td>
<td>16,846</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Period ended February 28:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in spot-forward difference</td>
<td>3,873</td>
<td>(3,873)</td>
<td></td>
</tr>
<tr>
<td>Change in fair value of designated proportion</td>
<td>6,063</td>
<td>(6,063)</td>
<td></td>
</tr>
<tr>
<td>Reclassification of gain</td>
<td>12,127</td>
<td>(12,127)</td>
<td></td>
</tr>
<tr>
<td>Fair value on February 28</td>
<td>38,909</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Period ended March 31:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in spot-forward difference</td>
<td>2,718</td>
<td>(2,718)</td>
<td></td>
</tr>
<tr>
<td>Change in fair value of designated proportion</td>
<td>12,448</td>
<td>(12,448)</td>
<td></td>
</tr>
<tr>
<td>Reclassification of gain</td>
<td>6,223</td>
<td>$ (6,223)</td>
<td></td>
</tr>
<tr>
<td>Fair value on March 31</td>
<td>60,298</td>
<td>(17,114)</td>
<td>17,114</td>
</tr>
<tr>
<td>Period ended April 30:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in spot-forward difference</td>
<td>2,445</td>
<td>(2,445)</td>
<td></td>
</tr>
</tbody>
</table>
55-76 The effect on earnings of the royalty agreement and hedging relationship illustrated in this Example is summarized by month in the following table.

<table>
<thead>
<tr>
<th>Period Ended</th>
<th>Amounts Recognized in Earnings Related to</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Receivable</td>
</tr>
<tr>
<td></td>
<td>USD Equivalent of EUR 1 Million Royalty</td>
</tr>
<tr>
<td>January 31</td>
<td>$ 597,000</td>
</tr>
<tr>
<td>February 28</td>
<td>590,900</td>
</tr>
<tr>
<td>March 31</td>
<td>584,700</td>
</tr>
<tr>
<td>April 30</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>$ 1,772,600</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Excerpt from ASC 815-30


55-81 This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to accounting for a cash flow hedge of a fixed-rate foreign-currency-denominated debt in which all of the variability in the functional-currency-equivalent cash flows are eliminated by the effect of the hedge.

55-82 On July 1, 20X1, Entity DEF, a U.S. dollar (USD) functional currency entity, issues a zero-coupon debt instrument with a notional amount of FC 154,766.79 for FC 96,098.00. The interest rate implicit in the debt is 10 percent. The debt will mature on June 30, 20X6. Entity DEF enters into a forward contract to buy FC 154,766.79 in 5 years at the forward rate of 1.090148194 (USD 168,718.74) and designates the forward contract as a hedge of the variability of the USD 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 the hedging relationship will achieve perfect offset. The USD interest rate implicit in the
forward contract is 11.028 percent. The market data, period end balances, and journal entries from cash flow hedge accounting are as follows.

<table>
<thead>
<tr>
<th>Period</th>
<th>Spot Rate USD/Functional Currency</th>
<th>Forward Rate USD/Functional Currency</th>
<th>Forward Rate Difference</th>
<th>Foreign Currency Present Value</th>
<th>USD Spot Amounts</th>
<th>USD Debt (@11.028%)</th>
<th>Fair Value Forward USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>1.040604383</td>
<td>1.090148194</td>
<td>0</td>
<td>$96,098.00</td>
<td>$100,000.00</td>
<td>$100,000.00</td>
<td>$-</td>
</tr>
<tr>
<td>1</td>
<td>1.1</td>
<td>1.184985966</td>
<td>0.094837771</td>
<td>105,707.80</td>
<td>116,278.58</td>
<td>111,028.04</td>
<td>9,327.97</td>
</tr>
<tr>
<td>2</td>
<td>1.1</td>
<td>1.163142906</td>
<td>0.072994712</td>
<td>116,278.58</td>
<td>127,906.44</td>
<td>123,272.25</td>
<td>8,041.09</td>
</tr>
<tr>
<td>3</td>
<td>1.1</td>
<td>1.141702484</td>
<td>0.051554290</td>
<td>127,906.44</td>
<td>140,697.08</td>
<td>136,866.76</td>
<td>6,360.72</td>
</tr>
<tr>
<td>4</td>
<td>1.1</td>
<td>1.120857277</td>
<td>0.030509083</td>
<td>140,697.08</td>
<td>154,766.79</td>
<td>151,960.48</td>
<td>4,215.89</td>
</tr>
<tr>
<td>5</td>
<td>1.1</td>
<td>1.009851806</td>
<td>0.009851806</td>
<td>154,766.79</td>
<td>170,243.47</td>
<td>168,718.74</td>
<td>1,524.73</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Period</th>
<th>Cash</th>
<th>Forward</th>
<th>Debt</th>
<th>Other Comprehensive Income</th>
<th>Interest Expense</th>
<th>Transaction Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/1/20X1</td>
<td>Borrow money</td>
<td>$100,000.00</td>
<td>$100,000.00</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6/30/20X2</td>
<td>Accrue interest on debt</td>
<td>$10,570.78</td>
<td>$10,570.78</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6/30/20X2</td>
<td>Mark debt to spot</td>
<td>$(5,707.80)</td>
<td>$(5,707.80)</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6/30/20X2</td>
<td>Mark forward to fair value</td>
<td>$9,327.97</td>
<td>$(4,077.43)</td>
<td>$457.26</td>
<td>$5,707.80</td>
<td>-</td>
</tr>
<tr>
<td>6/30/20X2</td>
<td>Balances</td>
<td>$100,000.00</td>
<td>$9,327.97</td>
<td>$(116,278.58)</td>
<td>$(4,077.43)</td>
<td>$11,028.04</td>
</tr>
<tr>
<td>6/30/20X3</td>
<td>Accrue interest on debt</td>
<td>$(11,627.96)</td>
<td>$11,627.96</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6/30/20X3</td>
<td>Mark forward to fair value</td>
<td>$(1,286.88)</td>
<td>$670.53</td>
<td>$616.35</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6/30/20X3</td>
<td>Balances</td>
<td>$100,000.00</td>
<td>$8,041.08</td>
<td>$(127,906.44)</td>
<td>$(3,406.90)</td>
<td>$23,272.25</td>
</tr>
<tr>
<td>6/30/20X4</td>
<td>Accrue interest on debt</td>
<td>$(12,790.64)</td>
<td>$12,790.64</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6/30/20X4</td>
<td>Mark forward to fair value</td>
<td>$(1,680.37)</td>
<td>$876.50</td>
<td>$803.87</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6/30/20X4</td>
<td>Balances</td>
<td>$100,000.00</td>
<td>$6,360.71</td>
<td>$(140,697.08)</td>
<td>$(2,530.40)</td>
<td>$36,866.76</td>
</tr>
<tr>
<td>6/30/20X5</td>
<td>Accrue interest on debt</td>
<td>$14,069.71</td>
<td>$14,069.71</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6/30/20X5</td>
<td>Mark forward to fair value</td>
<td>$(2,144.94)</td>
<td>$1,129.03</td>
<td>$1,024.01</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6/30/20X5</td>
<td>Balances</td>
<td>$100,000.00</td>
<td>$4,215.98</td>
<td>$(154,766.79)</td>
<td>$(1,409.57)</td>
<td>$51,960.48</td>
</tr>
<tr>
<td>6/30/20X6</td>
<td>Accrue interest on debt</td>
<td>$(15,476.68)</td>
<td>$15,476.68</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6/30/20X6</td>
<td>Mark forward to fair value</td>
<td>$(2,691.15)</td>
<td>$1,409.57</td>
<td>$1,281.58</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6/30/20X6</td>
<td>Balances</td>
<td>$100,000.00</td>
<td>$1,524.72</td>
<td>$(170,243.47)</td>
<td>$(457.26)</td>
<td>$68,718.74</td>
</tr>
</tbody>
</table>

55-83 Following are journal entries at inception of the loan and at the end of the first year.

**7/1/20X1**

**Debit**

<table>
<thead>
<tr>
<th>Cash</th>
<th>$100,000.00</th>
</tr>
</thead>
</table>

**Credit**

<table>
<thead>
<tr>
<th>Functional currency debt at spot</th>
<th>$100,000.00</th>
</tr>
</thead>
</table>

To record FC borrowing in USD.

**6/30/20X2**

**Debit**

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>$10,570.78</th>
</tr>
</thead>
</table>

**Credit**

<table>
<thead>
<tr>
<th>Debt</th>
<th>$10,570.78</th>
</tr>
</thead>
</table>

To accrue interest. Period and spot rate used for simplicity.

**Transaction loss**

<table>
<thead>
<tr>
<th>$5,707.80</th>
</tr>
</thead>
</table>

**Debt**

<table>
<thead>
<tr>
<th>$5,707.80</th>
</tr>
</thead>
</table>

To record a transaction loss on the debt.

**Derivative asset**

<table>
<thead>
<tr>
<th>$9,327.97</th>
</tr>
</thead>
</table>
Hedging foreign currency exposures

<table>
<thead>
<tr>
<th>Other comprehensive income</th>
<th>$ 9,327.97</th>
</tr>
</thead>
<tbody>
<tr>
<td>To record a derivative instrument at fair value and record the gain on the derivative in other comprehensive income.</td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>$ 5,250.54</td>
</tr>
<tr>
<td>Interest expense</td>
<td>457.26</td>
</tr>
<tr>
<td>Transaction gain/loss</td>
<td>$ 5,707.80</td>
</tr>
</tbody>
</table>

To reclassify an amount out of accumulated other comprehensive income to do both of the following:

a. To increase interest expense to the USD yield of 11.028 percent.
b. To offset the transaction loss on the debt.

55-84 Journal entries for the remaining four years are not displayed.
55-85 This Example would also be relevant for a non-interest-bearing foreign-currency-denominated receivable or payable instrument. An amount based on the rate implicit in the forward contract would be reported in earnings each period. Given the short maturities of many receivables and payables, the amount reported in earnings each period may be small.

---

Excerpt from ASC 815-20

>> Example 15: Portions of a Foreign-Currency-Denominated Financial Asset or Liability as Hedged Item

55-141 The following Cases illustrate the application of paragraph 815-20-25-41 to fixed-rate and variable-rate foreign-currency-denominated debt:

a. Foreign-currency-denominated fixed-rate debt (Case A)
b. Foreign-currency-denominated variable-rate debt (Case B).

55-142 Specifically, for each of the eight situations presented collectively in Cases A (see paragraph 815-20-55-143) and B (see paragraph 815-20-55-153), an entity can use cash flow hedge accounting to hedge the variability in the specific principal repayments, interest cash flows, or both by applying the guidance in paragraph 815-30-35-3(d) to the specifically identified hedged cash flows. Only an amount that would offset the transaction gain or loss arising from the remeasurement of a hedged cash flow would be reclassified each period from other comprehensive income to earnings. Also, the change in the fair value of the forward points (time value) attributable to the hedged future cash flows would be reported in other comprehensive income, while the change in the fair value of the forward points (time value) attributable to the unhedged future cash flows would be reported in earnings.

>>> Case A: Foreign-Currency-Denominated Fixed-Rate Debt

55-143 Entity ABC, a U.S. dollar (USD) functional entity, issues a five-year foreign-currency-denominated fixed-rate debt obligation that requires interest payments and partial principal payments annually in the foreign currency with the remaining principal due at the end of five years (maturity) in the foreign currency. More specifically, Entity ABC issues an FC 45 million debt obligation
Hedging

7. Hedging foreign currency exposures

on December 31, 20X0, with FC 5 million due on December 31 of each of the next 4 years and FC 25 million due on December 31, 20X5. Interest payments at 10 percent are paid annually.

55-144 In this Case, Entity ABC can use cash flow hedge accounting to hedge the variability in its functional-currency-equivalent cash flows associated with any of the following:

a. All of the payments of both principal and interest of the debt
b. All of the payments of principal of the debt
c. All or a fixed portion of selected payments of either principal or interest of the debt (such as either principal or interest payments on December 31, 2001, and December 31, 2003)
d. Selected payments of both principal and interest of the debt (such as principal and interest payments on December 31, 2001, and December 31, 2003).

55-145 For instance, Entity ABC could use a receive-fixed-rate, pay-fixed rate cross-currency interest rate swap or a series of forward contracts to eliminate variability attributable to foreign exchange rates.

55-146 The following illustrates the second option, hedging the variability in all principal cash flows attributable to foreign exchange risk.

55-147 Entity ABC enters into the following five forward contracts to hedge all principal cash flows:

a. Forward contract to purchase FC 5,000 on December 31, 20X1, at a forward rate of 1.05061019
b. Forward contract to purchase FC 5,000 on December 31, 20X2, at a forward rate of 1.06061601
c. Forward contract to purchase FC 5,000 on December 31, 20X3, at a forward rate of 1.07066924
d. Forward contract to purchase FC 5,000 on December 31, 20X4, at a forward rate of 1.08076989
e. Forward contract to purchase FC 25,000 on December 31, 20X5, at a forward rate of 1.090871.

55-148 Exchange rates are as follows.

<table>
<thead>
<tr>
<th>Period</th>
<th>Spot</th>
<th>12/31/X1 Forward</th>
<th>12/31/X2 Forward</th>
<th>12/31/X3 Forward</th>
<th>12/31/X4 Forward</th>
<th>12/31/X5 Forward</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/X0</td>
<td>1.04060438</td>
<td>1.05061019</td>
<td>1.06061601</td>
<td>1.07066924</td>
<td>1.08076989</td>
<td>1.090871</td>
</tr>
<tr>
<td>12/31/X1</td>
<td>1.1</td>
<td>1.12125604</td>
<td>1.14271548</td>
<td>1.16448149</td>
<td>1.18655697</td>
<td>1.18655697</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>1.1</td>
<td>1.12125604</td>
<td>1.14271548</td>
<td>1.16448149</td>
<td>1.18655697</td>
<td>1.18655697</td>
</tr>
<tr>
<td>12/31/X3</td>
<td>1.1</td>
<td>1.12125604</td>
<td>1.14271548</td>
<td>1.16448149</td>
<td>1.18655697</td>
<td>1.18655697</td>
</tr>
<tr>
<td>12/31/X4</td>
<td>1.1</td>
<td>1.12125604</td>
<td>1.14271548</td>
<td>1.16448149</td>
<td>1.18655697</td>
<td>1.18655697</td>
</tr>
<tr>
<td>12/31/X5</td>
<td>1.1</td>
<td>1.12125604</td>
<td>1.14271548</td>
<td>1.16448149</td>
<td>1.18655697</td>
<td>1.18655697</td>
</tr>
</tbody>
</table>

55-149 Entity ABC would make the following journal entries.

<table>
<thead>
<tr>
<th>Debit (Credit)</th>
<th>Cash</th>
<th>Forward Contracts</th>
<th>Note Payable</th>
<th>Income or Expense</th>
<th>Accum. Other Comprehensive Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inception 12/31/X0</td>
<td>46,827</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>December 31, 20X1 entries:</td>
<td>(46,827)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Hedging

7. Hedging foreign currency exposures

Hedging foreign currency exposures

Repayment of principal (5,500) 5,203 297
Payment of interest (4,950) 4,960
Transaction loss on note payable (2,376) 2,376
Fair value of forward contract #1 247 (247)
Settlement of forward #1 247 (247)
Offset $247 of loss on principal ($50 related to cost of hedge remains in earnings) (247) 247

Debit (Credit)

<table>
<thead>
<tr>
<th>Fair value of forward contracts</th>
<th>Cash</th>
<th>Forward Contracts</th>
<th>Note Payable</th>
<th>Income or Expense</th>
<th>Accum. Other Comprehensive Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>#2-5 (based on 6% discount rate)</td>
<td></td>
<td>2,853</td>
<td></td>
<td></td>
<td>(2,853)</td>
</tr>
<tr>
<td>Paragraph 815-30-35-3(d)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>adjustment—offset the transaction loss related to principal</td>
<td></td>
<td>(1,734)</td>
<td>1,734</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Paragraph 815-30-35-3(d)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>adjustment—effect of hedge</td>
<td></td>
<td>396</td>
<td></td>
<td></td>
<td>(396)</td>
</tr>
</tbody>
</table>

December 31, 20X2 entries:

Repayment of principal (5,500) 5,203 297
Payment of interest (4,400) 4,400
Fair value of forward contract #2 (89) 89
Settlement of forward #2 197 (197)
Offset $197 of loss on principal ($100 related to cost of hedge remains in earnings) (197) 197
Fair value of forward contracts #3-5 (based on 6% discount rate) (507) 507
Paragraph 815-30-35-3(d) adjustment—effect of hedge 299 (299)
Change in time value related to principal goes to other comprehensive income or change in time value related to interest goes to earnings(a) 297 (180) (117)

December 31, 20X3 entries:

Repayment of principal (5,500) 5,203 297
Payment of interest (3,850) (3,850)
Fair value of forward contract #3 (92) 92
Settlement of forward #3 147 (147)
Offset $147 of loss on principal ($150 related to cost of hedge remains in earnings) (147) 147
Fair value of forward contracts #4-5 (based on 6% discount rate) (477) 477
Paragraph 815-30-35-3(d) adjustment—effect of hedge 202 (202)
Change in time value related to principal goes to other comprehensive income or change in time value related to interest goes to earnings 297 (168) (129)

December 31, 20X4 entries:

Repayment of principal (5,500) 5,203 297
Payment of interest (3,300) 3,300
Hedging foreign currency exposures

7.

Fair value of forward contract #4 (95) 95
Settlement of forward #4 96 (96)
Offset $96 of loss on principal (3201 related to cost of hedge remains in earnings) (96) 96
Fair value of forward contract #5 (based on 6% discount rate) (437) 437
Paragraph 815-30-35-3(d) adjustment—effect of hedge 104 (104)

Debit (Credit)

| Change in time value related to principal goes to other comprehensive income or change in time value related to interest goes to earnings |
|---|---|---|---|
| Cash | Forward Contracts | Note Payable | Income or Expense | Accum. Other Comprehensive Income |
| 297 | (154) | (143) |

December 31, 20X5 entries:

| Repayment of principal | (27,500) | 26,015 | 1,485 |
| Payment of interest | (2,750) | 2,750 |
| Fair value of forward contract #5 | (488) | 488 |
| Settlement of forward #5 | 228 | (228) |
| Offset $228 of loss on principal | (228) | 228 |
| Paragraph 815-30-35-3(d) adjustment—effect of hedge | 1,485 | (1,001) | (484) |
| Change in time value related to principal goes to other comprehensive income or change in time value related to interest goes to earnings | (140) | (140) |

(21,008) - - -

a. The entry recording the $297 gain for the period ended December 31, 20X2, results from the spot exchange rate remaining unchanged from December 31, 20X1, and one less period remaining on the loan payable. The $117 principal portion of the gain goes to other comprehensive income because only principal is being hedged. The $180 interest portion of the gain goes to earnings because interest is not being hedged.

b. See Schedule 3 (paragraph 815-20-55-152) for income or expense for each period.

55-150 The following schedules support the preceding entries.

<table>
<thead>
<tr>
<th>Schedule 1</th>
<th>Foreign Currency</th>
<th>Functional Currency at 12/31/X0 Spot Rate (1)</th>
<th>Functional Currency at 12/31/X0 Current Spot Rate (2)</th>
<th>Transaction Gain or Loss</th>
<th>Change in Time Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/X0</td>
<td>Principal</td>
<td>30,976&lt;sup&gt;a&lt;/sup&gt;</td>
<td>32,234</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td>14,024&lt;sup&gt;a&lt;/sup&gt;</td>
<td>14,593</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Loan value</td>
<td>45,000</td>
<td>46,827</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/X1</td>
<td>Principal</td>
<td>29,192</td>
<td>30,377</td>
<td>32,111</td>
<td>1,734</td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td>10,808</td>
<td>11,247</td>
<td>11,889</td>
<td>642</td>
</tr>
<tr>
<td></td>
<td>Loan value</td>
<td>40,000</td>
<td>41,624</td>
<td>44,000</td>
<td></td>
</tr>
<tr>
<td>12/31/X2</td>
<td>Principal</td>
<td>27,222</td>
<td>28,328</td>
<td>29,945</td>
<td>1,617</td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td>7,778</td>
<td>8,093</td>
<td>8,555</td>
<td>462</td>
</tr>
<tr>
<td></td>
<td>Loan value</td>
<td>35,000</td>
<td>36,421</td>
<td>38,500</td>
<td></td>
</tr>
<tr>
<td>12/31/X3</td>
<td>Principal</td>
<td>25,048</td>
<td>26,065</td>
<td>27,553</td>
<td>1,488</td>
</tr>
</tbody>
</table>
Hedging

7. Hedging foreign currency exposures

Interest  4,952  5,153  5,447  294  168 = (462 – 294)
Loan value  30,000  31,218  33,000

<table>
<thead>
<tr>
<th>12/31/X4</th>
<th>Principal</th>
<th>Interest</th>
<th>Loan value</th>
</tr>
</thead>
<tbody>
<tr>
<td>22,649</td>
<td>2,351</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>23,568</td>
<td>2,447</td>
<td>26,015</td>
<td></td>
</tr>
<tr>
<td>24,913</td>
<td>2,586</td>
<td>27,500</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>1,345</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>140</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>154</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>12/31/X5 (before final principal payment is made)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Schedule 1</td>
</tr>
<tr>
<td>Foreign Currency</td>
</tr>
<tr>
<td>Principal</td>
</tr>
<tr>
<td>Interest</td>
</tr>
<tr>
<td>Loan value</td>
</tr>
</tbody>
</table>

(a) The value ascribed to the principal portion was determined by discounting the future principal payments at an annual rate of 10% compounded quarterly. The value ascribed to the interest portion was determined by discounting future quarterly interest accruals at an annual rate of 10%.

Schedule 2 provides the amount of cost attributed to each period for each forward contract. Each period’s cost is determined based on applying the interest method to each forward contract.

<table>
<thead>
<tr>
<th>Schedule 2</th>
<th>Forward Contract #1</th>
<th>Forward Contract #2</th>
<th>Forward Contract #3</th>
<th>Forward Contract #4</th>
<th>Forward Contract #5</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/X1</td>
<td>$ 50.03</td>
<td>$ 49.79</td>
<td>$ 49.63</td>
<td>$ 49.50</td>
<td>$ 246.61</td>
<td>$ 445.56</td>
</tr>
<tr>
<td>12/31/X2</td>
<td>50.27</td>
<td>50.11</td>
<td>49.97</td>
<td>248.95</td>
<td>399.30</td>
<td></td>
</tr>
<tr>
<td>12/31/X3</td>
<td>50.59</td>
<td>50.44</td>
<td>251.31</td>
<td>352.34</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/X4</td>
<td></td>
<td>50.92</td>
<td>253.69</td>
<td>304.61</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/X5</td>
<td></td>
<td></td>
<td>256.11</td>
<td>256.11</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$ 50.03</td>
<td>$ 100.06</td>
<td>$ 150.33</td>
<td>$ 200.83</td>
<td>$1,256.67</td>
<td>$1,757.92</td>
</tr>
</tbody>
</table>

Schedule 3 provides a breakdown for each year-end reporting period.

<table>
<thead>
<tr>
<th>Schedule 3</th>
<th>12/31/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 4,950</td>
<td>Interest expense</td>
</tr>
<tr>
<td>446</td>
<td>Cost of hedge (396 + (297 – 247))</td>
</tr>
<tr>
<td>642</td>
<td>Transaction loss related to unhedged interest (2,376 – 1,734)</td>
</tr>
<tr>
<td>$ 6,038</td>
<td>Total expense</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>12/31/X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 4,400</td>
</tr>
<tr>
<td>399</td>
</tr>
<tr>
<td>(180)</td>
</tr>
<tr>
<td>$ 4,619</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>12/31/X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 3,850</td>
</tr>
<tr>
<td>352</td>
</tr>
<tr>
<td>(168)</td>
</tr>
</tbody>
</table>
### Case B: Foreign-Currency-Denominated Variable-Rate Debt

**55-153** Entity XYZ, a U.S. dollar (USD) functional entity issues a five-year foreign-currency-denominated variable-rate debt obligation that requires interest payments and partial principal payments annually in the foreign currency with the remaining principal due at the end of five years (maturity) in the foreign currency. More specifically, Entity XYZ issues an FC 45 million debt obligation on December 31, 20X0, with FC 5 million due on December 31 of each of the next 4 years and FC 25 million due on December 31, 20X5. Interest payments are paid annually based on LIBOR.

**55-154** In this Case the guidance in paragraph 815-20-25-41 provides that Entity XYZ can use cash flow hedge accounting to hedge the variability in its functional-currency-equivalent cash flows associated with any the following:

a. All of the payments of both principal and interest of the debt  
b. All of the payments of principal of the debt  
c. All or a fixed portion of selected payments of either principal or interest of the debt  
d. Selected payments of both principal and interest of the debt (such as principal and interest payments on December 31, 2001, and December 31, 2003).

**55-155** An entity could use a receive-variable-rate, pay-fixed-rate cross-currency interest rate swap to eliminate variability attributable to interest rates and foreign exchange rates. In cash flow hedges of recognized foreign-currency-denominated assets and liabilities, the entity must assess whether the changes in cash flows attributable to the risk being hedged are expected to offset at the inception of the hedging relationship and on an ongoing basis. In a manner similar to that described beginning in paragraph 815-30-35-25, the entity would assess the effectiveness of the hedge using the hypothetical derivative method. After the initial quantitative assessment of hedge effectiveness, the entity may elect to assess hedge effectiveness on a qualitative or quantitative basis.
Hedging

7. Hedging foreign currency exposures

<table>
<thead>
<tr>
<th>12/31/X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 2,750</td>
</tr>
<tr>
<td>256</td>
</tr>
<tr>
<td>(140)</td>
</tr>
<tr>
<td>$ 2,866</td>
</tr>
</tbody>
</table>

>>> Case B: Foreign-Currency-Denominated Variable-Rate Debt

55-153 Entity XYZ, a U.S. dollar (USD) functional entity issues a five-year foreign-currency-denominated variable-rate debt obligation that requires interest payments and partial principal payments annually in the foreign currency with the remaining principal due at the end of five years (maturity) in the foreign currency. More specifically, Entity XYZ issues an FC 45 million debt obligation on December 31, 20X0, with FC 5 million due on December 31 of each of the next 4 years and FC 25 million due on December 31, 20X5. Interest payments are paid annually based on LIBOR.

55-154 In this Case the guidance in paragraph 815-20-25-41 provides that Entity XYZ can use cash flow hedge accounting to hedge the variability in its functional-currency-equivalent cash flows associated with any of the following:

a. All of the payments of both principal and interest of the debt
b. All of the payments of principal of the debt
c. All or a fixed portion of selected payments of either principal or interest of the debt
d. Selected payments of both principal and interest of the debt (such as principal and interest payments on December 31, 2001, and December 31, 2003).

55-155 An entity could use a receive-variable-rate, pay-fixed-rate cross-currency interest rate swap to eliminate variability attributable to interest rates and foreign exchange rates. In cash flow hedges of recognized foreign-currency-denominated assets and liabilities, the entity must assess whether the changes in cash flows attributable to the risk being hedged are expected to offset at the inception of the hedging relationship and on an ongoing basis. In a manner similar to that described beginning in paragraph 815-30-35-25, the entity would assess the effectiveness of the hedge using the hypothetical derivative method. After the initial quantitative assessment of hedge effectiveness, the entity may elect to assess hedge effectiveness on a qualitative or quantitative basis.
8. Net investment hedges

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### 8.5 Accounting for net investment hedges

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8.5.30 Assessing impairment

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**Question**

8.5.10 Is hedge accounting applied through the date an event causes a hedging relationship to no longer be effective as an economic hedge?

**Example**

8.5.10 Recognizing amounts in CTA
8.1 How the standard works

Throughout this chapter, FCD means foreign currency denominated.

A **net investment hedge** is a hedge of the exposure to foreign currency risk of a net investment in a foreign operation.

When the comprehensive hedge accounting model in Topic 815 was developed, the FASB did not reconsider the accounting for foreign currency translation. As a result, the FASB decided to continue to permit hedge accounting for net investment hedges, including that these hedging relationships would continue to be subject to only certain hedging criteria.

Net investment hedges are subject only to the following hedging criteria.

<table>
<thead>
<tr>
<th>General qualifying criteria for all foreign currency hedges (Section 7.3)</th>
<th>Hedging instrument. The entity with the foreign currency exposure needs to be a party to the hedging instrument (section 7.3.20).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedge effectiveness (Section 8.4)</td>
<td>Hedged item or transaction. The hedged net investment needs to be denominated in a currency other than the entity’s functional currency (section 7.3.30).</td>
</tr>
<tr>
<td>Formal documentation (Section 2.9)</td>
<td>The entity formally documents the hedging relationship.</td>
</tr>
</tbody>
</table>

In general, the net investment hedge accounting model works as follows.

- When a net investment is translated into the entity’s reporting currency, the effects of translation are recognized in CTA in AOCI.
- The changes in fair value of the derivative hedging instrument (or foreign currency transaction gains or losses of a FCD nonderivative hedging instrument) that are included in the effectiveness assessment are recognized in CTA in AOCI. These amounts remain in CTA until the sale, exchange or liquidation of the foreign operation.
The following diagram shows the general accounting and presentation for a net investment hedging relationship (assuming there are no excluded components).

Hedging instrument (derivative or nonderivative) → Hedged item – Net investment in foreign operation

Entire change in fair value of derivative (or transaction gain or loss of nonderivative) hedging instrument recorded in CTA → Apply Topic 830, including recording translation gains or losses in CTA

Reclassified when hedged net investment is sold, exchanged or liquidated

Reclassified when hedged net investment is sold, exchanged or liquidated

Record in the same income statement line item¹

Note:
1. In certain situations, a portion of the translation gain or loss should be reclassified from CTA to noncontrolling interest (see section 8.5.20).
8.2 Qualifying criteria for net investment hedges

8.2.10 Overview

The objective of a net investment hedge is to reduce or eliminate the exposure to foreign currency risk of a net investment in a foreign operation.

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 equity method investments.

Topic 830 (foreign currency matters) provides accounting guidance on foreign currency transactions and the translation of financial statements. Before the comprehensive hedge accounting model in Topic 815 was established, the foreign currency accounting guidance permitted hedge accounting for net investments and practice in this area was well-established. When the comprehensive hedge accounting model was developed, the FASB did not reconsider the accounting for foreign currency translation. As a result, the FASB decided to continue to permit hedge accounting for net investment hedges, including that these hedging relationships would only be subject to certain hedging criteria. [FAS 133.BC475–478]

Designation of a net investment in a foreign operation as a hedged item is permitted even though it is considered the same as designating a group of dissimilar assets and liabilities as the hedged item, which is not permitted for a fair value hedge or cash flow hedge.

Net investment hedges are subject only to the following hedging criteria:

— The operating unit with the foreign currency exposure needs to be a party to the hedging instrument (see section 7.3.20). [815-20-25-30(al)]

— The hedged net investment needs to be denominated in a currency other than the entity’s functional currency (see section 7.3.30). [815-20-25-30(b)]

— The entity needs to formally document the hedging relationship. The documentation requirements for net investment hedges are the same as those for other hedging relationships (see section 2.9). [815-20-25-3(b)]

— The entity needs to assess effectiveness at least quarterly and whenever financial statements or earnings are reported (see sections 8.2.20 and 8.4). [815-35-35-27]

— The hedging instrument must be designated and effective as an economic hedge of the net investment (see section 8.4). [815-20-25-26(e), 830-20-35-3]

As highlighted above, the operating unit that has the foreign currency exposure must be a party to the hedging instrument. However, as explained in section 7.3.20, another member of the consolidated group that has the same functional currency as the operating unit may instead be a party to the hedging instrument if there is no intervening subsidiary with a different functional currency. [815-20-25-23, 25-24, 25-30(a)]
Question 8.2.10
Can foreign currency risk related to a forecasted equity method investment be hedged?

Background: ABC Corp.'s functional currency is the US dollar. ABC anticipates acquiring a 35% equity interest in a Korean car manufacturer. ABC 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, Year 1.

Once it is acquired, ABC will account for the investment using the equity method. ABC forecasts that ₩500 million of net income will be earned related to the investment in the year after the acquisition.

Scenario 1: ABC wants to hedge the foreign currency risk related to the forecasted purchase of the equity method investee

Interpretive response: No. As explained in section 2.5.20, cash flow hedges of transactions relating to investments accounted for by the equity method are not permitted. Because ABC will account for the investment using the equity method, it cannot designate the forecasted transaction as the hedged item in a cash flow hedge. [815-20-25-43(b)(1)]

Scenario 2: ABC wants to hedge the foreign currency risk related to forecasted earnings of the investment after the acquisition

Interpretive response: No. Although ABC may designate the recognized equity method investee as the hedged item in a net investment of a foreign operation, forecasted earnings cannot be hedged. This is because net income represents the netting of many dissimilar transactions, rather than a series of individual but similar transactions sharing the same risk exposure. Additionally, dividends from an equity method investment may not be designated as the hedged item. [FAS 133.BC485, 815-20-25-39(c)]

Example 8.2.10
Hedging a foreign net investment with a FCD liability of another subsidiary

Parent’s functional currency is the US dollar. Parent has two subsidiaries: Sub NZ in New Zealand and Sub J in Japan. The functional currency of Sub J is its local currency (Japanese yen).

Scenario 1: Sub NZ’s functional currency is its local currency (NZ dollar)

Sub NZ issues yen-denominated notes. Parent is not permitted to designate the yen-denominated notes issued by Sub NZ as the hedging instrument in a hedge of its net investment in Sub J. This is because Sub NZ is not part of the operating unit that has the foreign currency exposure and Sub NZ has a functional currency different from that of the Parent.

Scenario 2: Sub NZ’s functional currency is the US dollar

Sub NZ issues yen-denominated notes and Parent designates those notes payable as the hedging instrument in its hedge of its net investment in Sub J.
This is permissible because Sub NZ has the same functional currency as Parent and there are no intervening subsidiaries with a different functional currency.

On a consolidated basis, Parent translates Sub J’s financial statements from its functional currency into US dollars. Any foreign currency translation gains or losses are recorded in CTA in AOCI.

In its stand-alone financial statements, Sub NZ’s yen-denominated notes are remeasured at spot through earnings to its functional currency (the US dollar) at period-end because the hedging relationship and related hedge accounting exist only in the context of Parent’s consolidated financial statements.

However, if Sub NZ’s yen-denominated notes are effective at hedging the exchange gains or losses arising on translation of Sub J’s financial statements from yen to US dollars, the gain or loss in Sub NZ’s stand-alone financial statements related to remeasuring the yen-denominated notes to US dollars is reclassified in consolidation to CTA in AOCI (i.e. in Parent’s consolidated financial statements).

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**8.2.20 Redesignation of the hedged item**

**Excerpt from Subtopic 815-35**

> **Redesignation**

**35-27** If an entity documents that the effectiveness of its hedge of the net investment in a foreign operation will be assessed based on the beginning balance of its net investment and the entity’s net investment changes during the year, the entity shall consider the need to redesignate the hedging relationship (to indicate what the hedging instrument is and what numerical portion of the current net investment is the hedged portion) 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 (for example, a dividend) occurs during the interim period. Example 1 (see paragraph 815-35-55-1) illustrates the application of this guidance.

Determining the amount of the net investment to hedge presents a challenge because the net investment balance is constantly changing as the foreign operation generates profits and losses. In practice, an entity designates the beginning balance (or a specified amount of it) as the hedged item (see Question 8.2.20). [815-35-35-27]

An entity is required to consider the need to prospectively redesignate the hedging relationship whenever financial statements or earnings are reported, and at least every three months. [815-35-35-27]

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, an entity may wish to do so to avoid volatility in the CTA in AOCI related to the net investment. [815-35-35-27]
This is because when the beginning balance of the net investment is designated as the hedged item, the hedging instrument is also designated based on that beginning balance (see Question 8.2.20). However, the ending balance of the net investment is translated in consolidation. As a result, when significant transactions occur during the interim period and the hedge is not redesignated, the translation of the net investment’s ending balance (which is recorded in CTA in AOCI) may not be exactly offset by the remeasurement of the hedging instrument that is recognized in CTA in AOCI. Redesignating the hedging relationship more frequently may reduce the volatility resulting from this lack of offset. [815-35-35-27]

Question 8.2.20
Can the ending or average balance be designated as the hedged item in a net investment hedge?

Interpretive response: No. We believe using the ending or average balance would be equivalent to hedging the foreign currency exposure associated with the future earnings (loss) of a foreign operation. As discussed in Question 8.2.10, it is not permitted to hedge the future earnings of a foreign operation.

Instead, we believe an entity should assess the effectiveness of the hedging relationship based on the beginning balance of the net investment.

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 in AOCI. This may be preferable if the entity expects significant decreases during a quarter.

FASB Example: Frequency of designation of hedged net investment
Subtopic 815-35’s Example 1 (paragraph 815-35-35-1) illustrates assessing the effectiveness of a hedge of the foreign currency exposure of a net investment when the balance changes.

— In the first scenario (paragraph 815-35-55-1(a)), the entity could enter into an additional forward contract to hedge the net investment balance exceeding the original forward contract’s notional amount.
— In both scenarios (paragraphs 815-35-55-1(a) and 55-1(b)), the full change in the fair value of the foreign currency forward contract would be recorded in the CTA in AOCI for the quarter then ended.
Hedging
8. Net investment hedges

Excerpt from Subtopic 815-35

>> Example 1: Frequency of Designation of Hedged Net Investment

55-1 This Example illustrates the application of paragraph 815-35-35-27. Assume that an entity enters into a foreign currency forward contract that has a notional amount equal to the beginning balance of its investment in a foreign operation (for example, 100,000 foreign currency units [FC]). 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, the entity would periodically assess the original hedging relationship and decide whether it needs to remove (that is, dedesignate) that original relationship and designate a new hedging relationship for the following assessment period. The following presents one method of such redesignation in those circumstances in which the entity chooses not to obtain a new derivative instrument:

a. If the net investment had increased (for example, to FC 120,000), the entire forward contract would be designated prospectively as hedging only a portion of the beginning balance of the net investment in that foreign operation. The hedged portion would be the ratio of the net investment at the inception of the hedge to the net investment at the beginning of the new assessment period (for example, five-sixths of the FC 120,000).

b. If the net investment had decreased (for example, to FC 90,000), only a proportion of the forward contract would be designated prospectively as hedging the entire beginning balance of the net investment in that foreign operation. The proportion of the forward contract designated prospectively as the hedging instrument would be the ratio of the net investment at the beginning of the new assessment period to the net investment at the inception of the hedge (for example, nine-tenths of the forward contract). 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 after the dedesignation date recognized currently in earnings pursuant to paragraph 815-20-35-1(a).

8.3 Hedging instruments

8.3.10 Overview

Excerpt from Subtopic 815-20

>>> Hedging Instruments in Net Investment Hedges

25-66 A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Subtopic 830-20 can be designated as hedging the foreign currency exposure of a net
investment in a foreign operation provided the conditions in paragraph 815-20-25-30 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 Subtopic 830-20 and, thus, cannot be designated as hedging the foreign currency exposure of a net investment in a foreign operation.

>>> Foreign-Currency-Denominated Debt Instrument as both Hedging Instrument and Hedged Item

55-38 A foreign-currency-denominated debt instrument that is 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 risk types that are permitted to be hedged individually under this Subtopic. Example 10 (see paragraph 815-20-55-127) illustrates this circumstance.

An entity may designate a derivative instrument or a FCD nonderivative financial liability as a hedge of the foreign currency exposure inherent in a net investment in a foreign operation, consistent with Topic 830 (foreign currency matters). [815-20-25-66]

To be used as a hedging instrument, a FCD nonderivative is required to be a financial liability that gives rise to a foreign currency transaction gain or loss under Topic 830. A FCD nonderivative that is reported at fair value (e.g. an instrument to which an entity has chosen to apply the fair value option under Topic 825 (financial instruments)) cannot be used as a hedging instrument because it does not give rise to a foreign currency transaction gain or loss under Topic 830. [815-20-25-66]

A FCD 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.

As a result of applying fair value hedge accounting, the debt's carrying amount will be adjusted to reflect changes in its FCD fair value attributable to interest rate risk. As a result, the notional amount of the debt designated to hedge the net investment amount will change over time, which may cause an entity to adjust the amount of the hedged net investment as discussed in section 8.2.20. For an example of using a FCD fixed-rate debt instrument as a hedging instrument and a hedged item in a fair value hedge of interest rate risk, see Subtopic 815-20’s Example 10 (reproduced in this section). [815-20-55-38, 55-129]

Cross-currency interest rate swaps that have either two fixed-rate legs or two variable-rate legs are eligible as hedging instruments. However, Topic 815 prohibits using compound derivatives as hedging instruments. As a result, cross-currency interest rate swaps with one fixed-rate and one variable-rate are not eligible as hedging instruments. Topic 815 also prohibits using a combination of hedging instruments (i.e. a single synthetic instrument) as a hedging instrument. For further discussion, see section 8.3.40. [815-20-25-67 – 25-68]

The hedging instrument’s gain or loss included in the effectiveness assessment is reported in CTA, consistent with the accounting for the net investment. [815-35-35-1 – 35-2]
Question 8.3.10

**Does the use of proceeds affect whether a FCD nonderivative debt obligation can be used as the hedging instrument in a net investment hedge?**

**Background:** Parent’s functional currency is the US dollar. Parent has a UK subsidiary and its functional currency is the pound sterling. Parent issues a debt obligation denominated in pound sterling to a third party and uses the proceeds to finance its US operations. Parent did not elect the fair value option for the debt obligation.

**Interpretive response:** No. A FCD nonderivative financial liability is eligible to be used as the hedging instrument in a hedge of a net investment in a foreign operation without regard to how the proceeds are used, provided it gives rise to a transaction gain or loss under Topic 830.

Because Parent’s debt obligation is denominated in pound sterling, its remeasurement each period to the Parent’s functional currency (US dollar) will give rise to a transaction gain or loss. As a result, Parent may designate the debt obligation as a hedging instrument in a net investment hedge of its net investment in the UK subsidiary. [815-20-25-66]

Question 8.3.20

**Can FCD variable-rate debt that is the hedging instrument in a net investment hedge be the hedged item in a cash flow hedge of interest rate risk?**

**Interpretive response:** Yes, we believe a FCD variable-rate debt instrument may be designated as the hedging instrument in a net investment hedge and also be the hedged item in a cash flow hedge of interest rate risk.

The cash flow hedge accounting model does not result in adjusting the notional amount of the debt, so the quarterly redesignation (discussed in section 8.2.20) would focus on changes of the net investment balance in assessing the prospective hedged amount.

**FASB Example: FCD debt instrument as both hedging instrument and hedged item**

*Excerpt from Subtopic 815-20*

>>> Example 10: Foreign-Currency-Denominated Debt Instrument as both Hedging Instrument and Hedged Item

55-127 This Example illustrates the application of paragraph 815-20-55-38.
55-128 A U.S. parent entity (Parent A) with a U.S. dollar (USD) functional currency has a German subsidiary that has the Euro (EUR) as its functional currency. On January 1, 2001, Parent A issues a five-year, fixed-rate EUR-denominated debt instrument and designates that EUR-denominated debt instrument as a hedge of its net investment in the German subsidiary. On the same date, Parent A enters into a five-year EUR-denominated receive-fixed, pay-Euribor-interest rate swap. Parent A designates the interest rate swap as a hedge of the foreign-currency-denominated fair value of the fixed-rate EUR-denominated debt instrument attributable to changes in Euribor interest rates, which is considered the benchmark interest rate for a hedge of the EUR-denominated fair value of that instrument.

55-129 As permitted by paragraph 815-20-55-38, Parent A may designate the EUR-denominated debt instrument as a hedge of its net investment in the German subsidiary and also as the hedged item in a fair value hedge of the debt instrument’s foreign-currency-denominated fair value attributable to changes in the designated benchmark interest rate. 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 that is designated as the hedging instrument in the net investment hedge will change over time such that it may not match the notional amount of the hedged net investment. The entity then applies the net investment hedge guidance in Subtopic 815-35 and the fair value hedge guidance in Subtopic 815-25. As discussed in paragraphs 815-35-35-13 through 35-14, because the notional amount of the nonderivative instrument designated as a hedge of the net investment does not match the portion of the net investment designated as being hedged, hedge effectiveness is assessed by comparing the following two values:

a. The foreign currency transaction gain or loss based on the spot rate change (after tax effects, if appropriate) of that nonderivative hedging instrument
b. The 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 has a notional amount that matches the portion of the net investment being hedged. The hypothetical nonderivative instrument also would have a maturity that matches the maturity of the actual nonderivative instrument designated as the net investment hedge.

8.3.20 Counterparty to hedging instrument

A derivative or nonderivative hedging instrument can be with either an unrelated third party or with a related party.

However, an internal derivative cannot be considered a 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. That is, the counterparty to the internal derivative (usually a treasury center) is required to enter into an offsetting contract with a third party.

This is because 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.

Similarly, an intercompany FCD liability cannot be considered a hedging instrument in the consolidated financial statements unless the counterparty to the FCD liability has entered into an unrelated third-party nonderivative financial instrument that offsets the foreign currency exposure. This requirement is the same as the requirement when using a FCD nonderivative as the hedging instrument to hedge the risk of changes in fair value attributable to changes in a foreign currency exchange rate associated with an unrecognized firm commitment. For further discussion, see section 7.4.60, including Question 7.4.40.

8.3.30 Tandem currency hedges

Excerpt from Subtopic 815-20

>>> Hedging Instruments in Net Investment Hedges

25-69 To designate a derivative instrument as a hedge of a net investment, an entity shall have an expectation that the derivative instrument 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 shall establish an expectation that the actual derivative instrument designated as the hedging instrument will be effective as an economic hedge.

25-70 For example, if an entity designates a derivative instrument that has an underlying exchange rate involving a currency other than the functional currency of the net investment, that exchange rate shall 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. Use of a currency different from the exposed currency is not limited to cases in which it is not practical or feasible to hedge in the exposed currency if all other qualifying criteria are met.

As discussed in section 7.3.40 (tandem or cross-currency hedging), an entity is not required to use a derivative instrument denominated in the same foreign currency as the hedged item. Instead, a hedging transaction can involve ‘tandem’ currencies – i.e. currencies from two different countries that are highly correlated. This is permitted as long as the hedging relationship is expected to be effective as an economic hedge. [815-20-25-33, 815-35-25-69 – 25-70]

See Subtopic 815-20’s Example 10 (reproduced in section 8.3.10) for an example of a tandem currency hedge.
8.3.40 Ineligible hedging instruments

Excerpt from Subtopic 815-20

>> Instruments Specifically Ineligible for Designation as Hedging Instruments

25-71 Besides those hedging instruments that fail to meet the specified eligibility criteria, none of the following shall be designated as a hedging instrument for the respective hedges:

d. With respect to net investment hedges only:
   1. A compound derivative instrument that has multiple underlyings—one based on foreign exchange risk and one or more not based on foreign exchange (for example, the price of gold or the price of an S&P 500 contract), except as indicated in paragraph 815-20-25-67 for certain cross-currency interest rate swaps
   2. A derivative instrument and a cash instrument in combination as a single hedging instrument (that is, an entity shall not consider a separate derivative instrument and a cash instrument as a single synthetic instrument for accounting purposes)

Topic 815 prohibits using a compound derivative or a combined hedging instrument (i.e. a single synthetic instrument) as a hedging instrument. [815-20-25-71(d)]

Compound derivatives

Excerpt from Subtopic 815-20

>>> Hedging Instruments in Net Investment Hedges

25-67 Hedging instruments that are eligible for designation in a net investment hedge include, among others, both of the following:

a. A receive-variable-rate, pay-variable-rate cross-currency interest rate swap, provided both of the following conditions are met:
   1. The interest rates are based on the same currencies contained in the swap.
   2. Both legs of the swap have the same repricing intervals and dates.

b. A receive-fixed-rate, pay-fixed-rate cross-currency interest rate swap. A cross-currency interest rate swap that has two fixed legs is not a compound derivative instrument and, therefore, is not subject to the criteria in (a).

25-68 A cross-currency interest rate swap that has either two variable legs or two fixed legs has a fair value that 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.
25-68A Under the guidance in paragraph 815-20-25-71(d)(1), a cross-currency interest rate swap with one fixed-rate leg and one floating-rate leg cannot be designated as the hedging instrument in a net investment hedge.

An entity may not use a compound derivative that has multiple underlyings – one based on foreign currency risk and one or more not based on foreign currency risk (e.g. interest rate index, Standard & Poor’s 500) – as the hedging instrument in a net investment hedge. [815-20-25-71(d)(1)]

Topic 815 provides the following guidance regarding whether different types of cross-currency interest rate swaps may be used as hedging instruments in a net investment hedge.

---

Two variable legs or two fixed legs

A receive-variable, pay-variable cross-currency interest rate swap can be designated as the hedging instrument in a net investment hedge if:

- the interest rates are based on the same currencies contained in the swap; and
- both legs of the swap have the same repricing intervals and dates.

A receive-fixed, pay-fixed cross-currency interest rate swap is not a compound derivative and may be designated as the hedging instrument in a net investment hedge. This type of derivative reacts very similarly to a foreign currency forward contract. These cross-currency interest rate swaps may be used because their fair value is primarily driven by changes in foreign exchange rates rather than changes in interest rates. Therefore, foreign currency risk – rather than interest rate risk – is the dominant risk exposure in such swaps.

---

One fixed and one variable leg

A cross-currency interest rate swap with one fixed-rate leg and one variable-rate leg may not be designated as the hedging instrument in a net investment hedge.

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Synthetic hedging instruments

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Excerpt from Subtopic 815-20

>>> Synthetic Foreign Currency Borrowing Ineligible as a Hedging Instrument

55-49 A debt instrument denominated in the investor’s functional currency and a cross-currency interest rate swap cannot be accounted for as synthetically created foreign-currency-denominated debt to be designated as a hedge of the entity’s net investment in a foreign operation.

55-50 For example, a parent entity that has the U.S. dollar (USD) as its functional and reporting currency has a net investment in a Japanese yen (JPY-) functional-currency subsidiary. The parent borrows in euros (EUR) on a fixed-rate basis and simultaneously enters into a receive-EUR, pay-Japanese yen currency swap (for all interest and principal payments) to synthetically...
convert the borrowing into a yen-denominated borrowing. The parent entity cannot designate the EUR-denominated borrowing and the currency swap in combination as a hedging instrument for its net investment in the JPY-functional-currency subsidiary.

**55-51** An approach that would involve measuring a derivative instrument and a cash instrument as a single unit at the current **spot rate** (which is used in the translation of the hedged net investment) violates the requirements of Subtopic 830-20 for translation of foreign-currency-denominated borrowings at the spot rate relevant to the currency of the borrowing. It also violates the requirements of Subtopic 815-10 for measurement of all derivative instruments at fair value. Accordingly, combining the EUR-denominated borrowing and the currency swap for designation as a single hedging instrument—a JPY-denominated borrowing—in a net investment hedge is not permitted.

**55-52** In contrast, an entity could designate a foreign currency derivative instrument and a foreign-currency-denominated cash instrument individually as hedging different portions of its net investment in a foreign operation provided the derivative instrument and the cash instrument each individually qualified as a hedging instrument.

**55-53** For example, a JPY-USD forward contract and a JPY-denominated cash instrument could each be designated as the hedging instrument in a hedge of different portions of the net investment in a JPY-functional-currency subsidiary (that is, two separate hedging relationships would be designated).

Topic 815 prohibits considering a separate derivative and a nonderivative financial instrument as a combined hedging instrument (i.e. single synthetic instrument) for hedge accounting purposes. [815-20-25-71(d)(2), 55-49]

This approach is prohibited because it would result in measuring a derivative and a financial instrument as a single unit at the current spot rate (synthetic accounting). This violates the requirements of Topic 830 for remeasurement of FCD debt at the spot rate relevant to the currency of the borrowing. It also violates the requirements of Topic 815 to measure all derivatives at fair value. [815-20-55-51]

However, an entity may designate a foreign currency derivative and a FCD nonderivative financial liability individually as hedging instruments that are hedging different portions of its net investment in a foreign operation. This is permitted if each of the instruments qualifies individually as a hedging instrument. [815-20-55-52]

---

**Example 8.3.10**

**Eligibility of financial instruments as hedging instruments**

The following example is based on paragraphs 815-20-55-50 and 55-3.

Parent has the US dollar as both its functional currency and its reporting currency. It has a net investment in a Japanese subsidiary (Sub J), which has Japanese yen as its functional currency.
Scenario 1: Synthetic fixed-rate, yen-denominated borrowing

Parent has both of the following financial instruments:

- fixed-rate, euro-denominated debt; and
- receive-euros, pay-yen currency swap (for all interest and principal payments on the euro-denominated debt).

As a result of the combination of these financial instruments, Parent has synthetically converted its borrowing into a fixed-rate, yen-denominated borrowing.

Parent is not permitted to designate the synthetic fixed-rate, yen-denominated borrowing as a hedging instrument for its net investment in Sub J.

Scenario 2: Separate forward contract and yen-denominated financial liability

Parent has both of the following:

- yen-US dollar forward contract; and
- yen-denominated nonderivative financial liability.

Each of these financial instruments could be designated as the hedging instrument in a hedge of different portions of the net investment in Sub J (i.e. two separate hedging relationships would be designated), as long as each qualifies individually as a hedging instrument.

8.4 Assessing effectiveness

8.4.10 Overview

Excerpt from Subtopic 815-35

Assessing Hedge Effectiveness and Measuring Hedge Results

35-4 If a derivative instrument is used as the hedging instrument, an entity may assess the effectiveness of a net investment hedge using either a method based on changes in spot exchange rates (as specified in paragraphs 815-35-35-5 through 35-15) or a method based on changes in forward exchange rates (as specified in paragraphs 815-35-35-17 through 35-26). This guidance can also be applied to purchased options used as hedging instruments in a net investment hedge. However, an entity shall consistently use the same method for all its net investment hedges in which the hedging instrument is a derivative instrument; use of the spot method for some net investment hedges and the forward method for other net investment hedges is not permitted. An entity may change the method that it chooses to assess the effectiveness of its net investment hedges in accordance with paragraphs 815-20-55-55 through 55-56A.

35-4A Hedge effectiveness shall be assessed on a quantitative basis at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(01) unless one of the exceptions in that paragraph applies. Subsequent assessments of hedge
effectiveness may be performed either on a quantitative basis or on a qualitative basis in accordance with paragraphs 815-20-35-2 through 35-2F.

To designate a derivative or FCD nonderivative as a hedging instrument in a net investment hedge, the relationship must be expected to be – and actually be – effective as an economic hedge of foreign currency risk associated with the hedged net investment. The entity is required to assess effectiveness of a net investment hedge at least quarterly and whenever financial statements or earnings are reported. [815-20-25-26(a), 815-35-35-27]

At inception, an entity is required to assess effectiveness quantitatively, unless the conditions that will result in perfect effectiveness are met (see sections 8.4.20 and 8.4.30). [815-20-25-3(b)(2)(iv), 815-35-35-5, 35-12]

Subsequently, an entity may assess effectiveness quantitatively, or qualitatively if certain conditions are met. See Questions 9.2.50 regarding whether a quantitative or qualitative method is used when the conditions that will result in perfect effectiveness are met; and section 9.5 for a discussion of the qualitative method. [815-35-35-4A]

Depending on the hedging instrument, an entity may assess effectiveness on a quantitative basis using a method based on either changes in spot exchange rates (the spot method) or changes in forward exchange rates (the forward method). [815-35-35-4]

The following table summarizes these methods as relevant for the categories of hedging instruments.

<table>
<thead>
<tr>
<th>Hedging instrument category</th>
<th>Effectiveness assessment method(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Derivative instrument</strong></td>
<td>— Spot method (i.e. intrinsic value method for purchased options)</td>
</tr>
<tr>
<td>E.g. a cross-currency interest rate swap, a foreign currency forward contract, purchased option</td>
<td>— Forward method (i.e. total value for purchased options)</td>
</tr>
<tr>
<td></td>
<td>— While either method is appropriate, the same method is required to be used for all net investment hedges using derivative hedging instruments. [815-35-35-4]</td>
</tr>
<tr>
<td><strong>Nonderivative financial instrument</strong></td>
<td>Spot method [815-35-35-14]</td>
</tr>
<tr>
<td>E.g. FCD debt obligation</td>
<td></td>
</tr>
</tbody>
</table>

Topic 815 permits hedging foreign currency risk on an after-tax basis, provided that the documentation of the hedge at inception indicated that the assessment of effectiveness will be on an after-tax basis (rather than on a pre-tax basis). [815-20-25-3(b)(2)(vi)]

If an entity has elected to hedge foreign currency risk on an after-tax basis, it must adjust the notional amount of its hedging instrument appropriately to reflect the effect of tax rates. In that case, the hypothetical derivative contract used to assess effectiveness when a hedging relationship is not perfectly effective 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. [815-35-35-26]

**Question 8.4.10**

**Does a change in tax rates affect effectiveness when it is assessed on an after-tax basis?**

**Interpretive response:** Yes. When effectiveness is assessed on an after-tax basis, the notional amount of the hedging instrument must be adjusted to appropriately reflect the effect of tax rates. If tax rates change, the notional amount of a hedging instrument that would result in perfect effectiveness is affected by the change in tax rates.

As a result, if an entity has a hedging relationship that is perfectly effective and tax rates change, the hedging relationship will no longer be perfectly effective unless the entity redesignates the hedging relationship taking into consideration the effect of the changed tax rates.

**Example 8.4.10**

**Adjusting the notional of the hedging instrument when hedging on an after-tax basis**

Parent’s functional currency is the US dollar. Parent has a wholly owned subsidiary, Sub, whose functional currency is the euro (€). As of January 1, Year 1, Parent has a net investment in Sub of €100 million.

Parent asserts indefinite reinvestment of Sub’s foreign earnings and therefore does not provide deferred taxes on its outside basis difference. It does provide deferred taxes on the derivative’s unrealized gains and losses because those amounts are not taxable or deductible until realized.

When designating its hedging relationship as of January 1, Year 1, Parent considered its enacted tax rate of 21% and designated a forward contract with a notional amount of €126.6 million [€100 million ÷ (1 - 21%)] to perfectly offset (on an after-tax basis) the foreign currency changes in its €100 million net investment in Sub.

**8.4.20 Spot method**

An entity may elect to assess effectiveness based on spot rates when the hedging instrument is a derivative. Additionally, this method is used when the hedging instrument is a FCD nonderivative.
Derivative hedging instrument

Excerpt from Subtopic 815-35

>>> Hedging Instrument Is a Derivative Instrument

35-5 The change in the fair value of the derivative instrument attributable to changes in the difference between the forward rate and spot rate would be excluded from the assessment of hedge effectiveness if all of the following conditions are met:

a. The notional amount of the derivative instrument designated as a hedge of a net investment in a foreign operation matches (that is, equals) the portion of the net investment designated as being hedged.

b. The derivative instrument’s underlying exchange rate is the exchange rate between the functional currency of the hedged net investment and the investor’s functional currency.

c. When the hedging derivative instrument is a cross-currency interest rate swap, it is eligible for designation in a net investment hedge in accordance with paragraph 815-20-25-67.

In that circumstance, the hedging relationship would be considered perfectly effective, and no quantitative effectiveness assessment is required at hedge inception. (See paragraph 815-20-25-3(b)(2)(iv)(01).)

35-5A An entity shall recognize in earnings the initial value of the component excluded from the assessment of effectiveness using a systematic and rational method over the life of the hedging instrument. Any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method shall be recognized in the same manner as a translation adjustment (that is, reported in the cumulative translation adjustment section of other comprehensive income).

35-5B An entity alternatively may elect to record changes in the fair value of the excluded component currently in earnings. This election shall be applied consistently to similar hedges in accordance with paragraph 815-20-25-81.

35-6 The interest accrual (periodic cash settlement) components of qualifying receive-variable-rate, pay-variable-rate and receive-fixed rate, pay-fixed-rate cross-currency interest rate swaps shall also be reported directly in earnings.

35-7 The change in fair value of the derivative instrument attributable to changes in the spot rate shall be reported in the same manner as a translation adjustment (that is, reported in the cumulative translation adjustment section of other comprehensive income).

35-8 The spot-to-spot changes in value reported in the cumulative translation adjustment section of other comprehensive income shall not be discounted.

35-9 The hedging relationship would not be considered perfectly effective, and the guidance in paragraph 815-35-35-10 shall be applied if any of the following conditions exist:

a. The notional amount of the derivative instrument does not match the portion of the net investment designated as being hedged.
b. The derivative instrument’s underlying exchange rate is not the exchange rate between the functional currency of the hedged net investment and the investor’s functional currency.

c. When the hedging derivative instrument is a cross-currency interest rate swap eligible for designation in a net investment hedge in accordance with paragraph 815-20-25-67, both legs are not based on comparable interest rate curves (for example, pay foreign currency based on the three-month London Interbank Offered Rate [LIBOR], receive functional currency based on three-month commercial paper rates).

35-10 If any of the conditions in paragraph 815-35-35-9 exist, the change in fair value of the hypothetical derivative instrument that does not incorporate those differences shall be compared with the change in fair value of the actual derivative instrument in assessing hedge effectiveness.

35-11 The hypothetical derivative instrument used to assess hedge effectiveness also shall have a maturity and repricing and payment frequencies for any interim payments that match the maturity and repricing and payment frequencies for any interim payments of the actual derivative instrument designated as the hedging instrument in the net investment hedge.

When a derivative instrument is designated as the hedging instrument in a net investment hedge under the spot method, an entity may assume the hedging relationship is perfectly effective if certain conditions are met.

**Conditions that will result in perfect effectiveness**

<table>
<thead>
<tr>
<th>[815-35-35-5, 35-9]</th>
</tr>
</thead>
<tbody>
<tr>
<td>The notional amount(^1) of the derivative hedging instrument matches (i.e. equals) the portion of the net investment designated as being hedged.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>When using the spot method, a non-zero fair value derivative designated as a hedging instrument may be assumed to not affect hedge effectiveness. This approach is consistent with the guidance in 815-35-35-17A to 35-18 regarding net investment hedging relationships that are considered perfectly effective. That is, those paragraphs do not require the derivative hedging instrument to have a zero fair value at hedge designation for the relationship to be perfectly effective.(^2)</td>
</tr>
<tr>
<td>If the derivative is a qualifying receive-variable, pay-variable cross-currency interest rate swap, both legs are based on comparable interest rate curves.(^3)</td>
</tr>
</tbody>
</table>

**How effectiveness is assessed if the conditions that will result in perfect effectiveness are not met**

<table>
<thead>
<tr>
<th>[815-35-35-10 – 35-11]</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the conditions that will result in perfect effectiveness (above) are not met, an entity must perform initial and subsequent hedge effectiveness assessments using the hypothetical derivative method (see section 9.7.30).</td>
</tr>
<tr>
<td>Under this method, the following are compared:</td>
</tr>
<tr>
<td>• the change in fair value of the actual hedging instrument; and</td>
</tr>
<tr>
<td>• the change in fair value of a PEH derivative.(^4)</td>
</tr>
</tbody>
</table>
Notes:

1. The notional amount is adjusted to reflect the effect of tax rates if effectiveness is assessed and hedge results are measured on an after-tax basis. [815-35-35-26]

2. As discussed in Question 8.4.100, a non-zero fair value due to the derivative hedging instrument being off-market at designation creates some complexity when determining the value of the excluded component (such as when an entity changes from the forward method to the spot method). When an amortization approach is used to recognize the excluded component, any systematic and rational approach that results in the off-market nature being reduced to zero at the end of the hedging relationship generally is acceptable. Nonetheless, an approach designed specifically to take advantage of structuring opportunities to achieve a desired accounting result would not meet the spirit of a systematic and rational approach.

3. See Question 8.4.40 regarding what interest rate curves are considered ‘comparable’.

4. The PEH derivative is one that meets conditions for the relationship to be perfectly effective and also has a maturity date, repricing dates and payment frequencies for any interim payments that match the actual derivative hedging instrument. [815-35-35-10 – 35-11]

Topic 815 permits an entity to exclude forward points of a forward contract (i.e. the spot-forward difference) or time value of an option from its effectiveness assessments when using a derivative as the hedging instrument in a net investment hedge (see also section 9.2.70). In these situations, an entity recognizes the initial value of the excluded component in earnings using either an amortization approach or a mark-to-market approach. [815-35-35-5A – 35-5B]

— Amortization approach. The initial value of the excluded component is amortized into earnings using a systematic and rational method over the life of the hedging instrument. The difference between the amortized amount and the change in the excluded component’s fair value is recognized in CTA for the period.

— Mark-to-market approach. The entire change in fair value of the excluded component is immediately recognized in earnings.

The interest accrual/periodic cash settlement components of qualifying cross-currency interest rate swaps (i.e. the periodic amortization in a cross-currency interest rate swap whose terms are at-market) are reported directly in earnings. [815-35-35-6]

When a hedging relationship is effective as an economic hedge, the change in fair value of the derivative hedging instrument attributable to changes in the spot rate is reported in the same manner as a translation adjustment (i.e. reported in CTA in AOCI). The spot-to-spot changes in value reported in CTA in AOCI should not be discounted. [815-35-35-7 – 35-8]

Question 8.4.20

Can the cross-currency basis spread be an excluded component when a cross-currency interest rate swap is used in a net investment hedge?

Interpretive response: No. While an entity is permitted to exclude the portion of the change in fair value of a currency swap attributable to a cross-currency
basis spread in a cash flow or fair value hedge, it cannot be the excluded component for a net investment hedge. [815-20-25-82]

For a cross-currency interest rate swap used in a net investment hedge, only the change in the fair value of the derivative instrument attributable to changes in the difference between the forward rate and the spot rate (spot-forward difference) can be excluded from the assessment of hedge effectiveness. [815-35-35-5]

**Question 8.4.30**

Where is the effect of the excluded components presented in earnings?

**Interpretive response:** For net investment hedges, Topic 815 does not specify a required presentation in earnings for excluded components. [815-20-45-1C]

For fair value and cash flow hedges, Topic 815 requires that excluded components be presented in the same income statement line item in which the earnings effect of the hedged item is presented.

However, the FASB decided not to provide similar guidance for net investment hedges. This is because amounts in CTA related to a hedged net investment are not reclassified into earnings until the hedged net investment is sold, exchanged or liquidated (see section 8.5.20). In contrast, the initial value of the excluded component is recognized in earnings over the life of the hedging instrument (using either an amortization or mark-to-market approach). As a result, requiring the excluded components to be presented together with the earnings effect of the hedged item could result in presentation in an income statement line item such as ‘gain or loss on sale of subsidiary’ even when that subsidiary has not or will not be sold. [ASU 2017-12.BC131]

Regardless of whether the entity chooses the amortization or mark-to-market approach, we believe an entity should develop a policy for income statement line item presentation for excluded components and apply that policy consistently for all applicable net investment hedges.

For example, many entities present the excluded component for net investment hedges in interest expense.

**Nonderivative hedging instrument**

**Excerpt from Subtopic 815-35**

>>> Hedging Instrument Is Not a Derivative Instrument

35-12 The translation gain or loss determined under Subtopic 830-30 by reference to the spot exchange rate between the transaction currency of the debt and the functional currency of the investor (after tax effects, if appropriate) shall be reported in the same manner as the translation adjustment associated with the hedged net investment (that is, reported in the
cumulative translation adjustment section of other comprehensive income) if both of the following conditions are met:

a. The notional amount of the nonderivative instrument matches the portion of the net investment designated as being hedged.
b. The nonderivative instrument is denominated in the functional currency of the hedged net investment.

In that circumstance, the hedging relationship would be considered perfectly effective, and no prospective quantitative effectiveness assessment is required at hedge inception (see paragraph 815-20-25-3(b)(2)(iv)(01)).

35-13 The hedging relationship would not be perfectly effective if either of the following conditions is met:

a. The notional amount of the nonderivative instrument does not match the portion of the net investment designated as being hedged.
b. The nonderivative instrument is denominated in a currency other than the functional currency of the hedged net investment.

35-14 Effectiveness shall be assessed by comparing the following two values:

a. The foreign currency transaction gain or loss based on the spot rate change (after tax effects, if appropriate) of that nonderivative instrument
b. The 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. The hypothetical nonderivative instrument shall also have a maturity that matches the maturity of the actual nonderivative instrument designated as the net investment hedge.

When a nonderivative instrument is designated as the hedging instrument in a net investment hedge under the spot method, an entity may assume the hedging relationship is perfectly effective if certain conditions are met.

<table>
<thead>
<tr>
<th>Conditions that will result in perfect effectiveness [815-35-35-12 – 35-13]</th>
</tr>
</thead>
<tbody>
<tr>
<td>— The principal amount (^1) of the nonderivative instrument matches the portion of the net investment designated as being hedged.</td>
</tr>
<tr>
<td>— The nonderivative instrument is denominated in the functional currency of the hedged net investment.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>How effectiveness is assessed if the conditions that will result in perfect effectiveness are not met [815-35-35-14]</th>
</tr>
</thead>
<tbody>
<tr>
<td>— If the conditions that will result in perfect effectiveness (above) are not met, an entity must perform initial and subsequent hedge effectiveness assessments by comparing:</td>
</tr>
<tr>
<td>— the foreign currency transaction gain or loss of the nonderivative instrument based on the spot rate change (after tax effects, if appropriate); and</td>
</tr>
<tr>
<td>— the 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 meet the conditions that would result in perfect effectiveness and also has a maturity that matches the maturity of the actual nonderivative hedging instrument.</td>
</tr>
</tbody>
</table>
8. Net investment hedges

Note:
1. The principal amount is adjusted to reflect the effect of tax rates if effectiveness is assessed and hedge results are measured on an after-tax basis. [815-35-35-26]

When a hedging relationship is effective as an economic hedge, the foreign currency transaction gain or loss upon remeasurement at the spot rate (after tax effects, if appropriate) is reported in the same manner as the translation adjustment associated with the hedged net investment (i.e. in the CTA in AOCI). [815-35-35-12]

Example 8.4.20
Using the spot method when FCD debt is used to hedge a net investment

Parent’s functional currency is the US dollar. Parent has a wholly owned subsidiary, Sub, whose functional currency is the euro (€). As of January 1, Year 1, Parent has a net investment of €10,000,000.

Parent also has a €12,000,000 debt obligation that matures on June 30, Year 1. Parent designates €10,000,000 of this debt obligation to hedge its €10,000,000 net investment.

Parent chooses to apply hedge accounting and formally designates and documents the hedging relationship on January 1, Year 1.

The following additional facts are relevant.

— All criteria for hedge accounting have been met.

— Parent assesses effectiveness based on changes in spot rates and on the balance of the net investment at the beginning of the hedging period. Parent believes that because the hedged amount matches the designated proportion of the debt obligation and the debt obligation is denominated in euros, the hedging relationship will provide an economically effective hedge of its net investment in Sub.

— The spot exchange rates for various dates and changes for remeasurement at the spot rate are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot rate</th>
<th>Translation gain/(loss) on €10,000,000 net investment balance</th>
<th>Remeasurement gain/(loss) on €12,000,000 debt balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, Year 1</td>
<td>€1 = $0.90</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>March 31, Year 1</td>
<td>€1 = $0.95</td>
<td>500,000</td>
<td>(600,000)</td>
</tr>
<tr>
<td>June 30, Year 1</td>
<td>€1 = $0.85</td>
<td>(1,000,000)</td>
<td>1,200,000</td>
</tr>
</tbody>
</table>

Notes:
1. €10,000,000 × (Spot exchange rate at respective date - Spot exchange rate at preceding measurement date).
2. €(12,000,000) × (Spot exchange rate at respective date - Spot exchange rate at preceding measurement date).
— Parent’s net investment in Sub did not change during the hedging relationship – i.e. Sub’s operations were break-even during the period.
— On April 1, Year 1, Parent redesignated this hedging relationship to be for the balance of the net investment at April 1, Year 1 of €10,000,000.

For simplicity, this example ignores the effect of commissions and other transaction costs, initial margins and income taxes.

**Journal entries – January 1, Year 1**

There is a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship.

**Journal entries – March 31, Year 1**

Parent records the following journal entries as of March 31, Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Sub</td>
<td>500,000</td>
</tr>
<tr>
<td>CTA</td>
<td>500,000</td>
</tr>
<tr>
<td><strong>To record change in carrying amount of net investment in Sub due to changes in spot exchange rates from January 1 to March 31.</strong></td>
<td></td>
</tr>
<tr>
<td>CTA</td>
<td>500,000</td>
</tr>
<tr>
<td>Transaction gain / loss</td>
<td>100,000</td>
</tr>
<tr>
<td>Debt obligation</td>
<td>600,000</td>
</tr>
<tr>
<td><strong>To record remeasurement of FCD debt obligation to Parent’s functional currency at March 31 spot rate.</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Note:**

1. The total remeasurement of €12,000,000 is recorded as follows.
   - The remeasurement of €10,000,000 of the debt obligation is recorded in CTA in AOCI because it was designated as hedging the corresponding net investment amount.
   - The remeasurement of €2,000,000 of the debt obligation is recorded as a transaction gain/loss.

**Journal entries – June 30, Year 1**

Parent records the following journal entries as of June 30, Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>CTA</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Investment in Sub</td>
<td>1,000,000</td>
</tr>
<tr>
<td><strong>To record change in carrying amount of net investment in Sub due to changes in spot exchange rates from April 1 to June 30.</strong></td>
<td></td>
</tr>
</tbody>
</table>
Parent was concerned that the dollar would strengthen relative to the euro and designated a euro-denominated debt obligation as a hedge of its net investment.

As a result of entering into this hedge, Parent was able to offset translation gains and losses on its net investment. This was achieved by recording the Topic 830 remeasurement adjustment on the designated portion of the euro-denominated debt obligation (€10,000,000) in CTA in AOCI to offset the translation adjustment.

Without the designation of the euro-denominated debt obligation as a hedging instrument, the remeasurement adjustment for the debt obligation would have been recorded in earnings, creating foreign exchange volatility in Parent’s earnings.

The undesignated portion of the debt obligation (€2,000,000) continued to be remeasured at the spot rate through earnings.

### 8.4.30 Forward method

**Excerpt from Subtopic 815-35**

**>> Method Based on Changes in Forward Exchange Rates**

35-17 Under a method based on changes in forward exchange rates, an entity shall report all changes in fair value of the derivative instrument in the same manner as a translation adjustment (that is, reported in the cumulative translation adjustment section of other comprehensive income), including the following amounts:

a. The time value component of purchased options
b. The interest accrual/periodic cash settlement components of qualifying receive-variable-rate, pay-variable-rate and receive-fixed-rate, pay-fixed-rate cross-currency interest rate swaps.
### Assessment of Effectiveness

35-17A If the notional amount of the derivative instrument designated as a hedge of a net investment in a foreign operation matches (that is, equals) the portion of the net investment designated as being hedged and the derivative instrument’s underlying relates solely to the foreign exchange rate between the functional currency of the hedged net investment and the investor’s functional currency, the hedging relationship would be considered perfectly effective, and no quantitative effectiveness assessment is required at hedge inception (see paragraph 815-20-25-3(b)(2)(iv)(01)).

35-18 However, the hedging relationship would not be considered perfectly effective if any of the following conditions exist:

a. The notional amount of the derivative instrument does not match the portion of the net investment designated as being hedged.
b. The derivative instrument’s underlying exchange rate is not the exchange rate between the functional currency of the hedged net investment and the investor’s functional currency.
c. When the hedging derivative instrument is a cross-currency interest rate swap eligible for designation in a net investment hedge in accordance with paragraph 815-20-25-67, both legs are not based on comparable interest rate curves (for example, pay foreign currency based on three-month LIBOR, receive functional currency based on three-month commercial paper rates).

35-19 The assessment of hedge effectiveness due to such differences between the hedging derivative instrument and the hedged net investment considers the following:

a. Different notional amounts. If the notional amount of the derivative instrument designated as a hedge of the net investment does not match the portion of the net investment designated as being hedged, hedge effectiveness shall be assessed by comparing the following two values:
   1. The change in fair value of the actual derivative instrument designated as the hedging instrument
   2. The change in fair value of a hypothetical derivative instrument that has a notional amount that matches the portion of the net investment being hedged and a maturity that matches the maturity of the actual derivative instrument designated as the net investment hedge. See paragraph 815-35-35-26 for situations in which the hedge of a net investment in a foreign operation is hedging foreign currency risk on an after-tax basis, as permitted by paragraph 815-20-25-3(b)(2)(vi).

b. Different currencies. If the derivative instrument designated as the hedging instrument 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), hedge effectiveness shall be assessed by comparing the following two values:
   1. The change in fair value of the actual cross-currency hedging instrument
   2. The change in fair value of a hypothetical derivative instrument that has as its underlying the foreign exchange rate between the functional currency of the hedged net investment and the investor’s functional currency and a maturity and repricing and payment frequencies for any
interim payments that match the maturity and repricing and payment frequencies for any interim payments of the actual derivative instrument designated as the net investment hedge.

c. Multiple underlyings. In accordance with paragraph 815-20-25-67(a), the only derivative instruments with multiple underlyings permitted to be designated as a hedge of a net investment are receive-variable-rate, pay-variable-rate cross-currency interest rate swaps that meet certain criteria. Paragraph 815-20-25-67(b) also permits receive-fixed-rate, pay-fixed-rate cross-currency interest rate swaps to be designated as a hedge of a net investment.

**35-20** If a receive-variable-rate, pay-variable-rate cross-currency interest rate swap is designated as the hedging instrument in a net investment hedge, hedge effectiveness shall be assessed by comparing the following two values:

a. The change in fair value of the actual cross-currency interest rate swap designated as the hedging instrument

b. The change in fair value of a hypothetical receive-variable-rate, pay-variable-rate cross-currency interest rate swap in which the interest rates are based on the same currencies contained in the hypothetical swap and both legs of the hypothetical swap have the same repricing intervals and dates. The hypothetical derivative instrument also shall have a maturity that matches the maturity of the actual cross-currency interest rate swap designated as the net investment hedge.

**35-21** If a receive-fixed-rate, pay-fixed-rate cross-currency interest rate swap is designated as the hedging instrument in a net investment hedge, hedge effectiveness shall be assessed by comparing the following two values:

a. The change in fair value of the actual cross-currency interest rate swap designated as the hedging instrument

b. The change in fair value of a hypothetical receive-fixed-rate, pay-fixed-rate cross-currency interest rate swap in which the interest rates are based on the same currencies contained in the hypothetical swap. The hypothetical derivative instrument shall also have a maturity that matches the maturity of the actual cross-currency interest rate swap designated as the net investment hedge.

**35-26** Paragraph 815-20-25-3(b)(2)(vi) 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 and measurement of hedge results will be on an after-tax basis (rather than on a pretax basis). If an entity has elected to hedge foreign currency risk on an after-tax basis, it shall adjust the notional amount of its derivative instrument appropriately to reflect the effect of tax rates. In that case, the hypothetical derivative instrument used! to assess effectiveness shall have a notional amount that has been appropriately adjusted (pursuant to the documentation at inception) to reflect the effect of the after-tax approach.

When a derivative instrument is designated as the hedging instrument in a net investment hedge, an entity may elect to assess effectiveness based on forward rates rather than spot rates.

When using the forward method, an entity may also assume the hedging relationship is perfectly effective if certain conditions are met.
### Conditions for applying this method

<table>
<thead>
<tr>
<th>Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>The hedging instrument is a derivative.</td>
</tr>
</tbody>
</table>

### Conditions that will result in perfect effectiveness

<table>
<thead>
<tr>
<th>Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>The notional amount(^2) of the derivative hedging instrument matches (i.e. equals) the portion of the net investment designated as being hedged.</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>If the derivative is a qualifying receive-variable, pay-variable cross-currency interest rate swap, both legs are based on comparable interest rate curves.(^4)</td>
</tr>
</tbody>
</table>

### How effectiveness is assessed if the conditions that will result in perfect effectiveness are not met

<table>
<thead>
<tr>
<th>Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the conditions that will result in perfect effectiveness (above) are not met, an entity must perform initial and subsequent hedge effectiveness assessments using the hypothetical derivative method (see section 9.7.30).</td>
</tr>
<tr>
<td>Under this method, the following are compared:</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>- the change in fair value of the actual hedging instrument.</td>
</tr>
<tr>
<td>- the change in fair value of a PEH derivative. See below for additional guidance for defining the PEH derivative.</td>
</tr>
</tbody>
</table>

Notes:

1. See Question 8.4.50 regarding whether a hedging relationship can be perfectly effective if a derivative hedging instrument has a non-zero fair value at designation.
2. The notional amount is adjusted to reflect the effect of tax rates if effectiveness is assessed and hedge results are measured on an after-tax basis. [815-35-35-26]
3. See Questions 8.4.60 and 8.4.70 regarding whether leverage has effectively increased the notional amount of a cross-currency interest rate swap, resulting in the notional amount of the derivative instrument not matching the hedged portion of the net investment.
4. See Question 8.4.40 regarding what interest rate curves are considered ‘comparable’.

When the hedging relationship does not meet the conditions to be considered perfectly effective, what is compared when assessing effectiveness depends on the cause of the relationship not being perfectly effective. This is shown in the following table. [815-35-35-19 – 35-21]
### Different notional amounts

| Compare: |  
|----------|----------------|
| — the change in fair value of the actual hedging derivative; and |  
| — the change in fair value of a PEH derivative contract that has a notional amount that matches the portion of the net investment being hedged and that has a maturity that matches that of the actual hedging derivative. |  

**Notes:**

1. The notional amount is adjusted to reflect the effect of tax rates if effectiveness is assessed and hedge results are measured on an after-tax basis. [815-35-35-26]
2. See Questions 8.4.60 and 8.4.70 regarding whether leverage has effectively increased the notional amount of a cross-currency interest rate swap, resulting in the notional amount of the derivative instrument not matching the hedged portion of the net investment.

### Different currencies

| Compare: |  
|----------|----------------|
| — the change in fair value of the actual hedging derivative; and |  
| — 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; and also that has a maturity date, repricing dates and payment frequencies for any interim payments that match the actual hedging derivative. |  

For example, if a cross-currency interest rate swap with two fixed legs is designated as the hedging derivative but the hedge uses a tandem currency, effectiveness would be assessed by comparing:

| — the change in fair value of the actual cross-currency interest rate swap; and |  
| — the change in fair value of a hypothetical receive-fixed, pay-fixed cross-currency interest rate swap 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 hedging derivative. |

### Cross-currency interest rate swaps with two variable legs (multiple underlyings)

The only derivative with multiple underlyings permitted to be designated as a hedge of a net investment is a cross-currency interest rate swap with two variable legs (see section 8.3.40). If a qualifying receive-variable, pay-variable cross-currency interest rate swap is the hedging instrument, compare:

| — the change in fair value of the actual cross-currency interest rate swap; and |  
| — the change in fair value of a hypothetical receive-variable, pay-variable cross-currency interest rate swap. The hypothetical swap should be based on the functional currencies of the hedged net investment and the investor, with the interest rates based on the same currencies and |
If the hedging relationship has multiple differences (i.e. different notional amounts, currencies and underlyings), effectiveness can be assessed by a single comparison of the actual hedging derivative to the appropriate hypothetical derivative contract that does not incorporate those differences.

**Question 8.4.40**

What interest rate curves are considered comparable?

**Interpretive response:** We believe ‘comparable interest rate curves’ means comparable credit quality curves. Therefore, a US dollar LIBOR and euro LIBOR index would be comparable, whereas the commercial paper rate and a LIBOR index rate reflect different credit quality.

**Question 8.4.50**

Can a hedging relationship be perfectly effective if a derivative hedging instrument has a non-zero fair value at designation?

**Interpretive response:** It depends on the approach to assessing effectiveness. We believe there are two acceptable approaches that an entity may take to assess effectiveness if a derivative hedging instrument has a non-zero fair value at hedge designation. An entity should adopt a policy and apply it on a consistent basis for all hedges of net investments in foreign operations.

**Approach 1: The non-zero fair value affects hedge effectiveness, similar to the approach for fair value and cash flow hedges**

Under this approach, the entity assesses effectiveness by comparing:

- the change in fair value of the actual hedging derivative; and
— the change in fair value of a hypothetical derivative with similar notional amounts, currencies, and underlyings as the hedged net investment. However in constructing the hypothetical derivative, 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 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: The non-zero fair value does not affect hedge effectiveness**

Under this approach, the non-zero fair value is assumed to not affect hedge effectiveness. This approach is consistent with the guidance in 815-35-35-17A to 35-18 regarding net investment hedging relationships that are considered perfectly effective. That is, those paragraphs do not require the derivative hedging instrument to have a zero fair value at hedge designation for the relationship to be perfectly effective.

In our experience, most entities apply Approach 2 in practice, because 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 currency risk associated with the hedged net investment.

**Question 8.4.60**

*What is the effect on a hedging relationship if the interest rates in a qualifying cross-currency interest rate swap are higher than normal market rates and the forward method is used?*

**Background:** When a qualifying cross-currency interest rate swap (having either two variable or two fixed legs) 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, but the fair value of the swap at inception is still zero.

For example, a US dollar functional currency entity has a euro-denominated foreign operation and wants to hedge its euro (€) net investment using a €/$ pay-fixed, receive-fixed cross-currency interest rate swap for a notional amount of €100 million/$113 million.

The normal market terms of the swap may have fixed coupons of 1.5% for euro and 2% for US dollar. The entity may decide to increase the coupon on the receive US dollar leg to 2.5%, and have the pay euro leg of the swap adjusted to an amount higher than 1.5% so that the fair value of the swap at inception is still zero.

**Interpretive response:** When leverage is added to the coupon rates of the cross-currency swap, it effectively increases the notional amount of the swap. If the swap’s notional amount matches the portion of the net investment being hedged, it may appear that the swap meets all the criteria outlined for the hedging relationship to be considered perfectly effective.
However, because the leverage has effectively increased the notional amount of the swap, the notional amount of the derivative instrument does not match the portion of the net investment designated as being hedged. As a result, the relationship cannot be considered to be perfectly effective.

**Question 8.4.70**

**Has leverage been added to coupon rates in a qualifying cross-currency interest rate swap that is designated in a hedge after its initial recognition?**

**Background:** As discussed in Question 8.4.60, leverage may be added to the coupon rates of a swap, resulting in a hedging relationship not being perfectly effective due to having notional amounts that do not match.

**Interpretive response:** No, we generally do 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 and the swap was not subsequently modified. This is even if the swap is later designated as a hedging derivative after market rates had changed.

**Example 8.4.30**

**Using the forward method when using a foreign currency forward to hedge a net investment**

Parent’s functional currency is the US dollar. Parent has a wholly owned subsidiary, Sub, whose functional currency is the pound sterling (£). As of January 1, Year 1, Parent has a net investment of £10,000,000.

Parent enters into a six-month forward contract to buy USD and sell the foreign currency. The hedging derivative has the following terms.

- Contract amount: £10,000,000
- Trade date: January 1, Year 1
- Maturity date: June 30, Year 1
- Forward contract rate: £1 = $1.50

The contract is at market, and therefore no cash is exchanged at inception.

Parent chooses to apply hedge accounting and formally designates and documents the hedging relationship on January 1, Year 1.

The following additional facts are relevant.

- **All criteria for hedge accounting have been met.**
- **Parent elects to assess effectiveness based on changes in the forward rates and on the 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 in AOCI because the hedged amount matches the notional amount of the forward contract and the underlying currency of the forward matches Sub’s functional currency. For the same**
reasons, Parent believes the foreign currency forward contract will provide an economically effective hedge of its net investment in Sub.

— The spot and forward exchange rates for various dates, along with the fair value and changes in fair value of the forward contract, are as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot rate</th>
<th>Forward rate</th>
<th>Fair value (\times 10^3)</th>
<th>Changes in fair value (\times 10^3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, Year 1</td>
<td>£1 = $1.475</td>
<td>£1 = $1.50</td>
<td>-1</td>
<td>N/A</td>
</tr>
<tr>
<td>March 31, Year 1</td>
<td>£1 = $1.48</td>
<td>£1 = $1.55</td>
<td>(493)</td>
<td>$(493)</td>
</tr>
<tr>
<td>June 30, Year 1</td>
<td>£1 = $1.45</td>
<td>N/A</td>
<td>500</td>
<td>993</td>
</tr>
</tbody>
</table>

Notes:
1. Determined using the change in forward rates discounted at an appropriate discount rate.
2. \(10,000,000 \times ($1.50 - $1.45)\).

— Parent’s net investment in Sub was $14,750,000 as of January 1, Year 1 (£10,000,000 \times $1.475 spot exchange rate).

— Parent’s net investment in Sub did not change during the hedging relationship (i.e. Sub’s operations were break-even during the period).

— On April 1, Year 1, Parent redesignated this hedging relationship to be for the balance of the net investment at April 1, Year 1 of £10,000,000.

— The foreign currency forward contract settles on June 30, Year 1 with Parent receiving $500,000.

For simplicity, this example ignores the effect of commissions and other transaction costs, initial margins and income taxes.

**Journal entries – January 1, Year 1**

There is a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship. The financial records of Parent are not otherwise affected as of this date because the forward contract has a fair value of zero at inception.

**Journal entries – March 31, Year 1**

Parent records the following journal entries as of March 31, Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Sub(^1)</td>
<td>50,000</td>
</tr>
<tr>
<td>CTA</td>
<td>50,000</td>
</tr>
<tr>
<td>To record change in carrying amount of net investment in Sub due to changes in spot exchange rates from January 1 to March 31.</td>
<td></td>
</tr>
<tr>
<td>CTA</td>
<td>493,000</td>
</tr>
<tr>
<td>Forward contract</td>
<td>493,000</td>
</tr>
<tr>
<td>To record change in fair value of foreign currency forward contract.(^4)</td>
<td></td>
</tr>
</tbody>
</table>
Notes:
1. £10,000,000 × ($1.48 - $1.475).
2. The amount recorded represents the entire change in fair value of the foreign currency forward contract.

### Journal entries – June 30, Year 1

Parent records the following journal entries as of June 30, Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>CTA</td>
<td>300,000</td>
</tr>
<tr>
<td>Investment in Sub(^1)</td>
<td>300,000</td>
</tr>
<tr>
<td>To record change in carrying amount of net investment in Sub due to changes in spot exchange rates from April 1 to June 30.</td>
<td></td>
</tr>
<tr>
<td>Forward contract</td>
<td>993,000</td>
</tr>
<tr>
<td>CTA</td>
<td>993,000</td>
</tr>
<tr>
<td>To record change in fair value of foreign currency forward contract.(^2)</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>500,000</td>
</tr>
<tr>
<td>Forward contract</td>
<td>500,000</td>
</tr>
<tr>
<td>To record settlement of foreign currency forward contract.</td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1. £10,000,000 × ($1.45 - $1.48).
2. The amount recorded represents the entire change in fair value of the foreign currency forward contract.

Parent was concerned that the dollar would strengthen relative to the pound sterling and entered into a foreign currency forward contract to hedge its net pound sterling investment.

As a result of entering into this hedge, Parent 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 Parent $500,000 \([($1.50 - $1.45) \times £10,000,000]\).

During the six months ended June 30, Year 1, Parent recorded a change in its net investment in Sub of $250,000 and an offsetting change in the fair value of the forward contract of $500,000 in CTA in AOCI.

The change in fair value of the forward contract exceeded the translation loss by $250,000. This amount represents the spot-forward difference (forward points) \([($1.50 forward rate - $1.475 spot rate at January 1, Year 1) \times £10,000,000]\).
8.4.40 Changing the effectiveness assessment method

An entity is permitted to change the method it uses to assess effectiveness of its net investment hedges. Guidance for changing effectiveness assessment methods is discussed in section 9.6.40. [815-35-35-4]

Question 8.4.80

Is an entity permitted to change the method it uses to assess effectiveness of a net investment hedge?

Interpretive response: Yes. An entity using a derivative hedging instrument in a net investment hedge may change from the forward method to the spot method or vice versa, provided that the new method is an improved method for assessing effectiveness (see Question 8.4.90). [815-35-35-4]

In addition, the entity is required to use the new method for all of its net investment hedges. Changing methods involves redesignating existing hedging relationships and redesignating hedging relationships (see Question 8.4.100). [815-20-55-56]

The ability to change methods is not applicable when a nonderivative hedging instrument is used, because only the spot method is applicable to such hedging relationships (see section 8.4.10).

Question 8.4.90

What does an entity consider in changing its method of assessing effectiveness for a net investment hedge?

Interpretive response: When changing the method of assessing effectiveness, an entity should document its justification for the new method being an improved method for assessing effectiveness.

When making the initial change, the entity establishes that the new method is an improved method. Therefore, it is unlikely that the entity could later support the original method as an improved method because this would contradict the original analysis.

For example, an entity that uses the forward method to assess effectiveness and wants to change to the spot method may be able to justify that the spot method is an improved method. This is because:

— its risk management objective is to hedge the changes in the spot exchange rates arising from the translation of its foreign operation(s); and
— it considers the excluded component as a ‘cost of the hedge’, which should be recognized ratably in earnings over the term of the hedge.

However, if that same entity wishes to change back to the forward method at a later date, it is unlikely that it could justify the change because this would contradict its original justification.
Question 8.4.100

What does an entity consider when it dedesignates and redesignates a net investment hedge?

Interpretive response: If an entity uses a derivative hedging instrument, it is likely that the derivative hedging instrument will have a non-zero fair value (i.e. be off-market) at redesignation. The non-zero fair value of the derivative instrument creates some complexity when determining the value of the excluded component at the time of redesignation.

If an entity changes from the forward method to the spot method, and it elects to subsequently amortize the excluded component (the spot-forward difference) using the amortization approach, it will have to develop an appropriate methodology at the date of redesignation to determine the value of the excluded component (the spot-forward difference) that subsequently is amortized. [815-35-35-6 – 35-5A]

In a February 2018 FASB meeting, the FASB discussed appropriate methodologies for amortizing the excluded component, including the off-market element of a derivative instrument that could occur at the time of redesignation. The FASB agreed that an appropriate amortization method would not violate the guidance in paragraphs 815-35-35-6 to 35-7, meaning that at the end of the hedging relationship only amounts of the derivative related to the changes in spot exchange rates over the hedge term on the notional amount of the net investment should remain in CTA in AOCI. Therefore any systematic and rational approach that results in the off-market nature of the swap being reduced to zero at the end of the hedging relationship is acceptable.

The FASB further clarified that any approach that is designed specifically to take advantage of structuring opportunities to achieve a desired accounting result does not meet the spirit of a systematic and rational approach. For example, if an entity deliberately enters into an off-market derivative to amortize the off-market amount into interest income to achieve a desired accounting result, the entity would have to use the terms of an at-market derivative to determine the appropriate amortization of the excluded component.

8.4.50 Counterparty credit risk and entity’s own nonperformance risk

An entity is required to consider the effects of counterparty credit risk and the entity’s own nonperformance risk when assessing hedging relationships.

The potential effect of counterparty credit risk (and an entity’s own nonperformance risk) on a net investment hedging relationship’s effectiveness as an economic hedge is ignored unless it is no longer probable that the derivative counterparty or the entity itself will not default.

However, if non-default by either party is no longer probable, an entity will be required to assess whether the hedging relationship has been and is expected to continue to be effective as an economic hedge. If an entity continues to expect the relationship to be effective as an economic hedge, strong evidence supporting the expectation would be needed.
See further discussion of considerations related to counterparty credit (and an entity’s own nonperformance) risk and related to credit risk adjustments determined at a portfolio level in section 9.2.60.

8.5 Accounting for net investment hedges

8.5.10 Overview

Excerpt from Subtopic 815-20

35-1 Paragraph 815-10-35-2 states that the accounting for subsequent changes in the fair value (that is, gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Specifically, subsequent gains and losses on derivative instruments shall be accounted for as follows:

...d. Net investment hedge. The gain or loss on the hedging derivative or nonderivative hedging 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, as provided in paragraph 815-20-25-66. If an entity excludes a portion of the hedging instrument from the assessment of hedge effectiveness in accordance with paragraphs 815-35-35-5 through 35-5B, the initial value of the excluded component shall be recognized in earnings using a systematic and rational method over the life of the hedging instrument. Any difference between the change in fair value of the excluded component and the amounts recognized in earnings under that systematic and rational method shall be recognized in the same manner as a translation adjustment (that is, reported in the cumulative translation adjustment section of other comprehensive income) in accordance with paragraph 815-35-35-5A. An entity also may elect to recognize the excluded component of the gain or loss currently in earnings in accordance with paragraph 815-35-35-5B.

> Income Statement Classification

45-1C For qualifying net investment hedges, an entity shall present in the same income statement line item that is used to present the earnings effect of the hedged net investment those amounts reclassified from accumulated other comprehensive income to earnings. This Subtopic provides no guidance on the required income statement classification of amounts excluded from the assessment of effectiveness in net investment hedges.

45-1D While the Derivatives and Hedging Topic does not specify whether certain income statement line items are either permitted or appropriate, the other hedging-related Subtopics in this Topic do contain specific disclosure requirements for those items. See Section 815-10-50 and Subtopics 815-25, 815-30, and 815-35.
> Statement of Cash Flows

For guidance on the classification of cash receipts and payments related to hedging activities, see paragraph 230-10-45-27.

> Excerpt from Subtopic 815-35

> Overall

35-1 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 (that is, reported in the cumulative translation adjustment section of other comprehensive income).

35-2 The hedged net investment shall be accounted for consistent with Topic 830. The provisions of Subtopic 815-25 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.

35-3 If an entity has designated and documented that it will assess effectiveness and measure hedge results on an after-tax basis as permitted by paragraph 815-20-25-3(b)(2)(vi), the portion of the gain or loss on the hedging instrument that exceeded the loss or gain on the hedged item shall be included as an offset to the related tax effects in the period in which those tax effects are recognized.

When a net investment is translated into the entity’s reporting currency, the effects of translation are recognized in CTA in AOCI. When the net investment is designated in a hedge that is effective as an economic hedge, changes in the fair value of a hedging derivative instrument (or foreign currency transaction gains or losses of a FCD nonderivative hedging instrument) are also recognized in CTA in AOCI (other than excluded components). [815-35-35-1 – 35-2]

When the hedging instrument is a derivative and the spot method is used, an entity excludes forward points (i.e. the spot-forward difference) from its effectiveness assessments. In these situations, an entity recognizes the initial value of the excluded component in earnings using either an amortization approach or a mark-to-market approach. See further discussion in sections 8.4.20 (derivative hedging instruments) and 9.2.70. [815-35-35-5A – 35-5B]

When the forward method is used, changes in the hedging derivative instrument’s fair value that are included in CTA in AOCI include the time value component of purchased options or forwards, or the interest accrual/periodic cash settlement components of qualifying cross-currency interest rate swaps. [815-35-35-17]

If an entity elects to assess effectiveness on an after-tax basis, the portion of the gain or loss on the hedging instrument that exceeds the loss or gain on the hedged net investment is included as an offset to the related tax effects in the period in which those tax effects are recognized. [815-35-35-3]
Amounts in CTA in AOCI – including amounts related to excluded components – generally remain in CTA until the hedged foreign entity is sold, exchanged or liquidated (see section 8.5.20). However, amounts in CTA are considered as part of the carrying amount when assessing impairment of a foreign operation if an entity has committed to a plan that will cause the CTA related to the foreign operation to be reclassified into earnings (see section 8.5.30).

Example 8.5.10
Recognizing amounts in CTA

On January 1, Year 1, Parent enters into a six-month foreign currency forward contract to sell FC1,000. This contract is designated as a hedge of the foreign currency exposure in its net investment of Subsidiary. The net investment in Sub balance at January 1, Year 1 is FC1,000.

At March 31, Year 1, the net investment balance has declined to FC800.

For the quarter ended March 31, Year 1, the entire change in fair value of the foreign currency forward contract is reflected in CTA because the entire contract was designated and deemed effective as a hedge of the beginning balance of the net investment.

8.5.20 Subsequent accounting for amounts in CTA

Excerpt from Subtopic 830-30

Sale or Liquidation of an Investment in a Foreign Entity

Upon sale or upon complete or substantially complete liquidation of an investment in a foreign entity, the amount attributable to that entity and accumulated in the translation adjustment component of equity shall be both:

- Removed from the separate component of equity
- Reported as part of the gain or loss on sale or liquidation of the investment for the period during which the sale or liquidation occurs.

A sale shall include:

- The loss of a controlling financial interest in an investment in a foreign entity resulting from circumstances contemplated by Subtopic 810-10 (see paragraph 810-10-55-4A for related implementation guidance)
- An acquirer obtaining control of an acquiree in which it held an equity interest, accounted for as an equity method investment that is a foreign entity, immediately before the acquisition date in a business combination achieved in stages (see paragraphs 805-10-25-9 through 25-10).

Partial Sale of Ownership Interest

If a reporting entity sells part of its ownership interest in an equity method investment that is a foreign entity, a pro rata portion of the accumulated translation adjustment component of equity attributable to that
equity method investment shall be recognized in measuring the gain or loss on the sale. If the sale of part of an equity method investment that is a foreign entity results in the loss of significant influence, see paragraphs 323-10-35-37 through 35-39 for guidance on how to account for the pro rata portion of the accumulated translation adjustment component of equity attributable to the remaining investment. For guidance if an entity sells a noncontrolling interest in a consolidated foreign entity, but still retains a controlling financial interest in the foreign entity, see paragraph 810-10-45-23 through 45-24.

40-3 Although partial liquidations by a parent of net assets held within a foreign entity may be considered similar to a sale of part of an ownership interest in the foreign entity if the liquidation proceeds are distributed to the parent, extending pro rata recognition (release of the cumulative translation adjustment into net income) to such partial liquidations would require that their substance be distinguished from ordinary dividends. Such a distinction is neither possible nor desirable. For those partial liquidations, no cumulative translation adjustment is released into net income until the criteria in paragraph 830-30-40-1 are met.

40-4 Under Subtopic 220-20, a gain or loss on disposal of part or all of a net investment may be recognized in a period other than that in which actual sale or liquidation occurs. Paragraph 830-30-40-1 does not alter the period in which a gain or loss on sale or liquidation is recognized under existing generally accepted accounting principles (GAAP).

Amounts recorded in CTA in AOCI as a result of applying net investment hedge accounting are subsequently accounted for in the same manner as translation adjustments. Those adjustments do not affect reporting currency cash flows until the respective foreign entity is sold, exchanged or liquidated. They can be viewed as unrealized gains or losses; therefore, they are not reported as part of the results of operations – but rather in CTA – until realized on sale, exchange, or liquidation of the foreign entity. [815-35-35-1, 830-30-40-1 – 40-3]

The following table summarizes the accounting for amounts in CTA in AOCI upon sale, exchange or liquidation of a hedged net investment.

<table>
<thead>
<tr>
<th>Nature of net investment in foreign operation</th>
<th>Accounting for amounts recorded in CTA (including amounts related to the excluded component) upon sale, exchange or liquidation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consolidated investment</strong></td>
<td><strong>Complete sale or substantial liquidation of investment in foreign entity</strong></td>
</tr>
<tr>
<td></td>
<td>— Amount recorded in CTA is reported in the income statement as part of the gain or loss on sale or liquidation of the investment.</td>
</tr>
<tr>
<td><strong>Sale of part of investment in foreign entity</strong></td>
<td>— <strong>Controlling financial interest is retained.</strong> Sale is accounted for as an equity transaction with a pro rata portion of CTA related to the interest sold transferred to noncontrolling interest.</td>
</tr>
<tr>
<td></td>
<td>— <strong>Controlling financial interest is not retained.</strong> Entire amount recorded in CTA related to the investment is reported in the income statement as part of the gain or loss on sale, even if significant influence is retained.</td>
</tr>
</tbody>
</table>
### Nature of net investment in foreign operation

<table>
<thead>
<tr>
<th>Accounting for amounts recorded in CTA (including amounts related to the excluded component) upon sale, exchange or liquidation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Other events leading to loss of control of investment in foreign entity</strong></td>
</tr>
<tr>
<td>— Entire amount recorded in CTA related to the investment is reported in the income statement as part of the gain or loss if the foreign entity (1) is a business and (2) is not in-substance real estate.</td>
</tr>
<tr>
<td><strong>Sale of foreign entity’s net assets</strong>¹</td>
</tr>
<tr>
<td>— <strong>Sale represents complete or substantially complete liquidation.</strong> Entire amount recorded in CTA related to the investment is reported in the income statement as part of the gain or loss on sale.</td>
</tr>
<tr>
<td>— <strong>Sale does not represent complete or substantially complete liquidation.</strong> No amount of CTA is released into earnings.</td>
</tr>
<tr>
<td><strong>Exchange of investments in foreign entities</strong></td>
</tr>
<tr>
<td>— The transaction’s specific facts and circumstances must be evaluated to determine the appropriate accounting for the amount recorded in CTA.</td>
</tr>
</tbody>
</table>

| Equity method investment |
| Complete sale or substantial liquidation |
| — Related portion of CTA is reported in the income statement as part of the gain or loss on sale or liquidation of the investment. |

### Sale of part of investment

| — Pro rata portion of CTA related to the interest sold is reported in the income statement as part of the gain or loss on sale. |
| — If significant influence is not retained after the sale, the pro rata portion of CTA related to the portion of investment that is not sold is offset against the carrying amount of the investment. To the extent the offset results in a carrying amount less than zero (i.e. the remaining CTA balance is a credit amount greater than the cost basis of the investment)), the carrying amount is reduced to zero and the remaining amount is recorded in earnings. |

### Exchange of investments in foreign entities

| — The transaction’s specific facts and circumstances must be evaluated to determine the appropriate accounting for the amount recorded in CTA. |

---

**Note:**

1. For purposes of this discussion, the concept of net asset groups includes subsidiaries but does not include subsidiaries or net assets that represent in-substance real estate or oil- and gas-producing activities. For guidance on transactions related to subsidiaries or net assets that represent in-substance real estate or oil- and gas-producing activities, see Topics 360 (property, plant and equipment) and 932 (oil and gas), respectively.

See paragraphs 4.036 to 4.054 in KPMG’s Handbook, *Foreign Currency*, for additional guidance on the accounting for translation adjustments upon the sale,
exchange or liquidation of an investment in a foreign entity, including guidance on how ‘substantial liquidation’ is interpreted.

## 8.5.30 Assessing impairment

### Excerpt from Subtopic 830-30

#### Consideration of Cumulative Translation Adjustment in Impairment Tests

45-13 An entity that has committed to a plan that will cause the cumulative translation adjustment for an equity method investment or a consolidated investment in a foreign entity to be reclassified to earnings shall include the cumulative translation adjustment as part of the carrying amount of the investment when evaluating that investment for impairment. The scope of this guidance includes an investment in a foreign entity that is either consolidated by the reporting entity or accounted for by the reporting entity using the equity method. This guidance does not address either of the following:

a. Whether the cumulative translation adjustment shall be included in the carrying amount of the investment when assessing impairment for an investment in a foreign entity when the reporting entity does not plan to dispose of the investment (that is, the investment or related consolidated assets are held for use)

b. Planned transactions involving foreign investments that, when consummated, will not cause a reclassification of some amount of the cumulative translation adjustment.

45-14 In both cases, paragraph 830-30-40-1 is clear that no basis exists to include the cumulative translation adjustment in an impairment assessment if that assessment does not contemplate a planned sale or liquidation that will cause reclassification of some amount of the cumulative translation adjustment. (If the reclassification will be a partial amount of the cumulative translation adjustment, this guidance contemplates only the cumulative translation adjustment amount subject to reclassification pursuant to paragraphs 830-30-40-2 through 40-4.)

45-15 An entity shall include the portion of the cumulative translation adjustment that represents a gain or loss from an effective hedge of the net investment in a foreign operation as part of the carrying amount of the investment when evaluating that investment for impairment.

When an entity has committed to a plan to dispose of a hedged foreign operation that will cause the related CTA in AOCI attributable to that operation to be reclassified to earnings, the entity should include the CTA as part of the carrying amount of the investment when evaluating that investment for impairment. This includes the portion of the CTA that resulted from applying hedge accounting. [830-30-45-13 – 45-15]
See paragraph 4.035 in KPMG’s Handbook, Foreign Currency, for additional guidance about accounting for translation adjustments when assessing impairment.

**8.5.40 Discontinuing hedge accounting**

Excerpt from Subtopic 815-35

> Discontinuing Hedge Accounting

>> Amounts Excluded from the Assessment of Effectiveness under an Amortization Approach

**40-1** When applying the guidance in paragraph 815-35-35-5A and a hedge is discontinued, any amounts that have not yet been recognized in earnings shall remain in the cumulative translation adjustment section of accumulated other comprehensive income until the hedged net investment is sold or liquidated in accordance with paragraphs 830-30-40-1 through 40-1A.

Hedge accounting is discontinued prospectively if any one of the following events occurs.

<p>| Change in eligibility or critical terms of hedged item (net investment in foreign operation) (section 2.10.20) | Hedged item no longer meets the eligibility criteria (see section 8.2). |
| Change in eligibility or critical terms of hedging instrument (section 2.10.30) | Hedging instrument no longer meets the eligibility criteria (see section 8.3). |
| | Hedging instrument expires or is sold, terminated or exercised. |
| | Modification of hedging instrument such that critical terms of the original hedging relationship have changed. |
| Change in the hedged risk (section 2.10.40) | Change in the hedged risk. [815-20-55-56] |</p>
<table>
<thead>
<tr>
<th>Change in hedge effectiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedging relationship is no longer effective as an economic hedge (see below).</td>
</tr>
<tr>
<td>— Change in the effectiveness assessment method, including changing from forward method to spot method, or vice versa (see section 8.4.40). [815-20-55-56]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Elective dedesignation</th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity may elect to discontinue the hedging relationship (see sections 8.2.20 and 2.10).</td>
</tr>
</tbody>
</table>

Amounts in CTA in AOCI related to a discontinued hedging relationship – including amounts related to excluded components – remain in CTA until the hedged net investment is sold, exchanged or liquidated (see section 8.5.20). [815-35-35-1, 40-1]

**Hedged net investment.** When hedge accounting is discontinued, the entity may designate prospectively the previously hedged net investment in a new hedging relationship with a different hedging instrument as long as the hedging criteria are met for the new relationship (see section 8.2.20).

**Hedging instrument.** The accounting for the hedging instrument after a hedging relationship is discontinued depends on whether the instrument is a derivative or nonderivative.

- **Derivative hedging instrument.** A derivative hedging instrument that remains outstanding continues to be recorded in the balance sheet at fair value. However, changes in its fair value (including changes in excluded components) are reflected in earnings – rather than CTA – unless it is designated as the hedging instrument in a new cash flow or net investment hedge.

- **Nonderivative hedging instrument.** Foreign currency transaction gains or losses on a FCD nonderivative financial instrument that is no longer designated as a hedging instrument are recognized in earnings – rather than CTA – unless it is designated as the hedging instrument in a new net investment hedge.

**Hedging relationship is no longer effective as an economic hedge**

If an entity’s hedge effectiveness assessment indicates that a hedging relationship is no longer highly effective, the hedging relationship is discontinued prospectively. In that case, generally no changes in the fair value of a derivative hedging instrument (or transaction gains or losses of a nonderivative hedging instrument) are recognized in CTA after the last date on which effectiveness testing indicated the relationship was effective as an economic hedge.
Question 8.5.10

Is hedge accounting applied through the date an event causes a hedging relationship to no longer be effective as an economic hedge?

Background: If in a fair value hedge an event or change in circumstances results in the 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 (see section 4.5.20). Topic 815 does not contain similar language for cash flow or net investment hedges. [815-25-40-4]

Based on discussions with the FASB staff, we believe cash flow hedge accounting should be applied through the date of such an event or change (see Question 6.5.30).

Interpretive response: Yes. We believe that when a hedging relationship was not effective as an economic hedge at the current assessment date, the entity generally should discontinue hedge accounting and should not recognize changes in the fair value of the hedging derivative (or remeasurement gains or losses of a FCD liability) in CTA in AOCI for that assessment period.

However, if the entity is able to identify the event or change in circumstances that resulted in the hedging relationship being discontinued, the entity must apply hedge accounting up to the date of that event or change in circumstances. All subsequent changes in fair value of the derivative (and remeasurement gains or losses of a FCD liability) that occurred from that date to the current assessment date are reported in earnings.
9. Hedge effectiveness

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9.3.70 Can the shortcut method be applied when hedging a portfolio of interest-bearing assets or liabilities or group of forecasted transactions?

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9.3.160 Is a debt instrument that becomes prepayable on the debtor's credit deterioration considered prepayable when applying the shortcut method?

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9.3.260 Can the shortcut method be applied to a partial-term fair value hedge?

9.3.270 Can the shortcut method be applied to a fair value hedge if the swap expires one day before or after the hedged item’s maturity date or assumed maturity date?

9.3.280 Can the shortcut method be applied to a fair value hedge if the swap’s variable leg is based on a tenor different from the hedged risk?

9.3.290 Can the shortcut method be applied to a fair value hedge if the variable interest rate of the swap has a cap or floor?

9.3.300 Can the shortcut method be applied to a cash flow hedge if the swap’s variable leg is based on a tenor different from the hedged risk?

9.3.310 Can the shortcut method be applied to a cash flow hedge if the hedged item is a variable-rate debt that contains a cap or floor?
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9.3.330 Can the shortcut method be applied to a cash flow hedge if the swap reprices in arrears, but the hedged forecasted transaction does not?

9.3.340 Does an entity consider counterparty credit risk or its own nonperformance risk when applying the shortcut method?

9.3.350 What happens if an entity does not document a quantitative method that it would use if the shortcut method was not (or no longer is) appropriate?

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**Examples**

9.7.10 Terminal value method is not appropriate

9.7.20 Terminal value method for a hedge of a forecasted foreign currency denominated sale with a purchased option

9.7.30 Using the caplet method to reclassify amounts from AOCI into earnings

9.7.40 PEH swap in a hedge of variable-rate debt that contains a floor

9.7.50 Projecting future cash flows using recent purchase orders

**9.8 Examples of effectiveness assessment methods relevant to various hedging instruments**

**9.9 Comparison of methods for assessing effectiveness**
9.1 How the standard works

Throughout this chapter, PEH means perfectly effective hypothetical (derivative).

Hedge accounting is permitted only if the hedging relationship is highly effective at managing the risk being hedged. Effectiveness assessments are required to be performed prospectively at hedge inception and both prospectively and retrospectively periodically thereafter (at least quarterly).

— For a prospective assessment, the entity evaluates whether the hedging relationship is expected to be highly effective.
— For a retrospective assessment, the entity evaluates whether the hedging relationship has actually been highly effective.

The following diagram summarizes how effectiveness is assessed.

Quantitative vs. qualitative. Topic 815 requires the initial (prospective) assessment to be performed on a quantitative basis unless the hedging relationship meets certain conditions. Subsequent assessments may be performed on a quantitative basis, or on a qualitative basis if certain conditions are met (see section 9.5).

Additionally, Topic 815 provides the three methods that allow an entity to assume a hedging relationship is perfectly effective if certain conditions are met:

— shortcut method (section 9.3);
— critical terms match method (section 9.4); and
— simplified hedge accounting approach, which is available for private companies that are not financial institutions (section 10.2).

An entity is generally required to apply the same method for assessing effectiveness to similar hedging relationships (see section 9.2.80).

This chapter discusses the general requirements for assessing hedge effectiveness and the specific requirements for various assessment methods. It also explains some additional considerations that affect the assessments, including the following.
— **Excluded components.** Improving hedge effectiveness by excluding certain components of the hedging instrument (e.g. the time value of an option) from effectiveness assessments. Excluding a component improves hedge effectiveness when the hedged item’s fair value (or hedged transaction’s cash flows) is not affected by (or not affected to the same extent as) the component (see section 9.2.70).

— The effects of **counterparty credit risk and the entity’s own nonperformance risk** when assessing hedging relationships. These considerations are different, depending on whether the hedging relationship is a cash flow, fair value, or net investment hedge and on the method used for assessing effectiveness (see section 9.2.60).

If a hedge was not highly effective in a period, hedge accounting is not applied for that period. Additionally, if an entity can no longer support its expectation of high effectiveness, hedge accounting is discontinued prospectively (see section 2.10.50).
9.2 General requirements for assessing effectiveness

9.2.10 Overview

Excerpt from ASC 815-20

> Hedge Effectiveness

25-73 Sections 815-25-55 and 815-30-55 illustrate some ways in which an entity may assess hedge effectiveness for specific strategies. The Examples are not intended to imply that other reasonable methods are precluded. However, not all possible methods are reasonable or consistent with this Subtopic. Those Sections also discuss some methods of assessing hedge effectiveness that are not consistent with this Subtopic and thus may not be used.

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-74 This guidance addresses hedge effectiveness criteria applicable to both fair value hedges and cash flow hedges.

25-75 To qualify for hedge accounting, the hedging relationship, both at inception of the hedge and on an ongoing basis, shall be expected to be highly effective in achieving either of the following:

a. Offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated (if a fair value hedge)

b. Offsetting cash flows attributable to the hedged risk during the term of the hedge (if a cash flow hedge), except as indicated in paragraph 815-20-25-50.

25-77 There would be a mismatch between the change in fair value or cash flows of the hedging instrument and the change in fair value or cash flows of the hedged item or hedged transaction in any of the following circumstances, among others:

a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction, to the extent that those bases do not move in tandem

b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in any of the following:
   1. Notional amounts
   2. Maturities
   3. Quantity
   4. Location (not applicable for hedging relationships in which the variability in cash flows attributable to changes in a contractually specified component is designated as the hedged risk)
   5. Delivery dates.

c. A change in the counterparty’s creditworthiness

25-78 Paragraph 815-20-55-62 discusses basis differences in cash flow hedges of interest rate risk.
Assessing effectiveness means determining the degree to which the change in fair value or cash flows 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 or cash flows of the derivative hedging instrument that are included in the assessment of effectiveness. This assessment can be expressed in terms of a percentage of offset and the percentage should be within the range of 80%–125% (see section 9.2.40). [815-20-25-75]

As discussed in section 2.8, hedge accounting is applied only if the hedging relationship is expected to be (and actually is) highly effective. [815-20-25-75]

<table>
<thead>
<tr>
<th>Fair value hedge</th>
<th>Cash flow hedge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gains or losses on the derivative hedging instrument that are included in the assessment of effectiveness are expected to be – and actually are – highly effective at <strong>offsetting changes in the fair value of the hedged item</strong> attributable to the designated hedged risk.</td>
<td>Gains or losses on the derivative hedging instrument that are included in the assessment of effectiveness are expected to be – and actually are – highly effective at <strong>offsetting changes in the cash flows of the hedged transaction</strong> attributable to the designated hedged risk.</td>
</tr>
</tbody>
</table>

For **net investment hedges**, hedge accounting is applied only if the hedging relationship is effective as an economic hedge (see section 8.4).

Topic 815 does not prescribe methods that must be used for assessing hedge effectiveness. Rather, it requires that the method used be reasonable and consistent with the risk management strategy; this means that the assessment is required to be performed in a manner that is consistent with the documented risk management objective (see section 9.2.30). Moreover, it generally requires an entity to assess effectiveness for similar hedges in a similar manner (see section 9.2.80).

To determine if a hedging relationship is both expected to be (prospectively will be) and actually is (retrospectively has been) highly effective, an entity performs effectiveness assessments both at inception of the hedging relationship and periodically thereafter (at least quarterly). The initial assessment is required to be quantitative, unless certain conditions are met (see Question 9.2.50). The subsequent assessments may be quantitative (see section 9.6) or qualitative if certain conditions are met (see section 9.5).

The assessment process can be complex. For example, an entity is required to consider the effect of counterparty credit risk (its own nonperformance risk) on the hedging relationship (see section 9.2.60). Additionally, an entity must select a period over which to assess effectiveness, which may result in an entity assessing effectiveness more frequently than quarterly (see section 9.2.50). Moreover, there are additional considerations:

— when using **options** as hedging instruments (see section 9.2.90);
— for **fair value hedges** related to prepayment risk under the last-of-layer method (section 9.2.100); and
— for **cash flow hedges** related to time value of money (see section 9.2.110).

Topic 815 streamlines the assessment process for certain hedging relationships by providing three methods that assume a hedging relationship is perfectly effective, each of which has specific criteria that must be met:
Hedging effectiveness

— shortcut method (see section 9.3)
— critical terms match method (see section 9.4)
— simplified hedge accounting approach, which is available for private companies that are not financial institutions (see section 10.2).

Topic 815 also permits an entity to exclude some components of the hedging instrument from the effectiveness assessment to increase the likelihood that the hedging relationship will be highly effective (see section 9.2.70).

**Hedging relationships that are not perfectly effective**

Some hedging relationships are not designed to be perfectly effective but nonetheless can be highly effective. A hedging relationship will not be perfectly effective in any of the following situations – i.e. there will be a mismatch between the change in fair value or cash flows of the hedging instrument and the change in fair value or cash flows of the hedged item or transaction. [815-20-25-77]

<table>
<thead>
<tr>
<th>Basis difference exists</th>
<th>A basis difference is a difference between the basis that drives the variability in cash flows of the hedging instrument and the hedged item or hedged transaction; for example, a difference between a contractually specified interest rate in existing variable-rate debt and the index on which cash flows of the variable leg of an interest rate swap are determined. [815-20-25-78, 55-62]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other critical terms do not match</td>
<td>Other critical terms do not match (i.e. the critical terms of the hedging instrument and the hedged item or transaction do not match), including differences in notional amounts, maturities, payment dates, quantity, location, and delivery dates.</td>
</tr>
<tr>
<td>Changes in creditworthiness</td>
<td>See section 9.2.60 regarding consideration of a counterparty’s credit risk and the entity’s own nonperformance risk. <strong>Fair value hedges.</strong> Changes in both counterparty credit risk and an entity’s own nonperformance risk affect the measurement of changes in the fair value of the derivative hedging instrument. These changes likely have no offsetting effect on changes in the measurement of the hedged item attributable to the hedged risk.</td>
</tr>
<tr>
<td>Additional items affecting the measurement of the hedging instrument</td>
<td>There are additional items that affect the measurement of the hedging instrument’s fair value or cash flows that affect the hedged item or transaction differently (or not at all). For example: In a fair value hedge, the effect of credit risk on the measurement of fair value may be different.</td>
</tr>
</tbody>
</table>

**Interest rate risk.** See also section 2.3.40 regarding basis differences in cash flow hedges of interest rate risk.
between the hedged item and hedging instrument. For example, in a hedge of the changes in fair value of a recognized fixed-rate liability due to changes in LIBOR (a benchmark interest rate), a collateralized interest rate swap (hedging instrument) could be discounted using the overnight index swap (OIS) rate while the change in the fair value of the liability attributable to LIBOR is discounted using LIBOR.

- The time value of an option, forward points in a forward or futures contract, or cross-currency basis spread in a currency swap affect the fair value of those hedging instruments unless they are excluded components (see section 9.2.70).

**Question 9.2.10**

*Is an entity permitted to deliberately overhedge or underhedge?*

**Background:** An overhedge occurs when the hedging instrument is expected to provide cash flows in excess of the expected cash flows of the forecasted transaction. For example, an entity has a $1,000,000 investment in a variable-rate (three-month LIBOR) corporate debt security and enters into an interest rate swap to hedge the variability in cash flows attributable to interest receipts due on the debt security, but designates the entirety of a swap contract with a $1,100,000 notional as the hedging instrument.

An underhedge occurs when the expected cash flows on the hedged transaction exceed the expected cash flows on the derivative hedging instrument. For example, an entity has a $1,000,000 investment in a variable-rate (three-month LIBOR) corporate debt security and enters into an interest rate swap contract to hedge the variability in cash flows attributable to interest receipts due on the debt security, but the swap contract has a $900,000 notional.

**Interpretive response:** Yes. An entity is permitted to deliberately overhedge or underhedge as long as the hedging relationship will still be highly effective. [815-20-25-75]

**Fair value hedge.** The effects of a fair value overhedge or underhedge are included in earnings immediately because the entire change in fair value of the hedging instrument included in the assessment of effectiveness is included in earnings.

**Cash flow hedge.** The effects of a cash flow overhedge or underhedge are initially recognized in OCI. These amounts are recognized when the hedged transaction affects earnings (see section 6.3).

**Net investment hedge.** The effects of a net investment overhedge or underhedge are initially recognized in CTA within AOCI. These amounts are recognized when the respective foreign entity is sold, exchanged, or liquidated (see section 8.5.20).
How is a hedging relationship affected when a physical (nonfinancial) asset’s actual location is different from that of the derivative’s underlying?

**Interpretive response:** Unless the hedged risk is a contractually specified component in a cash flow hedging relationship, an underlying of the hedged item or transaction being in a different location from the underlying of the derivative hedging instrument will cause a mismatch between changes in the fair value or cash flows of the hedged item or transaction and changes in the fair value or cash flows of the derivative hedging instrument. This would preclude the entity from assuming that the hedging relationship is perfectly effective.

This is because an entity is required to incorporate the location as one of a physical (nonfinancial) asset’s characteristics, unless the hedged risk is a contractually specified component in a cash flow hedging relationship. Specifically, actual location must be incorporated when measuring changes in the fair value of a physical asset that is the hedged item in a fair value hedge, or changes in the expected future cash flows of a forecasted transaction that involves a physical asset in a cash flow hedge. [815-20-25-12(e), 25-15(i)(2), 25-77]

For example, if an entity designates a Colombian coffee futures contract as the hedging instrument in a fair value hedge of its coffee inventory that is stored in Brazil, the entity may not assume the hedging relationship will be perfectly effective. This is because of the location difference between the physical asset that is the hedged item and location of the underlying of the hedging instrument.

If the hedged risk is a contractually specified component in a cash flow hedging relationship, Topic 815 does not require an entity to incorporate location as one of a physical (nonfinancial) asset’s characteristics. [815-20-25-15(i)(3), 25-77]

**FASB examples**

The following FASB examples are reproduced below.

**Fair value hedges**
- Fair value hedge of natural gas inventory with futures contracts (Subtopic 815-25’s Example 1). Effectiveness is assessed using the spot method and is affected by a location difference.
- Fair value hedge of tire inventory with a forward contract (Subtopic 815-25’s Example 2). Effectiveness is assessed using the spot method and is affected by a basis difference.
- Fair value hedge of growing wheat with futures contracts (Subtopic 815-25’s Example 3). Effectiveness is affected by the futures contract being for grown, harvested wheat while the inventory is not grown (or harvested).

**Cash flow hedges**
- Effectiveness of cash flow hedge with a basis swap (Subtopic 815-30’s Example 2). Effectiveness is affected by timing differences between the hedging instrument and forecasted transactions.
**Example 1: Fair Value Hedge of Natural Gas Inventory with Futures Contracts**

55-1 This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a **fair value hedge** of natural gas inventory with futures contracts. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

55-2 Entity A has 20,000 million British thermal units of natural gas stored at its location in West Texas. To hedge the **fair value** exposure of the natural gas, Entity A sells the equivalent of 20,000 million British thermal units of natural gas futures contracts on a national mercantile exchange. The futures contracts prices are based on delivery of natural gas at the Henry Hub gas collection point in Louisiana.

55-3 The price of Entity A’s natural gas inventory in West Texas and the price of the natural gas that is the **underlying** for the futures contracts it sold will differ as a result of regional factors (such as location, pipeline transmission costs, and supply and demand). Entity A therefore may not automatically assume that the hedge will be highly effective at achieving offsetting changes in fair value, and it cannot assess effectiveness by looking solely to the change in the price of natural gas delivered to the Henry Hub. The use of a hedging instrument with a different underlying basis than the item or **transaction** being hedged is generally referred to as a cross-hedge. The principles for cross-hedges illustrated in this Example also apply to hedges involving other risks. For example, the effectiveness of a hedge of **interest rate risk** in which one interest rate is used as a surrogate for another interest rate would be evaluated in the same way as the natural gas cross-hedge in this Example.

55-4 Both at inception of the hedge and on an ongoing basis, Entity A might assess the hedge’s expected effectiveness on a quantitative basis based on the extent of correlation in recent years for periods similar to the spot prices term of the futures contracts between the spot prices of natural gas in West Texas and at the Henry Hub. If those prices have been and are expected to continue to be highly correlated, Entity A might reasonably expect the changes in the fair value of the futures contracts attributable to changes in the spot price of natural gas at the Henry Hub to be highly effective in offsetting the changes in the fair value of its natural gas inventory. In assessing effectiveness during the term of the hedge, Entity A must take into account actual changes in spot prices in West Texas and at the Henry Hub. The period of time over which correlation of prices should be assessed would be based on management’s judgment in the particular circumstance.

55-5 Entity A may not assume that the change in the spot price of natural gas located at Henry Hub, Louisiana, is the same as the change in fair value of its West Texas inventory. The physical hedged item is natural gas in West Texas, not natural gas at the Henry Hub. In identifying the price risk that is being hedged, Entity A also may not assume that its natural gas in West Texas has a Louisiana natural gas component. Use of a price for natural gas located somewhere other than West Texas to assess the effectiveness of a fair value
hedge of natural gas in West Texas would be inconsistent with this Subtopic and could result in an assumption that a hedge was highly effective when it was not. If the price of natural gas in West Texas is not readily available, Entity A might use a price for natural gas located elsewhere as a base for estimating the price of natural gas in West Texas. However, that base price must be adjusted to reflect the effects of factors, such as location, transmission costs, and supply and demand, that would cause the price of natural gas in West Texas to differ from the base price.

55-6 Consistent with Entity A’s method of assessing whether the hedge is expected to be highly effective, the hedge would not be perfectly effective and there would be a net earnings effect to the extent that the actual change in the fair value of the futures contracts attributable to changes in the spot price of natural gas at the Henry Hub did not offset the actual change in the spot price of natural gas in West Texas per million British thermal units multiplied by 20,000.

55-7 That method excludes the change in the fair value of the futures contracts attributable to changes in the difference between the spot price and the forward price of natural gas at the Henry Hub in assessing effectiveness. The excluded amount would be recognized in earnings through an amortization approach in accordance with paragraph 815-20-25-83A or a mark-to-market approach in accordance with paragraph 815-20-25-83B and presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

Excerpt from ASC 815-25

>> Example 2: Fair Value Hedge of Tire Inventory with a Forward Contract

55-8 This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value hedge of tire inventory with a forward contract. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

55-9 Entity B manufactures tires. The production of those tires incorporates a variety of physical components, of which rubber and steel are the most significant, as well as labor and overhead. Entity B hedges its exposure to changes in the fair value of its inventory of 8,000 steel-belted radial tires by entering into a forward contract to sell rubber at a fixed price.

55-10 Entity B decides to perform subsequent hedge effectiveness assessments on a quantitative basis and bases its assessment on changes in the fair value of the forward contract attributable to changes in the spot price of rubber. To determine whether the forward contract is expected to be highly effective at offsetting the change in fair value of the tire inventory, Entity B could estimate and compare such changes in the fair value of the forward contract and changes in the fair value of the tires (computed as the market price per tire multiplied by 8,000 tires) for different rubber and tire prices. Entity B also should consider the extent to which past changes in the spot
prices of rubber and tires have been correlated. Because tires are a nonfinancial asset and rubber is only an ingredient in manufacturing them, Entity B may not assess hedge effectiveness by looking to the change in the fair value of only the rubber component of the steel-belted radial tires (see paragraph 815-20-25-12(e)). Both at inception of the hedge and during its term, Entity B must base its assessment of hedge effectiveness on changes in the market price of steel-belted radial tires and changes in the fair value of the forward contract attributable to changes in the spot price of rubber.

55-11 It is unlikely that this transaction would be highly effective in achieving offsetting changes in fair value. However, if Entity B concludes that the hedge will be highly effective and the hedge otherwise qualifies for hedge accounting, the hedge would have a net earnings effect to the extent that the actual changes in the following amounts did not offset:

a. The fair value of the forward contract attributable to the change in the spot price of rubber
b. The market price of steel-belted radials multiplied by the number of tires in inventory.

55-12 Because Entity B bases its assessment of effectiveness on changes in spot prices, the change in the fair value of the forward contract attributable to changes in the difference between the spot and forward price of rubber would be excluded from the assessment of effectiveness, recognized in earnings through an amortization approach in accordance with paragraph 815-20-25-83A or a mark-to-market approach in accordance with paragraph 815-20-25-83B, and presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

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Excerpt from ASC 815-25

>> Example 3: Fair Value Hedge of Growing Wheat with Futures Contracts

55-13 This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value hedge of growing wheat with futures contracts. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

55-14 Entity C has a tract of land on which it is growing wheat. Historically, Entity C has harvested at least 40,000 bushels of wheat from that tract of land. Two months before its expected harvest, Entity C sells 2-month futures contracts for 40,000 bushels of wheat, which it wants to designate as a fair value hedge of its growing wheat, rather than as a cash flow hedge of the projected sale of the wheat after harvest.

55-15 Even though the futures contracts are for the same type of wheat that Entity C expects to harvest in two months, the futures contracts and hedged wheat have different bases because the futures contracts are based on fully grown, harvested wheat, while the hedged item is unharvested wheat with two months left in its growing cycle. Entity C therefore may not automatically
assume that the hedge will be highly effective in achieving offsetting changes in fair value.

55-16 To determine whether the futures contracts are expected to be highly effective in providing offsetting changes in fair value for the growing wheat, Entity C would need to estimate and compare the fair value of its growing wheat and of the futures contracts for different levels of wheat prices. Entity C may not base its estimate of the value of its growing wheat solely on the current price of wheat because that price is for grown, harvested wheat. Entity C might, however, use the current price of harvested wheat together with other relevant factors, such as additional production and harvesting costs and the physical condition of the growing wheat, to estimate the current fair value of its growing wheat crop.

55-17 It is unlikely that wheat futures contracts would be highly effective in offsetting the changes in value of growing wheat.

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Excerpt from ASC 815-30

>> Example 2: Effectiveness of Cash Flow Hedge with a Basis Swap

55-9 This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to assessing effectiveness for a cash flow hedge with a basis swap. Assume that the entity elects to perform subsequent hedge effectiveness assessments on a quantitative basis and that all hedge documentation requirements were satisfied at inception.

55-10 Entity H has a 5-year, $100,000 variable-rate asset and a 7-year, $150,000 variable-rate liability. The interest on the asset is payable by the counterparty at the end of each month based on the prime rate as of the first of the month. The interest on the liability is payable by Entity H at the end of each month based on London Interbank Offered Rate (LIBOR) as of the tenth day of the month (the liability’s anniversary date). The reference rates for both the asset and the liability are contractually specified. Entity H enters into a 5-year interest rate swap to pay interest at the prime rate and receive interest at LIBOR at the end of each month based on a notional amount of $100,000. Both rates are determined as of the first of the month. Entity H designates the interest rate swap as a hedge of 5 years of interest receipts on the $100,000 variable-rate asset and the first 5 years of interest payments on $100,000 of the variable-rate liability. The hedged risk is the variability in the contractually specified interest payments received on the asset and paid on the liability. Assume the likelihood of credit default and the likelihood of principal prepayments each is remote.

55-11 Entity H may not automatically assume that the hedge always will be highly effective at achieving offsetting changes in cash flows because the reset date on the receive leg of the interest rate swap differs from the reset date on the corresponding variable-rate liability. Both at hedge inception and on an ongoing basis, Entity H’s assessment of expected effectiveness could be based on the extent to which changes in LIBOR have occurred during
9. Hedge effectiveness

comparable 10-day periods in the past. Entity H’s ongoing assessment of effectiveness would be on a cumulative basis and would incorporate the actual interest rate changes to date. There will be no perfect offset to the extent that the cumulative change in cash flows on the prime leg of the interest rate swap did not offset the cumulative change in expected cash flows on the asset, and the cumulative change in cash flows on the LIBOR leg of the interest rate swap did not offset the change in expected cash flows on the hedged portion of the liability. The terms of the interest rate swap, the asset, and the portion of the liability that is hedged are the same, with the exception of the reset dates on the liability and the receive leg of the interest rate swap. Thus, there will be no perfect offset in the hedging relationship if LIBOR has changed between the first of the month (the reset date for the interest rate swap) and the tenth of the month (the reset date for the liability).

55-12 See Topic 820 (including paragraph 820-10-55-13) for a discussion of expected cash flows.

9.2.20 Timing and nature of prospective and retrospective effectiveness assessments

Excerpt from ASC 815-20

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-79 An entity shall consider hedge effectiveness in two different ways—in prospective considerations and in retrospective evaluations:

a. Prospective considerations. The entity’s expectation that the relationship will be highly effective over future periods in achieving offsetting changes in fair value or cash flows, which is forward looking, must be assessed on a quantitative basis at hedge inception unless one of the exceptions in paragraph 815-20-25-3(b)(2)(iv)(01) is met. Prospective assessments shall be subsequently performed whenever financial statements or earnings are reported and at least every three months. The entity shall elect at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(03) whether to perform subsequent assessments on a quantitative or qualitative basis. See paragraphs 815-20-35-2A through 35-2F for additional guidance on qualitative assessments of hedge effectiveness. A quantitative assessment can be based on regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. The quantitative prospective assessment of hedge effectiveness shall consider all reasonably possible changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument and the hedged items for the period used to assess whether the requirement for expectation of highly effective offset is satisfied. The quantitative prospective assessment may not be limited only to the likely or expected changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument or the hedged items. Generally, the process of formulating an
expectation regarding the effectiveness of a proposed hedging relationship involves a probability-weighted analysis of the possible changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument and the hedged items for the hedge period. Therefore, a probable future change in fair value will be more heavily weighted than a reasonably possible future change. That calculation technique is consistent with the definition of the term expected cash flow in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements.

b. Retrospective evaluations. An assessment of effectiveness may be performed on a quantitative or qualitative basis on the basis of the entity’s election at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(03). That assessment shall be performed whenever financial statements or earnings are reported, and at least every three months. See paragraphs 815-20-35-2 through 35-4 for further guidance. At inception of the hedge, an entity electing a dollar-offset approach to perform retrospective evaluations on a quantitative basis may choose either a period-by-period approach or a cumulative approach in designating how effectiveness of a fair value hedge or of a cash flow hedge will be assessed retrospectively under that approach, depending on the nature of the hedge documented in accordance with paragraph 815-20-25-3. For example, an entity may decide that the cumulative approach is generally preferred, yet may wish to use the period-by-period approach in certain circumstances. See paragraphs 815-20-35-5 through 35-6 for further guidance.

25-79A See paragraphs 815-20-25-139 through 25-142 about the timing of hedge effectiveness assessments required by paragraph 815-20-25-79 for a private company that is not a financial institution or a not-for-profit entity (except for a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market).

Topic 815 requires effectiveness assessments to be performed and documented both at inception of a hedging relationship and periodically thereafter. These subsequent effectiveness assessments are also referred to as ‘quarterly hedge effectiveness assessments’ because they are required to be performed at least quarterly. More specifically, they are required to be performed whenever financial statements or earnings are reported and at least every three months. [815-20-25-79]

Effectiveness assessments are required to be performed consistently with the initially documented method for assessing effectiveness (see section 2.9). [815-20-25-79(b), 55-66 – 55-69]

Two types of effectiveness assessments are required to be performed. [815-20-25-79, 35-2]

<table>
<thead>
<tr>
<th>Description</th>
<th>Frequency</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Prospective assessment</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A forward-looking assessment of whether gains or losses on the derivative hedging</td>
<td>— At hedge inception. — Whenever financial</td>
<td>If this assessment does not support an expectation of high effectiveness, hedge accounting is discontinued</td>
</tr>
</tbody>
</table>
Hedging
9. Hedge effectiveness

<table>
<thead>
<tr>
<th>Description</th>
<th>Frequency</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>instrument that are included in the assessment of effectiveness are expected to be highly effective at offsetting changes in the fair value (cash flows) of the hedged item (forecasted transaction). This generally involves a probability-weighed analysis of possible changes and is required to consider all reasonably possible scenarios.</td>
<td>statements or earnings are reported and at least every three months. In practice, this assessment is usually supported by periodic retrospective assessments (see Question 9.2.30).</td>
<td>prospectively (see section 2.10.50).</td>
</tr>
</tbody>
</table>

**Retrospective assessment**

Focuses on actual performance – i.e. whether gains or losses on the derivative hedging instrument that are included in the assessment of effectiveness actually have been highly effective at offsetting changes in the fair value (cash flows) of the hedged item (forecasted transaction). See also section 9.6.20 regarding choosing a cumulative or period-by-period approach when the dollar-offset method is used to assess effectiveness quantitatively.

Whenever financial statements or earnings are reported and at least every three months. If this assessment demonstrates that the hedge was not highly effective, hedge accounting is not applied for the period being assessed. Additionally, this may result in an entity concluding that the hedging relationship is not expected to be highly effective in the future (prospectively), resulting in the hedging relationship being discontinued (see section 2.10.50).

The initial prospective assessment is required to be quantitative, unless certain conditions are met (see conditions in the table in Question 9.2.50).

Subsequent effectiveness assessments (both prospective and retrospective) may be either qualitative or quantitative, depending on whether certain conditions are met (see conditions in section 9.5.10).

Additionally, there are three assessment methods that assume the hedging relationship is perfectly effective:

— the shortcut method (see section 9.3);
— the critical terms match method (see section 9.4); and
— the simplified hedge accounting approach, which is available for private companies that are not financial institutions (see section 10.2).
If a hedging relationship qualifies for one of these three assessment methods and the entity elects that method, subsequent effectiveness assessments under that method are primarily qualitative in nature.

When the initial effectiveness assessment is required to be quantitative, an entity has until the earliest of several dates to perform and document the initial quantitative effectiveness assessment, the latest of which is three months after hedge designation (see section 2.9.40). [815-20-25-3(b)(2)(iv)(01-02)]

Certain private companies and certain not-for-profit entities have additional time to perform and document their initial and subsequent quarterly effectiveness assessments (see chapter 10). [815-20-25-79A]

**Question 9.2.30**

Is a quarterly hedge effectiveness assessment always performed only quarterly?

**Interpretive response:** No. Although the periodic effectiveness assessments that are required subsequent to hedge inception are commonly referred to as quarterly hedge effectiveness assessments, they are required to be performed whenever financial statements or earnings are reported and at least every three months. [815-20-25-79]

Further, if the hedging relationship is shorter than three months, the effectiveness assessment is required to be performed to match the hedge period; for example, daily or weekly, such as when a dynamic hedging strategy is used as described in section 9.2.50. In other words, if the hedge period is daily, the effectiveness assessment is required to be performed daily based on daily changes in fair value (cash flows) of the derivative and portfolio of hedged items (forecasted transactions).

**Question 9.2.40**

May an entity use different methods for its prospective and retrospective effectiveness assessments?

**Interpretive response:** Yes. Topic 815 permits an entity to use different methods for its prospective and retrospective effectiveness assessments, provided that it documents the different methods in its hedge documentation and consistently uses those methods during the hedge period. [815-20-55-68 – 55-70]

However, in practice, most entities use the same method for both their prospective and retrospective assessments to reduce the administrative burden of applying hedge accounting and because unusual results may occur otherwise. Unusual results include the following.

— If an entity’s prospective assessment does not support an expectation that the hedging relationship will be highly effective, the hedging relationship must be discontinued even if the entity’s retrospective assessment indicates that the hedging relationship was (1) highly effective, and (2)
Hedge effectiveness would, if used as the prospective method, support an expectation of high effectiveness.

If an entity’s retrospective assessment indicates that the hedging relationship was not highly effective, hedge accounting cannot be applied for the period assessed even if the entity’s prospective assessment (1) supports an expectation of high effectiveness, and (2) would have, if used as the retrospective method, indicated that the hedging relationship was highly effective in the period assessed.

**Initial effectiveness assessments**

The following flowchart summarizes considerations related to whether an entity performs an initial hedge effectiveness assessment on a quantitative basis.

- Is the entity required to perform an initial prospective hedge effectiveness assessment on a quantitative basis? [815-20-25-3(b)(2)(iv)(01)]
  - Yes: Perform initial hedge effectiveness assessment on a quantitative basis (section 9.6)
  - No: Has the entity elected to perform an initial prospective hedge assessment on a quantitative basis?
    - Yes: Initial hedge effectiveness assessment not performed on a quantitative basis
      - No: Does the initial quantitative assessment support a prospective assessment that the hedging relationship will be highly effective? (section 9.2.40)
        - Yes: Hedge accounting may be elected
        - No: Do not apply hedge accounting
**Subsequent effectiveness assessments**

The following flowchart summarizes considerations related to whether an entity performs subsequent effectiveness assessments on a quantitative or qualitative basis.

---

**Question 9.2.50**

If an entity is not required to perform an initial prospective assessment on a quantitative basis, on what basis are its subsequent effectiveness assessments performed?

**Interpretive response:** It depends on the reason the initial prospective assessment is not required to be performed on a quantitative basis.

There are eight situations in which an initial quantitative assessment is not required (see also section 2.9.30 for formal documentation requirements). The following table summarizes those situations. In all cases, the critical terms are required to match. [815-20-25-3(b)(2)(iv)(01)]
## Description | Reference
--- | ---
**Fair value or cash flow hedges** |  |
(A) **Shortcut method**: Interest rate swap is used to hedge interest rate risk related to recognized assets or liabilities and certain conditions are met. [815-20-25-102 – 25-117] | Section 9.3 |

**Cash flow hedges** |  |
(B) **Critical terms match method**: A forward or option is used and the critical terms of the hedging instrument and hedged item match. [815-20-25-84 – 25-85, 35-9 – 35-12] | Section 9.4 |
(C) **Terminal value method**: A purchased option, net purchased option or zero-cost collar is used and certain conditions are met. [815-20-25-126, 25-129 – 25-129A] | Section 9.7.20 |
(D) **Simplified hedge accounting approach**: An interest rate swap is used to hedge interest rate risk of variable-rate borrowings and certain conditions are met. This approach is available to private companies that are not financial institutions. [815-20-25-133 – 25-138] | Section 10.2 |
(E) **Change-in-variable-cash-flows method**: An interest rate swap is used to hedge variability in interest receipts or payments and certain conditions are met. [815-30-35-16 – 35-24] | Section 9.7.40 |
(F) **Hypothetical derivative method**: A derivative instrument is used to hedge any eligible risk (an interest rate swap is used to hedge variability in interest receipts or payments) and the critical terms of the hedging instrument and hedged transaction match. [815-30-35-25 – 35-29] | Section 9.7.30 and 9.7.40 |

Note:
1. We believe the critical terms match method is precluded for fair value hedging relationships in the vast majority of circumstances (see section 9.4.20).

**Net investment hedges** |  |
(G) **Changes in spot rate method**: Certain conditions are met, depending on whether the hedging instrument is a derivative or a nonderivative. [815-35-35-5, 35-12] | Section 8.4.20 |
(H) **Changes in forward rate method**: Certain conditions are met. [815-35-35-17A] | Section 8.4.30 |

**Shortcut method (A), critical terms match method (B), or simplified hedge accounting approach (D)**

If the entity is applying one of these methods, it applies the specific guidance applicable to that method. The subsequent effectiveness assessments under these methods are primarily qualitative in nature.

**Other situations (C, E to H)**

In these situations, Topic 815 indicates that the hedging relationships will be perfectly effective if all conditions are met. However, it does not specify whether the subsequent effectiveness assessments are to be performed using the guidance for quantitative or qualitative assessments. As a result, we believe an entity may choose to perform its quarterly hedge effectiveness assessments on a quantitative or qualitative basis.
Why may an entity elect to perform subsequent assessments on a qualitative – rather than a quantitative – basis?

Background: As discussed in Question 9.2.50, an initial prospective assessment is not required to be performed on a quantitative basis in eight situations. In five of these situations (the ‘other situations’ referenced in Question 9.2.50), Topic 815 does not provide specific guidance regarding subsequent assessments. When an entity has applied one of these other qualitative approaches in its initial effectiveness assessment, we believe it may choose to perform its subsequent hedge effectiveness assessments on a quantitative or qualitative basis.

Interpretive response: In the other situations referenced in Question 9.2.50, the subsequent ongoing assessments will be largely similar regardless of whether an entity documents that it is applying a quantitative or a qualitative assessment as long as the critical terms of the hedging instrument and hedged item or transaction match. However, we believe electing to perform subsequent effectiveness assessments on a qualitative basis – rather than on a quantitative basis – may provide an entity with more flexibility should the critical terms of the hedging relationship cease to match (or other conditions cease to be met, if applicable).

This is because when the critical terms cease to match (or other conditions cease to be met), it may be possible for an entity to revert to performing qualitative assessments after performing a quantitative assessment if it can reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods.

This is explained further in the following table.

<table>
<thead>
<tr>
<th>Scenario 1: Critical terms continue to match (and other conditions continue to be met, if applicable) throughout the hedging relationship</th>
</tr>
</thead>
<tbody>
<tr>
<td>In this scenario, an entity’s quarterly hedge effectiveness assessment focuses on confirming and documenting the fact that the critical terms continue to match (and other conditions continue to be met, if applicable), whether the assessment is on a quantitative or qualitative basis.</td>
</tr>
<tr>
<td>Additionally, the entity is required to include in its initial hedge documentation a quantitative method, even if it elects to perform subsequent assessments on a qualitative basis (see discussion of formal documentation in section 2.9.30). This method is required to be the same as that used to support the entity’s initial prospective hedge effectiveness assessment.</td>
</tr>
<tr>
<td>Further, when an entity will perform its subsequent effectiveness assessments on a quantitative basis, we believe that an entity is not required to perform the actual calculation when the results of the quantitative test are known with mathematical certainty without performing the full calculation (see Question 9.6.80).</td>
</tr>
</tbody>
</table>
**Scenario 2: Critical terms cease to match (and/or other conditions cease to be met, if applicable) during the hedging relationship**

In this scenario, the subsequent assessment requirements differ depending on whether the entity chose to perform subsequent assessments on a quantitative or qualitative basis.

- **Quantitative basis.** If the entity documented that it will perform quantitative (rather than qualitative) assessments each period, it will be required to perform quantitative assessments in all periods – i.e. dollar-offset or statistical analysis, as selected in the initial documentation.

- **Qualitative basis.** If the entity documented that it will perform qualitative assessments, it is required to use its judgment in determining whether there has been a change in facts and circumstances such that it can no longer assert qualitatively that the hedging relationship was and continues to be highly effective (as discussed in section 9.5.20). We believe the entity would apply judgment when the critical terms of the hedging instrument and hedged item or transaction cease to match.

- The entity is permitted to perform a quantitative assessment in any reporting period to validate whether qualitative assessments of hedge effectiveness remain appropriate. [815-20-35-2D]

- If the entity was required or elected to perform quantitative effectiveness assessments, it is permitted to revert to qualitative effectiveness assessments if it can reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods (see Question 9.5.50).

As a result, an entity may conclude that continued qualitative assessments are appropriate (e.g. if the degree to which the critical terms cease to match is minimal) and/or may perform a quantitative assessment in one period to validate its assertion that continued qualitative assessments are appropriate in future periods.

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**9.2.30 Aligning effectiveness assessments with the designated hedged risk**

**Excerpt from ASC 815-20**

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-76 If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, either of the following conditions shall be met:

a. The increases (or decreases) in the fair value of the hedging instrument are expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item (if a fair value hedge).
b. The cash inflows (outflows) from the hedging instrument are expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction (if a cash flow hedge).

>>> Hedge Effectiveness When Hedged Exposure Is More Limited Than Hedging Instrument

25-100 An entity may designate as the hedging instrument in a fair value hedge or cash flow hedge a derivative instrument that does not have a limited exposure comparable to the limited exposure of the hedged item to the risk being hedged. However, to make that designation, in accordance with paragraph 815-20-25-75, the entity shall establish that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated. See paragraph 815-20-25-79(a) for additional guidance on prospective considerations of hedge effectiveness in this circumstance.

Effectiveness assessments are required to be performed in a manner that is consistent with the documented risk management objective. That is, when assessing effectiveness, the change in the fair value or cash flows of the hedged item or 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 change in fair value or cash flows (other than excluded components). [815-20-25-75]

Topic 815 provides flexibility in designating the hedged risk, including that the hedged risk is not always required to be the entire change in the fair value or cash flows of the hedged item or forecasted transaction (see section 2.2.20). Similarly, Topic 815 permits using a variety of hedging instruments (see section 2.6), and permits excluding certain components of the hedging instrument from effectiveness assessments (see section 9.2.70). However, in all cases, an entity is required to select a derivative hedging instrument for which the change in fair value or cash flows (other than excluded components) is expected to be highly effective at offsetting changes in fair value or cash flows attributable to the hedged risk. [815-20-25-76]

The following are examples of designating the hedged risk and selecting a hedging instrument in the context of assessing effectiveness.

| Hedged risk is one-sided | For example, an entity may hedge only an increase in the benchmark (or contractually specified) interest rate when hedging existing fixed-rate (or variable-rate) debt. It may be necessary for the entity to select a hedging instrument that provides one-sided offset when the hedged risk is one-sided to achieve a highly effective hedging relationship. Typically, an option is used because of its one-sided nature. [815-20-25-76] See also section 9.2.70 regarding excluded components, and section 9.2.90 regarding using options as hedging instruments. |
**Hedged exposure is limited but hedging instrument’s exposure is not**

For example, an entity may hedge fixed-rate debt that is prepayable in a **fair value hedge** with a hedging instrument that does not have a mirror prepayment feature. Or, an entity may hedge variable-rate debt that has a floor of zero on the interest rate in a **cash flow hedge** with a hedging instrument that does not have a floor. The entity is required to demonstrate that the hedging instrument in each case is expected to be highly effective at offsetting changes in fair value or cash flows attributable to the hedged risk, including consideration of the mismatch of exposures between the hedging instrument and hedged item. [815-20-25-100, 55-193 – 55-197]

This type of relationship may be highly effective in some circumstances. For example, an entity enters into a cash flow hedge of variable-rate debt that has a cap on the interest rate with a hedging instrument that does not. Although the effectiveness assessment must consider all reasonably possible changes in cash flows (rather than only likely or expected changes) the assessment involves a probability-weighted analysis.

This means that probable changes are more heavily weighted than reasonably possible changes. As a result, if it is unlikely that interest rates will fall below the level in the floor, they will not have a significant effect on the expected cash flows of the hedging instrument and the hedging relationship may be highly (although not perfectly) effective. [815-20-25-79(a), 55-197]

See also Subtopic 815-20’s Example 22 reproduced below.

**Hedged risk is within a range and the hedging instrument is a net purchased option**

For example, an entity may wish to hedge against changes in the benchmark (or contractually specified) interest rate on existing fixed-rate (or variable-rate) debt only within a certain range of interest rates. In this situation, the entity may designate as the hedging instrument a combination of options (deemed to be a net purchased option) and assess effectiveness based only on changes in the underlying that cause a change in the intrinsic value of that net purchased option. [815-20-25-130 – 25-131]

See section 9.2.70 regarding excluded components, and section 9.2.90 regarding using options as hedging instruments (including Example 9.2.60).

If the hedged risk is basis risk, each leg of the basis swap is required to be linked to a designated item with the same underlying. For a discussion of the special rule for basis swaps, see section 5.5.10. [815-20-25-50 – 25-51]

**Examples**

The following examples demonstrate effectiveness assessments that are consistent with the documented risk management objective.

— Consistency of effectiveness assessment with documented risk management objective (Example 9.2.10).
— Cesignation if hedged exposure is limited but derivative instrument exposure is not (Subtopic 815-20’s Example 22).
**Example 9.2.10**

Consistency of effectiveness assessment with documented risk management objective

ABC Corp.’s documented hedged risk objective includes hedging only the change in fair value (or cash flows) related to interest payments on debt due to an increase in the benchmark rate above 7%.

Therefore, the change in fair value of the hedged item (or change in cash flows of the forecasted transaction) that is included in the effectiveness assessment is limited to the extent of the change in fair value (or change in cash flows) of the debt resulting from increases in the benchmark interest rate over 7%.

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**Excerpt from ASC 815-20**

>> Example 22: Designation If Hedged Exposure Is Limited but Derivative Instrument Exposure Is Not

55-193 The following Cases illustrate the application of paragraph 815-20-25-100 to situations in which the hedged item or hedged forecasted transaction may have a risk exposure that is limited, but the derivative instrument that the entity desires to designate as a hedging instrument does not have comparable limits:

a. Fair value hedge (Case A)
b. Cash flow hedge (Case B).

55-194 For the purposes of both Cases A and B, it is assumed that the shortcut method may not be applied.

>>> Case A: Fair Value Hedge

55-195 Entity A issues 10-year fixed-rate debt that is callable at the end of the fifth year. It decides to convert the interest payments on the bond from fixed-rate to variable-rate by entering into a 10-year receive-fixed, pay-variable interest rate swap. The interest rate swap is not cancelable at the end of the fifth year. From Entity A’s perspective, if interest rates increase, there is a gain on the debt (the liability’s fair value decreases) and a loss on the swap (fair value either decreases as an asset or increases as a liability). If interest rates decrease, there is a loss on the debt (the liability’s fair value increases) and a gain on the swap (fair value either increases as an asset or decreases as a liability). However, during the first five years, if interest rates decrease, the gain on the swap will exceed the loss on the debt because the debt’s fair value change will consider the impact of the call feature, which is in the money when interest rates fall below the stated rate on the debt. Entity A wishes to designate the interest rate swap as the hedging instrument in a fair value hedge of interest rate risk of the fixed-rate debt. The conclusions for Case A and Case B are discussed in paragraph 815-20-55-197.
Case B: Cash Flow Hedge

Entity B issues 10-year, variable-rate debt that reprices based on 6-month LIBOR. The interest rate on the debt is capped at 9 percent. Entity B decides to convert the interest payments on the debt from variable-rate to fixed-rate by entering into a receive-variable, pay-fixed interest rate swap. There is no cap on the variable-rate leg of the interest rate swap. From Entity B’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 such that the variable rate on the swap would be greater than 9 percent, 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, which is in the money if interest rates increase such that the variable rate on the debt would exceed 9 percent. Entity B wishes to designate the interest rate swap as the hedging instrument in a cash flow hedge of interest rate risk of the variable-rate debt.

In both Cases A and B, the entity must assess, based on an appropriate methodology, whether the changes in fair value or cash flows of the interest rate swap could be expected to be highly effective in offsetting changes in fair value or cash flows of the debt attributable to interest rate risk taking into account the effect of the embedded call option (Case A) or the effect of the interest rate cap (Case B). As required by paragraph 815-20-25-6, the effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. Therefore, if the options in Cases A and B are expected to be out of the money based on a probability-weighted analysis of the range of possible changes in interest rates, then those options would be expected to have a minimal effect on changes in fair value or cash flows of the debt, and the hedging relationships could meet the requirement for an expectation of high effectiveness. In the case of a fair value hedge of callable debt discussed in Case A, in accordance with paragraph 815-20-25-6B, Entity A may assess hedge effectiveness on the basis of whether the debt will be called at the end of the fifth year because of expected changes in benchmark interest rates, but not because of other factors potentially affecting the exercise of the call feature. Entity A intends to assess hedge effectiveness on this basis.

Meaning of ‘highly effective’

Entities commonly think of a highly effective hedging relationship from an economic point of view – i.e. whether the derivative provides the desired risk management effect. Often, that view is consistent with Topic 815’s notion that high effectiveness is achieved when the changes in the fair value or cash flows of a derivative hedging instrument are highly effective at offsetting changes in the fair value or cash flows of the hedged item or hedged transaction attributable to the hedged risk. However, the distinction between an effective economic hedge and a hedge that is permitted under Topic 815 is significant.
because hedge accounting is permitted only if the specific criterion of high effectiveness and other eligibility criteria are met.

Hedge effectiveness is measured using the following formula.

\[
\frac{\text{Absolute value of change in fair value or cash flows of hedging instrument (other than excluded components)}}{\text{Absolute value of change in fair value or cash flows of hedged item or transaction due to hedged risk}} \times 100\% = \text{Percentage of offset}
\]

To be highly effective, should be within the range of 80%–125% (see Question 9.2.70)

**Question 9.2.70**

**Does Topic 815 define highly effective?**

**Interpretive response:** No. Topic 815 does not define ‘highly effective’.

When the term was initially introduced in FASB Statement No. 133 (now Topic 815), the FASB intended it to have essentially the same meaning as the notion of ‘high correlation’ used in FASB Statement No. 80 (futures contracts). As a result, we believe that ‘highly effective’ describes a relationship in which the change in the fair value or cash flows of the derivative hedging instrument is within 80% to 125% of the opposite change in the fair value or cash flows of the hedged item or cash flows attributable to the hedged risk.

Additionally, the FASB has acknowledged that practice has interpreted highly effective to mean an 80%–125% offset. [ASU 2017-12.BC165]

**Example 9.2.20**

**Calculations of effectiveness**

The following scenarios show how the extent of effectiveness of a hedging relationship is computed.

<table>
<thead>
<tr>
<th>Scenario 1: Fair value hedge – 80% effective</th>
<th>Increase (decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in fair value of derivative hedging instrument included in the assessment of effectiveness</td>
<td>$80</td>
</tr>
<tr>
<td>Change in fair value of hedged item attributable to the hedged risk</td>
<td>$(100)</td>
</tr>
<tr>
<td>Effectiveness</td>
<td>80%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 2: Scenario 1: Fair value hedge – 125% effective</th>
<th>Increase (decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in fair value of derivative hedging instrument included in the assessment of effectiveness</td>
<td>$100</td>
</tr>
<tr>
<td>Change in fair value of hedged item attributable to the hedged risk</td>
<td>$(80)</td>
</tr>
<tr>
<td>Effectiveness</td>
<td>125%</td>
</tr>
</tbody>
</table>
9.2.50 Determining the period for assessing effectiveness

Excerpt from ASC 815-20

>>> Hedge Effectiveness during Designated Hedge Period

25-101 It is inappropriate under this Subtopic for an entity to designate a derivative instrument as the hedging instrument if the entity expects that the derivative instrument will not be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated, unless the entity has documented undertaking a dynamic hedging strategy in which it has committed itself to an ongoing repositioning strategy for its hedging relationship.

It is not appropriate for an entity to designate a derivative as the hedging instrument when it expects that the derivative will not be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period over which effectiveness will be assessed. [815-20-25-101]

However, an entity is not required to assess effectiveness using an assessment period that is as long as the term of the hedging instrument. Instead, an entity may undertake 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. When an entity does this, effectiveness is expected over that assessment period. [815-20-25-101]

The following are examples of dynamic hedging strategies.

**Delta-neutral dynamic hedging strategy**

In a delta-neutral dynamic hedging strategy for a fair value hedge, an entity may commit to constant monitoring of the ratio of changes in the option’s price to changes in the price of the hedged item (referred to as the option’s delta).

As the ratio changes, the entity rebalances 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.

In this situation, the hedging instrument is constantly being changed and the assessment of effectiveness considers only the change in fair value to the next rebalancing date.

See also Question 2.10.60 regarding whether a rebalancing of hedging derivatives when such a strategy is used requires discontinuation of the hedging relationship.

**Tailing strategy**

In a tailing strategy with futures contracts in a cash flow hedge, 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 the offset of cash flows, 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.

In this situation, an entity is required to 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 it is probable that the forecasted transactions will occur. [815-20-25-121]

See also section 9.2.110 for a discussion of the time value of money and Question 2.10.60 regarding whether a rebalancing of hedging derivatives when such a strategy is used requires discontinuation of the hedging relationship.

Additionally, Topic 815 does not prescribe the historical period that should be used when assessing whether a hedging instrument is expected to be (or has been) highly effective at offsetting the hedged risk (see Question 9.2.80).

**Question 9.2.80**

How does an entity determine the historical period when initially assessing hedge effectiveness?

**Interpretive response:** Regardless of the technique used to assess hedge effectiveness, we believe an entity should document the historical relationship between changes in fair values of the hedged item (or cash flows of the
forecasted transaction) and changes in the fair value (or cash flows) of the
derivative hedging instrument over an appropriate period.

Judgment is required in determining the appropriate period to be used.
However, an entity should consider that the objective of the prospective
effectiveness assessment is to conclude that the hedging relationship is
expected to be highly effective. As a result, an entity should consider a
historical period for which the potential changes are reasonably expected to
reflect those expected over the documented hedge period.

For example, if an entity is considering a two-year foreign currency hedging
relationship involving US dollars and euros (€), its prospective effectiveness
assessment should not be limited to changes in the $/€ exchange rate for the
last month. The 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.

Once an entity has initially assessed hedge effectiveness, the historical period
to be used when performing subsequent effectiveness assessments depends
on the method used to assess effectiveness. For discussion of the information
to be used when performing quantitative effectiveness assessments using
dollar-offset method and regression analysis, see sections 9.6.20 and 9.6.30,
respectively.

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**Special criterion for fair value hedges only**

Excerpt from ASC 815-20

> > Hedge Effectiveness Criterion Applicable to Fair Value Hedges Only

25-118 In documenting its risk management strategy for a fair value hedge, an
entity may specify an intent to consider the possible changes (that is, not
limited to the likely or expected changes) in value of the hedging derivative
instrument and the hedged item only over a shorter period than the derivative
instrument'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. The entity does not need to contemplate the
offsetting effect for the entire term of the hedging instrument.

When designating a fair value hedging relationship, an entity can specify an
intent to consider changes in the values of the hedging instrument and hedged
item over a period shorter than the hedging instrument’s remaining life when
assessing effectiveness. To do so, the entity needs to consider the possible
changes in these values, not only the likely or expected changes. Therefore, 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. [815-20-25-118]

This approach may be useful when a hedged item’s risk exposure is limited, but
the risk exposure of the hedging derivative is not. Subtopic 815-20’s
Example 22 (reproduced in section 9.2.30) demonstrates a situation in which an
entity hedges 10-year debt that is callable after five years with a 10-year interest
rate swap that is not cancelable. In that situation, an entity may choose to assess effectiveness by considering the possible changes in the fair value of the derivative hedging instrument for a period shorter than the derivative’s life, such as the next three months.

**Interest rate risk.** Alternatively, an entity may choose to use a partial-term hedging strategy when the hedged risk is interest rate risk or a combination of interest rate risk and foreign currency risk, which is discussed in section 3.3.80. Under this strategy, an entity measures the change in the hedged item’s fair value attributable to interest rate risk using an assumed term that reflects only the designated cash flows and assumes that the principal payment occurs at the end of the hedge term. This strategy may result in a hedge that is more likely to be highly effective, as explained in Question 3.3.210.

**FASB Example: Hedge effectiveness horizon in a fair value hedge when effectiveness is assessed on a quantitative basis**

<table>
<thead>
<tr>
<th>Excerpt from ASC 815-20</th>
</tr>
</thead>
</table>

**Example 25: Hedge Effectiveness Horizon in a Fair Value Hedge When Effectiveness Is Assessed on a Quantitative Basis**

55-204 This Example illustrates the application of paragraph 815-20-25-118. Under the guidance in that paragraph, if a derivative instrument with a five-year term is designated as the hedging instrument in a fair value hedge of a financial asset that also has a five-year term, an entity may base its expectation that the hedging relationship will be highly effective in achieving offsetting changes in fair value for the risk being hedged by considering the possible changes in value occurring only over a shorter period than the life of the derivative instrument, such as over only the first three months of the derivative instrument’s five-year life. For example, an entity may specify, in documenting its risk management strategy, that every three months it will do both of the following:

a. It will assess the effectiveness of the existing hedging relationship for the past three-month period.

b. It intends to consider possible changes in value of the hedging derivative and the hedged item over the next three months in deciding whether it has an expectation that the hedging relationship will continue to be highly effective at achieving offsetting changes in fair value.
9.2.60 Considering counterparty credit risk and entity’s own non-performance risk

Excerpt from ASC 815-20

>>> Consideration of Counterparty Credit Risk

25-122 For a cash flow hedge, an entity shall consider the likelihood of the counterparty’s compliance with the contractual terms of the hedging derivative instrument that require the counterparty to make payments to the entity. Paragraph 815-20-35-14 states that, for an entity to conclude on an ongoing basis that a cash flow hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows, the entity shall not ignore whether it will collect the payments it would be owed under the contractual provisions of the derivative instrument. See paragraphs 815-20-35-14 through 35-18 for further guidance.

> Possibility of Default by the Counterparty to Hedging Derivative

35-14 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 shall not ignore whether it will collect the payments it would be owed under the contractual provisions of the derivative instrument. In complying with the requirements of paragraph 815-20-25-75(b), the entity shall assess the possibility of whether the counterparty to the derivative instrument will default by failing to make any contractually required payments to the entity as scheduled in the derivative instrument. In making that assessment, the entity shall also consider the effect of any related collateralization or financial guarantees. The entity shall be aware of the counterparty’s creditworthiness (and changes therein) in determining the fair value of the derivative instrument. Although a change in the counterparty’s creditworthiness would not necessarily indicate that the counterparty would default on its obligations, such a change shall warrant further evaluation.

35-15 If the likelihood that the counterparty will not default ceases to be probable, 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.

35-16 In contrast, a change in the creditworthiness of the derivative instrument’s counterparty in a fair value hedge would have an immediate effect because that change in creditworthiness would affect the change in the derivative instrument’s fair value, which would immediately affect both of the following:

a. The assessment of whether the relationship qualifies for hedge accounting
b. The amount of mismatch between the change in the fair value of the hedging instrument and the hedged item attributable to the hedged risk recognized in earnings under fair value hedge accounting.

35-18 Paragraph 815-20-25-103 states that, in applying the shortcut method, an entity shall consider the likelihood of the counterparty’s compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity. That paragraph explains that implicit in the
Hedge effectiveness criteria for the shortcut method is the requirement that a basis exist for concluding on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair values or cash flows.

Topic 815 – in combination with Topic 820 (fair value) – requires an entity to consider the effects of counterparty credit risk and the entity’s own nonperformance risk when assessing the effectiveness of hedging relationships. These considerations are different for fair value versus cash flow hedges, and also differ depending on the effectiveness assessment method, as follows.

### Fair value hedge

- Changes in both counterparty credit risk and an entity’s own nonperformance risk affect the measurement of changes in the fair value of the derivative hedging instrument. These changes likely have no offsetting effect on changes in the measurement of the hedged item attributable to the hedged risk.
- As a result, changes in counterparty credit risk and the entity’s own nonperformance risk will result in a hedge not being perfectly effective and such changes have an immediate effect on the assessment of effectiveness.
- However, if the shortcut method is used (see section 9.3), the potential effect of these differences on the hedging relationship’s effectiveness is ignored unless it is no longer probable that the derivative counterparty or the entity itself will not default. If non-default by either party is no longer probable, the shortcut method is required to be discontinued.

### Cash flow hedge

- Changes in both counterparty credit risk and an entity’s own nonperformance risk affect the measurement of changes in the fair value of the derivative hedging instrument – and therefore the derivative gains or losses recognized in OCI.
- The effectiveness assessment may also be affected by changes in counterparty credit risk and an entity’s own nonperformance risk even if effectiveness is not assessed based on a method that uses the derivative hedging instrument’s fair value change.
- The potential effect on the hedging relationship’s effectiveness of these changes is ignored. However, if it is no longer probable that the derivative counterparty or the entity itself will not default, an entity will be unable to conclude that the hedging relationship is expected to be highly effective and will therefore be required to discontinue the hedging relationship.
- In addition, an entity is required to consider the credit risk of the counterparty to the hedged transaction to determine the likelihood that it will occur, particularly if the hedged transaction involves payments under a contractual obligation.
An entity is required to consider the effects of counterparty credit risk and the entity’s own nonperformance risk when assessing hedging relationships.

Changes in both counterparty credit risk and an entity’s own nonperformance risk affect the measurement of changes in the fair value of a derivative hedging instrument, and therefore the derivative gains or losses recognized in CTA within AOCI.

The potential effect of these differences on a net investment hedging relationship’s effectiveness as an economic hedge is ignored unless it is no longer probable that the derivative counterparty or the entity itself will not default. If the forward method is used and meets the conditions to be perfectly effective, the total changes in the fair value of the derivative instrument are included in CTA within AOCI.

However, if non-default by either party is no longer probable, an entity will be required to assess whether the hedging relationship has been and is expected to continue to be effective as an economic hedge. If an entity continues to expect the relationship to be effective as an economic hedge, strong evidence supporting the expectation would be needed.

See also KPMG’s Q&A: Fair value measurement, including:

Section O, Application issues: Derivatives and hedging, including Question O70, which provides additional information about whether (and how) the requirements to include counterparty credit risk and an entity’s own nonperformance risk in measuring the fair values of derivative instruments affect hedging relationships.

Question C70, which addresses how to consider the existence of a separate arrangement (such as a master netting agreement or credit support agreement) that mitigates credit risk exposure in the event of default when measuring the fair value of a financial instrument.

**Question 9.2.90**

*If a hedging instrument is in a liability (asset) position, can changes in counterparty creditworthiness (its own nonperformance risk) be ignored?*

**Interpretive response:** No. Changes in a derivative hedging instrument’s underlying can cause it to move into an asset position before its settlement or maturity. As a result, an entity must consider the effect that changes in the counterparty’s credit risk would have on the hedging relationship if the derivative were to move into an asset position. If the current likelihood of counterparty default would cause the entity to discontinue a cash flow hedge (or a fair value hedge for which the shortcut method is used) for which the
Hedging instrument is in an asset position, the entity typically should discontinue the hedging relationship even if the hedging derivative is in a liability position. That is, the possibility that a change in the underlying could cause the derivative to move into an asset position before settlement or maturity typically would cause the hedging relationship to be not highly effective on a prospective basis.

Similarly, an entity cannot ignore the effect of its own nonperformance risk if a derivative hedging instrument is in an asset position. Because the derivative could move into a liability position before its settlement or maturity, an entity must consider the effect its own nonperformance risk would have on the hedging relationship in the same way that the entity must consider the counterparty’s credit risk when the derivative is in a liability position.

See also KPMG’s Q&A: Fair value measurement, including Section O, Application issues: Derivatives and hedging. In particular, see Question O20, which provides information about how credit valuation adjustments (CVA) for counterparty credit risk and debit valuation adjustments (DVA) for an entity’s own nonperformance risk are determined in measuring derivatives at fair value.

**Consideration of credit risk adjustments determined at a portfolio level for hedging instruments**

Derivative instruments are measured on the balance sheet at fair value. The fair values of derivative instruments are typically determined on an individual basis. However, if certain conditions are met, an entity is permitted to measure the fair value of a group of financial assets and liabilities based on a price that would be received to sell or paid to transfer the net risk position (referred to as a ‘portfolio measurement exception’). [820-10-35-18D – 35-18E]

If an entity has a group of derivative assets and liabilities with a particular counterparty and applies the portfolio measurement exception to that counterparty’s credit risk, the effect on the entity’s net exposure to the credit risk of that counterparty (or on the counterparty’s net exposure to the entity’s own nonperformance risk) may result in a portfolio-level credit risk adjustment when measuring fair value to be recognized on the entity’s balance sheet.

Even though the credit risk adjustment may be determined at a portfolio level under the portfolio measurement exception, hedge effectiveness is assessed on an individual hedging relationship basis. This means that an entity is required to consider the effect of counterparty credit risk (or its own nonperformance risk) on each individual hedging relationship when assessing hedge effectiveness. As a result, it may be necessary to allocate a portfolio-level credit risk adjustment to individual hedging relationships, as explained in Questions 9.2.90 and 9.2.100.

Because the effect of a portfolio-level credit risk adjustment is part of an entity’s effectiveness assessments, an entity needs to determine the adjustment as frequently as it performs the hedge effectiveness assessments (whether daily, weekly, monthly, quarterly or other frequency).

Additionally, an entity may be required to allocate a portfolio-level credit risk adjustment to individual hedging derivatives to properly account for the
derivatives, even if such an allocation is not necessary for assessing effectiveness (see Question 9.2.140).

See also KPMG’s Q&A: Fair value measurement. In particular, see:

— Section L, Portfolio measurement exception, which addresses the circumstances under which it is appropriate to apply the portfolio measurement exception and related issues.

— Section O, Application issues: Derivatives and hedging, including Question O70, which discusses how the requirements to include counterparty credit risk and an entity’s own nonperformance risk in measuring the fair values of derivative instruments affect hedging relationships.

The flowchart below summarizes considerations when evaluating whether a portfolio-level credit risk adjustment (that results from applying the portfolio measurement exception when measuring the fair value to be recognized on the balance sheet for a group of derivatives) is required to be allocated to individual derivative instruments either for purposes of assessing effectiveness of hedging relationships or for other purposes.
Hedging
9. Hedge effectiveness

What is the type of hedging relationship?

- Cash flow hedge;
- Fair value hedge - shortcut method is used to assess effectiveness; or
- Net investment hedge.

Continue

Is it probable the counterparty to the hedging instrument will not default?

No

Yes

Continue

Fair value hedge - effectiveness is assessed using a method other than the shortcut method

Is it appropriate for the entity to qualitatively evaluate the effect of a portfolio-level credit risk adjustment on individual fair value hedging relationships? (see Question 9.2.110 and Example 9.2.30)

No

Yes

Continue

The hedging relationship is discontinued, so there is no longer a hedging relationship to which to make a quantitative allocation of the portfolio-level credit risk adjustment. (see Question 9.2.100)

A quantitative allocation of the portfolio-level credit risk adjustment is required to assess effectiveness. (see Question 9.2.120)

A quantitative allocation of the portfolio-level credit risk adjustment is not required for purposes of assessing hedge effectiveness. (see Question 9.2.110)

An allocation of the portfolio-level credit risk adjustment may be necessary for accounting purposes. (see Question 9.2.140)

Question 9.2.100

Must an entity allocate a portfolio-level credit risk adjustment to individual hedging relationships when assessing effectiveness?

Interpretive response: Generally, yes. When assessing hedge effectiveness, an entity generally is required to determine the individual credit risk adjustments to arrive at the fair values of the individual hedging derivatives or the appropriate credit risk adjustment for a group of derivatives that have been designated together as the hedging instrument in a single hedging relationship.

However, it may not be necessary to make such an allocation, depending on the type of hedging relationship and the method used to assess effectiveness, as explained in the following table.
### Fair value and cash flow hedges – shortcut method

Under the shortcut method, a hedge is assumed to be perfectly effective – with changes in fair value of the hedging derivative serving as a proxy for changes in the fair value of the hedged item – when it is probable that the interest rate swap’s counterparty or the entity itself will not default.

In this situation, an entity may conclude that the hedging relationship is highly effective without allocating the portfolio-level credit risk adjustment.

If it is not probable that the counterparty or the entity itself will not default, the shortcut method is required to be discontinued and there is no longer a hedging relationship to which to make an allocation.

### Fair value hedges – long-haul methods

For all fair value hedges other than those using the shortcut method, changes in the fair value of a derivative – including those related to counterparty credit risk and an entity’s own nonperformance risk – have an immediate effect on the assessment of effectiveness. Normally, this results in a requirement to allocate a portfolio-level credit risk adjustment to the individual hedging instruments.

However, in some situations, it may be possible for an entity to qualitatively evaluate whether it is necessary to allocate the portfolio-level credit risk adjustment to individual fair value hedging relationships (see Question 9.2.110).

### Cash flow hedges – all methods other than shortcut

An entity is permitted to ignore the effects of changes in both counterparty credit risk and an entity’s own nonperformance risk for a cash flow hedge if it is probable that the counterparty to the derivative instrument and the entity itself will not default.

In this situation, an entity may conclude that the hedging relationship is highly effective without performing an allocation of the portfolio-level credit risk adjustment.

Additionally, if it is not probable that the counterparty or the entity itself will not default, an entity will be unable to conclude that the hedging relationship is expected to be highly effective and must discontinue the hedge. If the hedge is discontinued, there is no longer a hedging relationship in which to make an allocation.

### Net investment hedges

An entity is permitted to ignore the effects of changes in both counterparty credit risk and an entity’s own nonperformance risk for a net investment hedge if it is probable that the counterparty to the derivative instrument and the entity itself will not default. In this situation, an entity may conclude that the hedging relationship is effective as an economic hedge without performing an allocation of the portfolio-level credit risk adjustment.

If it is not probable that the counterparty or the entity itself will not default, an entity will frequently conclude that the hedging relationship is no longer expected to be effective as an economic hedge and discontinue the hedge. If the hedge is discontinued, there is no longer a hedging relationship in which to make an allocation. If the entity concludes that the hedging relationship continues to be expected to be effective as an economic hedge, the entity is required to allocate the portfolio-level credit risk adjustment to the individual hedging relationships when assessing effectiveness.
Under what circumstances may an entity qualitatively evaluate the effect of a portfolio-level credit risk adjustment on individual fair value hedging relationships?

Interpretive response: The SEC staff will not object to using a qualitative analysis to conclude that it is not necessary to allocate the portfolio-level credit risk adjustment to the individual fair value hedging relationships when assessing effectiveness, provided the qualitative analysis results in a reasonable conclusion, based on the specific facts and circumstances.

An entity should use reasonable judgment in performing a qualitative analysis. A conclusion that it is probable that the counterparty and the entity itself will not default is not, in isolation, a sufficient qualitative analysis. Instead, the qualitative analysis should consider all relevant facts and circumstances, including:

- the size of the portfolio-level credit risk adjustment;
- the hedging relationships’ degree of effectiveness without considering the portfolio-level credit risk adjustment;
- the creditworthiness of the counterparty and the entity itself;
- the probability of default by either party; and
- the method used to assess effectiveness.

Further, if an entity is unable to conclude it is probable that the counterparty or the entity itself will not default, a solely qualitative analysis is not appropriate. Additionally, if the shortcut method is used to assess effectiveness, the hedging relationship is required to be discontinued.

When a reasonable conclusion that the hedging relationships, including derivative instruments subject to the portfolio-level credit risk adjustment, would be highly effective cannot be reached solely through a qualitative analysis, a quantitative analysis is necessary.

Example 9.2.30

Qualitative analysis of whether allocation of portfolio-level credit risk adjustment is required

ABC Corp. applies the portfolio measurement exception to its derivative assets and liabilities with DEF Counterparty and applies the portfolio measurement exception to DEF’s credit risk, resulting in a portfolio-level credit risk adjustment.

The net position of ABC’s derivative instruments with DEF is a $10 billion liability position and the portfolio-level credit risk adjustment is $1 million. The derivative instruments are part of fair value hedging relationships for which ABC uses regression analysis (a long-haul method) for assessing effectiveness.

Both ABC and DEF are AA-rated and the likelihood of either party not defaulting is deemed probable.
Other causes of the relationship not being perfectly effective are minimal, such that the hedging relationships are at least 95% effective without consideration of the portfolio-level credit risk adjustment.

Based on these facts, ABC may conclude that a qualitative analysis is sufficient for determining an allocation of the portfolio-level credit adjustment when assessing effectiveness.

However, ABC may be required to allocate the portfolio-level credit adjustment for reasons other than assessing effectiveness, as explained in Question 9.2.140.

**Question 9.2.120**

What methods may be used to quantitatively allocate a portfolio-level credit risk adjustment to individual fair value hedging relationships?

**Interpretive response:** When measuring the fair values of individual hedging instruments to assess effectiveness, we believe an entity should adopt a reasonable and consistently applied methodology for allocating credit risk adjustments determined at a portfolio level to individual derivative instruments.

In our experience, the following allocation methods generally are used for credit risk adjustments.

— **Relative fair value method.** The portfolio-level credit risk adjustment is allocated to the individual instruments in the portfolio based on their relative fair values. There are two methods that are used in practice.

  — Allocate the adjustment to all instruments in the portfolio based on their relative fair values.
  
  — Allocate the adjustment only to those instruments that are in the same position (asset or liability) as the net position with the counterparty, based on their relative fair values. For example, if the net position is an asset, the portfolio-level credit risk adjustment is allocated only to the financial assets in the portfolio based on their relative fair values.

— **Relative credit adjustment method.** The portfolio-level credit risk adjustment is allocated to the individual instruments in the portfolio based on their relative stand-alone credit risk adjustments. Applying this method requires the entity to calculate the credit risk adjustment both on a gross basis (assuming that the portfolio measurement exception is not applied) and on a net basis.

The appropriate allocation method is affected by the fair value hierarchy of the financial instruments within the portfolio (see Question 9.2.130).

See also KPMG’s Q&A: Fair value measurement. In particular, see:

— Section L, Portfolio measurement exception, including Question L60, which addresses allocations of a net portfolio basis adjustment to individual financial assets and liabilities that make up the portfolio.

— Section O, Application issues: Derivatives and hedging, including Question O70, which discusses how the requirements to include
counterparty credit risk and an entity’s own nonperformance risk in measuring the fair values of derivative instruments affect hedging relationships.

Question 9.2.130

How does a financial instrument’s level in the fair value hierarchy affect allocation of a portfolio-level credit risk adjustment to individual hedging relationships?

Interpretive response: We understand from conversations with the FASB staff that they believe the fair value allocated to financial instruments within the portfolio categorized in Level 1 of the fair value hierarchy should be determined using the instrument price times the quantity (i.e. P×Q), which is consistent with the guidance in Topic 820 for Level 1 inputs. The FASB staff indicated that the net portfolio measurement exception allows an entity to estimate the fair value of financial instruments at levels different from the unit of account prescribed by other Topics, but does not provide an exception to the other conclusions and concepts of fair value measurement under Topic 820.

We believe this guidance is unlikely to apply in many circumstances because the portfolios to which portfolio-level credit risk adjustments would apply frequently do not contain Level 1 derivative instruments.

See also KPMG’s Q&A: Fair value measurement, including Question L60, which addresses allocations of a net portfolio basis adjustment to individual financial assets and liabilities that make up the portfolio.

Question 9.2.140

Could an entity be required to quantitatively allocate a portfolio-level credit risk adjustment for reasons other than assessing effectiveness?

Interpretive response: Yes. Even if an entity is not required to quantitatively allocate a portfolio-level credit risk adjustment to the individual derivative assets and liabilities within the group for which the portfolio measurement exception is applied when assessing effectiveness (see Questions 9.2.90 and 9.2.100), such an allocation frequently is necessary for other purposes.

The following are examples of when a quantitative allocation might be necessary for reasons other than assessing effectiveness.
**Derivatives in the group are used in fair value, cash flow and net investment hedging relationships**

It is necessary to allocate a portfolio-level credit risk adjustment to the individual hedging instruments. This is because the change in fair value of a hedging instrument in a fair value hedge is recorded immediately in earnings while the change in a cash flow or net investment hedge is recorded in OCI (or CTA in AOCI).

**Derivatives in the group are used in fair value hedges of different types of risk**

If the changes in fair value of the derivatives in the group are recorded in different income statement line items, it is necessary to allocate a portfolio-level credit risk adjustment between income statement line items.

**Derivatives in the group are used in fair value hedges that use the shortcut method—basis adjustments**

- When the shortcut method is used to assess effectiveness for a fair value hedge of **interest rate risk**, the change in fair value of the hedging instrument is used as a proxy for the change in fair value of the hedged item (i.e., the basis adjustment).
- It may be necessary to allocate a portfolio-level credit risk adjustment to determine the hedged item’s amortized cost basis (which includes the basis adjustment) for purposes of applying other applicable GAAP, including impairment (see section 4.3.30).

**Derivatives in the group are used in cash flow hedges of different types of risk and/or to hedge forecasted transactions that affect earnings in different periods**

- In these situations, it is necessary to allocate a portfolio-level credit risk adjustment to the individual hedging instruments. This is because the net derivative gain or loss is reclassified from AOCI into earnings when the hedged transaction affects earnings and is presented in the same line item as the effect of the hedged transaction (see section 6.3).
- If the hedged risk varies for the derivatives in the group, the income statement line items in which the allocated credit risk should be recorded when reclassified into earnings may vary.
- If the timing of the hedged transaction affecting earnings varies, the timing of reclassifications from AOCI will also vary.
- Additionally, certain other circumstances also may result in reclassifying amounts from AOCI, as discussed in section 6.4.
9.2.70  Excluded components

Excerpt from ASC 815-20

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-82 In defining how hedge effectiveness will be assessed, an entity shall specify whether it will include in that assessment all of the gain or loss on a hedging instrument. An entity may exclude all or a part of the hedging instrument’s time value from the assessment of hedge effectiveness, as follows:

a. If the effectiveness of a hedge with an option is assessed based on changes in the option’s intrinsic value, the change in the time value of the option would be excluded from the assessment of hedge effectiveness.

b. If the effectiveness of a hedge with an option is assessed based on changes in the option’s minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract shall be excluded from the assessment of hedge effectiveness.

c. An entity may exclude any of the following components of the change in an option’s time value from the assessment of hedge effectiveness:
   1. The portion of the change in time value attributable to the passage of time (theta)
   2. The portion of the change in time value attributable to changes due to volatility (vega)
   3. The portion of the change in time value attributable to changes due to interest rates (rho).

d. If the effectiveness of a hedge with a forward contract or futures contract is assessed based on changes in fair value attributable to changes in spot prices, the change in the fair value of the contract related to the changes in the difference between the spot price and the forward or futures price shall be excluded from the assessment of hedge effectiveness.

e. An entity may exclude the portion of the change in fair value of a currency swap attributable to a cross-currency basis spread.

25-83 No other components of a gain or loss on the designated hedging instrument shall be excluded from the assessment of hedge effectiveness nor shall an entity exclude any aspect of a change in an option’s value from the assessment of hedge effectiveness that is not one of the permissible components of the change in an option’s time value. For example, an entity shall not exclude from the assessment of hedge effectiveness the portion of the change in time value attributable to changes in other market variables (that is, other than rho and vega).

>>> Components of Option Time Value

55-57 This guidance discusses implementation of paragraph 815-20-25-82.

55-58 Some entities may wish to assess hedge effectiveness based on the change in an option’s value excluding a certain aspect of the change in the option’s time value. For example, some entities may wish to exclude the change in time value attributable to the passage of time (theta) from the assessment of hedge effectiveness, while assessing hedge effectiveness.
based on the remaining components of changes in an option’s value. As an illustration, if out-of-the-money options are designated as hedging instruments, changes in value of the option are primarily driven by the change, if any, in the value of the underlying (delta). If the price of the underlying asset changes, in effective hedging strategies involving out-of-the-money options, the hedge gain or loss due to delta would offset the change in value of the hedged item; however, if the price of the underlying does not change, there is no change in fair value attributable to changes in delta. In that case, the only change in the option’s value is attributable to the passage of time (theta), or to changes in other market variables such as volatilities or interest rates. Accordingly, for those hedging relationships to qualify for hedge accounting, an entity may need to exclude the change in value attributable to theta from the assessment of hedge effectiveness.

55-59 Other entities may wish to exclude changes in time value attributable to certain market variables—volatility (vega) or interest rates (rho)—from the assessment of hedge effectiveness. An entity may wish to exclude changes in time value attributable to volatility (vega) from the assessment of hedge effectiveness because the fair value measurement of the hedged item does not incorporate a measure of implied volatility.

55-60 Similarly, an entity may seek to exclude changes in time value attributable to interest rates (rho) from the assessment of hedge effectiveness. For example, in a foreign currency hedge involving a country in which interest rates are volatile, a substantial portion of the change in value of the option may be attributable to fluctuations in those interest rates, while the fair value of the hedged item is not affected correspondingly. Accordingly, for these hedging relationships to qualify for hedge accounting, an entity may need to exclude the change in value attributable to the relevant market variable from the assessment of hedge effectiveness.

55-61 In summary, the exclusion of a certain aspect of the change in an option’s time value from the assessment of hedge effectiveness is driven by the fact that, in certain circumstances, the measurement of changes in fair value of the hedged item or changes in the cash flows of the hedged transaction does not depend on or incorporate that aspect. Option valuation models are capable of isolating the various aspects of changes in an option’s time value.

Topic 815 permits entities to exclude some components of a derivative hedging instrument’s changes in fair value (i.e. cash flows) from the effectiveness assessment. [815-20-25-82 – 25-83]

Hedge effectiveness is improved by excluding a component when the hedged item’s fair value (or hedged transaction’s cash flows) is not affected by (or not affected to the same extent as) the component. As a result, the ability to exclude certain components from effectiveness assessments is important because it improves effectiveness, which increases the likelihood of being able to apply hedge accounting. [815-20-55-57 – 55-61]

Including all gains and losses on the derivative hedging instrument may result in reduced levels of effectiveness if the fair value or cash flows of the hedged item or transaction is not affected by (or to the same extent as) the excluded components (e.g. time value).
The following components of a hedging instrument’s fair value or cash flows may be excluded from the effectiveness assessment. [815-20-25-82]

<table>
<thead>
<tr>
<th>Hedging instrument</th>
<th>Excluded component</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flow, fair value and net investment hedges</td>
<td>Excluded component depends on the method used to assess effectiveness.</td>
</tr>
<tr>
<td>Options</td>
<td>— Changes in intrinsic value. All changes in time value or changes in time value attributable to either passage of time (rho), volatility (theta) or interest rates (vega) may be excluded.</td>
</tr>
<tr>
<td></td>
<td>— Changes in minimum value (i.e. intrinsic value after the effect of discounting). Volatility value may be excluded.</td>
</tr>
<tr>
<td>Forward or futures contract</td>
<td>Spot-forward difference – i.e. the difference between the spot price and the forward or futures price (referred to as forward points). This method is referred to as the spot method.</td>
</tr>
<tr>
<td>Cash flow and fair value hedges</td>
<td>Currency swap Cross-currency basis spread – this represents a charge to convert one currency to another; its initial cost is embedded in the coupon payments that an entity has agreed to pay the counterparty.</td>
</tr>
</tbody>
</table>

For additional considerations when using options (or combinations of options) as a hedging instrument, see section 9.2.90.

No components (or portions of components) other than those specified in Topic 815 may be excluded. [815-20-25-83]

**Example 9.2.40**

**Effect of time value on hedge effectiveness**

ABC Corp. purchases wheat to be used in its production of cereal. ABC enters into a firm commitment to purchase wheat in six months at a fixed price from DEF; this purchase is considered a ‘normal’ purchase.

ABC 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. This is because ABC will be required to pay the fixed price in the firm commitment even if the market value for the wheat is less than that six months from now.

To hedge this exposure, ABC enters into a futures contract, which settles net in 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.

ABC 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 wheat futures contract – i.e. time value is not an excluded component). Including all gains and losses of the derivative hedging instrument improves effectiveness if the time value element of the futures contract changes in amounts similar to (but in amounts opposite from) the time value of the firm commitment.

In contrast, if ABC was hedging the fair value of its wheat inventory, the time value element of the wheat futures contract would likely reduce the effectiveness of the hedging relationship. This is because there is no time value associated with the fair value of recognized inventory.

Question 9.2.150

Are there circumstances where the time value does not affect the assessment of effectiveness even though it is not considered an excluded component?

Interpretive response: Yes, but only when the terminal value method is used.

When the hedging instrument is a purchased option or combination of options resulting in a net purchased option or zero-cost collar, generally the option’s premium (time value) does not offset hedged changes in cash flows. This generally results in the time value affecting the hedging relationship’s effectiveness unless time value is excluded from the assessment.

However, the time value component does not affect hedge effectiveness when the terminal value method is used, even though time value is not an excluded component under that approach (see section 9.7.20). This is because the terminal value method focuses on the option’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.

Recognizing excluded components

Excerpt from ASC 815-20

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-83A For fair value and cash flow hedges, the initial value of the component excluded from the assessment of effectiveness shall be recognized in earnings using a systematic and rational method over the life of the hedging instrument. Any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method shall be recognized in other comprehensive income. Example 31 beginning in paragraph 815-20-55-235 illustrates this approach for a cash flow hedge in which the hedging instrument is an option and the entire time value is excluded from the assessment of effectiveness.
For fair value and cash flow hedges, an entity alternatively may elect to record changes in the fair value of the excluded component currently in earnings. This election shall be applied consistently to similar hedges in accordance with paragraph 815-20-25-81 and shall be disclosed in accordance with paragraph 815-10-50-4EEEEE.

**Income Statement Classification**

For qualifying fair value and cash flow hedges, an entity shall present both of the following in earnings in the same income statement line item that is used to present the earnings effect of the hedged item:

a. The change in the fair value of the hedging instrument that is included in the assessment of hedge effectiveness
b. Amounts excluded from the assessment of hedge effectiveness in accordance with paragraphs 815-20-25-83A through 25-83B.

See paragraphs 815-20-55-79W through 55-79AD for related implementation guidance.

For cash flow hedges in which the hedged forecasted transaction is probable of not occurring in accordance with paragraph 815-30-40-5, this Subtopic provides no guidance on the required income statement classification of amounts reclassified from accumulated other comprehensive income to earnings.

While the Derivatives and Hedging Topic does not specify whether certain income statement line items are either permitted or appropriate, the other hedging-related Subtopics in this Topic do contain specific disclosure requirements for those items. See Section 815-10-50 and Subtopics 815-25, 815-30, and 815-35.

If an entity has excluded components from its assessment of hedge effectiveness, it can recognize the initial value of the excluded components in earnings using either of the following approaches. [815-20-25-83A – 25-83B]

— **Amortization approach.** A systematic and rational method over the life of the hedging instrument.

— **Mark-to-market approach.** A method that recognizes all fair value changes of the excluded components currently in earnings.

When using the amortization approach, any difference between the change in fair value of the excluded component and the amounts recognized in earnings are included in AOCI (or CTA in AOCI). This election is applied consistently to similar hedges, as discussed in section 9.2.80. If an entity elects the mark-to-market approach, that election is disclosed. [815-10-50-4EEEEE, 815-20-25-83A – 25-83B]

An entity presents amounts related to excluded components that are recognized in earnings in the same income statement line item that is used to present the earnings effect of the hedged item. [815-20-45-1A]
Question 9.2.160

What is a systematic and rational method to recognize an excluded component?

Interpretive response: The FASB did not prescribe a specific methodology to satisfy the requirement that the excluded component be recognized in earnings using a systematic and rational method over the life of the hedging instrument.

However, one method that an entity may consider to be systematic and rational is the straight-line method. [815-20-55-237]

Additionally, the FASB noted that, similar to forward points (or the spot-forward difference), cross-currency basis spreads reduce to zero by the time the derivative matures. In the FASB’s view, recognizing the cross-currency basis spread in earnings through the swap accrual is a systematic and rational method for recognizing the cost of the cross-currency basis spread in earnings. [ASU 2017-12.BC162–BC163]

When an entity elects to consider a cross-currency basis spread as an excluded component and to recognize it through the swap accrual (an amortization approach), the change in fair value of the swap attributable to the cross-currency basis spread incorporated in the discount rates used to value the swap is included in AOCI. It is not necessary to manually amortize any amounts when their effect on the swap discounting reverses to zero in AOCI because the swap matures. [ASU 2017-12.BC164]

Question 9.2.170

Under the amortization approach, is the excluded component recognized when the hedged transaction affects earnings?

Interpretive response: Not necessarily. The excluded component can be viewed as the ‘cost of the hedge’. The amortization approach allows that cost to be recognized over the term of the hedging relationship and could be viewed as smoothing the effect of the excluded component in earnings. However, if the forecasted transaction(s) will only affect earnings at the end of the hedging relationship, the excluded component (cost of the hedge) will be recognized earlier than when the hedged item actually affects earnings.

For example, an entity purchases an option to hedge its price exposure on the anticipated sale of a nonfinancial item and decides to exclude the time value from the assessment of hedge effectiveness. In that case, the effect of time value is recognized over the period of the hedge, which is before the anticipated sales revenue is recognized in earnings.
Question 9.2.180

Is the caplet method acceptable for recognizing the initial value of an excluded component?

Background: The caplet method involves associating the initial fair value of an interest rate cap with each caplet within the rate cap, and reclassifying the amount of each caplet from AOCI to earnings when the respective forecasted interest payment occurs. [815-30-35-41B]

Interpretive response: No. The initial value of excluded components is required to be recognized in earnings using either an amortization approach or the mark-to-market approach, both of which result in the initial fair value of the excluded component being recognized in earnings over the life of the hedging instrument.

In contrast, the caplet method recognizes amounts when the hedged transactions are reported in earnings. This may not occur during each period of the hedging instrument’s life. For example, the hedged transaction may be sales that occur in only certain periods or occur after the life of the hedging instrument.

As a result, we believe that the caplet method is not an acceptable method for recognizing the initial value of an excluded component.

Question 9.2.190

How does an entity account for amounts included in AOCI related to an excluded component if hedge accounting is discontinued?

Interpretive response: These amounts should be recognized in earnings consistent with existing guidance for discontinued fair value or cash flow hedges.

Fair value hedges

Any amounts associated with the excluded component remaining in AOCI when a fair value hedge is discontinued are recorded in earnings in the same manner as other components (e.g. the basis adjustment) of the carrying amount of the hedged asset or liability when the hedged item continues to exist. [815-25-40-7]

When the hedged item is derecognized, the amounts remaining in AOCI are recognized in earnings immediately. [815-25-40-7]

For further guidance on the discontinuation of fair value hedge accounting, see section 4.5.10.

Cash flow hedges

Any amounts associated with the excluded component remaining in AOCI when a cash flow hedge is discontinued are recognized in earnings when the hedged transaction affects earnings (see section 6.5.10). [815-30-40-6A]
If the cash flow hedge relates to a forecasted transaction that it is probable will not occur (i.e. a missed forecast), any amounts associated with the excluded component remaining in AOCI are recognized currently in earnings. See also section 6.5.20, including Question 6.5.100 related to income statement presentation in such situations.

**Net investment hedges**

Any amounts remaining in the cumulative translation adjustment (CTA) in AOCI related to a discontinued hedging relationship – including amounts related to excluded components – remain in CTA until the hedged net investment is sold, exchanged or liquidated (see sections 8.5.20 and 8.5.40). For guidance on the income statement presentation of excluded components, see Question 8.4.30. [815-35-35-1(c), 40-1]

**Examples**

The following are examples that demonstrate the amortization and mark-to-market approaches.

— Option time value excluded from the assessment of effectiveness in a cash flow hedge and recorded in earnings under an amortization approach (Subtopic 815-20’s Example 31).

— Comparison of approaches to recognize the excluded component for a cash flow hedge (Example 9.2.50).

See sections 4.2.20 and 6.2.20 for additional examples of approaches to recognize the excluded component for fair value and cash flow hedges, respectively.

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**Excerpt from Subtopic 815-20**

**>> Example 31: Option Time Value Excluded from the Assessment of Effectiveness in a Cash Flow Hedge and Recorded in Earnings under an Amortization Approach**

55-235 This Example illustrates the application of paragraph 815-20-25-83A.

55-236 On December 31, 20X0, an entity intends to purchase 1,000 barrels of crude oil in December 20X4. The entity decides to hedge changes in the price of the crude oil by purchasing an at-the-money call option on 1,000 barrels of crude oil. The entity purchases the option on December 31, 20X0, with an initial premium of $9,250, a strike price of $75, and a maturity date of December 31, 20X4. The entity designates the option as the hedging instrument in a cash flow hedge of a forecasted purchase of crude oil.

55-237 The entity elects to exclude the time value of the option from the assessment of effectiveness in accordance with paragraph 815-20-25-82 and applies the amortization approach for recognizing excluded components in accordance with paragraph 815-20-25-83A. The entity applies a straight-line amortization method and, based on the initial option premium of $9,250, the
entity determines an annual amortization amount of $2,313. The entity records all changes in fair value over the term of the derivative in other comprehensive income and records amortization in earnings each period with an offsetting entry to other comprehensive income. The changes in value of the option over the life of the hedging relationship are as follows.

<table>
<thead>
<tr>
<th></th>
<th>12/31/20X1</th>
<th>12/31/20X2</th>
<th>12/31/20X3</th>
<th>12/31/20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ending market price of crude oil</td>
<td>$ 77</td>
<td>$ 76</td>
<td>$ 74</td>
<td>$ 81</td>
</tr>
<tr>
<td>Ending fair value of option:</td>
<td>$9,500</td>
<td>$6,500</td>
<td>$3,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>Time value</td>
<td>7,500</td>
<td>5,500</td>
<td>3,000</td>
<td>-</td>
</tr>
<tr>
<td>Intrinsic value</td>
<td>2,000</td>
<td>1,000</td>
<td>-</td>
<td>6,000</td>
</tr>
<tr>
<td>Total</td>
<td>$ 9,500</td>
<td>$ 6,500</td>
<td>$ 3,000</td>
<td>$ 6,000</td>
</tr>
<tr>
<td>Change in time value</td>
<td>$ 1,750</td>
<td>$ 2,000</td>
<td>$ 2,500</td>
<td>$ 3,000</td>
</tr>
<tr>
<td>Change in intrinsic value</td>
<td>$ 2,000</td>
<td>$ 1,000</td>
<td>$ 1,000</td>
<td>$ 6,000</td>
</tr>
<tr>
<td>Total current-period gain (loss) on derivative</td>
<td>$ 250</td>
<td>$ (3,000)</td>
<td>$ (3,500)</td>
<td>$ 3,000</td>
</tr>
</tbody>
</table>

On December 31, 20X4, the entity purchases 1,000 barrels of crude oil, and the option expires with an intrinsic value of $6,000. This amount will remain in accumulated other comprehensive income until the commodity is sold in 20X5. The journal entries over the life of the hedging relationship are as follows.

**December 31, 20X0**
- **Derivative asset** $9,250
  - **Cash** $9,250
  - To record the derivative asset based on the initial premium.

**December 31, 20X1**
- **Derivative asset** $250
  - **Other comprehensive income** $250
  - To record the change in value of the derivative in other comprehensive income.
  - **Cost of goods sold** $2,313
    - **Other comprehensive income** $2,313
    - To record amortization of the excluded amount.

**December 31, 20X2**
- **Other comprehensive income** $3,000
  - **Derivative asset** $3,000
  - To record the change in value of the derivative in other comprehensive income.
  - **Cost of goods sold** $2,313
    - **Other comprehensive income** $2,313
    - To record amortization of the excluded amount.
**December 31, 20X3**

- Other comprehensive income $3,500
  - Derivative asset $3,500
  
  To record the change in value of the derivative in other comprehensive income.

- Cost of goods sold $2,313
  - Other comprehensive income $2,313
  
  To record amortization of the excluded amount.

**December 31, 20X4**

- Derivative asset $3,000
  - Other comprehensive income $3,000
  
  To record the change in value of the derivative in other comprehensive income.

- Cost of goods sold $2,311
  - Other comprehensive income $2,311
  
  To record amortization of the excluded amount.

**July 1, 20X5**

- Accumulated other comprehensive income $6,000
  - Cost of goods sold $6,000
  
  Upon sale of commodity, to record intrinsic value to cost of goods sold.

(a) $2 rounding adjustment

---

**Example 9.2.50**

**Comparison of approaches to recognize the excluded component for a cash flow hedge**

Using the fact pattern in Subtopic 815-20’s Example 31, the following shows the effect on earnings if the entity has elected to recognize the change in the excluded component currently in earnings (mark-to-market approach).

<table>
<thead>
<tr>
<th>December 31</th>
<th>Year 0</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ending fair value of the option:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time value</td>
<td>$9,250</td>
<td>$7,500</td>
<td>$5,500</td>
<td>$3,000</td>
<td>$ -</td>
</tr>
<tr>
<td>Intrinsic value</td>
<td>-</td>
<td>2,000</td>
<td>1,000</td>
<td>-</td>
<td>6,000</td>
</tr>
<tr>
<td>Total</td>
<td>$9,250</td>
<td>$9,500</td>
<td>$6,500</td>
<td>$3,000</td>
<td>$6,000</td>
</tr>
</tbody>
</table>
### December 31

<table>
<thead>
<tr>
<th>Year 0</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in time value</td>
<td>$(1,750)</td>
<td>$(2,000)</td>
<td>$(2,500)</td>
<td>$(3,000)</td>
</tr>
<tr>
<td>Change in intrinsic value</td>
<td>2,000</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>6,000</td>
</tr>
<tr>
<td><strong>Total current-period gain (loss) on derivative</strong></td>
<td>$ 250</td>
<td>$(3,000)</td>
<td>$(3,500)</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

The following journal entry recognizes the purchase of the derivative.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivative asset (option)</td>
<td>9,250</td>
</tr>
<tr>
<td>Cash</td>
<td>9,250</td>
</tr>
</tbody>
</table>

*To record derivative asset based on initial premium paid.*

The following journal entry recognizes the change in the fair value of the derivative for Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold¹</td>
<td>1,750</td>
</tr>
<tr>
<td>Derivative asset (option)</td>
<td>1,750</td>
</tr>
</tbody>
</table>

*To record change in time value.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivative asset (option)²</td>
<td>2,000</td>
</tr>
<tr>
<td>AOCI</td>
<td>2,000</td>
</tr>
</tbody>
</table>

*To record change in intrinsic value.*

Notes:

1. Beginning time value of $9,250 - ending time value of $7,500.
2. Beginning intrinsic value of $0 - ending intrinsic value of $2,000.

The following journal entry recognizes the change in the fair value of the derivative for Year 2.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold¹</td>
<td>2,000</td>
</tr>
<tr>
<td>Derivative asset (option)</td>
<td>2,000</td>
</tr>
</tbody>
</table>

*To record change in time value.*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>AOCI²</td>
<td>1,000</td>
</tr>
<tr>
<td>Derivative asset (option)</td>
<td>1,000</td>
</tr>
</tbody>
</table>

*To record change in intrinsic value.*
Notes:
1. Beginning time value of $7,500 - ending time value of $5,500.
2. Beginning intrinsic value of $2,000 - ending intrinsic value of $1,000.

The following journal entry recognizes the change in the fair value of the derivative for Year 3.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold¹</td>
<td>2,500</td>
</tr>
<tr>
<td>Derivative asset (option)</td>
<td>2,500</td>
</tr>
<tr>
<td><strong>To record change in time value.</strong></td>
<td></td>
</tr>
<tr>
<td>AOCI²</td>
<td>1,000</td>
</tr>
<tr>
<td>Derivative asset (option)</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>To record change in intrinsic value.</strong></td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1. Beginning time value of $5,500 - ending time value of $3,000.
2. Beginning intrinsic value of $1,000 - ending intrinsic value of $0.

The following journal entry recognizes the change in the fair value of the derivative for Year 4.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold¹</td>
<td>3,000</td>
</tr>
<tr>
<td>Derivative asset (option)</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>To record change in time value.</strong></td>
<td></td>
</tr>
<tr>
<td>Derivative asset (option)²</td>
<td>6,000</td>
</tr>
<tr>
<td>AOCI</td>
<td>6,000</td>
</tr>
<tr>
<td><strong>To record change in intrinsic value.</strong></td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1. Beginning time value of $3,000 - ending time value of $0.
2. Beginning intrinsic value of $0 - ending intrinsic value of $6,000.

The following table compares the earnings effect of the excluded component under the two methods:

— amortization approach (Subtopic 815-20’s Example 31); and
— mark-to-market approach (KPMG example).

<table>
<thead>
<tr>
<th>Approach</th>
<th>December 31</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
</tr>
<tr>
<td>Amortization</td>
<td>$2,313</td>
<td>$2,313</td>
</tr>
<tr>
<td>Mark-to-market</td>
<td>1,750</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Difference</strong></td>
<td><strong>$ 563</strong></td>
<td><strong>$ 313</strong></td>
</tr>
</tbody>
</table>
9.2.80  **Consistency of methods between hedging relationships**

---

**Excerpt from ASC 815-20**

**Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges**

25-81 This Subtopic does not specify a single method for assessing whether a hedge is expected to be highly effective. The method of assessing effectiveness shall be reasonable. The appropriateness of a given method of assessing hedge effectiveness depends on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, an entity shall assess effectiveness for similar hedges in a similar manner, including whether a component of the gain or loss on a derivative instrument is excluded in assessing effectiveness for similar hedges. Use of different methods for similar hedges shall be justified. The mechanics of isolating the change in **time value of an option** discussed beginning in paragraph 815-20-25-98 also shall be applied consistently.

An entity should assess effectiveness for similar hedges in a similar manner, and is required to justify using different methods for similar hedges. This includes whether a component of a hedging instrument is an excluded component for similar hedges, how the change in time value in an option is isolated, and the method that will be used to recognize excluded components (see section 9.2.70). [815-20-25-81]

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**Question 9.2.200**

Are there situations in which an entity may use different effectiveness assessment methods for similar hedges?

**Interpretive response:** Yes. Topic 815 permits an entity to use different effectiveness assessment methods when the entity can justify doing so. We believe that judgment may be used when determining whether using different methods is justified. For example, we believe an entity may be justified in using different methods between autonomous business units when those business units individually manage risk.

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**Question 9.2.210**

Must an entity use qualitative effectiveness assessments for all similar hedges?

**Interpretive response:** No. Topic 815 ordinarily requires an entity to justify using different methods for assessing the effectiveness of similar hedges. However, the FASB observed that requiring an entity to perform qualitative
assessments for all similar hedges may have unintended consequences. Instead, it decided to allow the election to be made on a hedge-by-hedge basis to be consistent with its intent to provide more flexibility and relieve operational burden. As a result, an entity is permitted to elect to perform subsequent qualitative effectiveness assessments on a hedge-by-hedge basis. [815-20-25-81, 35-2B, ASU 2017-12.BC207]

However, an entity still needs to justify using different quantitative methods for similar hedges. Unless using different quantitative methods is justified, an entity is expected to specify in its initial hedge documentation the same quantitative method to be used for assessing effectiveness for similar hedges, both for the initial prospective effectiveness assessment, and in the event that the entity is required to perform a quantitative test subsequently (see Question 9.5.20). [815-20-25-81, 35-2B, ASU 2017-12.BC207]
Interpretive response: Due to operational concerns, the FASB provided relief for entities from the requirement to assess effectiveness for similar hedges in a similar manner. In the situations specified in the following table, an entity is not required to comply with the requirement.

| Shortcut method | ASU 2017-12 permits an entity to document a quantitative method to be used if the shortcut method was not or no longer is appropriate (see section 11.4.60). An entity may document a quantitative effectiveness method for new shortcut method hedging relationships executed after the date of adoption of ASU 2017-12 regardless of whether the entity modifies its hedge documentation to include a quantitative effectiveness method for hedges existing at the date of adoption. [815-20-65-3(i)(1), ASU 2017-12.BC261] |
| Contractually specified component or interest rate | ASU 2017-12 added as a new hedging strategy the ability to designate a contractually specified component or interest rate as the hedged risk in a cash flow hedge (see section 11.4.40). An entity may continue designating the variability in total cash flows as the hedged risk for hedging relationships that existed on the date of adoption, and designate the hedged risk as the variability in the contractually specified component or contractually specified interest rate for hedging relationships executed after the date of adoption. [815-20-65-3(i)(2)] |
| Method for recognizing excluded components | Before ASU 2017-12, entities were required to use the mark-to-market approach for recognizing excluded components. ASU 2017-12 permits an entity to use the mark-to-market approach or an amortization approach (see section 11.4.50). An entity may continue recognizing excluded components using a mark-to-market approach for hedging relationships that existed on the date of adoption, and elect an amortization approach for hedging relationships executed after the date of adoption. [815-20-65-3(i)(3)] |

9.2.90 Additional considerations when using options as the hedging instrument

Excerpt from ASC 815-20

>>> Additional Considerations for Options in Cash Flow Hedges

25-123 When an entity has documented that the effectiveness of a cash flow hedge will be assessed based on changes in the hedging option’s intrinsic value pursuant to paragraph 815-20-25-82(a), that assessment (and the related cash flow hedge accounting) shall be performed for all changes in intrinsic
value—that is, for all periods of time when the option has an intrinsic value, such as when the underlying is above the strike price of the call option.

25-124 When a purchased option is designated as a hedging instrument in a cash flow hedge, an entity shall not define only limited parameters for the risk exposure designated as being hedged that would include the time value component of that option. An entity cannot arbitrarily exclude some portion of an option’s intrinsic value from the hedge effectiveness assessment simply through an articulation of the risk exposure definition. It is inappropriate to assert that only limited risk exposures are being hedged (for example, exposures related only to currency-exchange-rate changes above $1.65 per pound sterling as illustrated in Example 26 [see paragraph 815-20-55-205]).

25-125 If an option is designated as the hedging instrument in a cash flow hedge, an entity may assess hedge effectiveness based on a measure of the difference, as of the end of the period used for assessing hedge effectiveness, between the strike price and forward price of the underlying, undiscounted. Although assessment of cash flow hedge effectiveness with respect to an option designated as the hedging instrument in a cash flow hedge shall be performed by comparing the changes in present value of the expected future cash flows of the forecasted transaction to the change in fair value of the derivative instrument (aside from any excluded component under paragraph 815-20-25-82), that measure of changes in the expected future cash flows of the forecasted transaction based on forward rates, undiscounted, is not prohibited. With respect to an option designated as the hedging instrument in a cash flow hedge, assessing hedge effectiveness based on a similar measure with respect to the hedging instrument eliminates any difference that the effect of discounting may have on the hedging instrument and the hedged transaction. Pursuant to paragraph 815-20-25-3(b)(2)(iv), entities shall document the measure of intrinsic value that will be used in the assessment of hedge effectiveness. As discussed in paragraph 815-20-25-80, that measure must be used consistently for each period following designation of the hedging relationship.

An entity can exclude time value (or certain portions of time value) from its effectiveness assessments when the hedging instrument is an option (see section 9.2.70).

When time value is excluded, effectiveness is assessed based on the option’s intrinsic value. In those situations, effectiveness is assessed during those periods when the option has intrinsic value — such as when the underlying is above the strike price of a call option. [815-20-25-123]

In addition to the considerations in this section, an entity using an option contract, a combination of option contracts, or a combination of an option contract with a non-option derivative as a hedging instrument is required to consider whether the option or combination is a net written option. This is because there is a special rule for written options (see sections 2.7.50 and 2.7.60).
Interpretive response: An option’s total value at any point in time comprises the following.

<table>
<thead>
<tr>
<th>Component</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time value</td>
<td>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.</td>
</tr>
<tr>
<td>Intrinsic value</td>
<td>The amount by which the value of the underlying exceeds (call option) or is less than (put option) an option’s strike price. This is commonly characterized by the term ‘in the money’ or ‘out of the money.’ In either case, intrinsic value normally can only be a positive amount (i.e. an option cannot have an intrinsic value less than zero from the holder’s perspective), even when it is out of the money.</td>
</tr>
</tbody>
</table>

As a result, time value may be viewed as the portion of an option’s total value that is not represented by intrinsic value (see Question 9.2.240).

Interpretive response: The following table presents the methods that market convention considers to be measures of intrinsic value, and whether those methods may be used for fair value, cash flow or net investment hedging relationships that use the intrinsic value method to assess effectiveness – i.e. that exclude time value from the effectiveness assessment.

<table>
<thead>
<tr>
<th>Method for measuring intrinsic value</th>
<th>Hedging relationships that may use it</th>
</tr>
</thead>
<tbody>
<tr>
<td>The difference between the strike price and the spot price of the underlying asset</td>
<td>Fair value, cash flow or net investment</td>
</tr>
<tr>
<td>The present value of the difference between the strike price (i.e. contractual price) and the forward price (i.e. forward rate in the market on the measurement date) of the underlying asset</td>
<td>Fair value or cash flow</td>
</tr>
</tbody>
</table>
| The difference between the strike price (i.e. contractual price) and the forward price (i.e. forward rate in the market on the measurement date) of the underlying, undiscounted | Cash flow only [815-20:25-125]  
This method is available for cash flow hedges due to the greater flexibility provided in measuring the change in value of the hedged cash flow |
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. That measure must be used consistently for each period following designation of the hedging relationship.[815-20-25-125]

**Question 9.2.250**

**How is the intrinsic value of a cap option that involves a series of payments measured?**

**Background:** An entity may purchase an option that involves a series of payments. For example, an entity may purchase an interest rate cap (option) that it designates as the hedging instrument in a cash flow hedge of changes in the cash flows of forecasted interest payments that are attributable to changes in a referenced interest rate when it exceeds a specified level (e.g. 8%).

**Interpretive response:** Topic 815 does not specify how to measure the intrinsic value of a cap option if the option involves a series of payments. We believe that the following are two acceptable methods.

— Estimate the intrinsic value of the cap assuming the referenced interest rate remains constant for the remaining term of the hedge. In the background example, the intrinsic value for all future periods would be assumed to be 1% if the referenced interest rate is 9% at the valuation date (9% referenced interest rate less 8% specified level in the interest rate cap). Under this method, the effect of the forward yield curve is excluded from the intrinsic value and instead is included in other components (e.g. time value).

— Estimate the intrinsic value of the cap for each period based on the market’s expectations of movements in the referenced interest rate using the forward yield curve for that interest period.

**Question 9.2.260**

**How are portions of time value (passage of time, market variables) measured?**

**Excerpt from ASC 815-20**

>>>> Computing Changes in an Option's Time Value

25-98 In computing the changes in an option’s time value that would be excluded from the assessment of hedge effectiveness, an entity shall 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—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.

25-99 Based on that general methodology, if only one aspect of the change in time value is excluded from the assessment of hedge effectiveness (for example, theta), that aspect shall 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 for assessing hedge effectiveness. However, if more than one aspect of the change in time value is excluded from the assessment of hedge effectiveness (for example, theta and vega), an entity shall determine the amount of that change in time value by isolating each of those two aspects in turn in a prespecified 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 shall be determined by deducting from the total change in time value the portion of the change in time value attributable to excluded components.

Interpretive response: To measure portions of the changes in an option’s time value that may be excluded from the effectiveness assessment, an entity uses a technique that appropriately isolates those components of the change in time value. [815-20-25-98]

Generally, to allocate the total change in an option’s time value to its different aspects (i.e. the passage of time versus market variables), the change in time value attributable to the first component to be isolated is determined by holding all other components constant as of the beginning of the period. Each remaining component is then determined in turn in a specified order based on the ending values of the previously isolated components. [815-20-25-99]

— Only one component of the change in time value is excluded. Using theta as the example component that is excluded, the change in time value for theta is measured first. Its value would be determined by holding all other parameters constant for the period used to assess hedge effectiveness.

— More than one component is excluded. Using theta and vega as the example components that are excluded, the entity determines the amount of that change in time value by isolating each of those two components in a pre-specified order (e.g. theta first and vega second). Vega is isolated based on the ending value theta and the beginning values of the remaining components that are not excluded.

The portion of the change in time value that is not an excluded component (i.e. the portion that is included in the effectiveness assessment) is determined by deducting from the total change in time value the portion that is attributable to excluded components. [815-20-25-99]
**Question 9.2.270**

Must an entity assess effectiveness for all periods that the option has intrinsic value?

**Interpretive response:** Yes. Regardless of the method selected for measuring an option’s intrinsic value, the effectiveness assessment (and related hedge accounting) must be performed for all changes in the intrinsic value – i.e., for all periods of time in which the option has an intrinsic value. An entity cannot arbitrarily exclude some portion of the option’s intrinsic value from the effectiveness assessment simply through an articulation of the risk exposure definition. See also Subtopic 815-20’s Example 26 reproduced below. [815-20-25-124]

However, an entity may be able to use the terminal value method when assessing effectiveness. This approach includes the time value component of the option in the assessment of effectiveness, but 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 (see section 9.7.20).

**FASB Example: Defining the risk exposure for hedging relationships involving an option contract as the hedging instrument**

**Excerpt from ASC 815-20**

>> Example 26: Defining the Risk Exposure for Hedging Relationships Involving an Option Contract as the Hedging Instrument

55-205 This Example illustrates the application of paragraph 815-20-25-124.

55-206 Entity XYZ, a U.S. dollar (USD) functional currency entity forecasts the purchase of goods with the payment denominated in pounds sterling (GBP). To hedge the foreign currency exposure from the forecasted purchase, Entity XYZ purchases an at-the-money call option on GBP. The notional amount of the option equals the forecasted value of goods to be purchased, and the option exercise date is the date the purchase consummates. At inception of the hedging relationship the strike price and the forward market exchange rate for GBP 1 are both USD 1.50. The time value component on the option is USD 0.15 per GBP. The foreign currency option in this Example could be effective as a hedging instrument only if effectiveness for that hedging relationship were based solely on either of the following:

a. Changes in the option’s intrinsic value
b. Changes in the option’s entire fair value.
As stated in paragraph 815-20-25-124, it is inappropriate to assert that only limited risk exposures are being hedged, such as exposures related only to currency-exchange-rate changes above USD 1.65 per GBP.

**Using a net-purchased combination of options as the hedging instrument (assessing effectiveness only when intrinsic value changes)**

Excerpt from ASC 815-20

>>> Hedge Effectiveness of a Net-Purchased Combination of Options

25-130 The guidance in the following paragraph addresses a cash flow hedging relationship that meets both of the following conditions:

a. A combination of options (deemed to be a net purchased option) is designated as the hedging instrument.

b. The effectiveness of the hedge is assessed based only on changes in intrinsic value of the hedging instrument (the combination of options).

25-131 The assessment of effectiveness of a cash flow hedging relationship meeting the conditions in the preceding paragraph may be based only on changes in the underlying that cause a change in the intrinsic value of the hedging instrument (the combination of options). Thus, the assessment can exclude ranges of changes in the underlying for which there is no change in the hedging instrument’s intrinsic value.

If a combination of options is deemed to be a net-purchased option (see section 2.7.60), it may qualify for hedge accounting even if it offers protection only within various ranges of changes in the underlying – instead of in all ranges of change.

In this situation, effectiveness is assessed based only on changes in the underlying that cause a change in the intrinsic value of the hedging instrument(s). Effectiveness assessment excludes ranges of changes in the underlying for which there is no change in the hedging instrument’s intrinsic value. [815-20-25-130 – 25-131]

See Subtopic 815-20’s Example 28 reproduced below.

**Question 9.2.280**

If the hedged risk is changes within a range and time value is an excluded component, how are changes in the underlying that do not cause a change in intrinsic value accounted for?

**Interpretive response:** When the hedged risk is changes within a range and time value is an excluded component, the effectiveness assessment is based only on changes in the underlying that cause a change in the intrinsic value of
the hedging instrument. Under this method, the changes in the hedging instrument’s underlying that occur outside of the various ranges not covered in the hedging strategy are part of the excluded component. The related changes in the fair value of the combination of options for the excluded components are recognized using either the amortization or mark-to-market approach discussed in section 9.2.70.

**Cash flow hedges.** However, for cash flow hedges we believe an entity may use the terminal value method when assessing effectiveness if the conditions for that approach are met (see section 9.7.20).

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**Question 9.2.290**

*If a zero-cost collar has different notional amounts, can the hedged item be different proportions of the same asset referenced in the collar?*

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**Excerpt from ASC 815-20**

**>>> Different Proportions of the Same Asset as a Hedged Item**

**25-10** In a hedging relationship in which a collar that is comprised of a purchased option and a 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 make up the collar. That is, the quantities of the asset designated as being hedged may be different based on those price ranges in which the collar’s intrinsic value is other than zero. This guidance shall be applied only to 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. This guidance shall not be applied by analogy to other derivative instruments designated as hedging instruments. Although the quantities of the asset designated as being hedged may be different based on the upper and lower price ranges in the collar, the actual assets that are the subject of the hedging relationship may not change. The quantities that are designated as hedged for a specific price or rate change shall be specified at the inception of the hedging relationship and shall not be changed unless the hedging relationship is redesignated. Since the hedge’s effectiveness is based on changes in the collar’s intrinsic value, the assessment of hedge effectiveness shall compare the actual change in intrinsic value of the collar to the change in value of the prespecified quantity of the hedged asset that occurred during the hedge period.

**Interpretive response:** Yes. If 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, the hedged item may be specified as two different proportions of the same asset.
Hedging effectiveness referenced in the collar – based on the upper and lower price ranges specified in the two options that comprise the collar. In this situation, hedge effectiveness is assessed based on changes in the collar’s intrinsic value.

Specifically, the quantities of the forecasted transaction that are designated as being hedged may differ based on the price ranges in which the collar’s intrinsic value is other than zero. This strategy is used when an entity seeks full protection of downside risk while partially paying for this protection by selling some of the upside potential.

See Subtopic 815-20’s Example 9 reproduced below.

We believe this approach may also be used when the notional amounts in the zero-cost collar are the same but the strike prices are different.

**Cash flow hedges.** We also believe that the terminal value method may be used for cash flow hedges if the conditions for its use are met (see section 9.7.20).

**Fair value hedges.** We do not believe an entity may designate a series of possible percentages of servicing right assets (prohibition of preset hedge coverage ratios) that each correspond to a specified independent variable, such as an interest rate (see section 3.3.60).

### Examples

The following are examples that demonstrate using a net-purchased combination of options as the hedging instrument (assessing effectiveness only when intrinsic value changes).

- Assessing effectiveness with an interest rate cap (Example 9.2.60)
- Effectiveness of a combination of options involving one written option and two purchased options (Subtopic 815-20’s Example 28).
- Definition of hedged item when using a zero-cost collar with different notional amounts (Subtopic 815-20’s Example 9).

### Example 9.2.60

**Assessing effectiveness with an interest rate cap**

ABC Corp. issues floating-rate debt (indexed to three-month LIBOR, a contractually specified component) 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%. ABC 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 interest rate cap represents a net purchased option (see section 2.7.60), ABC can designate the hedged risk as the risk of variability in cash flows due to changes in a contractually specified component (i.e. three-month LIBOR) when it exceeds 7% but is below 12%.
Example 28: Effectiveness of a Combination of Options Involving One Written Option and Two Purchased Options

This Example illustrates the application of paragraph 815-20-25-131. Entity JPN is a Japanese subsidiary of a U.S. entity. Entity JPN’s functional currency is the Japanese yen (JPY). Entity JPN has forecasted inventory purchases to be paid in U.S. dollars (USD). As a result, Entity JPN is exposed to changes in the JPY-USD exchange rate: its functional currency cash outflows will increase (loss) if JPY weakens versus USD and decrease (gain) if JPY strengthens versus USD.

Entity JPN would like to hedge the foreign currency exposure related to the forecasted transaction by entering into a combination of foreign-currency-denominated option contracts designated as a single hedging instrument.

For purposes of this discussion, assume all of the following:

a. Entity JPN has met the qualifying criteria regarding forecasted transactions eligible for designation as hedged transactions pursuant to paragraph 815-20-25-15 and the options are entered into contemporaneously with the same counterparty and can be transferred independently of each other.

b. The combination of foreign currency option contracts meets all of the conditions in paragraphs 815-20-25-89 through 25-90 to be considered a net purchased option (that is, considered not to be a net written option subject to the requirements of paragraph 815-20-25-94).

Entity JPN employs the following hedging strategy:

a. The forecasted transaction is estimated at USD 150,000,000. The at-the-money forward rate is JPY 120 per USD 1.

b. Entity JPN’s documented hedge objective is to offset the foreign exchange risk to the functional currency equivalent cash flows at levels above JPY 125/USD 1 and in the range from JPY 113/USD 1 to JPY 108/USD 1. In the range JPY 113/USD 1 to JPY 125/USD 1 and at levels below JPY 108/USD 1, Entity JPN chooses not to offset the foreign exchange risk to the functional currency equivalent cash flows.

c. To implement this hedge objective, Entity JPN enters into all three of the following option contracts and jointly designates them as the hedging instrument:

1. Option 1. One purchased option that gives Entity JPN the right to purchase USD 150,000,000 at an exchange rate of JPY 125/USD 1. Premium paid: USD 1,536,885.

2. Option 2. One sold (written) option that, if exercised, obligates Entity JPN to purchase USD 150,000,000 at an exchange rate of JPY 113/USD 1. Premium received: USD 1,536,885.

3. Option 3. One purchased option that gives Entity JPN the right to sell USD 150,000,000 at an exchange rate of JPY 108/USD 1. Premium paid: USD 737,705.
The time value of the combination of options is to be excluded from the assessment of effectiveness and, therefore, effectiveness is based only on changes in intrinsic value related to the combination of options.

The purpose of Option 1 is to protect Entity JPN when the JPY-USD exchange rate increases above JPY 125/USD 1. As the JPY-USD exchange rate increases, Entity JPN will be required to purchase the USD 150,000,000 inventory at a greater JPY-equivalent cost. As the JPY-USD exchange rate increases above JPY 125/USD 1, the intrinsic value of the option increases as the option is increasingly in the money. That increase in the option's intrinsic value is expected to offset the increase in the JPY-equivalent expenditure on the forecasted transaction.

Entity JPN also writes an option (Option 2) that obligates Entity JPN to purchase USD from the counterparty at an exchange rate of JPY 113/USD 1. The counterparty will exercise the option whenever the JPY-USD exchange rate is below JPY 113/USD 1. As the JPY-USD exchange rate decreases, Entity JPN will be required to purchase the USD 150,000,000 inventory at a lesser JPY-equivalent cost. As the JPY-USD exchange rate decreases below JPY 113/USD 1, Entity JPN's losses related to increases in the intrinsic value of the written option are expected to offset the decrease in the JPY-equivalent expenditure on the forecasted transaction.

Entity JPN also purchases an option to sell USD (Option 3) for a notional amount equal to the notional of the written option (Option 2) with a strike price of JPY 108/USD 1. Entity JPN will exercise Option 3 whenever the JPY-USD exchange rate is below JPY 108/USD 1. When the exchange rate is below JPY 108/USD 1, although Entity JPN will be obligated to make a payment in relation to Option 2, it will also receive a payment in relation to Option 3. As a result of purchasing Option 3, Entity JPN will be exposed to exchange rate fluctuations on Option 2 only when the exchange rate is between JPY 113/USD 1 and JPY 108/USD 1. Hence, with Options 2 and 3, Entity JPN has effectively limited its hedge offset to changes in cash flows on the forecasted item to levels between JPY 113/USD 1 and JPY 108/USD 1. Changes in the exchange rate below JPY 108/USD 1 result in no change in the intrinsic value of the combination of options because the change in Option 2 offsets the change in Option 3. However, when the exchange rate is below JPY 108/USD 1, the combination of options has an intrinsic value other than zero.

In summary, potential changes in intrinsic value related to this combination option hedge construct (Options 1, 2, and 3) would limit the hedge offset to corresponding changes in functional currency cash flows on the forecasted transaction only at levels above JPY 125/USD 1 and in the range JPY 108/USD 1 to JPY 113/USD 1, consistent with Entity JPN's documented hedge objective.

The cash flow hedging relationship in this Example involving a combination of options may be considered effective at offsetting the change in cash flows due to foreign currency exchange rate movements related to the forecasted transaction. Specifically, Entity JPN may assess the effectiveness of the hedge based only on changes in the underlying that cause a change in the intrinsic value of the combination of options. Thus, in that case, Entity JPN would assess effectiveness of the hedge only when the JPY-USD exchange rate is above JPY 125/USD 1 and between JPY 113/USD 1 and
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9. Hedge effectiveness

JPY 108/USD 1. Likewise, Entity JPN's assessment would exclude changes in the JPY-USD exchange rate between JPY 113/USD 1 and JPY 125/USD 1 and below JPY 108/USD 1.

55-223 The combination of options used by Entity JPN as a hedging instrument is deemed to be a net purchased option based on the provisions of this Subtopic. Therefore, the hedging relationship avoids being subject to the hedge effectiveness test for written options in paragraph 815-20-25-94.

55-224 In particular, as it relates to paragraph 815-20-25-89(a), the aggregate premium (that is, the time values) for the three options comprising the hedging instrument results in Entity JPN paying a net premium.

55-225 The evaluation of whether a net premium has been received under paragraph 815-20-25-89(a) must include consideration of only the time value components of the options designated as the hedging instrument. That evaluation must not include the intrinsic value, if any, of the options.

Excerpt from ASC 815-20

>> Example 9: Definition of Hedged Item When Using a Zero-Cost Collar with Different Notional Amounts

55-117 The following Example illustrates the application of paragraph 815-20-25-10 to a currency collar.

>>> Case B: Currency Collar

55-123 Entity B forecasts that it will purchase inventory that will cost 100 million foreign currency (FC) units. Entity B’s functional currency is the U.S. dollar (USD). To limit the variability in USD-equivalent cash flows associated with changes in the USD-FC exchange rate, Entity B constructs a currency collar as follows:

a. A purchased call option providing Entity B the right to purchase FC 100 million at an exchange rate of USD 0.885 per FC 1.

b. A written put option obligating Entity B to purchase FC 50 million at an exchange rate of USD 0.80 per FC 1.

55-124 The purchased call option provides Entity B with protection when the USD-FC exchange rate increases above USD 0.885 per FC 1. The written put option partially offsets the cost of the purchased call option and obligates Entity B to give up some of the foreign currency gain related to the forecasted inventory purchase as the USD-FC exchange rate decreases below USD 0.80 per FC 1. (For both options, the underlying is the same—the USD-FC exchange rate.) Assuming that a net premium was not received for the combination of options and all the other criteria in paragraphs 815-20-25-89 through 25-90 have been met, if Entity B chooses to use the combination of options as a hedging instrument, it is not required to comply with the provisions contained in paragraph 815-20-25-94 related to written options.
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55-125 Entity B would like to designate the combination of options as a hedge of the variability in USD-equivalent cash flows of its forecasted purchase of inventory denominated in FC. Assume Entity B specifies in the hedge effectiveness documentation that the collar’s time value would be excluded from the assessment of hedge effectiveness.

55-126 The hedging relationship involving the currency collar designated as a hedge of the effect of fluctuations in the USD-FC exchange rate qualifies for cash flow hedge accounting. In that example, the hedged risk is the risk of changes in USD-equivalent cash flows attributable to foreign currency risk (specifically, the risk of fluctuations in the USD-FC exchange rate). The foreign currency collar is hedging the variability in USD-equivalent cash flows for 100 percent of the forecasted FC 100 million purchase price of inventory for USD-FC exchange rate movements above USD 0.885 per FC 1 and variability in USD-equivalent cash flows for 50 percent of the forecasted FC 100 million purchase price of inventory for USD-FC exchange rate movements below USD 0.80 per FC 1. Cash flow hedge effectiveness will be determined based on changes in the underlying (the USD-FC exchange rate) that cause changes in the collar’s intrinsic value (that is, changes below USD 0.80 per FC 1 and above USD 0.885 per FC 1). Because the hedge’s effectiveness is based on changes in the collar’s intrinsic value, hedge effectiveness must be assessed based on the actual exchange rate changes by comparing the change in intrinsic value of the collar to the change in the specified quantity of the forecasted transaction for those changes in the underlying.

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**9.2.100 Additional consideration for fair value hedges – prepayment risk under the last-of-layer method**

Excerpt from ASC 815-20

>>> Fair Value Hedges of Interest Rate Risk in Which the Hedged Item Can Be Settled before Its Scheduled Maturity

25-6B An entity may designate a fair value hedge of interest rate risk in which the hedged item is a prepayable instrument in accordance with paragraph 815-20-25-6. The entity may consider only how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity (for example, an entity may consider only how changes in the benchmark interest rate affect an obligor’s decision to call a debt instrument when it has the right to do so). The entity need not consider other factors that would affect this decision (for example, credit risk) when assessing hedge effectiveness. Paragraph 815-25-35-13A discusses the measurement of the hedged item.

>>> Consideration of Prepayment Risk Using the Last-of-Layer Method

25-118A In a fair value hedge of interest rate risk designated under the last-of-layer method in accordance with paragraph 815-20-25-12A, an entity may exclude prepayment risk when measuring the change in fair value of the hedged item attributable to interest rate risk.
An entity is prohibited from hedging prepayment risk (see Question 2.3.20). However, it generally is required to consider prepayment risk when assessing hedge effectiveness and measuring the change in fair value of the hedged item attributable to interest rate risk. Two exceptions and an election apply in some instances to simplify the assessment process regarding prepayment risk.

— As exceptions. If an entity uses the following fair value hedges of interest rate risk, it does not consider prepayment risk for assessing hedge effectiveness and measuring the change in fair value of the hedged item:

  - partial-term hedges, when the assumed term ends before (or on) the initial date a financial instrument can be prepaid (see section 3.3.80); and
  - last-of-layer method (see section 3.3.100). [815-20-25-118A]

— As an election. Topic 815 allows an entity to consider only the effect of changes in the benchmark interest rate on the decision to prepay a financial instrument. If an entity elects this approach, it does not consider in its assessment of hedge effectiveness how other factors (e.g. credit risk) might affect the decision to prepay the financial instrument. [815-20-25-6B]

For further discussion of hedging interest rate risk on prepayable financial instruments, see section 3.4.10.

### 9.2.110 Additional consideration for cash flow hedges – time value of money

<table>
<thead>
<tr>
<th>Excerpt from ASC 815-20</th>
</tr>
</thead>
</table>

>>> Consideration of the Time Value of Money

25-120 In assessing the effectiveness of a cash flow hedge, an entity generally shall consider the time value of money, especially if the hedging instrument involves periodic cash settlements.

25-121 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 do not distort the results of the hedge. To assess offset of expected cash flows when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

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 considered in assessing effectiveness. This is especially important if the hedging instrument involves periodic cash settlements. However, Topic 815 does not prescribe a required method for measuring the changes in the derivative hedging instrument’s cash flows or the changes in the hedged transaction’s cash flows attributable to the hedged risk. [815-20-25-120]
An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts, which is discussed in section 9.2.50. To assess the offset of cash flows when using this strategy, 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. [815-20-25-121]

Question 9.2.300

How is the timing of cash flows considered in an effectiveness assessment for a cash flow hedge?

Interpretive response: We believe a present value methodology generally should be used to consider the timing of cash flows of both the hedging instrument and the forecasted transaction attributable to the hedged risk. The discount rates to be used when determining the change in cash flows for purposes of assessing effectiveness are summarized as follows.

<table>
<thead>
<tr>
<th>Rate for discounting derivative hedging instrument’s cash flows</th>
<th>Rate for discounting cash flows of the hedged transaction attributable to the hedged risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount rate used to determine the fair value of the instrument.</td>
<td>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 cash flows identical to those of the hedged transaction.</td>
</tr>
</tbody>
</table>

The discount rates may differ between the derivative hedging instrument and the hedged transaction as a result of the timing of the respective cash flows, the credit risk of the counterparty to the derivative, the entity’s own nonperformance risk and other relevant factors.

However, because cash flow hedging relationships are focused on the changes in cash flows of the derivative hedging instrument and the hedged transaction, credit risk (or the entity’s own nonperformance risk) has no effect on hedge effectiveness under certain assessment methods, as long it is probable that the counterparty to the derivative or the entity will not default.

- **Hypothetical derivative method (section 9.7.30) and change-in-variable-cash-flow method (section 9.7.40).** An entity is permitted to use the same credit risk adjustment that is used to determine the fair value of the derivative when measuring the change in the cash flows of the hedged transaction, as long it is probable that the counterparty to the derivative or the entity will not default. As a result, credit risk (or the entity’s own nonperformance risk) and changes therein do not affect hedge effectiveness.

- **Change-in-fair-value method (section 9.7.40).** Even though the same discount rate is used under the change-in-fair-value method when measuring the swap and the present value of the cumulative change in expected cash flows of the hedged transaction, the mechanics of applying...
this method may cause effectiveness to be affected in periods that creditworthiness changes.

However, if it is not probable that an entity will not default, a cash flow hedging relationship should be discontinued (see section 9.2.60).

**Question 9.2.310**

Is discounting required when the spot method is used?

**Interpretive response:** No. One exception to Topic 815’s guidance that discounting should generally be incorporated when assessing effectiveness is when an entity uses the spot method – i.e. uses a forward contract as the hedging instrument and chooses to exclude the spot-forward difference from the effectiveness assessment.

In these circumstances, the entity chooses one of the following methods.

— **Cash flows are discounted.** The expected cash flows of the derivative hedging instrument and the hedged transaction are discounted to convert them to current amounts based on the date the respective cash flows will actually occur.

— **Cash flows are not discounted.** The expected cash flows of the derivative hedging instrument and the hedged transaction are not discounted because they are both assumed to occur at the reporting date. In effect, a critical terms match approach could be used and perfect effectiveness would result when the other terms, such as notional amount and underlying, are the same.

Under both methods, the excluded component (changes in value of the spot-forward difference) are recognized using either an amortization approach or a mark-to-market approach (see section 9.2.70).

The choice of method for calculating the spot-forward difference is considered an accounting policy election that should be applied consistently to all similar hedging relationships.

These methods are illustrated in Example 9.2.70.

**Question 9.2.320**

How does discounting affect a hedging relationship when a forward contract does not settle on the date of the forecasted transaction?

**Background:** As discussed in section 9.2.50, Topic 815 requires that a 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 hedging relationship. However, it does not require that the hedging derivative expire or terminate on the same date that the forecasted transaction is expected to occur.
or that the cash inflows (outflows) from the derivative occur at the same time as the cash outflows (inflows) from the forecasted transaction.

**Interpretive response:** When the timing of the derivative differs from the timing of the forecasted transaction, the hedging relationship will not be perfectly effective in either of the following situations.

— The entity elects to include the entire change in the cash flows of the derivative hedging instrument in assessing effectiveness rather than excluding the spot-forward difference from the effectiveness assessment (see discussion of excluded components in section 9.2.70).

— The entity elects to discount expected cash flows of the derivative hedging instrument and forecasted transaction (see Question 9.2.310).

When the hedging relationship is not perfectly effective due to timing differences between the derivative and the forecasted transaction, strategies that an entity may implement to improve hedge effectiveness include the following.

— **The hedging relationship is rebalanced.** The entity implements a hedging strategy whereby the derivative instrument will be rebalanced. See discussion of dynamic hedging strategies in section 9.2.50.

— **The notional amounts of the derivative and hedged transaction do not match.** The entity implements a hedging strategy for which the notional amount of the derivative instrument is different from the notional amount of the hedged transaction; however, 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.

### Examples

The following KPMG examples demonstrate the effect of considering time value of money in cash flow hedging relationships.

— Comparison of excluding spot-forward difference – discounted vs. undiscounted (Example 9.2.70).

— Measuring changes in cash flows – discounted vs. undiscounted (Example 9.2.80).

**Example 9.2.70**

**Comparison of excluding spot-forward difference – discounted vs. undiscounted**

The following table summarizes the effects of excluding (or including) the spot-forward difference and of discounting (or not discounting) expected cash flows on hedge effectiveness in a forecasted sale of widgets that is expected to occur on a different date than when the hedging derivative settles.
This example summarizes potential effects in a hedging relationship involving a single settlement date for each of the forecasted sale and the hedging derivative. Similar effects occur if an entity designates a derivative with multiple settlements as the hedging instrument in a relationship involving a series of forecasted transactions. That is, differences between the hedging derivative’s
settlement dates and the dates of the forecasted transactions may cause the relationship to lack perfect effectiveness.

Example 9.2.80
Measuring changes in cash flows – discounted vs. undiscounted

ABC Corp. is a manufacturer with the US dollar as its functional currency. On January 1, Year 1, ABC forecasts the sale of 1,000,000 worth of goods denominated in foreign currency (FC) to a foreign country on August 31, Year 1 (eight 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.

ABC is exposed to changes in the $/FC exchange rates and enters into a six-month forward contract to buy US dollars and sell the foreign currency. The hedging derivative has the following terms:

— Contract amount: FC1,000,000;
— Trade date: January 1, Year 1;
— Maturity date: June 30, Year 1; and
— Forward contract rate: FC1 = $1.20.

ABC chooses to apply hedge accounting and formally designates and documents the hedging relationship on January 1, Year 1. ABC elects to exclude the spot-forward difference and recognize changes in the excluded component using the mark-to-market approach.

The following additional facts are relevant.

— The spot and forward exchange rates for various dates as applicable to the actual hedging derivative are in the following table.

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot rate</th>
<th>Forward rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, Year 1</td>
<td>$1.11 = FC1</td>
<td>$1.20 = FC1</td>
</tr>
<tr>
<td>March 31, Year 1</td>
<td>$1.13 = FC1</td>
<td>$1.23 = FC1</td>
</tr>
<tr>
<td>June 30, Year 1</td>
<td>$1.14 = FC1</td>
<td>-</td>
</tr>
</tbody>
</table>

— The fair value of the actual hedging derivative as of March 31, Year 1 is $(29,851) – i.e. a liability position to the entity. This is based on changes in forward rates discounted over three months (because it matures on June 30, Year 1) at an assumed discount rate of 2% – i.e. it is the present value of $30,000 [FC1,000,000 x ($1.20 - $1.23)] discounted at 2%.

— The spot and forward exchange rates for various dates as applicable to the hedged forecasted sale are in the following table.

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot rate</th>
<th>Forward rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, Year 1</td>
<td>$1.11 = FC1</td>
<td>$1.25 = FC1</td>
</tr>
<tr>
<td>March 31, Year 1</td>
<td>$1.13 = FC1</td>
<td>$1.28 = FC1</td>
</tr>
<tr>
<td>June 30, Year 1</td>
<td>$1.15 = FC1</td>
<td>-</td>
</tr>
</tbody>
</table>
On March 31, Year 1, ABC calculates the amounts to be reflected in the financial statements.

Scenario 1: Changes in cash flows due to changes in spot prices are not discounted

In this scenario, the entity does not discount changes in cash flows due to changes in spot prices when assessing hedge effectiveness. The changes in fair value of the forward contract and changes in cash flows of the hedged transaction are as shown in the table below.

<table>
<thead>
<tr>
<th></th>
<th>Change in fair value of forward contract gain (loss)</th>
<th>Change in cash flows of the hedged forecasted sale gain (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total change in fair value</td>
<td>$(29,851)</td>
<td>$ -</td>
</tr>
<tr>
<td>Change in cash flows due to changes</td>
<td>(20,000)(^1)</td>
<td>20,000(^2)</td>
</tr>
<tr>
<td>in spot rates</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change due to spot-forward difference</td>
<td>(9,851)(^3)</td>
<td>-</td>
</tr>
<tr>
<td>(excluded component recognized in</td>
<td></td>
<td></td>
</tr>
<tr>
<td>earnings)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1. \(FC1,000,000 \times ($1.11 - $1.13)\)
2. \(FC1,000,000 \times ($1.13 - $1.11)\)
3. $(29,851) - $(20,000)

This approach results in perfect effectiveness, as the change in fair value of the forward exchange contract and changes in cash flows of the hedged anticipated sale due to changes in the spot rate will be equal.

Scenario 2: Changes in cash flows due to changes in spot prices are discounted

In this scenario, the entity discounts changes in cash flows due to changes in spot prices when assessing hedge effectiveness.

— The projected cash flows of the forward contract are discounted over three months because it matures on June 30, Year 1. The discount rate is assumed to be 2%.
— The projected cash flows of the anticipated sale are discounted over five months because it is forecasted to occur on August 31, Year 1. The discount rate is assumed to be 2.05%.

The changes in fair value of the forward contract and changes in cash flows of the hedged transaction are shown in the table below.

<table>
<thead>
<tr>
<th></th>
<th>Change in fair value of forward contract gain (loss)</th>
<th>Change in cash flows of the hedged forecasted sale gain (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total change in fair value</td>
<td>$(29,851)</td>
<td>$ -</td>
</tr>
<tr>
<td>Change in cash flows due to changes</td>
<td>(19,900)(^1)</td>
<td>19,830(^2)</td>
</tr>
<tr>
<td>in spot rates</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change due to spot-forward difference</td>
<td>(9,951)(^3)</td>
<td>-</td>
</tr>
<tr>
<td>(excluded component recognized in</td>
<td></td>
<td></td>
</tr>
<tr>
<td>earnings)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Notes:
1. Present value of $20,000 [FC1,000,000 × ($1.11 - $1.13)] discounted over three months at 2%.
2. Present value of $20,000 [FC1,000,000 × ($1.11 - $1.13)] discounted over five months at 2.05%.
3. $(29,851) - $(19,900)

This approach results in the hedge not being perfectly effective, as the change in fair value of the forward exchange contract is $70 different from the change in cash flows of the hedged anticipated sale ($19,900 - $19,830).

9.3 Shortcut method for interest rate swaps

9.3.10 Overview

Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-102 The conditions for the shortcut method do not determine which hedging relationships qualify for hedge accounting; rather, those conditions determine which hedging relationships qualify for a shortcut version of hedge accounting that assumes perfect hedge effectiveness. If all of the applicable conditions in the list in paragraph 815-20-25-104 are met, an entity may assume perfect effectiveness in a hedging relationship of interest rate risk involving a recognized interest-bearing asset or liability (or a firm commitment arising on the trade [pricing] date to purchase or issue an interest-bearing asset or liability) and an interest rate swap (or a compound hedging instrument composed of an interest rate swap and a mirror-image call or put option as discussed in paragraph 815-20-25-104[e]) provided that, in the case of a firm commitment, the trade date of the asset or liability differs from its settlement date due to generally established conventions in the marketplace in which the transaction is executed. The shortcut method’s application shall be limited to hedging relationships that meet each and every applicable condition. That is, all the conditions applicable to fair value hedges shall be met to apply the shortcut method to a fair value hedge, and all the conditions applicable to cash flow hedges shall 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 perfect effectiveness justified by applying other criteria. The verb match is used in the specified conditions in the list to mean be exactly the same or correspond exactly.

>>>>> Application of the Shortcut Method to a Portfolio of Hedged Items

25-116 Portfolio hedging cannot be used to circumvent the application of the shortcut method criteria beginning in paragraph 815-20-25-102 to a fair value hedge of an individual interest-bearing asset or liability. A portfolio of interest-bearing assets or interest-bearing liabilities cannot qualify for the shortcut
method if it contains an interest-bearing asset or liability that individually cannot qualify for the shortcut method.

25-117 The fair value hedge requirements of paragraph 815-20-25-12(b)(1) ensure that the individual items in a portfolio share the same risk exposure and have fair value changes attributable to the hedged risk that are expected to respond in a generally proportionate manner to the overall fair value changes of the entire portfolio. That requirement restricts the types of portfolios that can qualify for portfolio hedging; however, it also permits the existence of a mismatch between the change in the fair value of the individual hedged items and the change in the fair value of the hedged portfolio attributable to the hedged risk in portfolios that do qualify. As a result, the assumption of perfect effectiveness required for the shortcut method generally is inappropriate for portfolio hedges of similar assets or liabilities that are not also nearly identical (except for their notional amounts). Application of the shortcut method to portfolios that meet the requirements of paragraph 815-20-25-12(b)(1) is appropriate only if the assets or liabilities in the portfolio meet the same stringent criteria in paragraphs 815-20-25-104(e), 815-20-25-104(g), and 815-20-25-105(a) as required for hedges of individual assets and liabilities.

>>> Applicability of the Shortcut Method

55-71 Given the conditions in paragraph 815-20-25-104, the shortcut method cannot be applied, for example, to any of the following hedging relationships:

a. Those hedging interest rate risk that involve hedging instruments other than interest rate swaps.

b. For fair value hedges, those that involve hedged risks other than the risk of changes in fair value attributable to changes in the designated benchmark interest rate.

bb. For cash flow hedges, those that involve hedging relationships in which the contractually specified interest rate of a recognized interest-bearing asset or liability does not match the interest rate index of the variable leg of the interest rate swap.

c. Those that do not involve a recognized interest-bearing asset or liability.

55-72 Based on (c) in the preceding paragraph, the shortcut method cannot be applied in a cash flow hedge of a forecasted transaction, even if an entity determines that all critical terms of the hedging instrument and the hedged forecasted transaction are matched.

The shortcut method is an elective method that greatly simplifies the hedge effectiveness assessment for a hedge of interest rate risk. If a hedging relationship meets the criteria for this method, the entity can assume that the hedging relationship is perfectly effective. Therefore, the method simplifies the hedge effectiveness assessment by eliminating the initial and ongoing quantitative aspect of the assessment. [815-20-25-102]

**Fair value hedges.** For shortcut method fair value hedges, the hedged item’s change in fair value attributable to the hedged risk is the inverse of the hedging instrument’s change in the fair value. For example, if the hedging instrument’s fair value increases by $100, the entity assumes that the hedged item’s change in fair value attributable to the hedged risk has decreased by $100.
**Cash flow hedges.** For shortcut method cash flow hedges, an entity records the change in fair value of the hedging instrument in AOCI. An entity accounts for all cash flow hedges in this manner. However, if an entity does not apply the shortcut method, it will need to perform initial and ongoing effectiveness assessments. [815-20-25-102, 35-1(c)]

**Criteria for applying shortcut method**

The shortcut method applies only to hedges of interest rate risk, and then only if general requirements and specific criteria are met. It is narrow in scope by design and cannot be applied by analogy. Specifically, the SEC staff has indicated that the circumstances in which an entity can apply the shortcut method 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 an entity can meet without strictly complying with the stated requirements. [815-20-25-102, 2006 AICPA Conf]

The general requirements are discussed in section 9.3.20. The specific criteria are summarized here and discussed in the referenced sections.

**General criteria for both fair value hedges and cash flow hedges**

| Criterion 1 (section 9.3.30) | Swap’s notional amount matches the hedged item’s principal amount [815-20-25-104(a)] |
| Criterion 2 (section 9.3.40) | Swap’s fair value at hedge inception is zero [815-20-25-104(b), 25-104(c)] |
| Criterion 3 (section 9.3.50) | Swap has a consistent formula for computing net settlements each period [815-20-25-104(d)] |
| Criterion 4 (section 9.3.60) | Hedged item is not prepayable [815-20-25-104(e)] |
| Criterion 5 (section 9.3.70) | All other terms are typical and do not invalidate assumption of perfect effectiveness [815-20-25-104(g)] |

**Additional shortcut criteria for fair value hedges** (section 9.3.80)

- The maturity dates of the swap and hedged item(s) match. [815-20-25-105(a)]
- The variable interest rate of the swap has no cap or floor. [815-20-25-105(b)]
- The repricing intervals on the swap’s variable rate are frequent enough to assume that the variable rate is a market rate. [815-20-25-105(c)]
9. Hedge effectiveness

### Additional shortcut criteria for fair value hedges
(section 9.3.80)

The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the hedged interest rate. [815-20-25-105(1)]

### Additional shortcut criteria for cash flow hedges
(section 9.3.90)

All of the hedged transaction’s interest payments during the swap’s term are hedged, and none of its interest payments beyond the swap’s term are hedged. [815-20-25-106(a), 25-106(b)]

Either the swap has no cap or floor, or if the hedged transaction has a cap or floor, the swap has a comparable cap or floor. [815-20-25-106(c)]

The repricing dates of the swap and the hedged transaction match. [815-20-25-106(d)]

The index on which the variable leg of the swap is based matches the contractually specified interest rate designated as the hedged interest rate. [815-20-25-106(g)]

### 9.3.20 General requirements

There are general requirements regarding the nature of the hedged item or transaction, hedging instrument and hedged risk that must be met before an entity can determine whether a hedging relationship meets the specific criteria to be assessed under the shortcut method.

#### Interest rate risk

First, the hedging relationship needs to hedge interest rate risk as follows. [815-20-25-102, 55-71]

<table>
<thead>
<tr>
<th>Fair value hedge</th>
<th>Cash flow hedge</th>
</tr>
</thead>
<tbody>
<tr>
<td>The hedged risk is a benchmark interest rate.</td>
<td>The hedged risk is the interest rate index contractually specified in the interest-bearing asset or liability.</td>
</tr>
</tbody>
</table>

Additional requirements for the hedged item or transaction and hedging instrument are as follows.

<table>
<thead>
<tr>
<th>Hedging instrument needs to be:</th>
</tr>
</thead>
<tbody>
<tr>
<td>— a simple interest rate swap without embedded options; or</td>
</tr>
<tr>
<td>— a compound hedging instrument comprising an interest rate swap and an embedded call or put option that mirrors the call or put option embedded in the hedged item. [815-20-25-102]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Hedged item or transaction needs to be:</th>
</tr>
</thead>
<tbody>
<tr>
<td>— a recognized interest-bearing asset (e.g. a debt instrument classified as AFS);</td>
</tr>
<tr>
<td>— a recognized interest-bearing liability (e.g. fixed-rate debt issued); or</td>
</tr>
<tr>
<td>— a firm commitment arising from a difference between the trade date and settlement date relating to a purchase of an interest-bearing asset or issuance of an interest-bearing liability. [815-20-25-102]</td>
</tr>
</tbody>
</table>
For a portfolio of interest-bearing assets or interest-bearing liabilities to qualify for the shortcut method, each asset or liability in the portfolio must individually qualify for the shortcut method. [815-20-25-116]

**Question 9.3.10**

**Can the shortcut method be applied to a hedge of the forecasted issuance or purchase of a financial instrument?**

**Interpretive response:** Generally an entity cannot apply the shortcut method to the hedge of a forecasted purchase of an asset or issuance of a liability – e.g. the variability in interest payments on the forecasted issuance of fixed rate debt. This is because a forecasted purchase is not a recognized interest-bearing asset or interest-bearing liability. This is true even if the critical terms of the interest rate swap match the forecasted purchase or issuance. [815-20-25-102, 55-71, 55-72]

However, an entity could apply the shortcut method to a firm commitment that arises on the trade date if the difference between the trade and settlement dates is due to generally established conventions in the marketplace in which the transaction is executed (see **Question 9.3.20**). [815-20-25-102]

**Question 9.3.20**

**How does an entity determine whether the trade and settlement dates of a firm commitment differ due to market conventions?**

**Background:** An entity may designate a firm commitment as the hedged item in a shortcut method hedge if: [815-20-25-102]

- the firm commitment arises on the trade date to purchase or issue an interest-bearing asset or liability; and
- the reason for the difference between the trade date of the firm commitment and settlement date of the interest-bearing asset or liability is due to generally established conventions in the marketplace in which the transaction is executed.

**Interpretive response:** An entity applies judgment when determining whether the trade and settlement dates of a firm commitment to purchase or issue an interest-bearing asset or liability differ due to established market conventions. It considers the facts and circumstances of the specific transaction and the market in which the transaction is executed.
Example 9.3.10
Debt hedged on trade date

Debt issued and hedged with an interest rate swap

ABC Corp. issues a fixed-rate debt instrument. On the same day, ABC enters into an interest rate swap whereby it will receive a fixed rate and pay a variable rate.

The fixed-rate debt will settle five days after its trade date (i.e. date issued). ABC determines that the reason for the five-day difference between the trade and settlement dates is due to established market conventions. ABC applies the shortcut method.

**Fair value hedge designation**

<table>
<thead>
<tr>
<th>Hedged item</th>
<th>Fixed-rate debt issued</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedging instrument</td>
<td>Receive fixed, pay variable interest rate swap</td>
</tr>
<tr>
<td>Hedged risk</td>
<td>Three-month LIBOR</td>
</tr>
</tbody>
</table>

**Fair value hedge accounting – shortcut method**

<table>
<thead>
<tr>
<th>Trade date</th>
<th>The interest rate swap and a firm commitment representing the debt that will settle in five days both have fair values of zero.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade date to settlement date</td>
<td>ABC applies the shortcut method. Therefore, it records the change in fair value of the interest rate swap and an equal and offsetting change in fair value of the firm commitment in earnings. In addition, ABC adjusts the carrying amount of the interest rate swap to its fair value and adjusts the carrying amount of the firm commitment in an equal and offsetting amount.</td>
</tr>
<tr>
<td>Settlement date</td>
<td>ABC recognizes the debt instrument and incorporates the prior carrying amount of the firm commitment into the amount it recognizes.</td>
</tr>
<tr>
<td>After settlement date</td>
<td>ABC continues to apply the shortcut method.</td>
</tr>
</tbody>
</table>

**What if the debt had a variable interest rate?**

If ABC had issued variable-rate debt, it would have been exposed to cash flow variability beginning on the debt’s trade date. ABC could have designated the hedging relationship as a **cash flow hedge** and applied the shortcut method. All changes in the fair value of the interest rate swap would have been recorded in AOCI and are reclassified to earnings as the hedged item affects earnings. On settlement date, ABC would have recognized the variable-rate debt instrument.
Question 9.3.30
Can a lessee or lessor apply the shortcut method to a cash flow hedge of the variability in lease payments of an interest rate indexed operating lease?

Interpretive response: No. Neither the lessee nor the lessor may apply the shortcut method to a cash flow hedge of the variability in lease payments for an interest-rate-indexed operating lease. The lease is neither an interest-bearing asset or liability, nor a firm commitment to purchase or issue an interest-bearing asset or liability with a settlement date that differs from its trade date due to established market conventions. [815-20-25-102, 55-71]

Question 9.3.40
Can an entity replace the hedged item or transaction during a shortcut method hedging relationship?

Interpretive response: No. An entity must identify and document the specific hedged item or transaction at the inception of the specific interest-bearing asset or liability. Therefore, an entity is not permitted to replace the hedged item or transaction during the hedging relationship. If the entity derecognizes the hedged item or transaction that was designated in its original hedge documentation, the hedging relationship would be terminated. [815-20-25-3]

The hedge of a firm commitment and subsequent recognition and continued hedge of the related interest-bearing asset or liability is not considered a replacement of the hedged item or transaction.

Question 9.3.50
Are there documentation considerations that are specific to the shortcut method?

Interpretive response: Yes. We believe that at hedge inception, an entity should formally document how each of the applicable shortcut criteria are met.

In addition, an entity may want to consider documenting at hedge inception a quantitative method it would use to assess hedge effectiveness if it subsequently determines the shortcut method was not or no longer is appropriate (see section 9.3.110). [815-20-25-117A]
Question 9.3.60

Can the shortcut method be applied when a portion (i.e. a percentage) of an interest-bearing asset or liability is designated as the hedged item or transaction?

Interpretive response: Yes. An entity may designate a portion (i.e. a percentage) of an interest-bearing asset or liability as the hedged item (or interest payments on a portion of the principal amount of an interest-bearing asset or liability as the hedged transaction) in a shortcut method hedge. However, the notional amount of the interest rate swap and the principal amount of the hedged item or transaction must match (see section 9.3.30). [815-20-25-105(d), 25-106(e)]

For guidance on designating a portion (or percentage) of a hedged item in a fair value hedge, see section 3.3.60. For guidance on specifically identifying a forecasted transaction in a cash flow hedge, see section 5.3.30.

Question 9.3.70

Can the shortcut method be applied when hedging a portfolio of interest-bearing assets or liabilities or group of forecasted transactions?

Interpretive response: Yes. An entity may designate a portfolio of similar interest-bearing assets or liabilities (or proportions thereof) as the hedged item or a group of forecasted transactions as the hedged transaction in a shortcut method hedge as long as: [815-20-25-105(e), 25-106(f), 25-116]

— the notional amount of the interest rate swap and the aggregate notional amount of the designated portfolio or group of forecasted transactions match (see section 9.3.30); and
— each individual item in the portfolio or group meets all applicable shortcut criteria.

As a practical matter, these criteria result in the need for the characteristics of the individual items in the portfolio or group to be the same except for their notional amounts. Therefore, opportunities for hedging a portfolio of items or group of transactions using the shortcut method are limited.

For guidance on designating a portfolio of similar assets or liabilities in a fair value hedge, see section 3.3.40. For guidance on designating a group of similar forecasted transactions, see section 5.3.60.
9.3.30 **Criterion 1: Swap’s notional amount matches the hedged item’s principal amount**

<table>
<thead>
<tr>
<th>Excerpt from ASC 815-20</th>
</tr>
</thead>
</table>

>>> **Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)**

25-104 All of the following conditions apply to both fair value hedges and cash flow hedges:

- The notional amount of the interest rate swap matches the principal amount of the interest-bearing asset or liability being hedged.

25-105 All of the following incremental conditions apply to fair value hedges only: …

- For fair value hedges of a proportion of the principal amount of the interest-bearing asset or liability, the notional amount of the interest rate swap designated as the hedging instrument (see (a) in paragraph 815-20-25-104) matches the portion of the asset or liability being hedged.

- For fair value hedges of portfolios (or proportions thereof) of similar interest-bearing assets or liabilities, both of the following criteria are met:
  1. The notional amount of the interest rate swap designated as the hedging instrument matches the aggregate notional amount of the hedged item (whether it is all or a proportion of the total portfolio).
  2. The remaining criteria for the shortcut method are met with respect to the interest rate swap and the individual assets or liabilities in the portfolio.

25-106 All of the following incremental conditions apply to cash flow hedges only: …

- For cash flow hedges of the interest payments on only a portion of the principal amount of the interest-bearing asset or liability, the notional amount of the interest rate swap designated as the hedging instrument (see paragraph 815-20-25-104(a)) matches the principal amount of the portion of the asset or liability on which the hedged interest payments are based.

- For a cash flow hedge in which the hedged forecasted transaction is a group of individual transactions (as permitted by paragraph 815-20-25-15(a)), if both of the following criteria are met:
  1. The notional amount of the interest rate swap designated as the hedging instrument (see paragraph 815-20-25-104(a)) matches the notional amount of the aggregate group of hedged transactions.
  2. The remaining criteria for the shortcut method are met with respect to the interest rate swap and the individual transactions that make up the group. For example, the interest rate repricing dates for the variable-rate assets or liabilities whose interest payments are included in the group of forecasted transactions shall match (that is, be exactly the same as) the reset dates for the interest rate swap.
When the hedged item or transaction is an entire financial asset or financial liability, the shortcut method’s first criterion requires the notional amount of the interest rate swap to match the principal amount of the hedged item or transaction. [815-20-25-104(a)]

<table>
<thead>
<tr>
<th>Hedged item or transaction</th>
<th>Hedging instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal amount of interest-bearing asset or liability</td>
<td>Notional amount of interest rate swap</td>
</tr>
</tbody>
</table>

This criterion is met for portions and portfolios or groups of hedged items or transactions as follows.

**Fair value hedge**
- The interest rate swap notional amount must match the principal amount of the portion (i.e. a percentage) of the interest-bearing asset or liability. [815-20-25-105(d)]

**Cash flow hedge**
- The interest rate swap notional amount must match the principal amount of the portion of the asset or liability on which hedged interest payments are based. [815-20-25-106(e)]

**If hedged item or transaction is a portfolio or group of similar interest-bearing assets or liabilities (or portion thereof) ...**
- The interest rate swap notional amount must match the aggregate principal amount of the hedged portfolio. [815-20-25-105(e)]
- The interest rate swap notional amount must match the principal amount of the aggregate group of hedged transactions. [815-20-25-106(f)]

**Question 9.3.80**
Can the shortcut method be applied to a hedging relationship if the hedging instrument is a part of a derivative instrument?

**Interpretive response:** Yes, an entity may designate a proportion of an interest rate swap as the hedging instrument in a shortcut method hedge if the swap’s notional amount and the hedged item’s principal amount match. For example, an entity could hedge $50 million notional of a $100 million notional. [815-20-25-104(a)]
9.3.40 **Criterion 2: Swap’s fair value at hedge inception is zero**

| Excerpt from ASC 815-20 |

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-104 All of the following conditions apply to both fair value hedges and cash flow hedges: ...

b. If the hedging instrument is solely an interest rate swap, the fair value of that interest rate 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. The guidance in the preceding sentence 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 820-10-35-9B). If the hedging instrument is solely an interest rate swap that at the inception of the hedging relationship has a positive or negative fair value, but does not meet the one exception specified in this paragraph, the shortcut method shall not be used even if all the other conditions are met.

c. If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in (e), the premium for the mirror-image call or put option shall be paid or received in the same manner as the premium on the call or put option embedded in the hedged item based on the following:

1. If the implicit premium for the call or put option embedded in the hedged item is being paid principally over the life of the hedged item (through an adjustment of the interest rate), the fair value of the hedging instrument at the inception of the hedging relationship shall be zero (except as discussed previously in (b) regarding differing prices due to the existence of a bid-ask spread).

2. If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium), the fair value of the hedging instrument at the inception of the hedging relationship shall be equal to the fair value of the mirror-image call or put option.

The shortcut method’s second criterion requires the following.

<table>
<thead>
<tr>
<th>If the hedged instrument is:</th>
<th>The fair value of that interest rate swap at hedge inception must be zero, with the exception of bid-ask spreads. [815-20-25-104(b)]</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Solely an interest rate swap</strong></td>
<td></td>
</tr>
</tbody>
</table>

The hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in (e), the premium for the mirror-image call or put option shall be paid or received in the same manner as the premium on the call or put option embedded in the hedged item based on the following:

1. If the implicit premium for the call or put option embedded in the hedged item is being paid principally over the life of the hedged item (through an adjustment of the interest rate), the fair value of the hedging instrument at the inception of the hedging relationship shall be zero (except as discussed previously in (b) regarding differing prices due to the existence of a bid-ask spread).

2. If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium), the fair value of the hedging instrument at the inception of the hedging relationship shall be equal to the fair value of the mirror-image call or put option.
If the hedged instrument is:

| A compound derivative composed of an interest rate swap with an embedded mirror-image call option | The entity must pay or receive the premium for the mirror-image call or put option and the premium for the call or put option embedded in the hedged item or transaction in the same manner. [815-20-25-104(c)] |

Because of the requirement that the fair value of the interest rate swap be zero at hedge inception, it is highly unlikely that a hedging relationship could qualify for the shortcut method unless an entity designates the hedging relationship at the swap’s trade date. Immediately thereafter, the swap will very likely have a fair value of other than zero because of the movement in both market interest rates and the passage of time.

Question 9.3.90
Are there exceptions to the requirement that an interest rate swap’s fair value be zero at hedge inception?

Interpretive response: The shortcut method generally requires that the fair value of the interest rate swap be zero at hedge inception. However, the swap’s fair value may be other than zero if: [815-20-25-104(b)]

— the entity enters into the swap at hedge inception;
— the swap’s transaction price is zero (excluding commissions and other transaction costs described in Subtopic 820-10) in the entity’s principal or most advantageous market as applicable; and
— the difference between the swap’s transaction price and its fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction.

In addition, a compound derivative comprising an interest rate swap and a call or put option that mirrors the call or put option embedded in the hedged item or transaction may have a non-zero fair value.

Question 9.3.100
How does an entity determine whether the interest rate swap has a zero fair value if it includes a premium for an embedded call or put option?

Background: An entity may hedge an interest-bearing asset or liability that has an embedded call or put option for interest rate risk with an interest rate swap containing a mirror-image call or put option. Typically, parties to both the asset or liability and the swap will pay or receive a premium for the options. [815-20-25-102]

Interpretive response: The shortcut method requires an entity to pay or receive the premium for the mirror-image option contained in the interest rate
swapped in the same manner as it receives or pays the premium on the call or put option embedded in the hedged item or transaction. [815-20-25-104(c)]

Therefore, an entity determines whether the implicit premium for the call or put option embedded in the hedged item or transaction was paid at inception (through an original issue discount or premium) or is being paid over the life of the hedged item or transaction (through an interest rate adjustment). An entity makes this determination by comparing the hedged item or transaction with the embedded option to an instrument without such an embedded option, but equivalent to the hedged item or transaction in all other respects. [815-20-25-104(c)]

If the premium for a call or put option embedded in the hedged item or transaction is paid over the life of the hedged item or transaction, the fair value of the hedging instrument at hedge inception must be zero. However, if such a premium is paid at inception of the hedged item or transaction, the fair value of the hedging instrument at hedge inception must equal the fair value of the mirror-image call or put option. [815-20-25-104(c)]

<table>
<thead>
<tr>
<th>Premium for call or put option embedded in the hedged item or transaction is paid:</th>
<th>To apply the shortcut method, the fair value of the hedging instrument at hedge inception must equal:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over the life of the hedged item or transaction</td>
<td>Zero [815-20-25-104(c)]</td>
</tr>
<tr>
<td>At inception of the hedged item or transaction</td>
<td>The fair value of the mirror-image call or put option [815-20-25-104(c)]</td>
</tr>
</tbody>
</table>

When applying the shortcut method, an entity does not perform the written option effectiveness test if the options embedded in the hedging instrument and hedged item have terms that mirror one another. This is because an entity assumes that the written option effectiveness test would be met if a hedging relationship also meets the requirements for application of the shortcut method.

### Example 9.3.20

**Day 1 fair value of a compound interest rate swap**

ABC Corp. issues a callable debt instrument with a fixed rate of 5.5% and designates the following in a shortcut method fair value hedge.

<table>
<thead>
<tr>
<th>Hedged item</th>
<th>Callable debt with a fixed rate of 5.5%.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedging instrument</td>
<td>An interest rate swap, whereby ABC receives 5.5% and pays three-month LIBOR, that contains a written embedded call option that mirrors the call option in the debt.</td>
</tr>
</tbody>
</table>

If the swap did not contain the mirror option, ABC would not be able to apply the shortcut method.

**Does ABC pay for the debt’s premium and receive the swap’s premium in the same manner?**

ABC determines that the interest rate it is paying over the life of the debt instrument includes a premium of 50 basis points for its purchased call option.
That is, if the bond that ABC issued had been non-callable, its interest rate would have been 5%. ABC also determines that an interest rate swap with terms that match the debt and has a fair value of zero at inception would have a fixed leg that pays 5%.

Because the swap that ABC designated as the hedging instrument has a fixed-rate leg of 5.5%, it has a fair value of other than zero. However, this value is offset by the value of the written option’s premium embedded in the swap. Therefore, the net fair value of the compound derivative is zero at inception of the hedging relationship. In this situation, ABC is receiving a premium of 50 basis points for the swap’s mirror-image written call option over the swap’s life as part of the swap’s fixed interest rate. Therefore, this hedging relationship meets the second criterion for the shortcut method because ABC pays for the premium on the debt and receives the premium on the swap in the same manner.

**What if the debt had a fixed rate of 5%?**

If ABC had instead issued debt with a fixed rate of 5% (i.e. a discount to yield 5.5%), it would pay a premium for the embedded call option at inception through an original issue discount.

However, assume the terms of the interest rate swap are the same as described above (i.e. ABC receives 5.5% and pays three-month LIBOR). In that case, ABC receives a premium of 50 basis points for the swap’s mirror-image written call option over the swap’s life as part of the swap’s fixed interest rate. In this situation, ABC does not pay for the premium on the debt and receive the premium on the swap in the same manner. Therefore, ABC cannot apply the shortcut method.

**Interpretive response:** Yes, in some cases. For example, a zero coupon swap discussed in Question 9.3.250 has an embedded financing arrangement, but it may be structured to have a zero fair value at inception. In other cases, an interest rate swap that has an embedded financing arrangement may not have a zero fair value at hedge inception because its fair value reflects the financing component. In any case, an interest rate swap with an embedded financing arrangement would not qualify for the shortcut method. This is because the swap would fail the criterion requiring it to have a consistent formula for computing net settlements each period. The swap would also fail the criterion requiring its terms to be typical for a swap and to not invalidate the assumption of perfect effectiveness. [815-20-25-14(b), 25-104(d), 25-104(g)]
Example 9.3.30

Day 1 fair value of an interest rate swap with an embedded financing arrangement

Bank accepts certificates of deposits acquired through Broker (i.e. brokered CDs). It designates a brokered CD as the hedged item in a shortcut method fair value hedge.

Broker charges a commission for providing the CDs to Bank. However, Bank does not pay the commission to Broker directly. Instead, Bank enters into an interest rate swap arrangement with Counterparty and designates the swap as the hedging instrument. Counterparty pays Broker the commission on behalf of Bank. Under the swap arrangement, Bank then reimburses Counterparty over time through its payments to Counterparty under the swap. That is, Bank pays Counterparty a rate that is 0.2% more than it would have if Counterparty had not financed the broker commissions.

The interest rate swap has an embedded financing arrangement. Its initial fair value is equal to Broker’s commission that Counterparty has financed. Because the fair value of the swap is not zero at hedge inception (due to the embedded financing arrangement), the swap does not qualify for the shortcut method.

When evaluating whether such a transaction qualifies for the shortcut method, an entity considers all unstated rights and privileges that may have been considered in negotiating the terms of the swap.

Continued use of shortcut method following a business combination

Excerpt from ASC 815-20

>> Example 24: No Continuation of the Shortcut Method Following a Purchase Business Combination

55-199 This Example addresses whether the shortcut method in paragraph 815-20-25-102 can be applied in the circumstances illustrated. This Example has the following assumptions:

a. Entity A acquires Entity B in a business combination. A business combination is accounted for as the acquisition of one entity by another entity. The acquiring entity, Entity A, records the assets acquired and liabilities assumed at fair value.

b. Subparagraph superseded by Accounting Standards Update No. 2017-12.

c. At the date of the business combination, Entity A and Entity B both have certain hedging relationships that have met the requirements as discussed beginning in paragraph 815-20-25-102 and that are being accounted for by the respective entities under the shortcut method of accounting.

d. At the date of the business combination, the fair value of the hedging swaps in Entity B’s hedging relationships is other than zero.
Hedging

9. Hedge effectiveness

55-200 Unless the applicable hedging relationships meet the requirements in paragraph 815-20-25-102 at the date of the business combination (which would be highly unlikely because the swap’s fair value would rarely be zero at that date) and the combined entity chooses to designate the swaps and the hedged items as hedging relationships to be accounted for under the shortcut method, the acquiror cannot continue to use the shortcut method of accounting for the hedging relationships of the acquiree that were being accounted for by the acquiree under the shortcut method of accounting at the date of the business combination.

55-201 Entity A is acquiring the individual assets and liabilities of Entity B at the date of the business combination and accordingly any preexisting hedging relationships of old Entity B must be designated anew by the combined entity at the date of the business combination in accordance with the relevant requirements of this Subtopic.

55-202 In part, this Example entails a determination of whether the business combination results in a new inception date for the combined entity for hedging relationships entered into by the acquiree before the consummation of the business combination that remain ongoing at the date of the business combination. The concept of acquisition accounting follows the accounting for acquisitions of individual assets and liabilities. That is, the combined entity should account for the assets and liabilities acquired in the business combination consistent with how it would be required to account for those assets and liabilities if they were acquired individually in separate transactions. The acquisition method is based on the premise that in an acquisition, the acquired entity (Entity B) ceases to exist and only the acquiring entity (Entity A) survives. Thus, the postacquisition hedging relationship designated by Entity A is a new relationship that has a new inception date.

55-203 Even in the unlikely circumstance that the new hedging relationship qualifies for the shortcut method, there would be no continuation of the shortcut method of accounting that had been applied by the acquired entity.

The acquiree in a business combination may have existing hedging relationships to which it has applied the shortcut method. Any post-combination designation of the existing hedging relationship by the acquirer would be considered a new hedging relationship. [815-20-55-202]

After a business combination, the acquirer may not use the shortcut method for a hedge that acquiree accounted for using the shortcut method before the business combination unless: [815-20-55-200]

— the applicable hedging relationship meets the shortcut criteria at the date of the business combination. This would be highly unlikely because the interest rate swap’s fair value rarely would be zero at that date; and

— the combined entity chooses to designate the swap and the hedged item or transaction as a hedging relationship to be accounted for under the shortcut method.
9.3.50 **Criterion 3: Swap has a consistent formula for computing net settlements each period**

<table>
<thead>
<tr>
<th>Excerpt from ASC 815-20</th>
</tr>
</thead>
</table>

>>> **Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)**

25-104 All of the following conditions apply to both fair value hedges and cash flow hedges:

d. The formula for computing net settlements under the interest rate swap is the same for each net settlement. That is, both of the following conditions are met:

1. The fixed rate is the same throughout the term.
2. The variable rate is based on the same index and includes the same constant adjustment or no adjustment. The existence of a **stub period** and **stub rate** is not a violation of the criterion in (d) that would preclude application of the shortcut method if the stub rate is the variable rate that corresponds to the length of the stub period.

The shortcut method’s third criterion requires that the formula for computing the net settlements of the interest rate swap to be the same for each net settlement. This means that throughout its term, the swap’s: [815-20-25-104(d)]

- fixed rate does not change; and
- variable rate is based on the same index and includes no or a constant fixed spread.

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**Question 9.3.120**

Can the shortcut method be applied if the hedging instrument is a forward-starting interest rate swap?

**Interpretive response:** No, an entity cannot apply the shortcut method to a hedging relationship that involves a forward-starting interest rate swap. [815-20-55-71, 25-102]

The FASB staff has noted that a forward-starting interest rate swap is not considered to have a consistent formula for computing net settlements. This is because settlements occur only after the effective date and not between the trade date and effective date.

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**Question 9.3.130**

Can the shortcut method be applied to a hedge if the swap contains an initial stub period?

**Background:** The variable leg of an interest rate swap often resets every three or six months. However, entities frequently enter into interest rate swaps on
dates other than a swap reset date. An interest rate swap that resets quarterly may have a first payment period that is shorter than a full quarter, referred to as a ‘stub period.’ That stub period is the period that begins on the date that coupon payments begin to accrue and ends on the first payment date. The floating rate set for that shorter period is the ‘stub rate’.

Interpretive response: Yes, an interest rate swap containing an initial stub period does not violate the shortcut method requirement that the swap have a consistent formula for calculating net settlements if the stub rate corresponds to the length of the stub period. A stub period is simply a market convention necessary to determine the prices of interest rate swaps that are traded on dates that do not coincide with swap reset dates. [815-20-25-104(d)(2)]

Question 9.3.140
Can the shortcut method be applied to a hedge if the first cash flow on the swap includes debt issuance fees?

Interpretive response: No. If the first cash flow on the interest rate swap includes debt issuance fees, the swap is not eligible for the shortcut method. To qualify for the shortcut method, the interest rate swap must have a consistent formula for computing net settlements each period. Therefore, if the first cash flow on the swap includes debt issuance fees, it is not eligible because the formula for each net settlement is not the same. This transaction would also not meet the second criterion for the shortcut method because the interest rate swap would not have a zero fair value at inception (see section 9.3.40). [815-20-25-104(b), 25-104(d)]

9.3.60 Criterion 4: Hedged item is not prepayable, with limited exceptions

Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-104 All of the following conditions apply to both fair value hedges and cash flow hedges:

e. The interest-bearing asset or liability is not prepayable, that is, able to be settled by either party before its scheduled maturity or the assumed maturity date if the hedged item is measured in accordance with paragraph 815-25-35-13B, with the following qualifications:

1. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option (put option) if the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image call option (put option).
2. The call option embedded in the interest rate swap is considered a mirror image of the call option embedded in the hedged item if all of the following conditions are met:
   i. The terms of the two call options match exactly, including all of the following:
      01. Maturities
      02. Strike price (that is, the actual amount for which the debt instrument could be called) and there is no termination payment equal to the deferred debt issuance costs that remain unamortized on the date the debt is called
      03. Related notional amounts
      04. Timing and frequency of payments
      05. Dates on which the instruments may be called.
   ii. The entity is the writer of one call option and the holder (purchaser) of the other call option.

25-108 Any discount or premium in the hedged debt’s carrying amount (including any related deferred issuance costs) is irrelevant to and has no direct impact on the determination of whether an interest rate swap contains a mirror-image call option under paragraph 815-20-25-104(e). Typically, the call price is greater than the par or face amount of the debt instrument. The carrying amount of the debt is economically unrelated to the amount the issuer would be required to pay to exercise the call embedded in the debt.

>>>> Application of Prepayable Criterion

25-112 An interest-bearing asset or liability shall be considered prepayable under the provisions of paragraph 815-20-25-104(e) if one party to the contract has the right to cause the payment of principal before the scheduled payment dates unless either of the following conditions is met:

a. 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 absent that right.

b. 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 absent that right.

25-113 However, none of the following shall be considered a prepayment provision:

a. 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 upon the occurrence of a specific event related to the debtor’s credit deterioration or other change in the debtor’s credit risk, such as any of the following:
   1. The debtor’s failure to make timely payment, thus making it delinquent
   2. The debtor’s failure to meet specific covenant ratios
   3. The debtor’s disposition of specific significant assets (such as a factory)
   4. A declaration of cross-default
   5. A restructuring by the debtor.

b. 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 upon the occurrence of a specific event that meets all of the following conditions:
   1. It is not probable at the time of debt issuance.
2. It is unrelated to changes in benchmark interest rates, contractually specified interest rates, or any other market variable.

3. It 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.

c. Contingent acceleration clauses that permit the debtor to accelerate the maturity of an outstanding note only upon the occurrence of a specified event that meets all of the following conditions:
   1. It is not probable at the time of debt issuance.
   2. It is unrelated to changes in benchmark interest rates, contractually specified interest rates, or any other market variable.
   3. It is related to regulatory actions, legislative actions, or other similar events that are beyond the control of the debtor or creditor.

25-114 Furthermore, 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 because that right would have a fair value of zero at all times and essentially would provide only liquidity to the holder.

25-115 Application of this guidance to specific debt instruments is illustrated in paragraph 815-20-55-75.

The shortcut method’s fourth criterion requires that the hedged item or transaction not be prepayable, except in limited situations described in Question 9.3.150. [815-20-25-104(e)]

**Question 9.3.150**

**What financial instruments does an entity consider prepayable?**

**Interpretive response:**

**Prepayment amount always equals instrument’s fair value**

An entity generally considers an interest-bearing asset or liability prepayable when one party can prepay or require the other party to prepay the principal amount before its scheduled payment date; or in the case of a partial-term hedge, the assumed maturity date of the hedged item.

However, it does not consider an interest-bearing asset or liability to be prepayable for purposes of applying the shortcut method if: [815-20-25-104(e), 25-112, 25-113]

<table>
<thead>
<tr>
<th>The debtor has the right to:</th>
<th>The creditor has the right to:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cause settlement of the entire instrument before its stated maturity at an amount that is always greater than the current fair value of the contract without that right.</td>
<td>Cause settlement of the entire instrument before its stated maturity at an amount that is always less than the current fair value of the contract without that right.</td>
</tr>
</tbody>
</table>

An entity does not consider a hedged item or transaction prepayable if the right to prepay always results in a prepayment amount equal to the instrument’s
current fair value. This is because that right would have a fair value of zero at all times and essentially would provide only liquidity to the creditor. [815-20-25-114]

An entity should not assume that a variable-rate instrument always has a fair value equal to its par value when the interest rate resets to the applicable interest rate index. Other conditions (e.g. changes in credit risk) may affect the fair value of the variable-rate debt instrument. For example, variable-rate debt callable for par is not callable for fair value because its par value and fair value may differ due to changes in variables other than interest rates. [815-20-25-104(e)]

**Prepayment feature cannot be exercised during hedge term**

An entity does not consider a hedged item or transaction to be prepayable during the hedge term if the item has a prepayment feature (e.g. a call or put option) that cannot be exercised during the hedge term. This occurs in a partial-term hedge – i.e. a hedge in which an entity designates only a part of the instrument’s term.

**Other instruments not considered prepayable**

Other debt instruments may not be considered prepayable for purposes of applying the shortcut method depending on whether certain conditions are met. These include certain debt instruments that become prepayable: [815-20-25-113]

— on the occurrence of an event related to the debtor’s credit deterioration (see Question 9.3.160);

— on the occurrence of an event related to the debtor’s or creditor’s death, or to regulatory or legislative actions that are beyond the control of the debtor or creditor (see Question 9.3.170); and

— due to a contingent acceleration clause that permits the debtor to accelerate the maturity of an outstanding note only on the occurrence of one or more events that are beyond the control of the debtor or creditor (see Question 9.3.170).

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**Question 9.3.160**

*Is a debt instrument that becomes prepayable on the debtor’s credit deterioration considered prepayable when applying the shortcut method?*

**Interpretive response:** No. A debt instrument that gives the debtor (creditor) the right to prepay (require the other party to prepay) the debt instrument on the occurrence of a specific event related to the debtor’s credit deterioration or other change in the debtor’s credit risk is not considered prepayable for the purpose of applying the shortcut method. [815-20-25-113(a)]

The following are examples of such provisions:

— the debtor’s failure to make timely payment, thereby making it delinquent;

— the debtor’s failure to meet specific covenant ratios;

— the debtor’s disposal of specific significant assets;

— cross-default; and

— a restructuring by the debtor.
Question 9.3.170

Is a debt instrument that becomes prepayable on the occurrence of an event beyond the control of the debtor or creditor considered prepayable when applying the shortcut method?

Interpretive response: It depends. A debt instrument is not considered prepayable if it gives the debtor or creditor the right to prepay or require the other party to prepay the debt instrument on the occurrence of an event that:

- is not probable at the time of debt issuance;
- is unrelated to changes in benchmark interest rates, contractually specified rates, or any other market variable; and
- is related either to the debtor’s or creditor’s death, or to regulatory or legislative actions, or other similar events that are beyond the control of the debtor or creditor.

In addition, an outstanding note is not considered prepayable if it permits the debtor to accelerate its maturity only on the occurrence of an event that:

- is not probable at the time of debt issuance;
- is unrelated to changes in benchmark interest rates, contractually specified rates, or any other market variable; and
- is related to regulatory or legislative actions, or other similar events that are beyond the control of the debtor or creditor.

See Illustrative debt instrument 7 in paragraph 815-20-55-75 (reproduced in the FASB example that follows) for an example of a debt instrument that meets the above criteria.

Question 9.3.180

Are there exceptions to the requirement that a hedged item or transaction not be prepayable?

Interpretive response: Yes. As an exception, a hedged item or transaction that is prepayable may qualify for the shortcut method if the hedging instrument is a compound derivative comprising an interest rate swap and an option that is the mirror image of the option embedded in the hedged item or transaction. [815-20-25-104(e)(1)]

The following diagram illustrates when an option is considered a mirror image of the option embedded in the hedged item or transaction. [815-20-25-104(e)(2)]
Hedge effectiveness

9. Option is mirror image of embedded option if:
   (all characteristics must be included)

   - Entity is the writer of one option and holder of other option
   - Terms of the two call options need to match exactly

   Each of these terms of the two call options need to match exactly:
   - maturities;
   - strike prices;
   - notional amounts;
   - notification/election dates (the option notification date partially defines the term of the option, which is a key factor in determining its fair value);
   - how premiums are paid;
   - style of option;
   - timing and frequency of payments; and
   - call dates.

Question 9.3.190

How does a debt instrument’s carrying amount affect whether the swap used to hedge the debt contains a mirror-image call option?

Background: Before entering into a hedge, a debt instrument’s carrying amount may differ from its redemption amount at maturity. This difference may be due to an issuance premium or discount or deferred debt issuance costs. In addition, if the debt instrument is callable, the carrying amount often differs from the call option’s strike price.

Interpretive response: The carrying amount of the debt is economically unrelated to the amount the issuer would be required to pay to exercise the call embedded in the debt. Any discount or premium in the hedged debt’s carrying amount (including any related deferred issuance costs) is therefore irrelevant to determining whether an interest rate swap contains a mirror-image call option.

Typically, the call price is greater than the par amount of the debt instrument. The carrying amount of the debt is economically unrelated to the amount the issuer would be required to pay to exercise the call embedded in the debt. Therefore, for example, an interest rate swap is not permitted to contain a termination payment equal to the debt issuance costs that remain unamortized on the date the option is exercised if the shortcut method is to be applied.

[815-20-25-108]
**FASB Example: Applying the prepayable criterion under the shortcut method**

<table>
<thead>
<tr>
<th>Excerpt from ASC 815-20</th>
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>>> Application of the Prepayable Criterion under the Shortcut Method

55-74 This implementation guidance discusses the application of the prepayable criterion in paragraph 815-20-25-104(e) and related guidance beginning in paragraph 815-20-25-112.

55-75 A debt instrument may contain various terms and provisions that permit either the debtor or the creditor to cause prepayment of the debt (that is, cause the payment of principal before the scheduled payment dates), including the terms in the following illustrative instruments:

a. Illustrative debt instrument 1. Some fixed-rate debt instruments include a typical call option that permits the debt instrument to be called for prepayment by the debtor at a fixed amount, for example, at par or at a specified premium over par. In some instruments, the prepayment amount varies based on when the call option is exercised. Fixed-rate debt instruments that provide the borrower with the option to prepay at a fixed amount are considered prepayable under paragraph 815-20-25-104(e), because those contracts permit settlement at an amount that is potentially below the contract’s fair value (absent the effect of the call provision) as of the date of settlement. Such clauses can be exercised based on an economic advantage related to changes in the designated benchmark interest rate.

b. Illustrative debt instrument 2. Some debt instruments include contingent acceleration clauses that permit the lender to accelerate the maturity of an outstanding note only if a specified event related to the debtor’s credit deterioration or other change in the debtor’s credit risk occurs (for example, 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). A common example is a clause in a mortgage note secured by certain property that permits the lender to accelerate the maturity of the note if the borrower sells the property. Debt instruments that include contingent acceleration clauses that permit the lender to accelerate the maturity of an outstanding note only upon the occurrence of a specified event related to the debtor’s credit deterioration or other changes in the debtor’s credit risk are not considered prepayable under paragraph 815-20-25-104(e).

c. Illustrative debt instrument 3. Some fixed-rate debt instruments include a call option that permits the debtor to repurchase the debt instrument from the creditor at an amount equal to its then fair value. Fixed-rate debt instruments that provide the debtor with the option to repurchase from the creditor the debt at an amount equal to the then fair value of the contract are not considered prepayable under paragraph 815-20-25-104(e), because that right would have a fair value of zero at all times. Such clauses, which provide the debtor with the discretionary opportunity to settle its obligation before maturity, are not exercised based on an economic advantage.
related to changes in the designated benchmark interest rate because the
repurchases are done at fair value.

d. Illustrative debt instrument 4. Some fixed-rate debt instruments, typically
issued in private markets, include a make-whole provision. A make-whole
provision differs from a typical call option, which enables the issuer to
benefit by prepaying the debt if market interest rates decline. In a declining
interest rate market, the settlement amount of a typical call option is less
than what the fair value of the debt would have been absent the call
option. In contrast, a make-whole provision involves settlement at a
variable amount typically determined by discounting the debt’s remaining
contractual cash flows at a specified small spread over the current
Treasury rate. That calculation results in a settlement amount significantly
above the debt’s current fair value based on the issuer’s current spread
over the current Treasury rate. The make-whole provision contains a
premium settlement amount to penalize the debtor for prepaying the debt
and to compensate the investor (that is, to approximately make the
investor whole) for its being forced to recognize a taxable gain on the
settlement of the debt investment. In some debt instruments, the
prepayment option under a make-whole provision will not be exercisable
during an initial lock-out period. (For example, Private Entity A borrows
from Insurance Entity B under a 10-year loan with fixed periodic coupon
payments. The spread over the Treasury rate for Entity A at issuance of the
debt is 275 basis points. The loan agreement contains a make-whole
provision that if Entity A prepays the debt, it will pay Insurance Entity B an
amount equal to all the future contractual cash flows discounted at the
current Treasury rate plus 50 basis points.) Fixed-rate debt instruments that
include a make-whole provision (as previously described) are not
considered prepayable under paragraph 815-20-25-104(e), because it
involves settlement of the entire contract by the debtor before its stated
maturity at an amount greater than (rather than an amount less than) the
then fair value of the contract.

e. Illustrative debt instrument 5. Some variable-rate debt instruments include
a call option that permits the debtor to repurchase the debt instrument
from the creditor at each interest reset date at an amount equal to par.
Although illustrative debt instrument 5, a variable-rate debt instrument,
does have a fair value exposure between the date of a change in the
contractually specified interest rate and the reset date, a swap would not
be an appropriate hedging instrument to hedge that fair value exposure.
Thus, a fair value hedge of illustrative debt instrument 5 could not qualify
for the shortcut method discussed in paragraph 815-20-25-102, which
requires the hedging instrument to be an interest rate swap. In cash flow
hedges, if the reset provisions always result in the instrument’s par
amount being equal to its fair value at a reset date, then an option for the
debtor to prepay the variable-rate debt instrument at par at that reset date
would not be considered prepayable under paragraph 815-20-25-104(e).
However, if the reset provisions can result in the instrument’s par amount
not being equal to its fair value at those reset dates, then an option for the
debtor to prepay the variable-rate debt instrument at par at a reset date
would be considered prepayable under that paragraph. (Because the reset
provisions typically do not adjust the variable interest rate for changes in
credit sector spreads and changes in the debtor’s creditworthiness, the
variable-rate debt instrument’s par amount could seldom be expected to be
equal to its fair value at each reset date.) Furthermore, to qualify for cash
flow hedge accounting, the hedging relationship must meet the applicable conditions in this Subtopic and the entity designating the hedge (that is, the debtor or creditor) must conclude it is probable that future interest payments will be made during the term of the interest rate swap. If the creditor’s counterparty (that is, the debtor) on a recognized variable-rate asset related to the hedged forecasted interest payments can cause that asset to be prepaid, then that creditor would likely be unable to conclude that all the forecasted interest payments on its recognized interest-bearing asset are probable and, thus, the cash flow hedging relationship would not qualify for the shortcut method. (Even though the creditor believes it could immediately obtain a replacement variable-rate asset if prepayment occurs and thus could conclude that the forecasted variable interest inflows are probable, the only hedged forecasted interest inflows that are eligible for application of the shortcut method are those related to a recognized interest-bearing asset at the inception of the hedge.) However, paragraph 815-20-25-104(e) indicates that its criterion that prohibits a prepayment option in the interest-bearing asset or liability does not apply to a hedging relationship if the hedging interest rate swap contains an embedded mirror-image option. In that latter case, if both the prepayment option and the mirror-image option in the swap were exercised, there would be no future hedged interest cash flows related to the recognized interest-bearing asset or liability and no future cash flows under the swap and, thus, the existence of the prepayment option would not preclude the use of the shortcut method.

f. Illustrative debt instrument 6. Some fixed-rate debt instruments include both a call option as described in illustrative debt instrument 1 and a contingent acceleration clause as described in illustrative debt instrument 2. The same conclusions reached relative to illustrative debt instrument 1 also apply to illustrative debt instrument 6.

g. Illustrative debt instrument 7. Some debt instruments contain an investor protection clause (which is standard in substantially all debt issued in Europe) that provides that, in the event of a change in tax law that would subject the investor to additional incremental taxation by tax jurisdictions other than those entitled to tax the investor at the time of debt issuance, the coupon interest rate of the debt increases so that the investor’s yield, net of the incremental taxation effect, is equal to the investor’s yield before the tax law change. The debt issuance also contains an issuer protection clause (which is standard in substantially all debt issued in Europe) that provides that, in the event of a tax law change that triggers an increase in the coupon interest rate, the issuer has the right to call the debt obligation at par. There would be no market for the debt were it not for the prepayment and interest rate adjustment clauses that protect the issuer and investors. Illustrative debt instrument 7 is not considered prepayable under paragraph 815-20-25-104(e) because it meets the exclusion criteria under paragraph 815-20-25-113(c).

55-76 An entity is not precluded from applying the shortcut method to a fair value hedging relationship of interest rate risk involving illustrative debt instruments 1 and 6 that are prepayable due to an embedded purchased call option if the hedging interest rate swap contains an embedded mirror-image written call option.
Hedging

9. Hedge effectiveness

55-77 In addition, an entity is not precluded from applying the shortcut method to a fair value hedging relationship of interest rate risk involving illustrative debt instruments 2, 3, 4, and 7 that are not considered prepayable if the hedging interest rate swap does not contain an embedded purchased or written call option related to changes in the designated benchmark interest rate.

55-78 However, an entity would likely be precluded from applying the shortcut method to a cash flow hedging relationship of interest rate risk involving illustrative debt instrument 5 because the entity would likely be unable to conclude that all the forecasted interest payments on the recognized interest-bearing asset or liability are probable.

>>> Determining Whether a Mirror-Image Call Provision Exists in Application of the Shortcut Method

55-79 This implementation guidance addresses the application of paragraph 815-20-25-104(e). It is common to quote the call prices (strike prices) on debt as a percentage of par value. In contrast, the strike prices of options embedded in interest rate swaps are generally quoted as a rate or current yield (the current fixed-rate coupon on a noncallable-nonputtable swap having zero fair value at inception). One means of determining whether these 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-nonputtable debt instrument that is otherwise identical to the hedged debt instrument.

b. Compare that yield to the call or put yield embedded in the swap.

Financial instruments that are considered prepayable for purposes of the shortcut method may differ from the financial instruments that are considered prepayable for purpose of the last-of-layer method and for the purposes of applying paragraph 815-20-25-6B. For a discussion of what is considered prepayable for the purpose of applying the last-of-layer method and paragraph 815-20-25-6B, see Question 3.4.30.

9.3.70 Criterion 5: All other terms are typical and do not invalidate assumption of perfect effectiveness

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-104 All of the following conditions apply to both fair value hedges and cash flow hedges: …

g. Any other terms in the interest-bearing financial instruments or interest rate swaps meet both of the following conditions:
   1. The terms are typical of those instruments.
   2. The terms do not invalidate the assumption of perfect effectiveness.
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 are met.

The fixed interest rate on a hedged item need not exactly match the fixed interest rate on an interest rate swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on an interest rate swap designated as a cash flow hedge. An interest rate swap’s fair value comes from its net settlements. The fixed and variable interest rates on an interest rate swap can be changed without affecting the net settlement if both are changed by the same amount. That is, an interest rate swap with a payment based on LIBOR and a receipt based on a fixed rate of 5 percent has the same net settlements and fair value as an interest rate swap with a payment based on LIBOR plus 1 percent and a receipt based on a fixed rate of 6 percent.

The shortcut method’s fifth criterion requires that all of the ‘other’ terms of the hedging instrument (i.e. terms other than those discussed in Criteria 1 – 4) be typical of interest-bearing financial instruments or interest rate swaps. Moreover, none of these ‘other’ terms can invalidate the assumption of perfect effectiveness. The FASB included this criterion to ensure that all terms of the hedging relationship are considered in evaluating the appropriateness of the shortcut method. [815-20-25-104(g)]

This criterion suggests that a highly structured interest rate swap would not meet this criterion. However, whether a feature is typical is a matter of judgment on a case-by-case basis.

In general, to not invalidate the assumption of effectiveness, the terms of the hedged item or transaction and hedging instrument must match. This includes notional amounts, dates, day count conventions, calendar adjustments for business days for payments and fixing variable rates, interest calculation periods, interest rate fixing and payment conventions (in advance versus in arrears).

**Question 9.3.200**

Does the shortcut method require the fixed rate on the swap to match the fixed rate on the hedged item or transaction?

**Interpretive response:** No, the shortcut method does not require the fixed rate on the interest rate swap to match the fixed rate on the hedged item. The difference between the swap’s fixed rate and the hedged item’s fixed rate relates to the difference between the credit risk of the swap and the hedged item. [815-20-25-109]

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. [815-20-25-111]
Question 9.3.210

Can the shortcut method be applied to a hedge of a convertible debt instrument?

Interpretive response: No, a convertible debt instrument cannot be designated as the hedged item or transaction in a shortcut method hedge. 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.

Question 9.3.220

Can the shortcut method be applied to a hedge of a debt instrument issued by a trust preferred structure?

Background: Banks sometimes issue securities known as trust preferred securities through a trust structure. The bank establishes the trust that it funds with debt. The bank then sells ownership interests in the trust (trust preferred securities) to investors. These trust preferred securities are considered preferred stock and pay dividends on a set schedule. However, because the trust holds the bank’s debt, the payments the investors receive qualify as interest income for IRS purposes.

Interpretive response: No. We believe debt instruments with complex features, such as interest deferral features in debt instruments issued by financial institutions under trust preferred structures, cannot be designated as a hedged item or transaction in a shortcut method hedge. These interest deferral features allow the entity to defer the payment of interest at its option for a period of time if the entity is not in default. The deferred amounts themselves bear interest.

This feature would prohibit an entity from assuming perfect effectiveness, unless the interest rate swap had a mirror feature. Even if the swap did have a mirror feature, the hedging relationship would not meet the third criterion of the shortcut method because the swap would not have a consistent formula for computing net settlement (see section 9.3.50).

Question 9.3.230

Can the shortcut method be applied if the hedging instrument is a swap with a variable leg that reprices in arrears?

Background: In a plain vanilla interest rate swap, the swap’s variable interest rate is determined (i.e. reset) at the beginning of each period and payment generally occurs at the end of the period. In contrast, in an interest rate swap-in-arrears, the swap’s variable interest rate reprices in arrears. This means the swap’s variable rate is determined at the end of the period and is applied retrospectively to calculate the swap settlement.
Interpretive response: Yes. Topic 815 specifically permits the shortcut method for hedging relationships that involve interest rate swaps-in-arrears as long as other shortcut criteria are met. [815-20-25-107]

**Question 9.3.240**

Can the shortcut method be applied to a hedge of a fixed-rate debt instrument with an interest rate that increases if the issuer’s credit rating deteriorates?

Interpretive response: No, an entity may not apply the shortcut method when the hedged item is a fixed-rate debt instrument with an interest rate that increases if the issuer’s credit rating deteriorates.

The hedged item’s cash flows include the potential increased interest cash flows due to a deterioration of the issuer’s credit rating. However, a swap that would be appropriate for the shortcut method would not have cash flows with a similar potential to increase. When the hedged item’s cash flows have this potential to increase, the change in fair value of the swap is not expected to fully offset the hedged item’s change in fair value attributable to interest rate risk. Therefore, the hedging relationship would not meet the requirement that all terms be typical and not invalidate the assumption of perfect effectiveness.

Even if the swap has a mirror-image feature (i.e. the fixed leg of the swap increased as the interest rate on the debt increased), the shortcut method still would not apply. This is because:

— the shortcut method can be used only when the risk being hedged is interest rate risk, and in this case the hedging relationship would incorporate both interest rate and credit risk; and

— the fixed rate on the swap is not the same throughout the term as required by the third criterion—i.e. the swap must have a consistent formula for computing net settlements each period (see section 9.3.50).

**Question 9.3.250**

Can the shortcut method be applied to a hedge of a zero-coupon bond?

**Background:** A zero-coupon bond is a debt instrument that doesn’t pay interest (a coupon), and as a result it sells at a deep discount. It renders its profit at maturity when the investor redeems the bond for its face value.

For economic purposes, an entity may want to hedge a zero-coupon bond with a zero-coupon swap. Typically, a zero-coupon swap has a fixed leg with one lump sum payment at maturity and a floating leg that is tied to a floating rate that resets and settles periodically. The following is an example.

| Hedged item | Five-year zero-coupon bond with a face value of $90 million that was issued for $70 million (an imputed interest rate of 5.15% compounded annually). |
Hedging instrument

A zero-coupon swap with a notional of $70 million that receives $20 million at maturity and pays three-month LIBOR every three months.

Interpretive response: We believe an entity may not apply the shortcut method to a hedging relationship where the hedged item is a zero-coupon bond and the hedging instrument is a zero-coupon swap. Unlike a typical interest rate swap, which has a fixed leg that pays a fixed rate periodically during the life of the swap, a zero-coupon swap does not have a fixed leg that pays periodically. It typically makes one lump payment at maturity.

This means the swap contains a financing element – i.e. the periodic payments of the floating leg during the term of the swap finance the fixed payments of the fixed leg of the swap. Therefore, we believe that a zero-coupon swap violates the fifth criterion to qualify for the shortcut method, which requires all other terms of the interest-bearing financial instrument or interest rate swap to be typical for those instruments. In addition, the swap would also violate the third criterion, which requires it to have a consistent formula for computing net settlements each period (see section 9.3.50).

9.3.80 Additional criteria for fair value hedges

Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-105 All of the following incremental conditions apply to fair value hedges only:

a. The expiration date of the interest rate swap matches the maturity date of the interest-bearing asset or liability or the assumed maturity date if the hedged item is measured in accordance with paragraph 815-25-35-13B.

b. There is no floor or cap on the variable interest rate of the interest rate swap.

c. The interval between repricings of the variable interest rate in the interest rate 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).

...  
f. The index on which the variable leg of the interest rate swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.

In addition to the general requirements and the five specific criteria necessary to apply the shortcut method to both fair value and cash flow hedges, fair value hedges are required to meet the following additional criteria.
**Additional shortcut criteria for fair value hedges**

- The maturity dates of the swap and hedged item(s) match. [815-20-25-105(a)]
- The variable interest rate of the swap has no cap or floor. [815-20-25-105(b)]
- The repricing intervals on the swap’s variable rate are frequent enough to assume that the variable rate is a market rate. [815-20-25-105(c)]
- The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the hedged interest rate. [815-20-25-105(f)]

**Question 9.3.260**

**Can the shortcut method be applied to a partial-term fair value hedge?**

**Background:** In a partial-term hedge, an entity designates only certain consecutive interest payments of a financial instrument that represent an assumed term (see section 3.3.80). An assumed term begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable. [815-25-35-13B]

**Interpretive response:** The shortcut method may be used in a partial-term hedge if the expiration date of the interest rate swap matches the assumed maturity date of the hedged item and all the other shortcut method criteria are met. [815-20-25-104(a)]

**Question 9.3.270**

**Can the shortcut method be applied to a fair value hedge if the swap expires one day before or after the hedged item’s maturity date or assumed maturity date?**

**Interpretive response:** No. For an entity to apply the shortcut method, the expiration date of the interest rate swap must exactly match the maturity date of the hedged item, or the last day of the assumed term in the case of a partial-term hedge. [815-20-25-102, 25-105(a), 815-25-35-13B]

**Question 9.3.280**

**Can the shortcut method be applied to a fair value hedge if the swap’s variable leg is based on a tenor different from the hedged risk?**

**Interpretive response:** No. To qualify for the shortcut method, the index on which the variable leg of the interest rate swap is based must exactly match the hedged risk. [815-20-25-105(f)]
To meet this criterion, we believe the tenors must match exactly. For example, the relationship would not qualify for the shortcut method if the variable leg of a swap is indexed to 90-day LIBOR and the entity designates 60-day LIBOR as the hedged risk.

**Question 9.3.290**

Can the shortcut method be applied to a fair value hedge if the variable interest rate of the swap has a cap or floor?

**Interpretive response:** No, an entity may not apply the shortcut method to a hedging relationship where the variable interest rate of the swap has a cap or floor. If an entity were to enter into an interest rate swap with a cap or floor, changes in interest rates above the cap or below the floor would not affect the fair value of the swap. This would be inconsistent with the assumption of perfect effectiveness. [815-20-25-105(b)]

### 9.3.90 Additional criteria for cash flow hedges

**Excerpt from ASC 815-20**

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

**25-106** All of the following incremental conditions apply to cash flow hedges only:

a. All interest receipts or payments on the variable-rate asset or liability during the term of the interest rate swap are designated as hedged.

b. No interest payments beyond the term of the interest rate swap are designated as hedged.

c. Either of the following conditions is met:
   1. There is no floor or cap on the variable interest rate of the interest rate swap.
   2. The variable-rate asset or liability has a floor or cap and the interest rate swap has 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 purposes of this paragraph, comparable does not necessarily mean equal. For example, if an interest rate swap’s variable rate is based on LIBOR and an asset’s variable rate is LIBOR plus 2 percent, a 10 percent cap on the interest rate swap would be comparable to a 12 percent cap on the asset.

d. The repricing dates of the variable-rate asset or liability and the hedging instrument must occur on the same dates and be calculated the same way (that is, both shall be either prospective or retrospective). If the repricing dates of the hedged item occur on the same dates as the repricing dates of the hedging instrument but the repricing calculation for the hedged item...
is prospective whereas the repricing calculation for the hedging instrument is retrospective, those repricing dates do not match.

\[ \text{...} \]

g. The index on which the variable leg of the interest rate swap is based matches the contractually specified interest rate designated as the interest rate being hedged for that hedging relationship.

In addition to the general requirements and the five specific criteria necessary to apply the shortcut method to both fair value and cash flow hedges, cash flow hedges are required to meet the following additional criteria.

### Additional shortcut criteria for cash flow hedges

- All of the hedged transaction’s interest payments during the swap’s term are hedged, and none of its interest payments beyond the swap’s term are hedged. [815-20-25-106(a), 25-106(b)]
- Either the swap has no cap or floor, or if the hedged transaction has a cap or floor, the swap has a comparable cap or floor. [815-20-25-106(c)]
- The repricing dates of the swap and the hedged transaction match. [815-20-25-106(d)]
- The index on which the variable leg of the swap is based matches the contractually specified interest rate designated as the hedged interest rate. [815-20-25-106(g)]

**Question 9.3.300**

Can the shortcut method be applied to a cash flow hedge if the swap’s variable leg is based on a tenor different from the hedged risk?

**Interpretive response:** No. To qualify for the shortcut method, the index on which the variable leg of the interest rate swap is based must exactly match the hedged risk. To meet this criterion, we believe the tenors must match exactly. For example, the relationship would not qualify for the shortcut method if the variable leg of a swap is indexed to 90-day LIBOR and the entity designates 60-day LIBOR as the hedged risk. [815-20-25-106(g)]

**Question 9.3.310**

Can the shortcut method be applied to a cash flow hedge if the hedged item is a variable-rate debt that contains a cap or floor?

**Interpretive response:** Yes, an entity may apply the shortcut method to a cash flow hedging relationship where the hedged transaction is a variable-rate debt instrument that contains a cap or floor. However, the interest rate swap that is designated as the hedging instrument must contain a comparable cap or floor, which does not necessarily mean an equal cap or floor. For example, if an
Interest rate swap’s variable rate is based on LIBOR and an asset’s variable rate is LIBOR plus 2 percent, a 10 percent cap on the interest rate swap would be comparable to a 12 percent cap on the asset. [815-20-25-106(c)]

It is important for an entity to understand how the interest rate terms are defined in the legal documents for the hedged item and the swap – to determine what could happen if the underlying referenced interest rate were to become negative. If the hedged item or interest rate swap have terms that would prevent the rate from becoming negative, such a feature would be considered a floor.

**Question 9.3.320**

**Can the shortcut method be applied to a cash flow hedge of interest payments arising from variable-rate debt if the debt matures after the swap expires?**

**Interpretive response:** Yes, an entity may apply the shortcut method to cash flow hedges of the interest payments on only a portion of the term of the debt. Therefore, an entity may apply the shortcut method to a variable-rate debt instrument and an interest rate swap if the debt instrument matures after the swap expires. [815-20-25-106(a), 25-106(b)]

In this case, the entity has hedged all interest receipts or payments on the variable-rate asset or liability during the term of the swap. In addition, it has not hedged any interest payments beyond the term of the swap. [815-20-25-106(a), 25-106(b)]

**Question 9.3.330**

**Can the shortcut method be applied to a cash flow hedge if the swap reprices in arrears, but the hedged forecasted transaction does not?**

**Interpretive response:** No, an entity may not apply the shortcut method to an interest rate swap that reprices in arrears and a forecasted transaction that does not reprice in arrears. The term ‘match’ is defined narrowly and is intended to mean “be exactly the same as or correspond exactly.” Therefore, if the swap reprices in arrears, the hedged forecasted transaction also must reprice in arrears. [815-20-25-102, 25-106(d)]
9.3.100 Counterparty credit risk

Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-103 Implicit in the conditions for the shortcut method is the requirement that a basis exist for concluding on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair values or cash flows. In applying the shortcut method, an entity shall consider the likelihood of the counterparty’s compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity.

25-111 Comparable credit risk at inception is not a condition for assuming perfect effectiveness even though actually achieving perfect offset would require that the same discount rate be used to determine the fair value of the swap and of the hedged item or hedged transaction. To justify using the same discount rate, the credit risk related to both parties to the swap as well as to the debtor on the hedged interest-bearing asset (in a fair value hedge) or the variable-rate asset on which the interest payments are hedged (in a cash flow hedge) would have to be the same. However, because that complication is caused by the interaction of interest rate risk and credit risk, which are not easily separable, comparable creditworthiness is not considered a necessary condition for assuming perfect effectiveness in a hedge of interest rate risk.

Question 9.3.340

Does an entity consider counterparty credit risk or its own nonperformance risk when applying the shortcut method?

Interpretive response: Yes, counterparty credit risk and nonperformance risk are considered when applying the shortcut method.

Fair value of the interest rate swap

An entity considers counterparty credit risk and its own nonperformance risk when determining the fair value of the interest rate swap. This is the case regardless of whether it applies the shortcut method. [820-10]

The counterparty credit risk of a derivative instrument that is acquired on a regulated exchange is the credit risk of the exchange. [820-10]

See also KPMG’s Q&A: Fair value measurement, including:

— Section O, Application issues: Derivatives and hedging, including Question O70, which provides additional information about whether (and how) the requirements to include counterparty credit risk and an entity’s own nonperformance risk in measuring the fair values of derivative instruments affect hedging relationships.
— Question C70, which addresses how to consider the existence of a separate arrangement (such as a master netting agreement or credit support agreement) that mitigates credit risk exposure in the event of default when measuring the fair value of a financial instrument.

**Hedge inception**

Comparable credit risk between the hedging instrument and the hedged item or transaction is not necessary to assume perfect effectiveness for accounting purposes. The FASB allowed this accommodation as a practical matter even though a perfect economic offset requires the interest rate swap and hedged item or transaction to have the same credit risk. Nonetheless, an ongoing expectation of high effectiveness is implicit in the shortcut method. Therefore, when applying the shortcut method, an entity considers the likelihood of the counterparty complying with the swap’s payment terms. We believe this guidance should apply to the entity’s own nonperformance risk as well. [815-20-25-103, 25-111]

**Changes in counterparty credit risk and own nonperformance risk**

When using the shortcut method, an entity monitors hedges for changes in counterparty credit risk and nonperformance risk. We believe an entity may continue the shortcut method if the likelihood that the counterparty or the entity will not default continues to be probable. However, if the likelihood that the counterparty or the entity will not default is no longer probable, the entity should discontinue hedge accounting altogether.

If the entity can identify the date on which the counterparty or the entity not defaulting became less than probable, the entity stops hedge accounting prospectively from that day forward. If the entity cannot identify that date, it does not apply hedge accounting for the entire reporting period in which the counterparty or the entity not defaulting became less than probable.

---

**9.3.110 Discontinuing the shortcut method**

Excerpt from ASC 815-20

---

<table>
<thead>
<tr>
<th>Application of Whether the Shortcut Method Was Not or No Longer Is Appropriate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-117A</strong> In the period in which an entity determines that use of the shortcut method was not or no longer is appropriate, the entity may use a quantitative method to assess hedge effectiveness and measure hedge results without redesignating the hedging relationship if both of the following criteria are met:</td>
</tr>
<tr>
<td>a. The entity documented at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(04) which quantitative method it would use to assess hedge effectiveness and measure hedge results if the shortcut method was not or no longer is appropriate during the life of the hedging relationship.</td>
</tr>
<tr>
<td>b. The hedging relationship was highly effective on a prospective and retrospective basis in achieving offsetting changes in fair value or cash</td>
</tr>
</tbody>
</table>
flows attributable to the hedged risk for the periods in which the shortcut method criteria were not met.

25-117B If the criterion in paragraph 815-20-25-117A(a) is not met, the hedging relationship shall be considered invalid in the period in which the criteria for the shortcut method were not met and in all subsequent periods. If the criterion in paragraph 815-20-25-117A(a) is met, the hedging relationship shall be considered invalid in all periods in which the criterion in paragraph 815-20-25-117A(b) is not met.

25-117C If an entity cannot identify the date on which the shortcut criteria ceased to be met, the entity shall perform the quantitative assessment of effectiveness documented at hedge inception for all periods since hedge inception.

25-117D The terms of the hedged item and hedging instrument used to assess effectiveness, in accordance with paragraph 815-20-25-117A(b), shall be those existing as of the date that the shortcut criteria ceased to be met. For cash flow hedges, if the hypothetical derivative method is used as a proxy for the hedged item, the value of the hypothetical derivative shall be set to zero as of hedge inception.

The shortcut method is discontinued when:
— any of the applicable shortcut criteria are no longer met; or
— an entity determines that the shortcut method was inappropriately applied.

However, an entity may not need to dedesignate the hedging relationship if certain criteria are met.

<table>
<thead>
<tr>
<th>Hedging relationship may continue</th>
<th>In the period in which an entity makes this determination, it may use a quantitative method to assess hedge effectiveness and measure hedge results without dedesignating the hedging relationship if it: [815-20-25-117A]</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>— documented at hedge inception which quantitative method it would use to assess hedge effectiveness if the shortcut method becomes inappropriate; and</td>
</tr>
<tr>
<td></td>
<td>— determines that when that quantitative method is applied the hedge was highly effective for the periods in which the shortcut method criteria were not met.</td>
</tr>
</tbody>
</table>

| Hedging relationship must be dedesignated | If the above criteria are not met, the hedging relationship must be dedesignated. For guidance on the accounting consequences when the shortcut method is misapplied, see Question 9.3.350. |

When these criteria are met, the quantitative method is used to assess hedge effectiveness in all periods for which the shortcut method was not appropriate.
Question 9.3.350
What happens if an entity does not document a quantitative method that it would use if the shortcut method was not (or no longer is) appropriate?

Interpretive response: If an entity applies the shortcut method and does not document a quantitative effectiveness assessment method in the initial hedge documentation, there is no consequence if the shortcut method remains appropriate to use in all periods.

In contrast, there are accounting consequences when the shortcut method is misapplied and the entity did not document a quantitative effectiveness assessment method. In this event, an entity treats the misapplication as an accounting error under Topic 250 in all periods in which the shortcut method was misapplied. The amount of this accounting error usually will be greater than the amount of the accounting error had a quantitative assessment method been documented. This is because when no such method is documented, the amount of the error does not consider whether the hedging relationship would have been highly effective. Instead, it assumes that hedge accounting should not have been applied in those periods.

When the shortcut method is misapplied, the entity also evaluates the severity of any control deficiencies related to the failure to identify the inappropriate use of the shortcut method.

Question 9.3.360
When the shortcut method is required to be discontinued, as of what date(s) should an entity perform the quantitative assessments?

Interpretive response: If a shortcut method hedge is required to be discontinued, an entity should perform quantitative effectiveness assessments beginning at the date the shortcut method was not (or no longer is) appropriate. However, this assumes that the entity documented at hedge inception which quantitative method it would use if the shortcut method was not or no longer is appropriate.

The date(s) from which quantitative assessments should be performed depends on when the shortcut method ceased to be appropriate. [815-20-25-117B – 25-117C, ASU 2017-12, BC191 – BC192]

| The criteria for applying the shortcut method were not met at hedge inception | Quantitative assessments should be performed for all periods since hedge inception. |
| A term of the hedged item or hedging instrument changed after inception, causing the shortcut method criteria to no longer be met | Quantitative assessments should be performed for all periods since the date the shortcut method criteria were no longer met. |
The date at which the shortcut method ceased to be appropriate cannot be identified

Quantitative assessments should be performed for all periods since hedge inception.

Question 9.3.370

What is the effect of performing quantitative assessments once the shortcut method is discontinued?

Interpretive response: If the shortcut method was applied during prior periods when it was not appropriate, the guidance for accounting errors in Topic 250 is followed. However, permitting an entity to retroactively apply a quantitative method of assessing hedge criteria in this instance reduces the likelihood that the error is material (thereby reducing the likelihood of restatement).

The determination of the error when an entity documented a quantitative assessment method at hedge inception depends on whether the relationship was highly effective in the prior period(s) affected.

— **Not highly effective.** In this situation, the amount of the error is the difference between not applying hedge accounting and the results recorded by applying the shortcut method.

— **Highly effective.** In this situation, whether there is an error (and if so, its nature) depends on the type of hedge and also on whether the hedging instrument is measured appropriately.

   — **Cash flow hedges.** If the hedging instrument is measured properly, there is no error. However, the hedging instrument may not have been measured appropriately if its characteristics (including consideration of credit risk) were not properly defined in the prior reporting periods – e.g. because a changed term was not captured in its measurement. This would result in the hedging instrument’s recorded amount and the related amount recorded in AOCI being incorrect.

   — **Fair value hedges.** Under the shortcut method, the change in fair value of the hedging instrument is used as a proxy to measure the change in the fair value of the hedged item with no effect on net income. This approach for measuring the hedged item’s fair value is not appropriate in periods when the shortcut method is not appropriate. Because the hedged item was measured incorrectly in prior reporting periods, an error will result. Additionally, the hedging instrument may not have been measured appropriately if its characteristics (including consideration of credit risk) were not properly defined in prior reporting periods. Incorrect measurements would result in the recorded amounts for the hedged item and/or the hedging instrument – along with the related gains (losses) recognized in net income – being incorrect.

In both circumstances, the entity also evaluates the severity of any control deficiencies related to the failure to identify the inappropriate use of the shortcut method.
9.4. Critical terms match method

9.4.10 Overview

Excerpt from ASC 815-20

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-84 If the critical terms of the hedging instrument and of the hedged item or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be perfectly effective if all of the following criteria are met:

a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase. Location differences do not need to be considered if an entity designates the variability in cash flows attributable to changes in a contractually specified component as the hedged risk and the requirements in paragraphs 815-20-25-22A through 25-22B are met.

b. The fair value of the forward contract at inception is zero.

c. Either of the following criteria is met:
   1. The change in the discount or premium on the forward contract is excluded from the assessment of effectiveness pursuant to paragraphs 815-20-25-81 through 25-83.
   2. The change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

25-84A In a cash flow hedge of a group of forecasted transactions in accordance with paragraph 815-20-25-15(a)(2), an entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match in accordance with paragraph 815-20-25-84(a) if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month.

25-85 If all of the criteria in paragraphs 815-20-25-84 through 25-84A are met, an entity shall still perform and document an assessment of hedge effectiveness at the inception of the hedging relationship and, as discussed beginning in paragraph 815-20-35-9, on an ongoing basis throughout the hedge period. No quantitative effectiveness assessment is required at hedge inception if the criteria in paragraphs 815-20-25-84 through 25-84A are met (see paragraph 815-20-25-3(b)(2)(iv)(01)).

>> Assessing Effectiveness Based on Whether the Critical Terms of the Hedging Instrument and Hedged Item Match Relative Ease of Assessing Effectiveness

35-9 If, at inception, the critical terms of the hedging instrument and the hedged forecasted transaction are the same (see paragraphs 815-20-25-84 through 25-84A), the entity can conclude that changes in cash flows attributable to the risk being hedged are expected to be completely offset by
the hedging derivative. Therefore, subsequent assessments can be performed by verifying and documenting whether the critical terms of the hedging instrument and the forecasted transaction have changed during the period in review.

35-10 Because the assessment of hedge effectiveness in a cash flow hedge involves assessing the likelihood of the counterparty’s compliance with the contractual terms of the derivative instrument designated as the hedging instrument, the entity must also assess whether there have been adverse developments regarding the risk of counterparty default, particularly if the entity planned to obtain its cash flows by liquidating the derivative instrument at its fair value.

35-11 If there are no such changes in the critical terms or adverse developments regarding counterparty default, the entity may conclude that the hedging relationship is perfectly effective. In that case, the change in fair value of the derivative instrument can be viewed as a proxy for the present value of the change in cash flows attributable to the risk being hedged.

35-12 However, the entity must assess whether the hedging relationship is expected to continue to be highly effective using a quantitative assessment method (either a dollar-offset test or a statistical method such as regression analysis) if any of the following conditions exist:

a. The critical terms of the hedging instrument or the hedged forecasted transaction have changed.

b. There have been adverse developments regarding the risk of counterparty default.

The critical terms match method is elective and greatly simplifies the hedge effectiveness assessment when the hedging instrument is a forward or futures or option contract. [815-20-25-84 – 25-85]

If a hedging relationship meets the criteria for this method, the entity can assume that the hedging relationship is perfectly effective. Therefore, the method simplifies the hedge effectiveness assessment by eliminating the quantitative aspect of the assessment. [815-20-25-84 – 25-85]

One of the criteria for applying this method is that the critical terms of the hedging instrument and the hedged transaction are the same. When the critical terms are the same, the change in the cash flows of the hedging instrument (except for any amounts excluded from the assessment of effectiveness) can be viewed as a proxy for the change in the cash flows of the hedged transaction. [815-20-25-84]

This section discusses the application of the critical terms match method solely in the context of cash flow hedges. While Topic 815 permits application of the critical terms match method for fair value hedges, we believe the FASB intended the method to apply only to hedging relationships that will be perfectly effective. This has the practical effect of precluding the use of the critical terms match method for fair value hedges in the vast majority of circumstances because fair value hedges are rarely perfectly effective. There commonly is a lack of perfect effectiveness in fair value hedges because changes in both counterparty credit risk and an entity’s own nonperformance risk affect the measurement of changes in the fair value of the derivative hedging instrument.

The critical terms match method is elective and greatly simplifies the hedge effectiveness assessment when the hedging instrument is a forward or futures or option contract. [815-20-25-84 – 25-85]

If a hedging relationship meets the criteria for this method, the entity can assume that the hedging relationship is perfectly effective. Therefore, the method simplifies the hedge effectiveness assessment by eliminating the quantitative aspect of the assessment. [815-20-25-84 – 25-85]

One of the criteria for applying this method is that the critical terms of the hedging instrument and the hedged transaction are the same. When the critical terms are the same, the change in the cash flows of the hedging instrument (except for any amounts excluded from the assessment of effectiveness) can be viewed as a proxy for the change in the cash flows of the hedged transaction. [815-20-25-84]

This section discusses the application of the critical terms match method solely in the context of cash flow hedges. While Topic 815 permits application of the critical terms match method for fair value hedges, we believe the FASB intended the method to apply only to hedging relationships that will be perfectly effective. This has the practical effect of precluding the use of the critical terms match method for fair value hedges in the vast majority of circumstances because fair value hedges are rarely perfectly effective. There commonly is a lack of perfect effectiveness in fair value hedges because changes in both counterparty credit risk and an entity’s own nonperformance risk affect the measurement of changes in the fair value of the derivative hedging instrument.
9. Hedge effectiveness

These changes commonly have no offsetting effect on changes in the measurement of the hedged item attributable to the hedged risk.

9.4.20 Criteria

The criteria for applying the critical terms match method are as follows.

<table>
<thead>
<tr>
<th>Criterion 1</th>
<th>The hedging instrument (forward, futures or option contract) is for the purchase of the same quantity of the same commodity at the same time and location as the hedged transaction. [815-20-25-84(a)]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Criterion 2</td>
<td>Forward or futures contract has a fair value of zero at hedge inception. If the contract is an option it has an intrinsic value of zero at hedge inception. [815-20-25-104(b), 25-104(c)]</td>
</tr>
</tbody>
</table>

These criteria can be illustrated through a hedging transaction involving the forecasted sale of West Texas natural gas. If the hedging instrument is a forward contract, the criteria for the critical terms match method are met if the forward contract:

- has West Texas natural gas as its underlying;
- is for the same quantity of natural gas as the hedged transaction;
- settles at the same time and in the same location as the hedged transaction; and
- has a fair value of zero at hedge inception.

| Criterion 3 | For forwards or futures contracts: [815-20-25-84(c)(1)]
|-------------|----------------------------------------------------------------------------------------------------------|
|            | — change in the spot-forward difference on the forward or futures contract is excluded from the assessment of effectiveness; or
|            | — the change in the cash flows of the hedged transaction is based on the commodity’s forward price.
|            | For option contracts, the change in the time value of the option is excluded from the assessment of effectiveness. |

**Question 9.4.10**

Can the critical terms match method be applied if the hedging instrument has a non-zero fair value at hedge inception?

**Background:** The second criterion to apply the critical terms match method is that the fair value of the hedging instrument at hedge inception is zero. [815-20-25-84(b)]

**Interpretive response:** It depends. We believe an entity may apply the critical terms match method to a hedging relationship that uses a hedging instrument with a non-zero fair value at hedge inception. However, this is only the case if the non-zero fair value is due solely to a bid-ask spread. All of the other criteria for the critical terms match method must be met.
FASB Example: Cash flow hedge of the forecasted sale of a commodity when the critical terms match inventory

Example 5: Cash Flow Hedge of the Forecasted Sale of a Commodity When the Critical Terms Match

This Example illustrates the application of the guidance in paragraphs 815-20-25-84 through 25-85 and this Subtopic to the accounting for a cash flow hedge of a forecasted sale of a commodity. The terms of the hedging derivative have been negotiated to match the terms of the forecasted transaction. Assume that there is no time value in the derivative instrument. Entity ABC has chosen to hedge the variability of the cash flows from the forecasted sale of the commodity instead of the changes in its fair value. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

Because there is no contractually specified component, Entity ABC hedges the risk of changes in its cash flows relating to changes in the sales price of a forecasted sale of 100,000 bushels of Commodity A by entering into a derivative instrument, Derivative Z. Entity ABC expects to sell the 100,000 bushels of Commodity A on the last day of Period 1. On the first day of Period 1, Entity ABC enters into Derivative Z and designates it as a cash flow hedge of the forecasted sale. Entity ABC neither pays nor receives a premium on Derivative Z (that is, its fair value is zero). Entity ABC expects that there will be perfect offset between the hedging instrument and the hedged item because all of the following conditions exist:

a. The notional amount of Derivative Z is 100,000 bushels and the forecasted sale is for 100,000 bushels.

b. The underlying of Derivative Z is the price of the same variety and grade of Commodity A that Entity ABC expects to sell (assuming delivery to Entity ABC’s selling point).

c. The settlement date of Derivative Z is the last day of Period 1 and the forecasted sale is expected to occur on the last day of Period 1.

The entity need not perform an initial quantitative assessment of hedge effectiveness in accordance with paragraph 815-20-25-3(b)(2)(iv)(01) because the conditions in paragraphs 815-20-25-84 through 25-85 are met.

At inception of the hedge, the expected sales price of 100,000 bushels of Commodity A is $1,100,000. On the last day of Period 1, the fair value of Derivative Z has increased by $25,000, and the expected sales price of 100,000 bushels of Commodity A has decreased by $25,000. Both the sale of 100,000 bushels of Commodity A and the settlement of Derivative Z occur on the last day of Period 1. The following table illustrates the accounting, including the net effect on earnings and other comprehensive income, for the situation described.
9. Hedge effectiveness

### Question 9.4.20

**Can the critical terms match method be applied to a hedging relationship that uses an interest rate swap as the hedging instrument?**

**Interpretive response:** No. We believe the FASB intended that each general type of hedging instrument be able to qualify for a less burdensome method of documenting and assessing effectiveness. Therefore, we believe the critical terms match method is not available for hedging relationships that use interest rate swaps as the hedging instrument. This is the case even if the interest rate swap is perfectly effective at hedging the interest rate risk.

**Interest rate risk.** When hedging interest rate risk with an interest rate swap, an entity should apply the shortcut method (see section 9.3) or one of the other assessment methods for interest rate risk (see section 9.8).
Question 9.4.30
Can the critical terms match method be applied if one derivative instrument hedges multiple transactions over a period of time?

Interpretive response: Yes, an entity may designate one derivative instrument as the hedging instrument for a hedge of a group of forecasted transactions. The entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match (as required by paragraph 815-20-25-84(a)) if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month.

Example 23 in Subtopic 815-30 illustrates how to apply the critical terms match method to a group of forecasted transactions (reproduced below).

Excerpt from ASC 815-30

>> Example 23: Designation of a Cash Flow Hedge of a Forecasted Purchase of Inventory for Which Commodity Exposure Is Managed Centrally

55-142 This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to the designation of a cash flow hedge of a forecasted purchase of inventory in which the commodity exposure is managed centrally at the aggregate level. Assume the entity elects to perform subsequent assessments of hedge effectiveness on a qualitative basis and all hedge documentation requirements were satisfied at inception.

55-143 Entity Q is seeking to hedge the variability in cash flows associated with commodity price risk of its monthly plastic purchases for the next 12 months. It has two different manufacturing plant locations (Plant A and Plant B) that are purchasing five different grades of plastic from Supplier A. The plastic purchase price for each month is based on the month-end Joint Plastic (JP) index and a fixed basis differential component. The fixed basis differential offered by the supplier is determined by:

a. The grade of the plastic purchased
b. The distance between the plant location and supplier location.

55-144 At January 1, 20X1, Entity Q enters into a supply agreement with Supplier A to purchase plastic over the next 12 months. The respective agreements allow Entity Q to purchase the various grades of plastic at both of its plant locations as the need arises over the following year. The following table summarizes the pricing provisions contained in the supply agreement for each grade of plastic.
9. Hedge effectiveness

<table>
<thead>
<tr>
<th>Plant</th>
<th>Grade</th>
<th>Grade 2</th>
<th>Grade 3</th>
<th>Grade 4</th>
<th>Grade 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>JP + $0.14</td>
<td>JP + $0.11</td>
<td>JP + $0.09</td>
<td>JP + $0.05</td>
<td>JP – $0.02</td>
</tr>
<tr>
<td>B</td>
<td>JP + $0.16</td>
<td>JP + $0.12</td>
<td>JP + $0.07</td>
<td>JP + $0.06</td>
<td>JP – $0.03</td>
</tr>
</tbody>
</table>

Entity Q’s risk management objective is to hedge the variability in the purchase price of plastic attributable to changes in the JP index of the first 80,000 pounds of plastic purchased in each month regardless of grade or plant location delivered to. To accomplish this objective, Entity Q executes 12 separate forward contracts at January 1, 20X1, to purchase plastic as follows.

<table>
<thead>
<tr>
<th>Settlement Date</th>
<th>Notional Amount</th>
<th>Underlying Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan forward</td>
<td>January 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Jan forward</td>
<td>January 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Feb forward</td>
<td>February 28, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Mar forward</td>
<td>March 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>April forward</td>
<td>April 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>May forward</td>
<td>May 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>June forward</td>
<td>June 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>July forward</td>
<td>July 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Aug forward</td>
<td>August 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Sep forward</td>
<td>September 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Oct forward</td>
<td>October 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Nov forward</td>
<td>November 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
<tr>
<td>Dec forward</td>
<td>December 30, 20X1</td>
<td>80,000 (lbs)</td>
</tr>
</tbody>
</table>

Entity Q determines that the variable JP index referenced in the supply agreement constitutes a contractually specified component and that the requirements to designate variability in the cash flows attributable to changes in a contractually specified component as the hedged risk in paragraph 815-20-25-22A are met.

Because Entity Q determined that it will purchase at least 80,000 pounds of plastic each month in the coming 12 months to fulfill its expected manufacturing requirements, it documents that the hedged item (that is, the forecasted transaction within each month) is probable of occurring. Entity Q designates each forward contract as a cash flow hedge of the variability in cash flows attributable to changes in the contractually specified JP index on the first 80,000 pounds of plastic purchased (regardless of grade or plant location delivered to) for the appropriate month. The individual purchases of differing grades of plastic by Plant A and Plant B during each month share the risk exposure to the variability in the purchase price of the plastic attributable to changes in the contractually specified JP index. Therefore, the individual transactions in the hedged portfolio of plastic purchases for each month share the same risk exposure for which they are designated as being hedged in accordance with paragraph 815-20-25-15(a)(2).

In accordance with paragraph 815-20-25-3(b)(2)(iv)(01)(B), if Entity Q has determined the critical terms of the hedged item and hedging instrument match, it may elect to assess effectiveness qualitatively both at inception of
the hedging relationship and on an ongoing basis on the basis of the following factors in accordance with paragraphs 815-20-25-84 through 25-85:

a. The hedging instrument’s underlying matches the index upon which plastic purchases will be determined (that is, the JP Index).
b. The notional of the hedging instrument matches the forecasted quantity designated as the hedged item.
c. The date on which the derivatives mature matches the timing in which the forecasted purchases are expected to be made. That is, the quantity of the hedged item, 80,000 pounds, is an aggregate amount expected to be purchased over the course of the respective month (that is, the same 31-day period) in which the derivative matures.
d. Each hedging instrument was traded with at-market terms (that is, it has an initial fair value of zero).
e. Assessment of effectiveness will be performed on the basis of the total change in the fair value of the hedging instrument.
f. Although the amount of plastic being hedged each period is a cumulative amount across multiple grades of plastic, the basis differentials between grades of plastic and location are not required to be included in assessments of effectiveness because Entity Q has designated the variability in cash flows attributable to changes in the JP index (the contractually specified component) as the hedged risk within its purchases of plastics.

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**Question 9.4.40**

**Can the critical terms match method be applied to a forecasted transaction that gives rise to a receivable or payable that settles subsequently?**

**Background:** A forecasted sale of goods expected to occur on a certain date (e.g. September 30, Year 1) will give rise to an accounts receivable that will settle later (e.g. October 31, Year 1). The company enters into a forward contract that matures on September 30, Year 1 and hedges the cash flow variability only up to the forecasted sale date.

**Interpretive response:** Yes, assuming all the criteria are met. The first criterion of the critical terms match method requires that the forward or futures contact settle at the same time as the hedged transaction. \[815-20-25-84(a)\]

In the background example, we believe this criterion is met because in effect the forecasted sale transaction creates a cash inflow from the sale of the goods and a simultaneous cash outflow for the financing of the sale on September 30, Year 1. Therefore, a forward contract that hedges the forecasted sale transaction and expires on September 30, Year 1 has the same cash settlement date as the forecasted sale transaction.
Question 9.4.50
Can the critical terms match method be applied if the hedging instrument is a cross-currency interest rate swap?

**Background:** A cross-currency interest rate swap (CCIRS) is a contractual agreement between two parties to exchange fixed principal amounts of currencies as well as periodic interest cash flows. For further discussion of CCIRS, see section 2.6.20.

**Interpretive response:** We believe 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 for a number of reasons.

— We believe the FASB intended that each general type of hedging instrument be able to qualify for a less burdensome method of documenting and assessing effectiveness – e.g. the shortcut method or the critical terms match method. Because the shortcut method can only be applied to interest rate swaps, it appears reasonable that a receive-fixed, pay-fixed CCIRS is eligible for the critical terms match method.

— A CCIRS with two fixed legs has foreign exchange risk as the dominant risk exposure and is not considered a compound derivative instrument. We believe 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 a CCIRS reacts to changes in currency rates similar to a foreign currency forward contract. Therefore, economically a CCIRS is similar to a foreign currency forward contract, which is eligible for the critical terms match method.

We believe the following conditions should be met for the hedging relationship 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 transaction 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 transaction; and

— the fair value of the CCIRS at hedge inception is zero.

**Note:** 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.
**Question 9.4.60**

**Does an entity consider counterparty nonperformance risk when evaluating whether it is probable that a forecasted transaction will occur?**

**Background:** In order to apply cash flow hedge accounting, including the critical terms match method, the hedged transaction has to be probable of occurring.

**Interpretive response:** Yes, an entity considers counterparty nonperformance risk when evaluating whether it is probable that a forecasted transaction that is part of a cash flow hedge will occur even if it uses the critical terms match method. For further discussion of considering nonperformance credit risk, see section 9.2.60. [815-20-35-10]

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**Question 9.4.70**

**Can the critical terms match method be applied to an all-in-one hedge?**

**Background:** In an all-in-one hedge, the hedged transaction and hedging instrument are essentially the same (see section 5.3.90). In this hedging relationship, a derivative is 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 gross settlement of the derivative.

**Interpretive response:** Yes, an entity can apply the critical terms match method to an all in-one-hedge.

For example, Gas Co. enters into a forward contract (firm commitment) to purchase natural gas for the daily purchase of 5,000 MMBTUs at a fixed price in the month of January Year 10. The purchase contract does not qualify for the normal purchases and normal sales scope exception and is accounted for as a derivative. Gas Co. can document this transaction as an all-in-one hedge by designating the forecasted purchase of 5,000 MMBTUs per day in January Year 10 as the hedged transaction. The hedging instrument is the firm commitment (i.e. the same transaction). Therefore, the critical terms of the forecasted transaction and hedging instrument match.

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**9.4.40 Assessment**

Applying the critical terms match method does not eliminate the requirement to assess hedge effectiveness. However, it does eliminate the need to measure hedge effectiveness quantitatively. [815-20-25-85]

**Initial assessment**

During the initial hedge effectiveness assessment, the entity determines whether the critical terms of the hedging instrument and hedged transaction match and that the other criteria for the critical terms match method are met.
The entity documents its conclusion that the changes in the cash flows attributable to the risk being hedged are expected to be completely offset by changes in the cash flows of the hedging instrument. [815-20-25-85]

The extent of that assessment is based on judgment and varies depending on the complexity of the derivative and hedged transaction. However, an entity need not initially assess hedge effectiveness quantitatively. [815-20-25-85]

**Subsequent assessments**

An entity performs subsequent assessments by verifying and documenting that the critical terms of the hedging instrument and the hedged transaction have not changed during the assessment period. An entity also assesses whether there have been adverse developments related to counterparty credit risk or the entity’s own nonperformance risk related to the derivative hedging instrument.

The entity concludes and documents that the hedging relationship has been perfectly effective if it determines that there have been no changes in: [815-20-25-85, 35-10 – 35-11]

— critical terms; and

— creditworthiness of the counterparty to the derivative and the entity’s own nonperformance risk that would make the likelihood of the counterparty or the entity not defaulting no longer probable.

In contrast, an entity discontinues the critical terms match method if: [815-20-35-12]

— the critical terms of the hedging instrument or the hedged transaction no longer match; or

— the likelihood that the counterparty or the entity will not default is no longer probable.

**Question 9.4.80**

If the critical terms cease to match after hedge inception, is an entity required to discontinue hedge accounting?

**Interpretive response:** Not necessarily. If the critical terms of the hedging instrument and the hedged transaction cease to match at any point, or if there has been an adverse development regarding the risk of counterparty default, an entity is required to assess whether the hedging relationship is expected to continue to be highly effective using a quantitative assessment method. [815-20-35-12]

If the hedging relationship is expected to continue to be highly effective based on a quantitative effectiveness assessment, the hedging relationship may continue with ongoing effectiveness assessments performed quantitatively. The quantitative method may be selected when the criteria for the critical terms match method is no longer met. It does not need to be preselected upon hedge inception. See section 9.6.
If the hedging relationship is not expected to continue to be highly effective based on a quantitative effectiveness assessment, the hedging relationship is required to be discontinued (see section 2.10.50). [815-20-35-12]

**Question 9.4.90**

How does an entity consider counterparty credit risk or its own nonperformance risk when applying the critical terms match method to a cash flow hedge?

**Interpretive response:** Counterparty credit risk and the entity’s own nonperformance risk are considered when applying the critical terms match method to a cash flow hedge as follows.

**Fair value of the forward or futures contract or option contract**

An entity considers counterparty credit risk and its own nonperformance risk when determining the fair value of the forward, futures or option contract. This is the case regardless of whether it applies the critical terms match method. [820-10]

The counterparty credit risk of an exchange-traded futures contract is generally the credit risk of the futures exchange. [820-10]

See also KPMG’s Q&A: Fair value measurement, including:

- Section O, Application issues: Derivatives and hedging, including Question O70, which provides additional information about whether (and how) the requirements to include counterparty credit risk and an entity’s own nonperformance risk in measuring the fair values of derivative instruments affect hedging relationships.

- Question C70, which addresses how to consider the existence of a separate arrangement (such as a master netting agreement or credit support agreement) that mitigates credit risk exposure in the event of default when measuring the fair value of a financial instrument.

**Hedge inception**

Comparable credit risk between the hedging instrument and the hedged transaction is not necessary for a cash flow hedge to assume perfect effectiveness for accounting purposes. The FASB allowed this accommodation as a practical matter even though a perfect economic offset requires the forward, futures or option contract and hedged transaction to have the same credit risk.

Nonetheless, an ongoing expectation of high effectiveness is implicit in the critical terms match method. Therefore, when applying this method, an entity considers the likelihood of the counterparty complying with the hedging instrument’s payment terms. [815-20-35-9]

We believe this guidance should also apply to the entity’s own nonperformance risk.
Changes in counterparty credit risk and own nonperformance risk

When using the critical terms match method, an entity monitors hedges for changes in counterparty credit risk and nonperformance risk. We believe an entity may continue the critical terms match method if the likelihood that the counterparty or the entity will not default continues to be probable. However, if the likelihood that the counterparty or the entity will not default is no longer probable, the entity should discontinue hedge accounting altogether. [815-20-35-10 – 35-12]

If the entity can identify the date on which the counterparty or the entity not defaulting became less than probable, the entity stops hedge accounting prospectively from that day forward. If the entity cannot identify that date, it does not apply hedge accounting for the entire reporting period in which the counterparty or the entity not defaulting became less than probable.

9.5 Qualitative effectiveness assessments

9.5.10 Overview

Excerpt from ASC 815-20

> Effectiveness Assessments on a Qualitative Basis

35-2A An entity may qualitatively assess hedge effectiveness if both of the following criteria are met:

a. An entity performs an initial quantitative test of hedge effectiveness on a prospective basis (that is, it is not assuming that the hedging relationship is perfectly effective at hedge inception as described in paragraph 815-20-25-3(b)(ii)(ii)(ii), and the results of that quantitative test demonstrate highly effective offset.

b. At hedge inception, an entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods.

See paragraphs 815-20-55-79G through 55-79N for implementation guidance on factors to consider when determining whether qualitative assessments of effectiveness can be performed after hedge inception.

35-2B An entity may elect to qualitatively assess hedge effectiveness in accordance with paragraph 815-20-35-2A on a hedge-by-hedge basis. If an entity makes this qualitative assessment election, only the quantitative method specified in an entity’s initial hedge documentation must comply with paragraph 815-20-25-81.

>>> Eligibility of Hedging Relationships for Subsequent Qualitative Effectiveness Assessments

55-79G An entity should use judgment in determining whether it can reasonably support performing assessments of effectiveness after hedge inception on a qualitative basis. That judgment should include careful consideration of the following factors:
a. Results of the quantitative assessment of effectiveness performed for the hedging relationship.

b. Alignment of the critical terms of the hedging relationship. If one or more of the critical terms of the hedging instrument and the hedged item are not aligned, an entity should consider whether changes in market conditions may cause the changes in fair values or cash flows of the hedging instrument and hedged item or hedged forecasted transaction attributable to the hedged risk to diverge as a result of those differences in terms.

1. In cases in which the underlyings of the hedged item and hedging instrument are different, an entity should consider the extent and consistency of the correlation exhibited between the changes in the underlyings of the hedged item and hedging instrument.
   i. This may inform the entity about whether expected changes in market conditions could cause the changes in fair values or cash flows of the hedging instrument and the hedged item or hedged forecasted transaction attributable to the hedged risk to diverge. Particularly in the context of reverting to qualitative assessments of hedge effectiveness after being required to perform a quantitative assessment (as discussed in paragraph 815-20-35-2D), this may inform an entity about whether there is a reasonable expectation that the hedging relationship is expected to remain stable or whether that divergence is expected to continue or recur in the future.
   ii. A specific event or circumstance may cause a temporary disruption to the market that results in an entity concluding that the facts and circumstances of the hedging relationship have changed such that it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective. In those instances, if the results of the quantitative assessment of effectiveness do not significantly diverge from the results of the initial assessment of effectiveness, that market disruption should not prevent the entity from returning to qualitative testing in subsequent periods. If the results of the quantitative assessment of effectiveness do significantly diverge from the results of the initial assessment of effectiveness, the entity should continually monitor whether the temporary market disruption has been resolved when determining whether to return to qualitative testing in subsequent periods.

Topic 815 permits an entity to perform its subsequent effectiveness assessments on a qualitative (rather than quantitative) basis if certain criteria are met.

To elect to perform quarterly effectiveness assessments qualitatively, both of the following criteria must be met: [815-20-35-2A]

| **Criterion 1** | An initial quantitative test of hedge effectiveness on a prospective basis is performed and demonstrates highly effective offset. |
| **Criterion 2** | At hedge inception, the entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods. |
An entity uses judgment to determine whether it can reasonably support an expectation of high effectiveness on a qualitative basis after hedge inception. Factors to consider include: [815-20-55-79G, ASU 2017-12.BC202]

- the results of the quantitative assessment of effectiveness performed for the hedging relationship at hedge inception; and
- how well the critical terms of the hedging relationship are aligned.

When the critical terms are not aligned, an entity considers additional factors. [815-20-55-79G]

<table>
<thead>
<tr>
<th>Critical terms that are not aligned</th>
<th>Factor(s) to consider</th>
</tr>
</thead>
<tbody>
<tr>
<td>Critical terms of the hedging instrument and the hedged item are not aligned – e.g. underlyings, notional amounts, maturities, quantities, locations, delivery dates</td>
<td>— Whether changes in market conditions may cause the changes in fair values or cash flows of the hedging instrument and hedged item or hedged transaction attributable to the hedged risk to diverge as a result of those differences in terms.</td>
</tr>
</tbody>
</table>
| Underlyings of the hedged item and hedging instrument are different. | — The extent and consistency of the correlation exhibited between the changes in the underlyings of the hedged item and hedging instrument.  
— As part of this evaluation, the entity considers whether expected changes in market conditions are anticipated to prevent the hedging relationship from achieving highly effective offset. |

**Formal documentation.** When an entity elects qualitative effectiveness assessments, its initial hedge documentation is required to specify a quantitative method that will be used to assess effectiveness if facts and circumstances change and the entity is required to assess effectiveness quantitatively. This method is required to be the same as that used to support the entity’s initial prospective hedge effectiveness assessment. See section 2.9.30. [815-20-25-3(b)(2)(iv)(03)]

An entity is permitted to elect qualitative effectiveness assessments on a hedge-by-hedge basis, rather than being required to assess all similar hedges on a qualitative basis. However, if quantitative effectiveness assessments are required due to changes in facts and circumstances, the same quantitative method is required for similar hedges (see Question 9.2.210). [815-20-35-2B]

**Question 9.5.10**

*When the hedging relationship does not have perfect offset, how does an entity reasonably support its expectation of high effectiveness on a qualitative basis in subsequent periods?*

**Interpretive response:** A hedging relationship may not achieve perfect offset on a quantitative basis because some of the critical terms of the hedged item
and the hedging instrument are not aligned – e.g. when the underlying of the hedged item and hedging instrument are different.

In this circumstance, it may be more difficult for an entity to reasonably support an expectation of high effectiveness on a qualitative basis at hedge inception based on the factors the entity is required to consider under Topic 815. Additionally, it may be more difficult to determine when it is no longer appropriate to perform qualitative (rather than quantitative) assessments in subsequent periods; see Question 9.5.20 for factors to consider to be able to assert qualitatively that the hedge was and continues to be highly effective.

An entity should also consider the nature of its selected quantitative method for assessing effectiveness when evaluating the effect of known changes in relationships. For example, when the dollar-offset method is used, if the hedging instrument and the hedged transaction involve small dollar amounts but large percentages, small changes can result in the hedge not being perfectly effective. Conversely, an unusual change in the relationship that occurred during a period may not result in a lack of high effectiveness under regression analysis (e.g. because many data points are regressed). Such an unusual change may indicate that solely qualitative analyses are no longer appropriate. Additionally, when they occur over periods of time, small changes in each period may cumulatively cause the relationship between a hedging instrument and hedged item or transaction to cease being highly effective, regardless of the method used.

When evaluating whether the hedging relationship will be highly effective prospectively, an entity is required to consider all reasonably possible scenarios. [815-20-25-79(a)]

When some of the terms of the hedged item and the hedging instrument are different (see section 9.2.10 for examples of terms that are not aligned), we believe performing qualitative hedge effectiveness assessments includes monitoring whether the conditions in the subsequent periods are consistent with the conditions that were evaluated to support the initial determination that a qualitative assessment approach was appropriate. We also believe all factors that affect hedge effectiveness should be considered when evaluating whether an assertion of high effectiveness in subsequent periods is reasonably supported. For example, an entity is required to measure the fair value of both the hedging instrument and the fair value of the hedged item attributable to the hedged risk in a fair value hedge for purposes of accounting for the fair value hedge (see chapter 4); an entity should not disregard information obtained for this purpose when performing a qualitative hedge effectiveness assessment.

An entity may find it useful to include in its initial prospective assessment hypothetical scenarios that simulate changes in factors that affect hedge effectiveness to see whether the relationship still meets the highly effective threshold in each of the hypothetical scenarios. For example, if the underlyings in the hedged item and the hedging instrument are not aligned, identifying the extent of movements in those underlyings (whether in the same or opposite directions) that cause the relationship to cease being highly effective would allow the entity to compare the movements in subsequent periods to those in the hypothetical scenarios to demonstrate that those movements did not cause the relationship to cease being highly effective.
**Formal documentation.** We believe an entity should document its consideration of factors considered in support of its assertion that it could reasonably support its expectation of high effectiveness.

**Examples**

The following FASB examples (paragraphs 815-20-55-79H to 55-79N) demonstrate when an expectation of high effectiveness can be reasonably supported in subsequent periods. It is followed by Example 9.5.10, adapted in part from the FASB examples to further illustrate when this expectation can be reasonably supported.

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**Excerpt from ASC 815-20**

>>> Eligibility of Hedging Relationships for Subsequent Qualitative Effectiveness Assessments

55-79H In the following scenarios, assume that the entity is required to perform a quantitative assessment of effectiveness at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(01). For each scenario, a discussion of whether the entity could reasonably support performing qualitative assessments of effectiveness is included in paragraphs 815-20-55-79L through 55-79N.

>>>> Scenario A

79-I The following factors are present in the hedging relationship:

a. The results of the initial or most recent quantitative assessment of effectiveness performed indicate that the hedging relationship is close to achieving perfect offset.

b. All critical terms of the hedging relationship match except for the underlyings of the hedged item and hedging instrument.
   1. The changes in the underlyings of the hedged item and hedging instrument have been consistently highly correlated such that expected changes in market conditions are not anticipated to prevent the hedging relationship from achieving highly effective offset.

>>>> Scenario B

55-79J The following factors are present in the hedging relationship:

a. The results of the initial or most recent quantitative assessment of effectiveness performed indicate that the hedging relationship is close to failing the effectiveness test.

b. All critical terms of the hedging relationship match except for the underlyings of the hedged item and the hedging instrument.
   1. The changes in the underlyings of the hedged item and the hedging instrument have not been consistently highly correlated such that expected changes in market conditions could prevent the hedging relationship from achieving highly effective offset.
>>>> Scenario C

55-79K The following factors are present in the hedging relationship:

a. The results of the initial or most recent quantitative assessment of
effectiveness performed indicate that the hedging relationship is neither
close to achieving perfect offset nor close to failing the effectiveness test.
b. All critical terms of the hedging relationship match except for the
underlyings of the hedged item and the hedging instrument.
   1. The changes in the underlyings of the hedged item and the hedging
   instrument have not been consistently highly correlated such that
   expected changes in market conditions could prevent the hedging
   relationship from achieving highly effective offset.

55-79L In Scenario A, the entity could reasonably support performing
qualitative assessments of effectiveness. The quantitative assessment of
effectiveness was close to achieving perfect offset and past observations of
changes in the underlyings of the hedged item and hedging instrument (that is,
the only critical term that did not match) consistently exhibited high correlation.
This indicates that the results of subsequent assessments of effectiveness
may not significantly differ from those observed from the assessment of
effectiveness performed at hedge inception.

55-79M In Scenario B, the entity could not reasonably support performing
qualitative assessments of effectiveness. The lack of consistent high
correlation exhibited between the changes in the underlyings of the hedged
item and the hedging instrument could prevent the entity from concluding that
the results of subsequent assessments of effectiveness will be similar to the
results observed from the initial assessment of effectiveness. Had the changes
in underlyings of the hedged item and the hedging instrument been
consistently highly correlated, the entity may conclude that it is still unable to
reasonably support performing subsequent assessments of effectiveness on a
qualitative basis. Because the hedging relationship is close to failing its
quantitative assessment, minimal changes in the relationship between the
hedged item and hedging instrument could result in the hedging relationship
not being highly effective.

55-79N In Scenario C, the entity could not reasonably support performing
qualitative assessments of effectiveness. Although this hedging relationship is
not close to failing the quantitative assessment of effectiveness as in Scenario B,
the lack of consistent high correlation exhibited between the changes in the
underlyings of the hedged item and the hedging instrument prevent the entity
from concluding that the results of subsequent assessments of effectiveness
will be similar to the results observed from the initial or most recent quantitative
assessment of effectiveness. Had the changes in value of the underlyings of the
hedged item and the hedging instrument consistently been highly correlated, the
entity may conclude that it could reasonably support performing subsequent
assessments of effectiveness on a qualitative basis.
example 9.5.10
whether an expectation of high effectiveness can be reasonably supported in subsequent periods

the following example is adapted in part from scenarios a to c in paragraphs 815-20-55-79h to 55-79n.

abc corp. performs a quantitative assessment of effectiveness at hedge inception for five hedging relationships (hedges a – e). in each hedging relationship, all critical terms match except the underlyings of the hedged item and hedging instrument.

the following table summarizes each relationship and discusses whether an expectation of high effectiveness in subsequent periods can be reasonably supported.

<table>
<thead>
<tr>
<th>hedge a</th>
<th>results of initial quantitative effectiveness assessment</th>
<th>extent and consistency of correlation between changes in underlyings</th>
<th>do initial testing results and evaluation of correlation indicate the potential for an expectation of high effectiveness?</th>
</tr>
</thead>
<tbody>
<tr>
<td>close to achieving perfect offset.</td>
<td>changes have been consistently highly correlated.</td>
<td>yes. the high degree of offset achieved and the high correlation between changes in the underlyings indicate that the results of subsequent quarterly hedge effectiveness assessments may not significantly differ from those observed at hedge inception. [815-20-55-79i, 55-79l]</td>
<td></td>
</tr>
</tbody>
</table>

| hedge b | close to failing effectiveness test. | changes have not been consistently highly correlated. | no. the lack of consistent high correlation between changes in the underlyings precludes a conclusion that subsequent quarterly hedge effectiveness assessments will be similar to the results observed at hedge inception. [815-20-55-79j, 55-79m] |

| hedge c | close to failing effectiveness test. | changes have been consistently highly correlated. | maybe not. although the changes in underlyings are consistently highly correlated, the relationship is close to failing, so minimal changes in the relationship between the hedged item and hedging instrument could result in the hedging relationship not being highly effective. [815-20-55-79j, 55-79m] |

| hedge d | neither close to achieving perfect offset nor close to failing effectiveness test. | changes have not been consistently highly correlated. | no. the lack of consistent high correlation between changes in the underlyings precludes a conclusion that subsequent quarterly hedge effectiveness assessments will be similar to the results observed at hedge inception. [815-20-55-79k, 55-79n] |
## 9. Hedge effectiveness

### Results of initial quantitative effectiveness assessment

| Hedge E | Neither close to achieving perfect offset nor close to failing effectiveness test. | Changes have been consistently highly correlated. | Yes. The high degree of offset achieved and the high correlation between changes in the underlyings indicate that the results of subsequent quarterly hedge effectiveness assessments may not significantly differ from those observed at hedge inception. [815-20-55-79K, 55-79N] |

### Changes in facts and circumstances

#### Excerpt from ASC 815-20

**Effectiveness Assessments on a Qualitative Basis**

*35-2C* When an entity performs qualitative assessments of hedge effectiveness, it shall verify and document whenever financial statements or earnings are reported and at least every three months that the facts and circumstances related to the hedging relationship have not changed such that it can assert qualitatively that the hedging relationship was and continues to be highly effective. While not all-inclusive, the following is a list of indicators that may, individually or in the aggregate, allow an entity to continue to assert qualitatively that the hedging relationship is highly effective:

a. An assessment of the factors that enabled the entity to reasonably support an expectation of high effectiveness on a qualitative basis has not changed such that the entity can continue to assert qualitatively that the hedging relationship was and continues to be highly effective. This shall include an assessment of the guidance in paragraph 815-20-25-100 when applicable.

b. There have been no adverse developments regarding the risk of counterparty default.

*35-2D* If an entity elects to assess hedge effectiveness on a qualitative basis and then facts and circumstances change such that the entity no longer can assert qualitatively that the hedging relationship was and continues to be highly effective in achieving offsetting changes in fair values or cash flows, the entity shall assess effectiveness of that hedging relationship on a quantitative basis in subsequent periods. In addition, an entity may perform a quantitative assessment of hedge effectiveness in any reporting period to validate whether qualitative assessments of hedge effectiveness remain appropriate. In both cases, the entity shall apply the quantitative method that it identified in its initial hedge documentation in accordance with paragraph 815-20-25-3(b)(2)(iv)(03).
When an entity determines that facts and circumstances have changed and it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective, the entity shall begin performing subsequent quantitative assessments of hedge effectiveness as of the period that the facts and circumstances changed. If there is no identifiable event that led to the change in the facts and circumstances of the hedging relationship, the entity may begin performing quantitative assessments of effectiveness in the current period.

After performing a quantitative assessment of hedge effectiveness for one or more reporting periods as discussed in paragraphs 815-20-35-2D through 35-2E, an entity may revert to qualitative assessments of hedge effectiveness if it can reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods. See paragraphs 815-20-55-79G through 55-79N for implementation guidance on factors to consider when determining whether qualitative assessments of effectiveness can be performed after hedge inception.

When an entity elects to perform quarterly hedge effectiveness assessments on a qualitative basis, it may perform subsequent quarterly assessments on a qualitative basis as long as it qualifies to do so (see section 9.2.20). Therefore, during each quarterly assessment, an entity determines whether it qualifies to perform the assessment on a qualitative basis under the current facts and circumstances. [815-20-35-2C]

If facts and circumstances change, an entity may no longer be able to assert qualitatively that the hedging relationship was and continues to be highly effective. In that situation, the entity is required to assess effectiveness using the quantitative method identified in the hedge documentation at inception (see section 2.9.30). [815-20-35-2D]

Question 9.5.20
Under what circumstances is a subsequent quantitative assessment required if an entity initially elects to perform qualitative assessments?

Interpretive response: Determining whether the facts and circumstances have changed such that an entity is required to perform a quarterly hedge effectiveness assessment on a quantitative (rather than qualitative) basis requires judgment. In making this determination, an entity should consider whether:

- the factors assessed at inception of the hedging relationship that enabled the entity to reasonably support an expectation of high effectiveness on a qualitative basis have changed; and
- there have been any adverse developments in the risk of counterparty default.
**Question 9.5.30**

If required, for what periods are subsequent quantitative assessments performed?

**Interpretive response:** Quantitative assessments (if required) are performed beginning as of the period in which facts and circumstances changed such that the entity can no longer support qualitatively that the relationship is highly effective.

- If there is an identifiable event that led to the change, the quantitative assessments are performed beginning in the period that includes that event.
- If there is no identifiable event that led to the change, the quantitative assessments may begin in the current period.

Quantitative assessments are performed for each period thereafter unless it is appropriate to revert to qualitative effectiveness assessments in a future period (see Question 9.5.50). [815-20-35-2F]

See also Question 9.5.10 regarding how to support an expectation of high effectiveness when a relationship does not have perfect offset and Question 9.5.40 regarding the consequence of failing to timely identify that such an expectation is not supported.

**Question 9.5.40**

What is the consequence of failing to identify that an entity could not reasonably support performing qualitative assessments in a prior period?

**Interpretive response:** If an entity fails to identify that it was not appropriate to apply the qualitative method in a prior period(s), the quantitative assessment approach documented at hedge inception is used to determine whether the relationship was highly effective in that period(s).

The guidance in Topic 250 (accounting changes and errors) on accounting errors is also applied, and the determination of the error depends on whether the relationship was highly effective in the prior period(s) affected.

- **Not highly effective.** If the relationship was not highly effective in prior reporting periods, the amount of the error is the difference between not applying hedge accounting and the results recorded in the prior reporting period. [ASU 2017-12.BC215]

- **Highly effective.** If the relationship was highly effective and the hedged item (for a fair value hedge) and hedging instrument are measured properly, there is no error. However, an error will result if either of these is measured incorrectly. The nature of any error differs between cash flow and fair value hedges.
Hedging effectiveness

Fair value hedge
The hedged item and/or the hedging instrument may not have been measured appropriately if their characteristics (including consideration of credit risk) were not properly defined in the prior reporting periods. This would result in the recorded amounts for the hedged item and/or the hedging instrument – along with the related gains (losses) recognized in net income – being incorrect.

Cash flow hedge
The hedging instrument may not have been measured appropriately if its characteristics (including consideration of credit risk) were not properly defined in the prior reporting periods. This would result in the hedging instrument’s recorded amount and the related amount recorded in AOCI being incorrect.

In both circumstances, the entity also evaluates the severity of any control deficiencies related to the failure to identify the inappropriate use of the qualitative approach.

See KPMG’s ICFR reference guide for insights on assessing internal controls over financial reporting, including evaluating deficiencies.

Question 9.5.50
May an entity performing quantitative effectiveness assessments revert to qualitative effectiveness assessments?

Interpretive response: Yes. An entity that initially elects to perform qualitative effectiveness assessments may be required (or may elect) to perform a quantitative effectiveness assessment in a subsequent period(s). In this case, it may revert to performing qualitative effectiveness assessments once it can reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods. In making this determination, the entity considers the same factors that it considered when making the initial election to perform qualitative assessments (see section 9.5.10). [815-20-35-2E – 35-2F]

The FASB considered whether returning to qualitative effectiveness assessments should be prohibited. However, it decided that not all circumstances requiring an entity to perform quantitative assessments mean that facts and circumstances have changed to such a degree that performing qualitative assessments is no longer reliable. Rather, some changes in facts and circumstances may be the result of a “temporary market disruption or an anomalous or infrequent event that is not expected to recur.” As a result, the FASB concluded that an entity may revert to performing qualitative effectiveness assessments if it can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods. [815-20-35-2F, ASU 2017-12, BC204–BC206]

FASB Examples
The following FASB examples (815-20-55-79P to 55-79V) demonstrate when it may or may not be appropriate to revert to qualitative assessments after performing quantitative assessments.
>>> Change in Facts and Circumstances in Qualitative Effectiveness Assessments

>>>> Scenario A

55-79P Entity B expects to purchase 10,000 metric tons of cottonseed meal throughout April 20X3 based on the spot price of the cottonseed meal index on the respective date of each purchase. Entity B wants to hedge the variability in cash flows attributable to changes in the cottonseed meal index on the price that it will pay for the cottonseed meal. It enters into a forward contract on August 24, 20X1, with a notional of 10,000 metric tons, a maturity of April 1, 20X3, and an underlying of the soybean meal index because no market exists for derivatives indexed to the cottonseed meal index. Concurrent with the execution of the forward, Entity B designates the forward as the hedging instrument in a hedging relationship in which the hedged item is documented as the forecasted purchases of the first 10,000 metric tons of cottonseed meal expected to be purchased during April 20X3 and the hedged risk is documented as the variability in cash flows attributable to changes in the contractually specified cottonseed meal index in the not-yet-existing contract. On August 24, 20X1, Entity B determines that all requirements for cash flow hedge accounting are met and that the requirements of paragraph 815-20-25-22A will be met in the contract once executed in accordance with paragraph 815-20-25-22B. Entity B also will assess whether the criteria in 815-20-25-22A are met in the contract when it is executed.

55-79Q Because the hedged risk and forward contract are based on different indexes, the hedging relationship does not qualify for one of the exemptions in paragraph 815-20-25-3(b)(2)(iv)(01). Entity B performs an initial quantitative hedge effectiveness assessment and determines that the hedging instrument is highly effective at achieving offsetting cash flows associated with the hedged item attributable to the hedged risk. In Entity B’s hedge documentation, it elects to perform subsequent assessments of hedge effectiveness on a qualitative basis. It makes this election based on the following factors:

a. The results of the quantitative effectiveness assessment performed at hedge inception indicate that the hedging relationship is close to achieving perfect offset.

b. Changes in the value of the cottonseed meal index have been consistently highly correlated with changes in value of the soybean meal index such that expected changes in market conditions are not anticipated to prevent the hedging relationship from achieving highly effective offset.

c. Although the underlyings of the hedging instrument and hedged item do not match, the notional amount of the derivative and the expected quantity to be purchased do match. Based on the quantitative effectiveness assessment, Entity B also determined that the difference in timing between the maturity date of the derivative and the dates on which the group of forecasted purchases is expected to occur is insignificant.

55-79R During the fourth quarter of 20X1, a storm damages the soybean harvest, which leads to a shortage in soybean meal supply and a sharp
increase in the price of soybean meal based on the soybean meal index. The cottonseed meal index has not experienced a similar increase because cotton harvests were unaffected by the storm that damaged the soybean harvest. Because the increase in the soybean meal index is not reflected in the cottonseed meal index, Entity B concludes that a change in facts and circumstance has occurred that prevents a qualitative assertion in subsequent periods that the hedging relationship continues to be highly effective at achieving offsetting cash flows. Thus, on the next subsequent effectiveness assessment date (December 31, 20X1), the company begins performing quantitative assessments of hedge effectiveness based on the method used to perform the initial prospective assessment of effectiveness. In the effectiveness assessment performed on December 31, 20X1, Entity B determines that the hedging relationship remains highly effective but that it is not close to achieving perfect offset.

55-79S Entity B returns to assessing effectiveness qualitatively as of June 30, 20X2, because the evaluation of the following criteria leads to the conclusion that high effectiveness can be asserted prospectively on a qualitative basis:

a. Entity B determines that the event that caused the soybean meal index and cottonseed meal index to experience a lack of correlation was temporary, that it was an isolated weather event, and the effect of the weather event has passed.

b. The changes in value of the soybean meal index and cottonseed meal index reverted to levels of correlation that were consistent with those before the storm.

c. The results of the June 30, 20X2 quantitative assessment of effectiveness are in line with the results of the quantitative assessment of effectiveness performed at hedge inception.

d. No further disruptions in supply are expected.

>>>> Scenario B

55-79T On August 17, 20X1, Entity C issues at par a $100 million 5-year fixed-rate noncallable debt instrument with an annual 8 percent interest coupon. On that date, Entity C enters into a 5-year interest rate swap with Financial Institution D and designates it as the hedging instrument in a fair value hedge of the LIBOR interest rate risk of the $100 million liability. Under the terms of the interest rate swap, Entity C will receive fixed interest at 6 percent and pay variable interest at LIBOR based on a notional amount of $100 million. The variable leg of the interest rate swap resets at the end of each quarter for the interest payment that is due at the end of the following quarter.

55-79U Entity C performs the initial quantitative and first subsequent hedge effectiveness assessments on September 30 (the entity’s first quarterly testing date after hedge inception) and determines that the hedging relationship is highly effective at achieving offsetting changes in fair value attributable to interest rate risk. Entity C also elects at hedge inception to subsequently assess hedge effectiveness on a qualitative basis and documents how it would carry out that qualitative assessment. In its quarterly effectiveness assessment on December 31, the entity asserts that facts and circumstances related to the hedging relationship have not changed and the hedging relationship was and continues to be highly effective.
However, in the first quarter of 20X2, Financial Institution D’s risk of default significantly increases, which affects the valuation of the interest rate swap with Entity C. Entity C notes that it no longer can qualitatively assert that the hedging relationship was and continues to be highly effective at achieving offsetting changes in fair value attributable to changes in benchmark interest rates. Thus, on the next subsequent effectiveness assessment date (March 31, 20X2), Entity C begins performing quantitative assessments of effectiveness using the method documented at hedge inception. In subsequent periods, Entity C does not return to qualitative effectiveness assessments because it cannot reasonably support an expectation of high effectiveness on a qualitative basis for the following reasons:

a. The significant risk of default of Financial Institution D has not reversed and is not expected to be temporary.
b. The results of quantitative effectiveness tests performed indicate that the hedging relationship is close to no longer being highly effective.

9.6 Quantitative methods of assessing effectiveness

9.6.10 Overview

Excerpt from ASC 815-20

>> Hedge Effectiveness—After Designation

35-2 If a fair value hedge or cash flow hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test on either a quantitative basis (using either a dollar-offset test or a statistical method such as regression analysis) or a qualitative basis. See paragraphs 815-20-35-2A through 35-2F for additional guidance on qualitative assessments of effectiveness. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting. At least quarterly, the hedging entity shall determine whether the hedging relationship has been highly effective in having achieved offsetting changes in fair value or cash flows through the date of the periodic assessment.

35-4 Electing to use a regression or other statistical analysis approach instead of a dollar-offset approach to perform retrospective evaluations of assessing hedge effectiveness may affect whether an entity can apply hedge accounting for the current assessment period.

>>> Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges

55-68 As discussed in paragraph 815-20-25-80, if an entity assesses hedge effectiveness on a quantitative basis and elects at the inception of a hedging relationship to utilize a regression analysis approach for prospective considerations of assessing effectiveness and the dollar-offset method to perform retrospective evaluations of assessing effectiveness, then that entity
must abide by the results of that methodology as long as that hedging relationship remains designated. Thus, in its retrospective evaluation, an entity might conclude that, under a dollar-offset approach, a designated hedging relationship does not qualify for hedge accounting for the period just ended, but that the hedging relationship may continue because, under a regression analysis approach, there is an expectation that the relationship will be highly effective in achieving offsetting changes in fair value or cash flows in future periods. In its retrospective evaluation, if that entity concludes that, under a dollar-offset approach, the hedging relationship has not been highly effective in having achieved offsetting changes in fair value or cash flows, hedge accounting may not be applied in the current period. Whenever a hedging relationship fails to qualify for hedge accounting in a certain assessment period, the overall change in fair value of the derivative instrument for that current period is recognized in earnings (not reported in other comprehensive income for a cash flow hedge) and the change in fair value of the hedged item would not be recognized in earnings for that period (for a fair value hedge).

This section discusses the quantitative approach to assessing hedge effectiveness by explaining the common methods used when that approach is applied. Previous sections of this chapter discuss the other methods of effectiveness testing, including:

— the qualitative approach (section 9.5);
— shortcut method (section 9.3); and
— critical terms match method (section 9.4).

Topic 815 does not prescribe which quantitative method should be used to perform effectiveness assessments. Instead, Topic 815 provides an entity with flexibility in determining the method to use for assessing hedge effectiveness, provided the method is reasonable and is defined and documented at the inception of the hedging relationship. In addition, the chosen quantitative method needs to be consistent with the hedging strategy (see section 9.2.30).

Unlike the approaches listed above, there are no pre-conditions for electing a quantitative approach, aside from the documentation requirements. Rather, it is the fall-back approach when a hedging relationship does not qualify for any other approach. But even when other approaches are allowable, an entity can still elect to use the quantitative approach, and may even prefer to.

The two common quantitative methods are dollar-offset and statistical analysis, with the most common statistical analysis being a regression analysis. Either of these methods can be used in both the prospective and retrospective hedge effectiveness assessments. Alternatively, an entity may use one method for the prospective assessment and the other method for the retrospective assessment (see Question 9.2.40).

Each of the dollar-offset and statistical analysis methods has advantages and disadvantages. Moreover, each method may yield different results when applied to the same hedging relationship. Therefore, because the results of effectiveness assessments determine whether the entity can continue to apply hedge accounting, the selection of the right method to assess effectiveness at the inception of the hedging relationship should be carefully considered. [815-20-35-4]
The following diagram summarizes some main advantages and disadvantages of selecting dollar-offset versus statistical analysis (e.g. regression).

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dollar-offset</strong> (section 9.6.20)</td>
<td>Only considers data for the most recent assessment period</td>
</tr>
<tr>
<td></td>
<td>Limited elapsed time period may increase the likelihood that an unusual event or short-term volatility could result in a hedge not being highly effective over a short period</td>
</tr>
<tr>
<td></td>
<td>Impact of ‘law of small numbers’ less likely to demonstrate hedge is highly effective (see Question 9.6.40)</td>
</tr>
<tr>
<td></td>
<td>Mathematically simple and easy to interpret results</td>
</tr>
<tr>
<td></td>
<td>Historical data can be used to develop an assessment of effectiveness</td>
</tr>
<tr>
<td></td>
<td>Using a longer timeframe reduces the effect of short-term volatility or unusual events</td>
</tr>
<tr>
<td><strong>Statistical analysis</strong> (e.g. regression) (section 9.6.30)</td>
<td>Difficult to apply and interpret the results</td>
</tr>
</tbody>
</table>

An entity chooses and documents a method at the inception of a hedging relationship. It cannot switch from one method to another without redesignating the hedging relationship (see section 9.6.40).

The following guidance discussed in previous sections also applies for the quantitative assessments of hedge effectiveness:

- An entity is permitted to exclude some components of a hedging instrument from its effectiveness assessments (see section 9.2.70).
- An entity is required to use the same assessment method for similar hedging relationships, including whether any components are excluded (see section 9.2.80).
- An entity should consider the effect of counterparty credit risk (entity’s own nonperformance risk) on hedging relationships (see section 9.2.60).
- An entity generally is required to discontinue a hedging relationship if the results of retrospective testing indicate the relationship was not highly effective (see section 2.10.50). However, if a hedging relationship was not highly effective retrospectively, but is expected to be highly effective prospectively, hedge accounting is not necessarily required to be discontinued (see Question 2.10.90).

**Formal documentation.** Because Topic 815 provides for alternative methods and those methods have various application possibilities, an entity is required to document at the inception of a hedging relationship its decision about how it will assess effectiveness both on a retrospective and prospective basis. See section 2.9 for further discussion of the formal hedge documentation requirements.
Question 9.6.10

Why might an entity elect to use a quantitative method, even if the hedging relationship is eligible for a different method?

Interpretive response: Quantitative methods tend to be more complex to apply in practice than other methods. However, an entity may choose to apply a quantitative method – even if the hedging relationship is eligible for another method – due to limitations of, or cost considerations related to, the other effectiveness methods. For example:

— Using a quantitative method may mitigate the risk of being required to discontinue hedge accounting and/or of misapplying other methods such as the shortcut method or qualitative method.

— If an entity has a large number of hedging relationships, it may have systems and processes in place that are capable of performing timely quantitative tests for all hedges. In these situations, it may be more efficient for an entity to apply quantitative methods to all of its hedging relationships than the other available methods (e.g. the qualitative method described in section 9.5).

— Practical implications of applying a qualitative approach, where the assessment of effectiveness may not be easily determined qualitatively, requires a level of judgment, and quarterly documentation of those judgments, as well as additional processes and controls and monitoring efforts.

Question 9.6.20

Can an entity choose different effectiveness assessment methods each period based on the expected outcome?

Interpretive response: No. An entity is required to document its planned method of assessing hedge effectiveness at the inception of the hedging relationship as part of its formal documentation (see requirements in section 2.9). The documentation should be specific as to which method will be used for retrospective and prospective effectiveness testing. Moreover, this documented method must be used throughout the hedging relationship.

Additionally, an entity is not permitted to document that it will use a variety of different techniques for the prospective assessment (or the retrospective assessment), depending on the circumstances at the time of the testing.

For example, an entity may believe that the effectiveness of the hedging relationship will significantly change if there are unexpected movements in the fair value or cash flows of the hedged item or transaction or the hedging instrument. However, it cannot devise and document a variety of effectiveness tests whereby one method would be used in certain cases while another method would be used in other cases.
Interpretive response: It is our understanding that more entities choose to use regression analysis in their retrospective and prospective hedge effectiveness assessments.

While it is more difficult to apply and understand the results (see Questions 9.6.80 and 9.6.90), regression analysis is generally regarded as advantageous because it allows an entity to use historical data for periods before the inception of the hedge for both the initial and subsequent effectiveness assessments. In contrast, in applying the dollar-offset method for the ongoing retrospective effectiveness assessment, only data from the hedge period is considered.

For example, an entity is retrospectively assessing hedge effectiveness at the end of the first reporting period after inception of a hedging relationship (i.e. one quarter after inception) and the changes in the fair value or cash flows of the hedging instrument during the period did not effectively offset the changes in the fair value or cash flows of the hedged item or transaction.

— Dollar-offset. If the entity initially chose to use the dollar-offset method in its retrospective assessment, it would be required to conclude that the designated hedging relationship would not qualify for hedge accounting for the period just ended.

— Statistical analysis (regression). If the entity initially chose to use a statistical analysis based on a trailing 12-month period, 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. This is because the results of the nine months preceding the hedge period may negate the unfavorable hedge results of the most recent three months.

The hedge effectiveness testing results in this example – where one method (statistical analysis) supports hedge accounting while another method (dollar-offset) does not – is neither uncommon nor incorrect. Instead, it serves to highlight the importance of the selection of a method.

9.6.20 Dollar-offset method

Excerpt from ASC 815-20

>> Quantitative Hedge Effectiveness Assessments after Hedge Designation

35-5 In periodically (that is, at least quarterly) assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows) under a dollar-offset approach,
Hedging

9. Hedge effectiveness

An entity shall use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges):

a. Period-by-period approach. The period-by-period approach involves comparing the changes in the hedging instrument’s fair values (or cash flows) that have occurred during the period being assessed to the changes in the hedged item’s fair value (or hedged transaction’s cash flows) attributable to the risk hedged that have occurred during the same period. If an entity elects to base its comparison of changes in fair value (or cash flows) on a period-by-period approach, the period cannot exceed three months. Fair value (or cash flow) patterns of the hedging instrument or the hedged item (or hedged transaction) in periods before the period being assessed are not relevant.

b. Cumulative approach. The cumulative approach involves comparing the cumulative changes (to date from inception of the hedge) in the hedging instrument’s fair values (or cash flows) to the cumulative changes in the hedged item’s fair value (or hedged transaction’s cash flows) attributable to the risk hedged.

35-6 If an entity elects at inception of a hedging relationship to base its comparison of changes in fair value (or cash flows) on a cumulative approach, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Electing to utilize a period-by-period approach instead of a cumulative approach (or vice versa) to perform retrospective evaluations of assessing hedge effectiveness under the dollar-offset method may affect whether an entity can apply hedge accounting for the current assessment period.

The dollar-offset method compares the dollar amount of the change in fair value or cash flows of the hedging instrument with the dollar amount of the change in fair value or cash flows of the hedged item or transaction for the risk being hedged over the assessment period.

There are two approaches that may be used when applying the dollar-offset method: the period-by-period approach and the cumulative approach. Either approach can be elected to calculate the hedge effectiveness, which an entity documents as part of its formal hedge documentation. An entity is not permitted to switch from one approach to the other without redesignating (and redesignating) the hedging relationship (see section 9.6.40). [815-20-35-6]

<table>
<thead>
<tr>
<th>Period-by-period</th>
<th>Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>The period-by-period approach involves comparing the changes in the hedging instrument’s fair values or cash flows during the period being assessed with the changes in the hedged item’s or transaction’s fair value or cash flows attributable to the hedged risk during the same period.</td>
<td>The cumulative approach involves comparing the cumulative changes in the hedging instrument’s fair value or cash flows to the cumulative changes in the hedged item’s or transaction’s fair value or cash flows attributable to the hedged risk since inception of the hedging relationship. [815-20-35-5(b)]</td>
</tr>
</tbody>
</table>

The period for this assessment can be as short as an entity chooses (and documents), but cannot exceed three months. [815-20-35-5(a)]
Question 9.6.40
What implications arise under the dollar-offset method when changes in fair values during the period are small?

Interpretive response: The dollar-offset method may be less likely to demonstrate that the hedging relationship is highly effective when the change in the fair value or cash flows of the hedging instrument and the hedged item or transaction involve small dollar amounts but large percentages.

For example, if the fair value of a hedging instrument with a notional of $1 million changed by $1,000 while the hedged item’s fair value changed by $1,500, the dollar-offset method would indicate that the hedge was only 66% effective ($1,000 ÷ $1,500), which is out of the highly effective range of 80% – 125% (see section 9.2.40). However, this change may be insignificant when compared to the $1 million principal balance of the loan and $1 million notional of the hedging instrument.

This is referred to as the ‘small dollar problem’ or the ‘law of small numbers’.

Question 9.6.50
Which approach is more commonly applied when using the dollar-offset method: cumulative or period-by-period?

Interpretive response: It is our understanding most entities that choose the dollar-offset method for the retrospective assessment of effectiveness testing elect the cumulative approach instead of the period-by-period approach.

This is because the cumulative approach provides more periods of data, which may minimize the impact of short-term volatility or unusual events.

9.6.30 Regression analysis

Excerpt from ASC 815-20

>> Quantitative Hedge Effectiveness Assessments after Hedge Designation

35-2G Quantitative assessments can be based on regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information.

35-3 If an entity elects at the inception of a hedging relationship to use the same regression analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness, then during the term of that hedging relationship both of the following conditions shall be met:
a. Those regression analysis calculations shall generally incorporate the same number of data points.

b. That entity must periodically update its regression analysis (or other statistical analysis).

>>> Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges

55-69 As discussed in paragraph 815-20-35-3(b), if an entity assesses hedge effectiveness on a quantitative basis and elects at the inception of a hedging relationship to utilize a regression analysis (or other statistical analysis) approach for either prospective considerations or retrospective evaluations of assessing effectiveness, then that entity shall periodically update its regression analysis (or other statistical analysis). As long as an entity reruns its regression analysis and determines that the hedging relationship is still expected to be highly effective, then it can continue to apply hedge accounting without interruption.

55-70 The application of a regression or other statistical analysis approach to assessing effectiveness is complex. Those methodologies require appropriate interpretation and understanding of the statistical inferences.

Regression analysis is a statistical approach to measuring the effect that a change in one variable (the independent variable) can have on another variable (the dependent variable). In the case of hedging, a regression analysis could determine the relationship between the hedged item or transaction and a hedged instrument and whether it is expected to be – and actually has been – highly effective.

While regression analysis and other statistical analysis methods can be used for assessing effectiveness on a retrospective and/or prospective basis, 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. [815-20-55-70]

To determine if a highly effective relationship exists, multiple data points need to be evaluated. Topic 815 does not specify the number of data points (i.e. data that represents the relationship of the independent and dependent variables over time) that must be incorporated into a regression analysis.

As time progresses in the hedging relationship, the data points in the regression analysis should be updated to include the current data. The entity should generally incorporate the same number of data points in each analysis, as the current data replaces the old data. This may help to further prove, or disprove, the effectiveness of the hedging relationship. [815-20-35-3, 55-69]

A detailed discussion of regression analysis and other statistical methods for assessing hedge effectiveness is beyond the scope of this publication.
Question 9.6.60
What should be compared (regressed) in a regression analysis?

Interpretive response: Generally regression analysis is applied to the changes in two variables over time.

When using statistical analysis, such as regression analysis, 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. that the change in the fair value or cash flows of the derivative hedging instrument will be (and/or has been) highly effective at offsetting changes in the fair value or cash flows of the hedged item or transaction attributable to the hedged risk.

As a result, a regression analysis generally evaluates the relationship between changes in the fair values or cash flows of the derivative and the hedged item or transaction instead of the fair values or cash flows themselves.

Question 9.6.70
Must an entity perform the actual regression calculation if it is mathematically certain a cash flow hedge will be perfectly effective?

Interpretive guidance: No. In some circumstances, the variables to be compared through regression may be known at inception to always be identical.

For example, if an entity is using the hypothetical derivative method in a cash flow hedge and the terms of the actual hedging derivative exactly match those of the perfectly effective hypothetical derivative (see section 9.7.30), the entity knows with certainty that the changes in fair value or cash flows of the hypothetical derivative will be identical to the changes in fair value or cash flows of the actual hedging derivative. As a result, the entity knows with mathematical certainty that the relationship will be 100% effective without performing the actual quantitative calculation.

In those circumstances, we believe an entity is not required to perform the actual calculation. This is because when the corresponding values to be compared are identical, the results of the calculation are known with mathematical certainty without performing the full calculation. Instead, we believe an entity may satisfy the requirement to initially assess effectiveness by documenting this fact.
9. Hedge effectiveness

Question 9.6.80
What outputs of regression analysis should be evaluated?

Interpretive guidance: The SEC staff has indicated that an entity must consider all relevant outputs from a regression analysis used to determine whether the hedging relationship has been and is expected to be highly effective. [2003 AICPA Conf]

While that assessment will be determined based on the facts and circumstances of the specific relationship, the SEC staff stated that at least the following regression outputs should be considered.

- $R^2$ statistic (coefficient of determination): the portion of variability in a dependent variable that can be explained by variability in the independent variable.
- Slope coefficient: the straight line that represents the ‘best fit’ of the individual data points.
- F-statistic or t-statistic: statistics that aid in determining whether the relationship between the variables is statistically valid.

Depending on the specifics of the hedging strategy, other regression outputs may also need to be considered.

Question 9.6.90
Should an entity consider using specialists when it uses statistical analysis to assess effectiveness?

Interpretive guidance: Yes. Applying statistical analysis (including regression) is complex and an appropriate interpretation and understanding of the statistical inferences of statistical methods are critical in applying those methods. As a result, we believe an entity should ensure that it involves personnel with the requisite knowledge to apply the methods properly.

Question 9.6.100
Do quantitative effectiveness assessments require judgment?

Interpretive response: Yes. While they are quantitative in nature, judgment is still involved in assessing effectiveness using quantitative methods. In evaluating the overall effectiveness test of the given hedging relationship, the overall understanding of the method selected and the inputs into the quantitative methods are important considerations.
The following are examples of inputs to a quantitative assessment that frequently require the judgment.

<table>
<thead>
<tr>
<th>Type of hedging relationship</th>
<th>Inputs to quantitative assessment</th>
<th>Example judgment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fair value</strong></td>
<td>- Fair value of the hedged item</td>
<td>- Estimating fair value of the hedged item, unless the hedged risk is total changes in fair value and a quoted price for an identical item traded in an active market is available (i.e. Level 1 inputs).</td>
</tr>
<tr>
<td></td>
<td>- Fair value of the hedging instrument</td>
<td>- Estimating the fair value of the derivative hedging instrument, unless there are no excluded components and a quoted price for an identical item traded in an active market is available (i.e. Level 1 inputs).</td>
</tr>
<tr>
<td><strong>Cash flow</strong></td>
<td>- Cash flows of the hedged forecasted transaction</td>
<td>- Estimating the amount and timing of the cash flows of the hedged forecasted transaction, which may involve a probability-weighted assessment.</td>
</tr>
<tr>
<td></td>
<td>- Cash flows of the derivative hedging instrument</td>
<td>- Estimating the cash flows of the derivative hedging instrument, unless there are no excluded components and a quoted price for an identical item traded in an active market is available (i.e. Level 1 inputs).</td>
</tr>
<tr>
<td><strong>Fair value and cash flow</strong></td>
<td>- Selection of quantitative technique</td>
<td>- Determination of data to include in the assessment (daily points, monthly, etc).</td>
</tr>
<tr>
<td></td>
<td>- Number of data points used in a regression analysis</td>
<td>- Determining the number of data points to be used in a regression analysis.</td>
</tr>
<tr>
<td></td>
<td>- Historical period used</td>
<td>- Determining the historical period to be used in effectiveness assessments (see Question 9.2.80).</td>
</tr>
<tr>
<td></td>
<td>- Determination of data to include in the assessment (daily points, monthly, etc).</td>
<td></td>
</tr>
</tbody>
</table>

See also KPMG’s [Q&A: Fair value measurement](#), including Section O, Application issues: Derivatives and hedging.
9.6.40 Changing quantitative methods for assessing effectiveness

Excerpt from ASC 815-20

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-80 All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship. An entity shall use the quantitative effectiveness assessment method defined at hedge inception consistently for the periods that the entity either elects or is required to assess hedge effectiveness on a quantitative basis.

>>>> Change in Hedge Effectiveness Method When Hedge Effectiveness Is Assessed on a Quantitative Basis

35-19 If the entity identifies an improved method of assessing hedge effectiveness in accordance with the guidance in paragraph 815-20-25-80 and wants to apply that method prospectively, it shall do both of the following:

a. Discontinue the existing hedging relationship
b. Designate the relationship anew using the improved method.

35-20 The new method of assessing hedge effectiveness shall be applied prospectively and shall also be applied to similar hedges unless the use of a different method for similar hedges is justified. A change in the method of assessing hedge effectiveness by an entity shall not be considered a change in accounting principle as defined in Topic 250.

>>> Changes in Quantitative Assessment Methods

55-55 If an entity elects to or is required to assess hedge effectiveness on a quantitative basis after the initial quantitative assessment of hedge effectiveness, examples of changes in the types of methods an entity may use in assessing hedge effectiveness (see paragraph 815-20-35-20) could include the following:

a. A change from the dollar-offset method to the use of regression analysis or vice versa
b. A change between any one of the three methods discussed beginning in paragraph 815-30-35-10 (for example, a change from the change in variable cash flows method to either the hypothetical derivative method or the change in fair value method)
c. A change from excluding certain components of a derivative instrument gain or loss to including such components or vice versa (for example, a change from assessing effectiveness based on changes in intrinsic value to the entire change in an option’s fair value)
d. A change from assessing hedge effectiveness on a period-by-period basis to a cumulative basis or vice versa.

55-56 This Subtopic permits a hedging relationship to be dedesignated (that is, discontinued) at any time. (See paragraphs 815-25-40-1(c) and 815-30-40-1(c).) If an entity wishes to change any of the critical terms of the hedging relationship (including the method designated for use in assessing hedge effectivene
Hedging

9. Hedge effectiveness

Effectiveness, as documented at inception, the mechanism provided in this Subtopic to accomplish that change is the designation of the original hedging relationship and the designation of a new hedging relationship that incorporates the desired changes. However, as discussed in paragraph 815-30-35-37A, a change to the hedged risk in a cash flow hedge of a forecasted transaction does not result in an automatic designation of the hedging relationship if the hedging instrument continues to be highly effective at achieving offsetting cash flows associated with the hedged item attributable to the revised hedged risk. The designation of an original hedging relationship and the designation of a new hedging relationship represents the application of this Subtopic and is not a change in accounting principle under Topic 250, even though the new hedging relationship may differ from the original hedging relationship only with respect to the method designated for use in assessing the hedge effectiveness of that hedging relationship. Although paragraph 815-20-35-19 refers to discontinuing an existing hedging relationship and then designating and documenting a new hedging relationship using an improved method for assessing effectiveness, that reference was not meant to imply that the perceived improved method had to be justified as a preferable method of applying an accounting principle under Topic 250.

55-56A For the purposes of applying the guidance in paragraph 815-20-55-56, a change in the counterparty to a derivative instrument that has been designated as the hedging instrument in an existing hedging relationship would not, in and of itself, be considered a change in a critical term of the hedging relationship.

As discussed in section 2.9, an entity generally is required to define and document the quantitative method it will use for assessing hedge effectiveness at the time it designates a hedging relationship. That method must be applied consistently throughout the period of the hedge. [815-20-25-3(b)(2), 25-80]

If an entity wishes to change the documented hedge effectiveness method – i.e. because it has identified an improved method for assessing effectiveness – it generally must discontinue the existing hedging relationship and designate a new hedging relationship using the improved method. The new relationship must meet all hedging criteria, including the formal documentation requirements. [815-20-35-19]

The effect of discontinuing a hedging relationship is discussed in sections 4.5 (fair value hedges) and 6.5 (cash flow hedges).

The following are examples of changes in hedge effectiveness methods, and whether designation and redesignation of the hedging relationship is required. [815-20-35-19, 55-55 – 55-56A]

<table>
<thead>
<tr>
<th>Changes in hedge effectiveness methods – designation and redesignation required</th>
<th>Changes in hedge effectiveness methods – designation and redesignation not required</th>
</tr>
</thead>
<tbody>
<tr>
<td>— Change from the dollar-offset method to regression analysis or vice versa (see sections 9.6.20 and 9.6.30).</td>
<td>— An entity documents that it will use the qualitative method for subsequent effectiveness assessments and later is required (or elects) to perform quantitative effectiveness assessments using</td>
</tr>
<tr>
<td>— Change from period-by-period basis to cumulative basis or vice versa (see section 9.6.20).</td>
<td></td>
</tr>
</tbody>
</table>
Hedging

9. Hedge effectiveness

<table>
<thead>
<tr>
<th>Changes in hedge effectiveness methods – dedesignation and redesignation required</th>
<th>Changes in hedge effectiveness methods – dedesignation and redesignation not required</th>
</tr>
</thead>
<tbody>
<tr>
<td>— Change between any of the following methods (see section 9.7)</td>
<td>the method documented at hedge inception (see section 9.5.20).</td>
</tr>
<tr>
<td>— change-in-variable-cash-flows method</td>
<td>— Shortcut method is determined to not be or no longer be appropriate and the entity had documented at hedge inception the quantitative method that would be used in such circumstances (see section 9.3.110).</td>
</tr>
<tr>
<td>— hypothetical derivative method</td>
<td>— Critical terms cease to match when an entity applies the critical terms match method (see Question 9.4.80).</td>
</tr>
<tr>
<td>— change-in-fair-value method.</td>
<td></td>
</tr>
<tr>
<td>— Change from excluding to including certain components of a derivative instrument’s gain or loss or vice versa (see section 9.2.70).</td>
<td></td>
</tr>
</tbody>
</table>

Discontinuing a hedging relationship and designating a new hedging relationship with a different effectiveness assessment method is not a change in an accounting principle under Topic 250. As a result, no preferability letter is necessary and the auditor’s report need not refer to this change. Nevertheless, an entity that changes methods needs to:

— document its justification for the change, including why the new method is an improvement;
— apply the new method to all similar hedges, unless facts and circumstances support a different method (see section 9.2.80); and
— prepare documentation for the new hedging relationship (see section 2.9).

9.6.50 **Illustrative examples of quantitative methods to assess effectiveness**

The following examples illustrate the quantitative hedge effectiveness testing methods:

— Dollar-offset method for retrospective test (fair value hedge) (Example 9.6.10).
— Assessing effectiveness of a cash flow hedge of a forecasted purchase of inventory with a forward contract (contractually specified component) (Subtopic 815-30’s Example 22).
— Hedging forecasted purchases of fuel using regression analysis and the dollar-offset method (Example 9.6.20).

**Example 9.6.10**

**Dollar-offset method for retrospective test (fair value hedge)**

At inception of the hedge, on March 31, Year 1, a 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.
Formal documentation

ABC Corp. 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.

Quarterly effectiveness testing – March 31, Year 2

The following is ABC’s documentation supporting its retrospective assessment of hedge effectiveness using the cumulative dollar-offset method at March 31, Year 2.

<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, Year 1</td>
<td>$100</td>
<td>$(90)</td>
<td>111%</td>
<td>111%</td>
</tr>
<tr>
<td>June 30, Year 1</td>
<td>25</td>
<td>(21)</td>
<td>119%</td>
<td>113%</td>
</tr>
<tr>
<td>September 30, Year 1</td>
<td>(20)</td>
<td>24</td>
<td>83%</td>
<td>121%</td>
</tr>
<tr>
<td>December 31, Year 1</td>
<td>(5)</td>
<td>4</td>
<td>125%</td>
<td>120%</td>
</tr>
<tr>
<td>March 31, Year 2</td>
<td>25</td>
<td>(19)</td>
<td>132%</td>
<td>123%</td>
</tr>
</tbody>
</table>

**Net gain (loss) to date** $125 $(102)

To be highly effective, the extent of offset between the hedging instrument and the hedged item or forecasted transaction should be 80%–125% (see section 9.2.40).

ABC concludes that it cannot apply hedge accounting for the three months ended March 31, Year 2 if it selects the period-by-period dollar-offset method for its retrospective assessment of hedge effectiveness. This is because the extent of offset under the period-to-period assessment was 132% – i.e. not within a range of 80%–125%.

However, ABC is able to apply hedge accounting for the three months ended March 31, Year 2 because its chosen method of retrospectively assessing effectiveness is based on cumulative changes. As the table demonstrates, on a cumulative basis, this relationship has been highly effective.

---

Excerpt from Subtopic 815-30

>> Example 22: Assessing Effectiveness of a Cash Flow Hedge of a Forecasted Purchase of Inventory with a Forward Contract (Contractually Specified Component)

55-134 This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic for assessing effectiveness for a cash flow hedge of a forecasted purchase of inventory with a forward contract for which the hedged risk is variability in cash flows attributable to changes in a contractually
specified component. Assume the entity elects to perform subsequent assessments of hedge effectiveness on a quantitative basis using a cumulative-dollar-offset approach and all hedge documentation requirements were satisfied at inception.

55-135 Entity J manufactures keys for door locks on buildings and cars. The keys are cut from sheets of metal called key plates. Entity J primarily purchases its key plates from Supplier 1 as needed. Supplier 1 and Entity J have an outstanding agreement specifying that the per-unit cost of each key plate will be determined by Supplier 1 on the first business day of each month on the basis of the following pricing formula:

a. Spot price of COMEX Zinc per pound × 0.2 pounds, plus
b. Spot price of COMEX Copper per pound × 0.1 pounds, plus
c. The current cost of refining copper and zinc into key plates, plus
d. The current cost of transporting the key plates to Entity J.

55-136 In January 20X1, Entity J expects to purchase 100,000 key plates in July 20X1, which requires 10,000 pounds of copper for the manufacturing process. Entity J decides that it wishes to hedge only the change in value of the price of COMEX Copper used to create the key plates being purchased in July 20X1.

55-137 On January 15, 20X1, Entity J enters into a forward contract maturing on July 1, 20X1 (that is, the date on which the price of copper used to manufacture the key plates is fixed) to purchase 10,000 pounds of COMEX Copper at $2.10 per pound. Any settlement amount on the forward contract will be based on the difference between the contract price of $2.10 per pound and the spot price of COMEX Copper on the maturity date (July 1, 20X1), multiplied by the notional amount of 10,000 pounds.

55-138 Entity J designates a cash flow hedge in which the hedging instrument is the forward contract, the hedged item is the forecasted purchase of key plates in July 20X1, and the hedged risk is the variability in the purchase price of the key plates attributable to changes in the COMEX Copper price index, which is a contractually specified component within the frame agreement. Entity J documents in its hedge documentation that the requirements to designate variability in cash flows attributable to changes in a contractually specified component as the hedged risk in paragraph 815-20-25-22A are met.

55-139 Entity J bases its assessment of hedge effectiveness on cumulative changes in the fair value of the hedging instrument and the hedged item attributable to changes in the hedged risk.

55-140 In assessing hedge effectiveness on an ongoing basis, Entity J must consider the extent of offset between the change in expected cash flows on the hedging instrument (the copper forward contract) and the hedged item attributable to changes in the hedged risk (change in expected cash flows associated with forecasted purchases of key plates attributable to changes in the COMEX Copper price index). The table below illustrates the cumulative changes in the hedging instrument and hedged item attributable to changes in the hedged risk as of the first subsequent quarterly effectiveness assessment date.
Hedging

9. Hedge effectiveness

<table>
<thead>
<tr>
<th>Nature of the risk being hedged</th>
<th>Groups of similar forecasted transactions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exposure to variability in the overall cash outflows (i.e. price risk) for the purchase of fuel due to changes in spot prices at various locations.</td>
<td>The hedged forecasted transaction is defined as the first purchases of gallons of fuel over the 30-day period beginning on the first day of the month in which the derivative contract matures/settles that:</td>
</tr>
<tr>
<td>- in aggregate represent the number of gallons (or equivalent barrels) equal to the notional amount of the hedging instrument; and</td>
<td>- are not currently being hedged by another derivative instrument or were not previously identified in a relationship</td>
</tr>
</tbody>
</table>

**Table: Estimate of Change in Cash Flows**

<table>
<thead>
<tr>
<th>Hedging Instrument</th>
<th>Hedged Item Due to Fluctuation in Hedged Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward price of copper (dollars per pound)</td>
<td></td>
</tr>
<tr>
<td>At hedge inception (Jan 15, 20X1) $2.10</td>
<td>$2.10</td>
</tr>
<tr>
<td>At first subsequent assessment date (March 31, 20X1) $2.25</td>
<td>$2.25</td>
</tr>
<tr>
<td>Change in forward price of copper $0.15</td>
<td>$0.15</td>
</tr>
<tr>
<td>Cumulative change in copper (per pound) x 10,000 pounds of copper $1,500.00</td>
<td>$1,500.00</td>
</tr>
</tbody>
</table>

**55-141** Entity J could assess effectiveness as of March 31, 20X1, by comparing the $1,500 change in the hedging instrument with the $1,500 change in the hedged item attributable to changes in the hedged risk because the hedging instrument’s maturity date and the date on which the price of copper will be fixed match (that is, July 1, 20X1).

**Example 9.6.20**

**Hedging forecasted purchases of fuel using regression analysis and the dollar-offset method**

This is the continuation of Examples 2.9.50 and 5.3.30 involving forecasted purchases of fuel when hedging price risk.

- Formal documentation of hedging relationship – except for hedge effectiveness components, which are presented in this example (see Example 2.9.50).
- Similarity assessment for forecasted transactions (see Example 5.3.30).

Freight Co. purchases both jet fuel and diesel fuel at various locations across the US and internationally.

For ease of reference, details of the hedging relationships identified by Freight are summarized below.
originally designated earlier in priority that has been
terminated for which amounts remain in AOCI.

Only individual forecasted purchases that are considered to be
similar with respect to the risk being hedged are included within
the same hedged group of forecasted transactions. Hedged
transactions within each of the following groups are considered
similar, based first by type of fuel and then more specifically by
location:

- Group 1: Jet fuel; NY Harbor, US Gulf Coast, LA
- Group 2: Jet fuel; Singapore, Rotterdam
- Group 3: Diesel fuel; NY Harbor, US Gulf Coast
- Group 4: Diesel fuel; LA

Hedging instrument

<table>
<thead>
<tr>
<th>Futures or purchased options indexed to either:</th>
</tr>
</thead>
<tbody>
<tr>
<td>— the NYMEX Heating Oil or NY Harbor No. 2 index (generally used for relationships involving forecasted purchases of jet fuel); or</td>
</tr>
<tr>
<td>— the NYMEX West Texas Intermediate Crude Oil index (generally used for relationships involving forecasted purchases of diesel fuel).</td>
</tr>
</tbody>
</table>

The hedge period for individual relationships is typically three months.

**Documentation of hedge effectiveness methods**

The following illustrates how the methods chosen to assess effectiveness are documented at the inception of the hedging relationships.

**Hedge effectiveness at inception**

<table>
<thead>
<tr>
<th>Prospectively</th>
</tr>
</thead>
<tbody>
<tr>
<td>Freight will assess prospective effectiveness using a regression analysis to demonstrate high correlation between:</td>
</tr>
<tr>
<td>— the cumulative changes in fair value of the hedging instrument; and</td>
</tr>
<tr>
<td>— the cumulative changes in fair value of a PEH derivative (a proxy for the change in the present value of the expected future cash flows of the hedged forecasted purchases of fuel).</td>
</tr>
</tbody>
</table>

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, the regression analysis will demonstrate high correlation over a series of 32 three-month periods.

The hedged forecasted transaction specified for each hedging relationship is a group of individual forecasted purchases of fuel of the same type but from differing locations. Therefore, Freight 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 locations identified within each group of hedged forecasted transactions.

For example, for an individual hedging relationship associated with Group 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 NY Harbor index, (2) the US Gulf Coast index and (3) the LA index.
This analysis demonstrates that the hedging relationship would be highly effective regardless of the ultimate composition of the hedged group of forecasted transactions (e.g. if 100% of the forecasted purchases were from any one of the identified locations).

Each set of data points to be used in the regression analysis will be determined as discussed below. The 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.

<table>
<thead>
<tr>
<th><strong>Cumulative change in fair value of hedging instrument</strong></th>
<th>The cumulative change in the fair value of the derivative over a three-month period. If historical prices for the hedging instrument do not exist, the fair values will be measured with inputs based on:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>— the current spot price of the commodity underlying the derivative;</td>
</tr>
<tr>
<td></td>
<td>— the derivative’s maturity/settlement date; and</td>
</tr>
<tr>
<td></td>
<td>— 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.</td>
</tr>
<tr>
<td></td>
<td>Freight believes 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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Cumulative change in fair value of PEH 1 and PEH 2</strong></th>
<th>The cumulative change in the fair value of the PEH derivative over a three-month period.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>— <strong>Futures contracts.</strong> For relationships involving futures contracts, PEH 1 is a futures contract (with a zero fair value at inception of the hedging relationship) to purchase the type of fuel being hedged (e.g. jet fuel or diesel fuel) at the location within that group of forecasted transactions for which the regression is being prepared.</td>
</tr>
<tr>
<td></td>
<td>— <strong>Purchased options.</strong> For relationships involving purchased option contracts, PEH 2 is a European option contract to purchase the type of fuel being hedged at the location within that group of forecasted transactions for which the regression is being prepared; Freight is assessing effectiveness for option relationships based on total changes in the 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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Settlement date of PEH 1 and PEH 2</strong></th>
<th>The settlement date of PEH 1 and PEH 2 is determined at the inception of the hedge based on an analysis of the purchases made in the prior three-month period for each particular group of hedged forecasted transactions.</th>
</tr>
</thead>
</table>
|  | For example, in March Freight designates an individual relationship for the purchase of the first one million gallons of jet fuel associated with Group 1 in June. There were no other hedging relationships related to Group 1 previously designated for forecasted purchases in June. Freight accumulates the purchase data from the three-month period spanning December – February to determine how many days it took to purchase one million
Hedging effectiveness

Freight will update the regression analyses discussed above on a monthly basis, continuously using the most current 32 data points.

**Retrospectively**

The retrospective assessment is intended to determine whether the relationship has been highly effective cumulatively to date. Freight will assess retrospective effectiveness on a dollar-offset basis. To support hedge accounting for all relationships within each group 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 PEH derivatives.

**Prospectively**

Freight will determine whether it expects the hedging relationships to continue to be highly effective based on the updated regression analyses.
9.7 Cash flow hedges – Methods for measuring cash flows

9.7.10 Overview

Topic 815 does not prescribe a method for measuring the changes in the derivative hedging instrument’s cash flows or the changes in the hedged transaction’s cash flows attributable to the hedged risk. However, it describes several methods for measuring cash flows in cash flow hedges, some of which are only available for certain hedging strategies and/or when certain conditions are met.

<table>
<thead>
<tr>
<th>Method</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Terminal value method</td>
<td>This method may be used for certain cash flow hedging relationships when the hedging instrument is an option.</td>
</tr>
<tr>
<td>Change-in-variable-cash-flows method</td>
<td>These methods are applicable to cash flow hedges of variability in interest receipts or payments when the hedging instrument is an interest rate swap.</td>
</tr>
<tr>
<td>Hypothetical derivative method</td>
<td></td>
</tr>
<tr>
<td>Change-in-fair-value method</td>
<td></td>
</tr>
</tbody>
</table>

These methods may be used to measure the expected cash flows to be used when performing quantitative tests (see section 9.6). Some of these methods result in a hedge that is perfectly effective, depending on whether the critical terms of the hedging instrument and hedged transaction match.

In many cases, Topic 815 does not prescribe methods that must be used for assessing effectiveness for cash flow hedges. For example, Topic 815 does not prescribe specific guidance in the following situations:

- the hedging relationship includes a basis difference, to the extent that those bases do not move in tandem; this might occur, for example, when a pound sterling-based hedging instrument is used to hedge a euro-based forecasted transaction; and
- the critical terms do not match – e.g. when there is a difference between the notional amounts, maturities, quantity, location or delivery dates of the derivative hedging instrument and the hedged transaction.

In these situations, an entity is required to determine the changes in the forecasted transaction’s cash flows attributable to the hedged risk and compare these changes to the changes in cash flows of the derivative hedging instrument. As a result, methods have developed in practice for situations when Topic 815 does not prescribe how cash flows should be measured, including the following.

<table>
<thead>
<tr>
<th>Method</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hypothetical derivative method</td>
<td>This method is described in Topic 815 as being relevant to certain hedges involving interest payments when the hedging instrument is an interest rate swap. Additionally, FASB examples (e.g. Subtopic 815-30’s Example 1, which is reproduced in section 9.7.30) demonstrate using this method for other types of hedging relationships. In practice, the PEH derivative instrument</td>
</tr>
</tbody>
</table>
Hedging
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| Project future cash flows using forward price curves or using recent sales or purchase orders (section 9.7.50) | This method is used when hedging a forecasted sale or purchase of certain nonfinancial assets and a market is not available to help make estimates of their cash flows. |

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**Question 9.7.10**

What should an entity consider when assessing hedge effectiveness for a group of similar forecasted transactions?

**Background:** As discussed in section 5.3.60, a group of forecasted transactions (rather than an individual transaction) may be designated as the hedged transaction in a cash flow hedge, provided the transactions share the same risk exposure and certain conditions are met.

**Interpretive response:** Although each item in a group of transactions may share the same risk exposure, we believe an entity that identifies a group of transactions as the hedged transaction in a cash flow hedging relationship should consider additional factors when assessing whether the hedge is highly effective. Therefore, a group of transactions could pass the similarity test but the hedging relationship may not be highly effective.

The circumstances outlined below could result in a hedging relationship that is not highly effective.

| Timing of cash flows | Regardless of the risk being hedged, the timing of the individual cash flows of each transaction within a group of transactions will often not be the same as the timing of the cash flow(s) of a single derivative used as the hedging instrument. |
| Basis differences | Basis differences occur when the underlying price/index, contractually specified component or contractually specified interest rate of the hedged transaction is different from the price, index or interest rate of the hedging instrument. For example, a hedged transaction varies based on 30-day LIBOR and the hedging instrument varies based on 90-day LIBOR. For discussion of similarity assessments related to contractually specified interest rates, see Question 5.3.80. |
| Margin variability | When hedging price risk, margin variability may occur when each individual forecasted transaction in a group is based on the same underlying price, index or rate, but the spread above that price, index or rate may be different due to various factors. This would not be a factor when hedging exposure to changes in a contractually specified component or contractually specified interest rate. |
If the hedging relationship for a group of similar transactions is not highly effective, an entity may have the following alternatives:

— **Changing the groupings of hedged transactions.** Depending on the circumstances, an entity may need to consider whether multiple hedging relationships would be more appropriate. This could be different hedging relationships for each individual transaction or more disaggregated groups of similar forecasted transactions.

— **Use a combination of hedging instruments.** Alternatively, an entity could use a dynamic hedging strategy that uses a combination of derivatives as hedging instruments. As discussed in section 9.2.50, a dynamic hedging strategy involves an entity committing 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.

---

### 9.7.20 Terminal value method for certain cash flow hedges using an option as the hedging instrument

**Excerpt from ASC 815-20**

#### >>>> Assessing Hedge Effectiveness Based on an Option’s Terminal Value

25-126 The guidance in paragraph 815-20-25-129 addresses a cash flow hedge that meets all of the following conditions:

a. 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.

b. The exposure being hedged is the variability in expected future cash flows attributed to a particular rate or price beyond (or within) a specified level (or levels).

c. The assessment of effectiveness is documented as being 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, not just changes in intrinsic value).

25-127 This guidance has no effect on the accounting for fair value hedging relationships. In addition, in determining the accounting for seemingly similar cash flow hedging relationships, it would be inappropriate to analogize to this guidance.

25-128 For a hedging relationship that meets all of the conditions in paragraph 815-20-25-126, an entity may focus on the hedging instrument’s terminal value (that is, its expected future pay-off amount at its maturity date) in determining whether 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. An entity’s focus on the hedging instrument’s terminal value is not an impediment to the entity’s subsequently deciding to designate that cash flow hedge before the occurrence of the hedged transaction. If the hedging instrument is a purchased cap consisting of a series of purchased caplets that are each hedging an individual hedged transaction in a series of hedged transactions (such as caplets hedging a series of hedged
interest payments at different monthly or quarterly dates), the entity may focus on the terminal value of each caplet (that is, 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. The guidance in this paragraph applies to a purchased option regardless of whether at the inception of the cash flow hedging relationship it is at the money, in the money, or out of the money.

25-129 A hedging relationship that meets all of the conditions in paragraph 815-20-25-126 may be considered to be perfectly effective if all of the following conditions are met:

a. The critical terms of the hedging instrument (such as its notional amount, underlying, maturity date, and so forth) completely match the related terms of the hedged forecasted transaction (such as the notional amount, the variable that determines the variability in cash flows, the expected date of the hedged transaction, and so forth)

b. 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.

c. The hedging instrument’s inflows (outflows) at its maturity date completely offset the change in the hedged transaction’s cash flows for the risk being hedged.

d. The hedging instrument can be exercised only on a single date—its contractual maturity date.

The condition in (d) is consistent with the entity’s focus on the hedging instrument’s terminal value. If the holder of the option chooses to pay for the ability to exercise the option at dates before the maturity date (for example, by acquiring an American-style option), the hedging relationship would not be perfectly effective.

25-129A In a hedge of a group of forecasted transactions in accordance with paragraph 815-20-25-129(a), an entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match in accordance with paragraph 815-20-25-129(a) if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month.

Excerpt from ASC 815-30

>> Hedging Relationship in Which Hedge Effectiveness Is Based on an Option's Terminal Value

35-33 If an entity concludes under paragraphs 815-20-25-129 through 25-129A that the hedging relationship may not be considered to be perfectly effective, the entity shall assess hedge effectiveness by comparing the following amounts:

a. The change in fair value of the actual hedging instrument

b. The change in fair value of a perfectly effective hypothetical hedging instrument. That hypothetical hedging instrument shall have terms that
35-34 The change in fair value of the 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).

When an option is used as the derivative hedging instrument in a cash flow hedging relationship, the total change in the option’s cash flows may not perfectly offset the change in the forecasted transaction’s cash flows when the option premium (or time value) is included in that calculation.

In these situations, an entity may elect to use the terminal value method. This method includes the time value component of the option in the assessment of effectiveness. However, it 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.

As a result, the terminal value method 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.

The following table summarizes the terminal value method.

<table>
<thead>
<tr>
<th>Conditions for applying this method:</th>
</tr>
</thead>
<tbody>
<tr>
<td>[815-20-25-126]</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Hedging instrument.</strong> 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 (see sections 2.7.50 and 2.7.60).</td>
</tr>
<tr>
<td><strong>Hedged risk.</strong> The hedged risk is variability in expected future cash flows attributable to a particular rate or price beyond (or within) a specified level (or levels).</td>
</tr>
<tr>
<td><strong>Hedge effectiveness.</strong> The effectiveness assessment is based on total changes in the option’s cash flows – i.e. it includes the hedging instrument’s entire change in fair value, not just changes in intrinsic value.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Conditions that will result in perfect effectiveness:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>The critical terms of the hedging instrument completely match the related terms of the hedged transaction (notional amount, underlying, maturity and strike price). This includes that it is probable that the counterparty to the derivative and the entity will not default.</td>
</tr>
<tr>
<td>The strike 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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>The hedging instrument can be exercised only on a single date, its contractual maturity date.</td>
</tr>
<tr>
<td>See also Question 9.2.50 regarding whether subsequent assessments are performed on a qualitative or quantitative basis.</td>
</tr>
</tbody>
</table>
This method involves comparing:
- the option’s changes in the expected pay-off at its maturity;
  and
- the changes in the expected cash flows of the forecasted transaction.

However, if the conditions that will result in perfect effectiveness (above) are not met, an entity must perform initial and subsequent hedge effectiveness assessments by comparing the change in fair values of:
- the actual hedging instrument; and
- the perfectly effective hypothetical derivative (see section 9.7.30).

Note:
1. In determining whether these conditions are met, the entity may treat the timing of the hedged transactions and the hedging instrument as matching, if the hedged transactions occur and the hedging instrument matures within the same 31-day period (or fiscal month). [815-20-25-129A]

The terminal value method is available only for cash flow hedges (not fair value hedges) and cannot be used in cash flow hedges that do not meet the eligibility requirements included in the above table. [815-20-25-127]

As an alternative to the terminal value method, an entity may exclude changes in time value from its assessment of effectiveness (see section 9.2.70) to improve the extent of offset when an option premium (or time value) is paid. When time value is an excluded component, changes in time value are recognized using either an amortization approach or a mark-to-market approach. Either of these methods will result in the initial time value being recognized in earnings over the term of the hedging relationship. See also Example 6.3.30, which illustrates and compares the earnings effect of time value under each method. [815-20-25-83A – 25-83B]

Question 9.7.20

May the terminal value method be used by the buyer when the hedging instrument is a swaption?

Interpretive response: It depends on the hedged transaction.

The terminal value method 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 method 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; this is instead of the increase or decrease in cash flows to be exchanged during the term of the interest rate swap. As a result, using a swaption as the hedging instrument when the terminal value method is used to assess effectiveness may be effective when the hedged transaction is proceeds from issuing a fixed-rate debt instrument but may not be effective when hedging variability in individual interest payments from a forecasted variable-rate debt issuance (see Example 9.7.10).
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, to 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. As a result, the terminal value method may be used by the buyer when the hedging instrument is an interest rate swaption in a cash flow hedging relationship as long as the other eligibility requirements are met. Additionally, the hedging relationship may be considered perfectly effective if certain conditions are met.

**Examples**

The following are examples that demonstrate the terminal value method.

— Terminal value method is not appropriate (Example 9.7.10).
— Purchased option used in a cash flow hedge (Subtopic 815-20’s Example 27).
— Terminal value method for hedge of forecasted foreign currency denominated sale with a purchased option (Example 9.7.20).

---

**Example 9.7.10**

**Terminal value method is not appropriate**

ABC Corp. expects to issue $100 million of 10-year variable-rate debt in six months. ABC will be exposed to variability in cash flows in the future quarterly interest payments on the debt due to changes in the expected contractually specified interest rate.

ABC 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 ABC 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%, ABC will exercise its option. When three-month LIBOR is below 6%, ABC will allow its option to expire.

The conditions to apply the terminal value method are not met for the following reasons.

— 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.
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 increases or decreases in three-month LIBOR from 6%.

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**Excerpt from ASC 815-20**

**>> Example 27: Purchased Option Used in a Cash Flow Hedge**

55-208 This Example illustrates the application of paragraph 815-20-25-126.

55-209 An entity forecasts that 1 year later it will purchase 1,000 ounces of gold at 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 1-year cash-settled at-the-money gold option on 1,000 ounces of gold, paying 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. If the price of gold is $275 or below at the maturity date, the contract expires worthless. The option cannot be exercised before its contractual maturity date. The entity designates the purchased 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.

55-210 In assessing the effectiveness of the cash flow hedge, the entity would determine that because the change in the expected future pay-off amount of the purchased option completely offsets the change in the expected future cash flows on the purchase of 1,000 ounces of gold above $275 per ounce, the hedging relationship is expected to be highly effective under paragraph 815-20-25-75(b).

55-211 The entity would conclude there is perfect effectiveness because all of the following conditions exist:

a. All the critical terms of the hedging derivative completely match the hedged forecasted transaction.

b. The strike price of the hedging instrument matches the specified level ($275) beyond which the entity's exposure is being hedged.

c. 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.

d. The hedging option cannot be exercised before its contractual maturity date.
Example 9.7.20

Terminal value method for a hedge of a forecasted foreign currency denominated sale with a purchased option

ABC Corp.’s functional currency is the US dollar.

On January 1, Year 1, ABC forecasts a sale on credit for 10,000,000 euros (€). The sale is expected to occur on December 31, Year 1.

ABC purchases a European style put option for $442,000 for €10,000,000 notional amount with an exercise rate of €1 = $0.90.

ABC designates a cash flow hedge of the functional currency equivalent cash flows due to a depreciation of the euro below $0.90 from the date the sale is forecasted to be probable through the expected sale date.

The following additional facts are relevant.

— ABC expects this hedging relationship to be perfectly effective in hedging against a depreciation of the euro below $0.90. This is because 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).
  - ABC will assess effectiveness based on the terminal value method.
  - The put option is 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, ABC will not record any portion of the option’s cost or change in fair value in earnings until the forecasted sale affects earnings.

— The €/$ spot rate and fair value of the put option are as follows.

<table>
<thead>
<tr>
<th>Date of the Option</th>
<th>Spot rate €/$</th>
<th>Fair value of put option</th>
<th>Change in fair value of put option gain (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, Year 1</td>
<td>0.90</td>
<td>$442,000</td>
<td>N/A</td>
</tr>
<tr>
<td>March 31, Year 1</td>
<td>0.88</td>
<td>491,000</td>
<td>$49,000</td>
</tr>
<tr>
<td>June 30, Year 1</td>
<td>0.92</td>
<td>211,000</td>
<td>(280,000)</td>
</tr>
<tr>
<td>September 30, Year 1</td>
<td>0.89</td>
<td>261,000</td>
<td>50,000</td>
</tr>
<tr>
<td>December 31, Year 1</td>
<td>0.84</td>
<td>600,000</td>
<td>339,000</td>
</tr>
</tbody>
</table>

Note:
1. The fair value of the put option is based on an option pricing model.

— The put option settles on December 31, Year 1 with ABC receiving $600,000.

— Also on December 31, Year 1, the forecasted sale occurs.
For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
- The hedging relationship is perfectly effective.

**Journal entry – January 1, Year 1**

ABC records the following journal entries at January 1, Year 1.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Put option</td>
<td>442,000</td>
</tr>
<tr>
<td>Cash</td>
<td>442,000</td>
</tr>
</tbody>
</table>

*To record purchase of put option at fair value.*

There would also be a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship.

**Journal entries – March 31, Year 1**

ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Put option</td>
<td>49,000</td>
</tr>
<tr>
<td>OCI – Gains (losses) on cash flow hedging derivatives</td>
<td>49,000</td>
</tr>
</tbody>
</table>

*To record change in fair value of derivative for which hedge accounting is applied.*

**Journal entries – June 30, Year 1**

ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI – Gains (losses) on cash flow hedging derivatives</td>
<td>280,000</td>
</tr>
<tr>
<td>Put option</td>
<td>280,000</td>
</tr>
</tbody>
</table>

*To record change in fair value of derivative for which hedge accounting is applied.*

**Journal entries – September 30, Year 1**

ABC records the following journal entry.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Put option</td>
<td>50,000</td>
</tr>
<tr>
<td>OCI – Gains (losses) on cash flow hedging derivatives</td>
<td>50,000</td>
</tr>
</tbody>
</table>

*To record change in fair value of derivative for which hedge accounting is applied.*
Journal entries – December 31, Year 1

ABC records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>8,400,000</td>
</tr>
<tr>
<td>Sales revenue</td>
<td>8,400,000</td>
</tr>
</tbody>
</table>

*To record sale on credit.*

| Put option             | 339,000                 |
| OCI – Gains (losses) on cash flow hedging derivatives | 339,000 |

*To record change in fair value of derivative for which hedge accounting is applied.*

| Cash                   | 600,000                 |
| Put option             | 600,000                 |

*To record cash received from settlement of put option.*

| AOCI – Gains (losses) on cash flow hedging derivatives | 158,000 |
| Sales revenue          | 158,000                 |

*To reclassify net derivative gain from AOCI into earnings because hedged transaction (sale) affected earnings.*

Notes:
1. €10,000,000 sale price x €/$ spot rate of 0.84.
2. $600,000 settlement - purchase price $442,000.

Financial statement excerpts

At the end of each period, ABC’s financial statements reflect the following related to this hedging relationship.

<table>
<thead>
<tr>
<th>Account</th>
<th>3 months ended Mar 31</th>
<th>6 months ended Jun 30</th>
<th>9 months ended Sep 30</th>
<th>Year ended Dec 31</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet – assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Put option</td>
<td>$491,000</td>
<td>$211,000</td>
<td>$261,000</td>
<td></td>
</tr>
<tr>
<td><strong>Balance sheet – equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOCI – Gains (losses) on cash flow hedging derivatives</td>
<td>$49,000</td>
<td>$(231,000)</td>
<td>$(181,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales revenue</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$8,558,000</td>
</tr>
</tbody>
</table>
At December 31, Year 1, ABC records 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 €10,000,000 sale.

The difference between the functional currency equivalent value of $9,000,000 at the forecast date (€10,000,000 × $0.90 spot rate 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, ABC 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.

The put option was effective at hedging functional currency equivalent cash flows for a depreciation of the euro below $0.90. As a result of the hedge, ABC’s net effect on earnings attributable to changes in the foreign currency exchange rate during the forecasted period was the cost of the put option ($442,000) rather than the full effect of depreciation in the euro during the forecasted period ($600,000).

**Options with periodic (multiple) settlements**

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. [815-20-25-128]

As with other cash flow hedging relationships, the net derivative gain or loss that is reported in AOCI is reclassified into earnings when the hedged transaction affects earnings when the terminal value method is used. When the caplet method is used, 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.

As discussed in section 6.3.20, Topic 815 provides guidance for accounting for an initial non-zero fair value when a single derivative is used to hedge the variability in multiple cash flows or periodic settlements (e.g. purchased caps). In those situations, amounts in AOCI that are related to the initial fair value are required to be reclassified to earnings on a systematic and rational basis over the periods during which the hedged transactions affect earnings. One acceptable method for reclassification is the caplet method (see Question 6.3.50). [815-30-35-41A – 35-41B]
Example 9.7.30

Using the caplet method to reclassify amounts from AOCI into earnings

ABC Corp. documents a single interest rate cap as the hedging instrument in a hedge of the interest rate risk on variable-rate debt with quarterly interest payments over the next two years. ABC will use the terminal value method for assessing effectiveness and the conditions that will result in perfect effectiveness are met.

ABC allocates the fair value of the cap at the inception of the hedging relationship to the respective caplets within the single cap on a fair value basis at the inception of the hedging relationship. ABC reclassifies that original allocated fair value amount out of AOCI into earnings when each of the respective hedged 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.

See also Scenario 3 of Example 6.3.30.

9.7.30 Hypothetical derivative method

As mentioned in section 9.7.10, the hypothetical derivative method is used in practice for all types of cash flow hedges.

The following table summarizes the hypothetical derivative method.

| Conditions that will result in perfect effectiveness: [815-20-25-3(b)(2)(iv)(01)(F)] | — The critical terms of the hedging instrument match the related terms of the hedged transaction (that is, the terms of the actual hedging instrument and the perfectly effective hypothetical derivative are the same). |
| — The fair value of a PEH derivative (when the hedging instrument is a swap or a forward contract) is zero at hedge inception. |
| — See also Question 9.2.50 regarding whether subsequent assessments are performed on a qualitative or quantitative basis. |

| What is compared in assessing effectiveness: [815-30-35-25] | — The change in fair value of the actual hedging instrument. |
| — The change in fair value for a hypothetical derivative that would result in perfect offset (the PEH derivative). |

The PEH derivative instrument is one whose terms identically match the terms of the forecasted transaction. Therefore, the hypothetical derivative would be expected to perfectly offset the hedged cash flows. The change in the fair value of the PEH derivative can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction when assessing effectiveness.
The fair values of both the PEH interest rate swap and the actual interest rate swap should use discount rates based on the relevant interest rate swap curves, as appropriate. As discussed in Question 9.2.300, under the hypothetical derivative method, an entity is permitted to use the same credit risk adjustment that is used to determine the fair value of the derivative when calculating the change in the cash flows of the hedged transaction, as long it is probable that the counterparty to the derivative or the entity will not default. As a result, credit risk (or the entity’s own nonperformance risk) and changes therein do not affect hedge effectiveness. [815-30-35-29]

If the original terms of the forecasted transaction change during the hedge period, but the original transaction is still probable as described in the original hedge documentation, the terms of the PEH derivative are changed to perfectly offset the new terms of the transaction – i.e. the PEH derivative would be reset to the new terms of the transaction with a start date equal to the original date of the hedging relationship, and a fair value of zero if the hedging instrument is a swap or forward contract.

This method is relatively operational because entities are likely to be able to value cash flows that are identical to the variable-rate asset or liability being hedged without difficulty.

See also section 9.7.40 for discussion of applying the PEH derivative method when an interest rate swap is used in a cash flow hedge of variability in interest receipts or payments.

**Question 9.7.30**

*Can the hypothetical derivative method result in perfect effectiveness when the hedging instrument is not an interest rate swap and the hedged risk is not variability in interest receipts or payments?*

**Interpretive response:** Yes. Topic 815 only specifies that the hypothetical derivative method may result in perfect effectiveness when an interest rate swap is used in a cash flow hedge of variability in interest receipts or payments. However, we believe the same result will occur for all types of cash flow hedging relationships that use the hypothetical derivative method.

That is, when the critical terms of the actual hedging instrument match those of the perfectly effective hypothetical derivative, the hedging relationship will be perfectly effective.

In these situations, we believe the entity is not required to perform the actual calculation. This is because when the variables to be compared are identical, the results of the calculation are known with mathematical certainty without performing the full calculation (see Question 9.6.80).
How is the PEH derivative defined when a cross-currency interest rate swap is used to hedge intercompany fixed-rate debt in a cash flow hedge?

Interpretive response: There are unique considerations when applying the hypothetical derivative method for assessing effectiveness when a fixed-for-fixed cross-currency interest rate swap is used to hedge intercompany fixed-rate debt. This is because – under Topic 830 (foreign currency matters) – the intercompany interest is eliminated in consolidation while the effect of foreign currency exposure of the intercompany principal is not.

In a cash flow hedge of the foreign currency risk associated with foreign currency denominated (FCD) debt issued by a third party where the hedging instrument is a fixed-for-fixed cross-currency interest rate swap, the PEH derivative has a zero fair value at inception of the hedging relationship and the terms would match the terms of the hedged transactions.

However, judgment is required in defining the hypothetical derivative when the FCD debt is intercompany.

We believe there are two acceptable approaches that an entity may consider when determining the terms of the PEH derivative.

**Approach 1: Define the hedged risk as solely the foreign currency risk associated with the principal amount of the intercompany debt**

Under this approach, the PEH derivative would be defined as a forward contract that exactly matches the principal amount of the intercompany debt. In this situation, the foreign currency risk inherent in that principal amount is a risk that affects consolidated earnings during the life of the hedging relationship under Topic 830, even though the debt and the interest payments on that debt are eliminated in consolidation.

This approach does not include the foreign currency risk related to the interest payments on the intercompany debt because they are eliminated in consolidation. Accordingly, under Topic 830, foreign currency risk affects consolidated earnings only when interest payments are accrued but unpaid.

Under this approach, the relationship may not be highly effective due to the changes in fair value of the net coupon payments included in the hedging instrument (i.e. the fixed-for-fixed cross-currency interest rate swap) that would not be included in the hypothetical derivative.

**Approach 2: Define 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 PEH derivative is 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 situation, the foreign currency risk inherent in the principal amount is a risk that under 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 this approach is acceptable by analogy to paragraph 815-20-25-38(d) (reproduced in section 7.6.20). That paragraph 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. With the forecasted sale to or royalty from a foreign subsidiary, 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 amounts should be reclassified from AOCI into 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.

**FASB Example: Effectiveness of cash flow hedge of a forecasted purchase of inventory with a forward contract**

Excerpt from Subtopic 815-30

>> **Example 1: Effectiveness of Cash Flow Hedge of a Forecasted Purchase of Inventory with a Forward Contract**

55-1A This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to assessing effectiveness for a cash flow hedge of a forecasted purchase of inventory with a forward contract in which the forward contract index differs from the index of the underlying hedged transaction. Assume that the entity elected to perform subsequent quarterly hedge effectiveness assessments on a quantitative basis and that all hedge documentation requirements were satisfied at inception.

55-2 Entity G forecasts the purchase of 500,000 pounds of Brazilian coffee for U.S. dollars in 6 months. The agreement outlining purchase terms between Entity G and its supplier contains a **contractually specified component** referencing a Brazilian coffee index denominated in U.S. dollars. Entity G designates the variability in cash flows related to its forecasted purchase of Brazilian coffee attributable to changes in the contractually specified component (Brazilian coffee index) as the hedged risk. Rather than acquire a **derivative instrument** based on Brazilian coffee, Entity G enters into a 6-month forward contract to purchase 500,000 pounds of Colombian coffee for U.S. dollars and designates the forward contract as a hedging instrument in a cash flow hedge of the variability in cash flows attributable to changes in the contractually specified Brazilian coffee index component of its forecasted purchase of Brazilian coffee.
Entity G bases its assessment of hedge effectiveness on changes in forward prices, with the resulting gain or loss discounted to reflect the time value of money. Both at inception and on an ongoing basis, Entity G could assess the effectiveness of the hedge by comparing changes in the expected cash flows from the Colombian coffee forward contract with the expected net change in cash outflows attributable to changes in the contractually specified component for purchasing the Brazilian coffee for different market prices. (A simpler method that should produce the same results would consider the expected future correlation of the prices of Brazilian and Colombian coffee, based on the correlation of those prices over past six-month periods.)

In assessing hedge effectiveness on an ongoing basis, Entity G also must consider the extent of offset between the change in expected cash flows on its Colombian coffee forward contract and the expected net change in expected cash flows for the forecasted purchase of Brazilian coffee attributable to changes in the contractually specified component. Both changes would be measured on a cumulative basis for actual changes in the forward price of the respective coffees during the hedge period.

See Topic 820 (including paragraph 820-10-55-13) for a discussion of expected cash flow.

Because the only difference between the forward contract and forecasted purchase relates to the type of coffee (Colombian versus Brazilian), Entity G could consider the changes in the cash flows on a forward contract for Brazilian coffee to be a measure of perfectly offsetting changes in cash flows for its forecasted purchase of Brazilian coffee. For example, for given changes in the U.S. dollar prices of six-month and three-month Brazilian and Colombian contracts, Entity G could compute the effect of a change in the price of coffee on the expected cash flows of its forward contract on Colombian coffee and of a forward contract for Brazilian coffee as follows.

<table>
<thead>
<tr>
<th>Estimate of Change in Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Hedging Instrument:</strong> Forward Contract on Colombian Coffee</td>
</tr>
<tr>
<td>Forward price of Colombian and Brazilian coffee:</td>
</tr>
<tr>
<td>At hedge inception—6-month price</td>
</tr>
<tr>
<td>3 months later—3-month price</td>
</tr>
<tr>
<td>Cumulative change in price—gain</td>
</tr>
<tr>
<td>x 500,000 pounds of coffee</td>
</tr>
<tr>
<td>Estimate of change in cash flows</td>
</tr>
</tbody>
</table>

See Topic 820 (including paragraph 820-10-55-13) for a discussion of expected cash flows.

Using the amounts in paragraph 815-30-55-6, Entity G could evaluate effectiveness 3 months into the hedge on its first subsequent quarterly effectiveness assessment testing date by comparing the $45,000 change on
its Colombian coffee contract with what would have been a perfectly offsetting change in cash flow for its forecasted purchase—the $50,000 change on an otherwise identical forward contract for Brazilian coffee. Entity G concludes that the hedging relationship would be highly effective, and it would record the $45,000 change in the fair value of the forward contract on Colombian coffee in other comprehensive income.

9.7.40 Methods applicable when an interest rate swap is used in a cash flow hedge of variability in interest receipts or payments

Excerpt from ASC 815-30

>> Assessing Hedge Effectiveness in Certain Cash Flow Hedges Involving Interest Rate Risk When Effectiveness Is Assessed on a Quantitative Basis

35-10 This guidance addresses the following three methods of assessing effectiveness of certain cash flow hedges when hedge effectiveness is assessed on a quantitative basis in accordance with paragraphs 815-20-25-3(b)(2)(iv)(01) and 815-20-35-2 through 35-2F:

a. Change-in-variable-cash-flows method
b. Hypothetical-derivative method
c. Change-in-fair-value method

35-11 Those three methods relate to assessing the effectiveness of a cash flow hedge that involves any of the following:

a. A receive-variable, pay-fixed interest rate swap designated as a hedge of the variable interest payments on an existing floating-rate liability
b. A receive-fixed, pay-variable interest rate swap designated as a hedge of the variable interest receipts on an existing variable-rate asset
c. Cash flow hedges of the variability of future interest payments on interest-bearing assets to be acquired or interest-bearing liabilities to be incurred (such as the rollover of an entity’s short-term debt as described in Example 9 [see paragraph 815-30-55-52]).

35-12 The hedging relationships covered by this guidance encompass either of the following:

a. Hedges of interest rate risk (pursuant to paragraph 815-20-25-15(j)(2)) that do not qualify for the shortcut method
b. Hedges of the risk of overall changes in the hedged cash flows related to the asset or liability (pursuant to paragraph 815-20-25-15(j)(1)).

35-13 If, at the inception of the hedge, the fair value of the interest rate swap designated as the hedging instrument is zero or is somewhat near zero, any of the three methods in paragraph 815-30-35-10 may be applied to assess hedge effectiveness.

35-14 In contrast, if, at the inception of the hedge, the fair value of the interest rate swap is not somewhat near zero, the change-in-variable-cash-flows
method shall not be applied to assess hedge effectiveness because that method does not require entities to consider the interest element of the change in fair value of a hedging instrument that incorporates a financing element; instead, either the hypothetical-derivative method or the change-in-fair-value method shall be applied. Those latter two methods require entities to consider the interest element of the change in fair value of a hedging instrument that incorporates a financing element that is not somewhat near zero, such as if the interest rate swap has been structured to be significantly in the money at the inception of the hedging relationship.

35-15 Under all three methods, an entity shall consider the risk of default by counterparties that are obligors with respect to the hedging instrument (the interest rate swap) or hedged transaction, pursuant to the guidance in paragraphs 815-20-25-122 and 815-20-25-16(a), respectively. An underlying assumption in this guidance is that the likelihood of the obligor not defaulting is assessed as being probable.

35-15A When assessing hedge effectiveness using any of the three methods specified in paragraph 815-30-35-10, in addition to the guidance specific to each method, an entity also shall apply the general guidance in paragraph 815-20-25-79 on prospective considerations and retrospective evaluations of hedge effectiveness.

When a cash flow hedging relationship that involves an interest rate swap and variability in interest receipts or payments is not eligible for (or the entity does not elect) the shortcut method (see section 9.3), an entity is required to perform periodic assessments of effectiveness.

Topic 815 describes three methods that may be elected for certain of those hedging relationships, which are summarized in the following table. Alternatively, an entity may choose to use methods that have developed in practice, such as projecting cash flows based on forward price curves (see section 9.7.50). [815-30-35-10 – 35-14, 815-20-25-15(j)(1) – 25-15(j)(2)]

<table>
<thead>
<tr>
<th>Hedged risks</th>
<th>Hedged transactions</th>
<th>Methods for assessing effectiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate risk (see sections 2.3.20 and 5.4)</td>
<td>— An interest rate swap is used in a hedge of variable interest payments on an existing variable-rate asset or liability</td>
<td>Methods described in Topic 815:</td>
</tr>
<tr>
<td>— Contractually specified interest rate on existing variable-rate financial instruments or on forecasted issuances or purchases of variable-rate financial instruments</td>
<td>— A hedge of the variability of future interest payments on interest-bearing assets to be acquired or interest-bearing liabilities to be incurred such as the rollover of an entity’s short-term debt as described in Subtopic 815-30’s Example 9</td>
<td>— If the initial fair value is zero (or somewhat near zero):</td>
</tr>
<tr>
<td>— Benchmark interest rate on forecasted issuances or purchases of fixed-rate debt instruments</td>
<td></td>
<td>— Change-in-variable-cash-flows method</td>
</tr>
<tr>
<td></td>
<td></td>
<td>— Hypothetical derivative method</td>
</tr>
<tr>
<td></td>
<td></td>
<td>— Change-in-fair-value method</td>
</tr>
<tr>
<td></td>
<td></td>
<td>— If the initial fair value is not zero (or somewhat near zero):</td>
</tr>
</tbody>
</table>
Price risk – i.e. overall changes in the hedged cash flows (see section 2.3.70)

(reproduced in section 6.5.10)

These hedged transactions are referred to collectively in this section as ‘variability in interest receipts or payments’

— Hypothetical derivative method
— Change-in-fair-value method

Change-in-variable-cash-flows method

Excerpt from ASC 815-30

>>> Change-in-Variable-Cash-Flows Method

35-16 An entity shall assess hedge effectiveness under the change-in-variable-cash-flows method by comparing the following items:

a. The variable leg of the interest rate swap
b. The hedged variable-rate cash flows on the asset or liability.

35-17 As noted in paragraph 815-30-35-14, the change-in-variable-cash-flows method shall not be used in certain circumstances.

35-18 The change-in-variable-cash-flows method is consistent with the cash flow hedge objective of effectively offsetting the changes in the hedged cash flows attributable to the hedged risk. The method is based on the premise that only the floating-rate component of the interest rate swap provides the cash flow hedge, and any change in the interest rate swap’s fair value attributable to the fixed-rate leg is not relevant to the variability of the hedged interest payments (receipts) on the floating-rate liability (asset).

35-19 An entity shall assess hedge effectiveness under this method by comparing the following amounts:

a. The present value of the cumulative change in the expected future cash flows on the variable leg of the interest rate swap
b. The present value of the cumulative change in the expected future interest cash flows on the variable-rate asset or liability.

35-20 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 variable-rate asset or liability is based solely on changes in a variable-rate index, the present value of the cumulative changes in expected future cash flows on both the variable-rate leg of the interest rate swap and the variable-rate asset or liability shall be calculated using the discount rates applicable to determining the fair value of the interest rate swap.

35-22 The change-in-variable-cash-flows method will result in a perfectly effective hedge if all of the following conditions are met:

a. The variable-rate leg of the interest rate swap and the hedged variable cash flows of the asset or liability are based on the same interest rate index (for example, three-month London Interbank Offered Rate (LIBOR) swap rate).
b. The interest rate reset dates applicable to the variable-rate leg of the interest rate swap and to the hedged variable cash flows of the asset or liability are the same.

c. The hedging relationship does not contain any other basis differences (for example, if the variable leg of the interest rate swap contains a cap and the variable-rate asset or liability does not).

d. The likelihood of the obligor not defaulting is assessed as being probable.

However, a hedge would not be perfectly effective if any basis differences existed. For example, this would be expected to result from either of the following conditions, among others:

a. A difference in the indexes used to determine cash flows on the variable leg of the interest rate swap (for example, the three-month U.S. Treasury rate) and the hedged variable cash flows of the asset or liability (for example, three-month LIBOR)

b. A mismatch between the interest rate reset dates applicable to the variable leg of the interest rate swap and the hedged variable cash flows of the hedged asset or liability.

Example 15 (see paragraph 815-30-55-91) illustrates the application of the change-in-variable-cash-flows method.

The objective of a cash flow hedge is to offset the changes in the hedged cash flows related to the hedged risk. The change-in-variable-cash-flows method is most consistent with that objective. [815-30-35-18]

The following table summarizes the change-in-variable-cash-flows method.

<table>
<thead>
<tr>
<th>Conditions for applying this method: [815-30-35-14, 35-17]</th>
<th>This method may not be used if the fair value of the swap is not zero or somewhat near zero at inception of the hedge since this method does not require an entity to consider the interest element of the change in fair value of a hedging instrument that incorporates a financing element.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conditions that will result in perfect effectiveness: [815-30-35-22]</td>
<td>The variable-rate leg of the swap and the hedged variable cash flows of the asset or liability are based on the same interest rate index.</td>
</tr>
<tr>
<td></td>
<td>The interest rate reset dates that apply to the variable-rate leg of the swap and to the hedged variable cash flows of the asset or liability are the same.</td>
</tr>
<tr>
<td></td>
<td>The payment dates on the swap and hedged variable cash flows are the same.</td>
</tr>
<tr>
<td></td>
<td>The hedging relationship does not contain any other basis differences.</td>
</tr>
<tr>
<td></td>
<td>The likelihood of the obligor not defaulting is assessed as being probable.</td>
</tr>
<tr>
<td></td>
<td>See also Question 9.2.50 regarding whether subsequent assessments are performed on a qualitative or quantitative basis.</td>
</tr>
</tbody>
</table>
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What is compared in assessing effectiveness:

- The present value of the cumulative change in the expected future cash flows on the variable leg of the swap.
- The present value of the cumulative change in the expected future interest cash flows on the floating-rate asset or liability.

Note:

1. When determining the present values, the discount rates should be the rates that would be used to determine the fair value of the swap.

The theory behind this methodology is that the cash flow hedge is accomplished primarily through the variable leg of the interest rate swap. Therefore, the hedge’s effectiveness should not be affected by the change in fair value that is attributable to the fixed leg portion of the swap. Said differently, 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).

Perfect effectiveness will not result if any of the conditions specified in the table are not met. The following are examples.

- Any basis differences exist. For example, 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).
- There is 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.

**FASB Example: Change-in-variable-cash-flows method for assessing hedge effectiveness**

Excerpt from ASC 815-30

55-91 This Example demonstrates the application of the change-in-variable-cash-flows method discussed in paragraph 815-30-35-16 to assess hedge effectiveness.

55-92 An entity designates a receive-variable, pay-fixed interest rate swap with a zero fair value as a hedge of variable interest rate payments on a debt instrument. The variable leg of the interest rate swap is based on the three-month U.S. Treasury rate, and the variable cash flows of the debt are based on three-month LIBOR. Assume that the overall change in fair value of the interest rate swap from inception of the hedge is $16,300, the present value of the cumulative change in the cash flow on the variable leg of the interest rate
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 variable-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 interest rate swap and the variable-rate debt are discounted using the rates applicable to determining the fair value of the derivative instrument.)

55-93A The entity assesses effectiveness by comparing the present value of the cumulative change in the cash flow on the variable leg of the interest rate swap of $16,596 with the present value of the cumulative change in the expected future interest cash flows on the variable-rate liability of $16,396 and concludes that the hedging relationship is highly effective. As a result, the balance in accumulated other comprehensive income would reflect the cumulative change in the fair value of the swap since hedge inception ($16,300).

**Hypothetical derivative method**

Excerpt from ASC 815-30

>>> Hypothetical-Derivative Method

35-25 An entity shall assess hedge effectiveness under the hypothetical-derivative method by comparing the following amounts:

a. The change in fair value of the actual interest rate swap designated as the hedging instrument
b. The change in fair value of a hypothetical interest rate swap having terms that identically match the critical terms of the floating-rate asset or liability, including all of the following:
   1. The same **notional amount**
   2. The same repricing dates
   3. The same index (that is, the index on which the hypothetical interest rate swap’s variable rate is based matches the index on which the asset or liability’s variable rate is based)
   4. Mirror image caps and floors
   5. A zero fair value at the inception of the hedging relationship.

35-26 Essentially, the hypothetical derivative would need to satisfy all of the applicable conditions in paragraphs 815-20-25-104 and 815-20-25-106 necessary to qualify for use of the shortcut method except the criterion in paragraph 815-20-25-106(g) and the criterion in paragraph 815-20-25-104(e). Thus, the hypothetical interest rate swap would be expected to perfectly offset the hedged cash flows. Because the requirements of paragraph 815-20-25-104(e) were developed with an emphasis on fair value hedging relationships, they do not fit the more general principle that the hypothetical derivative in a cash flow hedging relationship should be expected to perfectly offset the hedged cash flows.
The change in the fair value of the perfect hypothetical interest rate swap can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction.

The determination of the fair value of both the perfect hypothetical interest rate swap and the actual interest rate swap shall use discount rates based on the relevant interest rate swap curves.

Section 9.7.30 describes the hypothetical derivative method.

To use the hypothetical derivative method in cash flow hedges of variability in interest receipts or payments, the terms of a PEH interest rate swap need to match the critical terms of the variable-rate asset or liability. Specifically, the following terms of the PEH swap need to identically match those of the hedged transaction: [815-30-35-25]

— 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 PEH derivative needs to satisfy all of the applicable conditions for the shortcut method (see section 9.3), except that the PEH is not required to include a mirror-image call or put option, as explained in Subtopic 815-20’s Example 7 (reproduced below). If these terms match, the PEH swap is expected to perfectly offset the hedged cash flows. As a result, the change in the fair value of the PEH swap can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction. [815-30-35-26 – 35-27]

As discussed in Question 9.2.300, under the hypothetical derivative method, an entity is permitted to use the same credit risk adjustment that is used to determine the fair value of the derivative when calculating the change in the cash flows of the hedged transaction, as long as it is probable that the counterparty to the derivative or the entity will not default. As a result, credit risk (or the entity’s own nonperformance risk) and changes therein do not affect hedge effectiveness. [815-30-35-29]

If the actual hedging instrument meets the above conditions (i.e. if all of the critical terms match), the hedging relationship will result in perfect effectiveness. [815-20-25-3(b)(2)[i][v](01)(F)]

Question 9.7.50

How is the PEH derivative defined when a deal contingent swap is used to hedge a forecasted debt issuance contingent on a business combination?

Background: As discussed in Question 2.5.60, we believe it could be acceptable to hedge the forecasted issuance of debt that is contingent on consummation of a business combination if the forecasted transaction does not directly affect the purchase price or the purchase accounting associated with
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the acquisition. An entity may wish to use a deal contingent forward-starting interest rate swap as the hedging instrument in such a relationship.

**Interpretive response:** When an entity hedges a forecasted debt issuance that is contingent on a business combination, we believe the PEH derivative is a forward-starting interest rate swap whose critical terms match those of the forecasted debt issuance and does not include a deal contingency.

Whether the entity will consummate a business combination is considered when determining whether the forecasted debt issuance is probable, which is a necessary condition for applying cash flow hedge accounting. Because the terms of the debt, once issued, will not be contingent on the business combination occurring, the PEH derivative should also not include a contingency related to consummation of the business combination.

If the actual derivative hedging instrument includes a deal contingency, the hedging relationship will not be perfectly effective because the deal contingency will be considered when measuring the expected cash flows of the actual derivative – but not when measuring the expected cash flows of the PEH derivative.

**Examples**

Following are examples that demonstrate the hypothetical derivative method when an interest rate swap is used to hedge variability in interest cash flows.

— PEH swap in a hedge of variable-rate debt that contains a floor (Example 9.7.40).
— Determination of the appropriate hypothetical derivative for variable-rate debt that is prepayable at par at each interest reset date (Subtopic 815-20’s Example 7).

**Example 9.7.40**

**PEH swap in a hedge of variable-rate debt that contains a floor**

ABC Corp. issues variable-rate debt that pays interest at the Prime rate (a contractually specified interest rate) plus a fixed credit spread. The debt agreement provides that the Prime rate can never be negative – i.e. it has a floor of zero. The floor was included in the debt agreement so that the lender receives a minimum amount of interest (i.e. the initial credit spread) and never has to make an interest payment to ABC.

ABC 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. ABC 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, ABC is precluded from using the shortcut method, and the hedging relationship will not have perfect offset. ABC documents that it will use the hypothetical derivative method to assess effectiveness.
The PEH swap incorporates terms that identically match the critical terms of the debt instrument and have an initial fair value of zero. The PEH swap will have the following differences from the actual hedging instrument.

— The PEH swap will incorporate a floor.
— As a result of the floor, the PEH swap will also likely have a different fixed leg than the actual swap so that the PEH swap will have an initial fair value of zero.

These differences from the actual swap are required to be considered when assessing whether the hedging relationship is highly effective.

It is not necessary for the Prime rate to actually decline below zero for this relationship to lack perfect offset. The mere potential for negative interest rates results in a lack of perfect offset because the probability of a negative benchmark rate is considered as part of determining the fair value of the PEH swap that contains the floor.

See also Example 6.2.20 for an example of accounting for a 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 transaction (i.e. variable-rate debt) does not.

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**Excerpt from ASC 815-20**

**>> Example 7: Determination of the Appropriate Hypothetical Derivative for Variable-Rate Debt That Is Prepayable at Par at Each Interest Reset Date**

55-106 This Example illustrates the application of paragraph 815-20-25-20.

55-107 Entity A issues variable-rate debt that is prepayable at par on each interest rate reset date. The credit sector spread on the debt issuance is not reset on the interest rate reset dates. Specifically, the debt bears interest at a rate of LIBOR plus 100 basis points, with LIBOR reset every quarter. Entity A also enters into a receive-variable, pay-fixed interest rate swap that is designated as a hedge of the variability in the debt interest payments due to changes in the contractually specified interest rate (LIBOR). During the term of the hedging relationship (that is, the specific term of the interest rate swap), Entity A expects to issue new variable-rate debt (in the event the original debt is repaid before maturity) to maintain an aggregate debt principal balance equal to or greater than the notional amount of the interest rate swap, and expects the new debt (if any) to share the key characteristics of the original debt issuance (specifically, quarterly repricing to the LIBOR index and no minimum, maximum, or periodic constraints of the debt interest rate). The hedging relationship meets all of the criteria for shortcut method accounting beginning in paragraph 815-20-25-102 except for the criterion in paragraph 815-20-25-104(e); the debt is prepayable and the interest rate swap does not contain a mirror-image call option to match the call option embedded in the debt instrument, as required by that paragraph.
Entity A wishes to apply the hypothetical derivative method (as described beginning in paragraph 815-30-35-25) for its initial and subsequent quantitative assessments of hedge effectiveness. Because the actual interest rate swap used in Entity A’s hedging relationship already meets all of the criteria in paragraph 815-20-25-102 except the criterion in paragraph 815-20-25-104(e), this guidance would seem to suggest that the hypothetical interest rate swap would need to be the same as the actual interest rate swap except that a mirror-image call option would need to be added to meet the criterion in that paragraph and the guidance beginning in paragraph 815-30-35-10. However, Entity A observes that because the hedged transactions are the variable interest payments (on debt with a principal amount equal to the notional amount of the swap) due to changes in the contractually specified interest rate (LIBOR), and because the transaction had to be probable of occurring under paragraph 815-20-25-15(b) for it to qualify for hedge accounting, the actual swap would be expected to perfectly offset the hedged cash flows.

In this fact pattern, the hypothetical interest rate swap under the guidance beginning paragraph 815-30-35-10 would be the same as the actual interest rate swap described in this Example. Because Entity A has concluded that if the original debt issuance is repaid before maturity, it is probable that a sufficient principal amount of variable-rate debt with key characteristics that match those of the original debt issuance (specifically quarterly repricing to the LIBOR index and no minimum, maximum, or periodic constraints of the debt interest rate) will be issued and remain outstanding during the term of the hedging relationship (providing exposure to LIBOR-interest-rate-based variable cash payments), the prepayment provisions of the debt instrument should not be considered in determining the appropriate hypothetical derivative under that guidance. The prepayment of the original variable-rate debt eliminates the contractual obligation to make those interest payments; however, this Subtopic permits replacing the hedged interest payments that are no longer contractually obligated to be paid without triggering the dedesignation of the original cash flow hedging relationship. Replacing the original debt issuance with a new variable-rate debt issuance is permissible in a cash flow hedge of interest rate risk and does not automatically result in the discontinuation of the original cash flow hedging relationship.

Although the entity can terminate the debt at any interest rate reset date for reasons that may be totally unrelated to changes in the contractually specified interest rate (which is the hedged risk), it expects to be at risk for variability in cash flows due to changes in the contractually specified interest rate in an amount based on debt principal equal to or greater than the notional amount of the swap during the specific term of the interest rate swap. Therefore, the prepayment feature of the debt is not relevant for purposes of determining the appropriate hypothetical swap under the guidance beginning in paragraph 815-30-35-10 as long as the relevant conditions to qualify for cash flow hedge accounting have been met with respect to the hedged transaction.
9.7.50 Project future cash flows using forward price curves or using recent sales or purchase orders

An entity may have the information available to use forward price curves to determine changes in the expected future cash flows of the hedged transaction. In these situations, that information can be used to estimate changes in expected future cash flows by performing the following steps.

— 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.
Hedging effectiveness

If the effectiveness technique requires a discounted value, discount those expected future cash flows. Because Topic 815 does not specify the rate to be used, an entity documents the discount rate it will use in its initial hedge documentation. See also section 9.2.110 regarding consideration of the time value of money for cash flow hedges.

The difference between the amount calculated above (either discounted or undiscounted, as appropriate) 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.

When hedging a forecasted sale or purchase of certain nonfinancial assets, an entity 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.

Example 9.7.50

**Projecting future cash flows using recent purchase orders**

On January 1, Year 1, ABC 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, ABC enters into a forward contract to sell 10,000 units for $95,000, which represents 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 ($5,000). This implies a current price for each widget on January 1, Year 1, of $10 ($100,000 ÷ 10,000).

On March 31, Year 1, ABC enters 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. ABC could base its estimate of the cumulative change in cash flows of the forecasted sale of 10,000 units using $1,000 (10,000 units × the difference between the original implied price of $10 less the current price of $9.90).

**9.8 Examples of effectiveness assessment methods relevant to various hedging instruments**

<table>
<thead>
<tr>
<th>Type of hedging relationship / Reference</th>
<th>Hedged item or transaction</th>
<th>Hedged risk</th>
<th>Method for assessing effectiveness</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate swaps (section 2.6.20)</td>
<td>Recognized interest-bearing asset or liability</td>
<td>Interest rate risk: Benchmark interest rate</td>
<td>Shortcut method (if certain criteria are met)</td>
<td>Assumes perfect effectiveness</td>
</tr>
<tr>
<td>Fair value (section 9.3)</td>
<td>Variability in interest receipts or payments on</td>
<td>Interest rate risk: Contractually</td>
<td>Shortcut method (if certain criteria are met)</td>
<td>Assumes perfect effectiveness</td>
</tr>
<tr>
<td>Cash flow (section 9.3)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hedging relationship / Reference</td>
<td>Hedged item or transaction</td>
<td>Hedged risk</td>
<td>Method for assessing effectiveness</td>
<td>Comments</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>-----------------------------</td>
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<td>----------</td>
</tr>
<tr>
<td><strong>Cash flow</strong> (section 9.7.40)</td>
<td>recognized interest-bearing asset or liability</td>
<td>specified interest rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cash flow</strong> (section 9.7.40)</td>
<td>Variability in interest receipts or payments</td>
<td>Interest rate risk or Overall changes in the hedged cash flows (i.e. price risk)</td>
<td>Change-in-variable-cash-flows method</td>
<td>If the initial fair value is not zero (or somewhat near zero), this method may not be used. If certain conditions are met, this method will result in perfect effectiveness</td>
</tr>
<tr>
<td><strong>Cash flow</strong> (section 9.7.40)</td>
<td>Variability in interest receipts or payments</td>
<td>Interest rate risk or Overall changes in the hedged cash flows (i.e. price risk)</td>
<td>Hypothetical derivative method</td>
<td>If certain conditions are met, this method will result in perfect effectiveness</td>
</tr>
<tr>
<td><strong>Cash flow</strong> (section 9.7.40)</td>
<td>Variability in interest receipts or payments</td>
<td>Interest rate risk or Overall changes in the hedged cash flows (i.e. price risk)</td>
<td>Change-in-fair-value method</td>
<td></td>
</tr>
<tr>
<td><strong>Fair value</strong> (sections 9.5 or 9.6)</td>
<td>Recognized interest-bearing asset or liability (or a firm commitment)</td>
<td>Interest rate risk: Benchmark interest rate</td>
<td>Other quantitative or qualitative method (if shortcut method is not appropriate or not selected)</td>
<td>Effectiveness may be assessed based on all contractual cash flows or on the benchmark interest rate component of contractual cash flows</td>
</tr>
<tr>
<td><strong>Cash flow</strong> (sections 9.5 or 9.6; 9.2.110)</td>
<td>Variability in interest receipts or payments</td>
<td>Interest rate risk or Overall changes in the hedged cash flows (i.e. price risk)</td>
<td>Quantitative method</td>
<td></td>
</tr>
<tr>
<td>Type of hedging relationship / Reference</td>
<td>Hedged item or transaction</td>
<td>Hedged risk</td>
<td>Method for assessing effectiveness</td>
<td>Comments</td>
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<tr>
<td>----------------------------------------</td>
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<td>--------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Other swaps (e.g. commodity, equity and foreign currency) (section 2.6.20)</td>
<td></td>
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</tr>
<tr>
<td><strong>Cash flow</strong> – cross-currency interest rate swap (section 9.4)</td>
<td>Fixed rate foreign currency denominated financial asset or liability</td>
<td>Foreign currency risk</td>
<td>Critical terms match</td>
<td>Assumes perfect effectiveness</td>
</tr>
<tr>
<td><strong>Net investment hedge</strong> – eligible cross-currency interest rate swap (section 8.4)</td>
<td>Net investment in a foreign operation</td>
<td>Foreign currency risk</td>
<td>Spot method, forward method, or qualitative method</td>
<td>If certain conditions are met, the spot or forward methods will result in perfect effectiveness</td>
</tr>
<tr>
<td><strong>Fair value or cash flow</strong> (sections 9.5 or 9.6)</td>
<td>Any eligible hedged item or transaction</td>
<td>Any eligible risk</td>
<td>Other quantitative or qualitative method</td>
<td></td>
</tr>
<tr>
<td><strong>Forwards /futures contracts</strong> (section 2.6.20)</td>
<td></td>
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</tr>
<tr>
<td><strong>Cash flow</strong> (section 9.4)</td>
<td>Any eligible forecasted transaction</td>
<td>Any eligible risk</td>
<td>Critical terms match</td>
<td>Assumes perfect effectiveness</td>
</tr>
<tr>
<td><strong>Net investment hedge</strong> (section 8.4)</td>
<td>Net investment in a foreign operation</td>
<td>Foreign currency risk</td>
<td>Spot method, forward method, or qualitative method</td>
<td>If certain conditions are met, the spot or forward methods will result in perfect effectiveness</td>
</tr>
<tr>
<td><strong>Fair value or cash flow</strong> (sections 9.5 or 9.6; 9.2.110)</td>
<td>Any eligible hedged item or transaction</td>
<td>Any eligible risk</td>
<td>Other quantitative or qualitative method</td>
<td></td>
</tr>
<tr>
<td><strong>Options, combinations of options, or combination of an option contract with a non-option derivative</strong> (for written options, section 2.7.50; for combinations of options, section 2.7.60)</td>
<td></td>
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</tr>
<tr>
<td><strong>Cash flow</strong> (section 9.7.20)</td>
<td>Any eligible hedged transaction</td>
<td>Any eligible risk</td>
<td>Terminal value method</td>
<td>If certain conditions are met, this method will result in perfect effectiveness</td>
</tr>
<tr>
<td><strong>Cash flow</strong> (section 9.4)</td>
<td>Any eligible hedged transaction</td>
<td>Any eligible risk</td>
<td>Critical terms match</td>
<td>Assumes perfect effectiveness</td>
</tr>
<tr>
<td><strong>Fair value or cash flow</strong> (sections 9.5 or 9.6; 9.2.90; 9.2.110)</td>
<td>Any eligible hedged item or transaction</td>
<td>Any eligible risk</td>
<td>Other quantitative or qualitative method</td>
<td></td>
</tr>
</tbody>
</table>
### Type of hedging relationship / Reference

<table>
<thead>
<tr>
<th>Hedging item or transaction</th>
<th>Hedged risk</th>
<th>Method for assessing effectiveness</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net investment hedge (section 8.4)</td>
<td>Net investment in a foreign operation</td>
<td>Foreign currency risk</td>
<td>Spot method, forward method, or qualitative method</td>
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### 9.9 Comparison of methods for assessing effectiveness

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<th>Shortcut method (section 9.3)</th>
<th>Critical terms match method (section 9.4)</th>
<th>Simplified hedge accounting approach (section 10.2)</th>
<th>Subsequent qualitative assessment approach (sections 8.4 and 9.5)</th>
<th>Quantitative methods (sections 8.4 and 9.6)</th>
</tr>
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<td>Types of hedging relationships</td>
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<tr>
<td>Fair value or cash flow</td>
<td>Cash flow</td>
<td>Cash flow</td>
<td>Fair value, cash flow or net investment hedges</td>
<td>Fair value, cash flow or net investment hedges</td>
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<table>
<thead>
<tr>
<th>Initial effectiveness assessment</th>
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<tbody>
<tr>
<td>Quantitative testing not required.</td>
<td>Quantitative testing not required.</td>
<td>Quantitative testing not required.</td>
<td>Quantitative testing required.</td>
<td>Quantitative testing required.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Nature of subsequent effectiveness assessments</th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>If the shortcut method requirements are met, the entity evaluates whether the credit risk of the counterparty to the derivative or its own nonperformance risk has changed such that it is no longer probable that the counterparty or it will not default. If neither party’s credit risk has changed in this manner, no further assessment of whether:</td>
<td>Assessment of whether:</td>
<td>If the simplified hedge accounting requirements are met, the entity evaluates whether the credit risk of the counterparty to the derivative or its own nonperformance risk has changed such that it is no longer probable that the counterparty or it will not default. If neither party’s credit risk has changed in this manner, no further qualitative assessment that consider whether facts and circumstances have changed such that the entity cannot assert qualitatively that the hedging relationship was and continues to be highly effective. This is an assessment requiring the entity to apply more judgment than the critical</td>
<td>Qualitative assessments</td>
<td>Quantitative.</td>
</tr>
<tr>
<td>— the critical terms match</td>
<td>— there has been an adverse development regarding counterparty credit risk or the entity’s own nonperformance risk for the hedging instrument (see section 9.2.60)</td>
<td>— there has been an adverse development regarding credit risk of</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shortcut method (section 9.3)</td>
<td>Critical terms match method (section 9.4)</td>
<td>Simplified hedge accounting approach (section 10.2)</td>
<td>Subsequent qualitative assessment approach (sections 8.4 and 9.5)</td>
<td>Quantitative methods (sections 8.4 and 9.6)</td>
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<td>-------------------------------</td>
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</tr>
<tr>
<td>assessment is required.</td>
<td>the counterparty to the hedged transaction (see section 9.2.60)</td>
<td>manner, no further assessment is required.</td>
<td>terms match method.</td>
<td></td>
</tr>
</tbody>
</table>

**Timing of selection of quantitative method to be used if the respective approach is no longer appropriate**

| Made at hedge designation, if elected. | Made at the time the critical terms change that cause this method to no longer be appropriate. | Not applicable. If this approach is no longer appropriate, the hedging relationship is discontinued. | Required to be made at hedge designation. | Not applicable. |

**Ability to revert to the approach after having to test quantitatively**


**Ability to deem settlement dates of hedged transactions and the hedging instrument as being the same**

| No. | Yes. Settlement dates of a group of hedged transactions and the hedging instrument may be deemed the same if they occur within the same 31-day period (or fiscal month). | Yes. The repricing and settlement dates for the interest rate swap and the borrowing are deemed the same if they differ by no more than a few days. | No. | Terminal value method (see section 9.7.20): Settlement dates of a group of hedged transactions and the hedging instrument may be deemed the same if they occur within the same 31-day period (or fiscal month). Other methods: No. |

**Note:**

1. We believe the critical terms match method is precluded for fair value hedging relationships in the vast majority of circumstances (see section 9.4.20).
10. Private companies

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10.1 How the standard works

Although hedge accounting can be an effective way to mitigate income statement volatility from reporting derivative instruments at fair value, many private companies historically have found the hedging requirements under the general hedge accounting guidance to be onerous. It may be difficult for smaller, less sophisticated companies to apply hedge accounting due to a lack of resources, the extensive documentation requirements, the timing of those documentation requirements, and required quarterly hedge effectiveness testing.

The FASB’s outreach revealed that private companies often enter into receive-variable, pay-fixed interest rate swaps to economically convert their variable-rate borrowings into fixed-rate borrowings. While these interest rate swaps are derivative instruments that are recorded at fair value on the balance sheet, hedge accounting is often not applied and users of the financial statements often see volatility in earnings.

To provide relief to private companies seeking to meet hedge accounting requirements, the FASB developed a simplified hedge accounting approach for private companies’ qualifying cash flow hedging relationships, as well as relief in documentation requirements for private companies not adopting the simplified hedge accounting approach and certain not-for-profit entities.

While the simplified hedge accounting approach may be beneficial in that it makes it easier for private companies to apply hedge accounting, it is not as beneficial for private companies that intend to become public business entities. Private company accounting cannot be applied in filings with the SEC (see Question 10.2.40 for further information).

In addition, there is additional relief in relation to the formal documentation and the timing of hedge effectiveness assessments for private companies where the simplified hedge accounting model is not applied. The additional time granted to eligible private companies more closely aligns with these entities’ reporting cycles and is consistent with the FASB’s efforts to make hedge accounting more operational. See section 10.3.
10.2 Simplified hedge accounting approach

Excerpt from ASC 815-20

> Hedge Accounting Provisions Applicable to Certain Private Companies

>> Assuming Perfect Hedge Effectiveness in a Cash Flow Hedge of a Variable-Rate Borrowing with a Receive-Variable, Pay-Fixed Interest Rate Swap Recorded under the Simplified Hedge Accounting Approach


25-134 The conditions for the simplified hedge accounting approach determine which cash flow hedging relationships qualify for a simplified version of hedge accounting. If all of the conditions in paragraphs 815-20-25-135 and 815-20-25-137 are met, an entity may assume perfect effectiveness in a cash flow hedging relationship involving a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap.

25-135 Provided all of the conditions in paragraph 815-20-25-137 are met, the simplified hedge accounting approach may be applied by a private company except for a financial institution as described in paragraph 942-320-50-1. An entity may elect the simplified hedge accounting approach for any receive-variable, pay-fixed interest rate swap, provided that all of the conditions for applying the simplified hedge accounting approach specified in paragraph 815-20-25-137 are met. Implementation guidance on the conditions set forth in paragraph 815-20-25-137 is provided in paragraphs 815-20-55-79A through 55-79B.

25-136 In applying the simplified hedge accounting approach, the documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed by the date on which the first annual financial statements are available to be issued after hedge inception rather than concurrently at hedge inception.

25-137 An eligible entity under paragraph 815-20-25-135 must meet all of the following conditions to apply the simplified hedge accounting approach to a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap:

a. Both the variable rate on the swap and the borrowing are based on the same index and reset period (for example, both the swap and borrowing are based on one-month London Interbank Offered Rate [LIBOR] or both the swap and borrowing are based on three-month LIBOR).

b. The terms of the swap are typical (in other words, the swap is what is generally considered to be a “plain-vanilla” swap), 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 derivative was executed to hedge the interest rate risk of the borrowing) is at or near zero.

e. The notional amount of the swap matches the principal amount of the borrowing 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 occurring on the borrowing during the term of the swap (or the effective term of the swap underlying the forward starting swap) are designated as hedged whether in total or in proportion to the principal amount of the borrowing being hedged.

>>> Simplified Hedge Accounting Approach

55-79A In complying with the condition in paragraph 815-20-25-137(b), comparable does not necessarily mean equal. For example, if the swap’s variable rate is the London Interbank Offered Rate (LIBOR) and the borrowing’s variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the borrowing.

55-79B For a forward-starting swap, only the effective term of the receive-variable, pay-fixed interest rate swap (that is, from its effective date through its expiration date) shall be considered in complying with the condition in paragraph 815-20-25-137(f). The period from the swap’s inception to the date the swap is effective shall not be considered in complying with the condition in paragraph 815-20-25-137(f) because the effective date of a forward-starting swap occurs after the swap’s inception. For example, a forward-starting receive-variable, pay-fixed, interest rate swap with a five-year effective term and an effective date commencing one year after the swap’s inception would meet the condition in paragraph 815-20-25-137(f) if designated as a hedge of a five-year, variable-rate borrowing forecasted to be entered into one year after the swap’s inception.

20 Glossary

Private Company – An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.

10.2.10 Overview

Topic 815 provides a simplified hedge accounting approach to account for interest rate swaps that are used to hedge the variability in cash flows of variable-rate borrowings. If the criteria to apply the simplified hedge accounting approach are met (see section 10.2.20), a private company:

| Hedge effectiveness | — may assume perfect hedge effectiveness for the qualifying cash flow hedging relationships; [815-20-25-134] |
| Hedge documentation   | — is exempt from quarterly hedge effectiveness testing because perfect effectiveness is assumed; [815-20-25-134] |
|                      | — has additional time to prepare the required hedge documentation (see section 10.2.50); and [815-20-25-136] |
Hedging Instrument — is allowed to measure the interest rate swap designated in the cash flow hedging relationship at settlement value instead of fair value (see section 10.2.30). [815-10:35-1A]

Question 10.2.10
What types of entities can apply the simplified hedge accounting approach?

Interpretive response: The simplified hedge accounting approach can be used by any private company other than a financial institution. A private company is any entity that is not a public business entity, a not-for-profit entity or an employee benefit plan. A financial institution is a bank, savings and loan association, savings bank, credit union, finance company or insurance entity. [815-20:25-135, 815-20 Glossary, 942-320-50-1]

Financial institutions were excluded from the simplified hedge accounting approach because they generally have greater exposure to financial instruments and typically have quarterly reporting requirements. [ASU 2017-12:BC184]

Question 10.2.20
Do all interest rate swaps qualify for simplified hedge accounting?

Interpretive response: No. Only a receive-variable, pay-fixed interest rate swap that is designated in a cash flow hedge of a variable-rate borrowing, or a forward-starting receive-variable, pay-fixed interest rate swap, qualifies for simplified hedge accounting. To qualify for simplified hedge accounting, the interest rate swap needs to meet the conditions specified in paragraph 815-20-25-137 (see section 10.2.20). [815-20-25-134, 25-138]

Question 10.2.30
Does simplified hedge accounting have to be applied to all eligible swaps?

Interpretive response: No. An eligible private company can elect to apply the approach on a swap-by-swap basis, provided that all of the conditions of applying simplified hedge accounting are met for each individual swap. [ASU 2014-03:BC20]

If simplified hedge accounting is not elected, an eligible private company wishing to apply hedge accounting may avail itself of the documentation relief applicable to private companies (see section 10.3) or follow the general hedge accounting guidance (see chapter 2).
**Question 10.2.40**

Why might a private company choose not to use simplified hedge accounting?

**Interpretive response:** There are two common reasons why a private company may decide not to apply simplified hedge accounting.

**Entity may not qualify throughout the hedging relationship’s life**

Before it adopts simplified hedge accounting, a private company may want to consider if it will be eligible to apply the simplified approach throughout the life of the hedging relationship. There may be costs due to the time and effort associated with discontinuing simplified hedge accounting and redesignating a new hedging relationship to apply the general hedge accounting guidance.

For example, a private company that becomes a public business entity will no longer be eligible for simplified hedge accounting for existing hedges or discontinued hedges that are included in the financial statements. In these circumstances, the entity will be required to retrospectively adjust its financial statements to remove the effects of the private company accounting guidance, including the accounting effects under simplified hedge accounting (see section 10.2.40). The entity will not be allowed to adopt the general hedge accounting guidance from inception of the hedge, because the contemporaneous documentation requirement and the additional qualifying criteria will not have been met (see section 2.9).

**Entity’s financial statements are incorporated into the financial statements of an SEC registrant**

A private company’s financial statements that are incorporated into a public parent entity’s financial statements, as filed with the SEC, cannot incorporate simplified hedge accounting.

This means that the private company could adopt simplified hedge accounting for its stand-alone reporting, but not for consolidation by the public parent entity. If the entity wanted to apply hedge accounting at the consolidated level, it would have to comply with the general hedge accounting guidance.

**Question 10.2.50**

What are the ongoing requirements when applying simplified hedge accounting?

**Interpretive response:** A private company that adopts simplified hedge accounting is exempt from quarterly hedge effectiveness testing. However, a private company should periodically verify that the criteria to apply simplified hedge accounting are still met.

If the interest rate swap is a forward-starting swap, the company should periodically reassess if the interest payments are still probable. If any of the conditions to apply simplified hedge accounting subsequently cease to be met,
10.2.20 Simplified hedge accounting criteria

The following conditions must be met before an entity applies simplified hedge accounting. [815-20-25-137]

<table>
<thead>
<tr>
<th>Hedged transaction</th>
<th>Hedging instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable-rate borrowing</td>
<td>Plain vanilla interest rate swap (receive-variable, pay-fixed)</td>
</tr>
</tbody>
</table>

— Swap and borrowing are based on the same index and reset period;
— The terms of the swap are typical and considered ‘plain vanilla’ (including forward starting swaps, see Question 10.2.70);
— Repricing and settlement dates match or differ by no more than a few days (see Question 10.2.90);
— Swap’s fair value at inception is at or near zero;
— Notional amount of the swap is equal to or less than the principal amount of the borrowing; and
— All interest payments on the borrowing during the term of the swap are designated as hedged.

Simplified hedge accounting approach

Note:
1. This would include borrowings where the borrower has an option to select the interest rate index (you pick ‘em debt) 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.

Question 10.2.60
Can the hedged risk be a nonbenchmark interest rate risk?

Interpretive response: Yes. Although interest rate swaps are commonly based on benchmark interest rates, simplified hedge accounting is not limited to hedges of benchmark interest rates. Therefore, simplified hedge accounting may be applied to borrowings that are not based on a benchmark interest rate (e.g. prime rate) as long as all the conditions are met. In other words, both the variable rate on the swap and the borrowing must be based on the same index.
Question 10.2.70

What qualifies as a plain vanilla swap to be eligible for simplified hedge accounting?

Interpretive response: The term ‘plain vanilla’ swap is not defined under US GAAP; therefore, judgment is required to determine what types of swaps are plain vanilla.

The FASB deliberated whether swaps other than plain vanilla swaps should be allowed to be designated under simplified hedge accounting. It decided to limit simplified hedge accounting to a narrow set of circumstances such that the approach addresses the prevalent practice issue of a private company entering into a plain vanilla receive-variable, pay-fixed interest rate swap for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing.

As such, the FASB observed that using of other than plain vanilla swaps may reflect more sophisticated structured financing arrangements that would not provide the sufficiently narrow set of circumstances to apply simplified hedge accounting. [ASU 2014-03.BC9]

The FASB acknowledged that forward-starting interest rate swaps may qualify if the occurrence of the hedged forecasted interest payments to be swapped is probable and the required conditions to apply simplified hedge accounting are met (see below, Forward-starting interest rate swaps). [ASU 2014-03.BC12]

Question 10.2.80

Can an entity hedge borrowings with embedded interest rate caps or floors under simplified hedge accounting?

Interpretive response: Yes. Borrowings with embedded interest rate caps or floors may qualify for simplified hedge accounting if there is a comparable feature in the swap. Topic 815 indicates that comparable does not necessarily mean equal. For example, if the swap’s variable rate is the LIBOR and the borrowing’s variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap is comparable to a 12 percent cap on the borrowing. [815-20-55-79A, ASU 2014-03.BC11]
Question 10.2.90

How should an entity evaluate the difference between the repricing and settlement dates of the debt and the interest rate swap?

Interpretive response: Paragraph 815-20-25-137 indicates that the repricing and settlement date of the swap and borrowing may differ by a few days but does not provide additional guidance. The FASB observed that 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. [ASU 2014-03.BC15]

Forward-starting interest rate swaps

Excerpt from ASC 815-20

> Hedge Accounting Provisions Applicable to Certain Private Companies

>> Assuming Perfect Hedge Effectiveness in a Cash Flow Hedge of a Variable-Rate Borrowing with a Receive-Variable, Pay-Fixed Interest Rate Swap Recorded under the Simplified Hedge Accounting Approach

25-138 A cash flow hedge established through the use of a forward starting receive-variable, pay-fixed interest rate swap may be permitted in applying the simplified hedge accounting approach only if the occurrence of forecasted interest payments to be swapped is probable. When forecasted interest payments are no longer probable of occurring, a cash flow hedging relationship will no longer qualify for the simplified hedge accounting approach and the General Subsections of this Topic shall apply at the date of change and on a prospective basis.

20 Glossary

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.

A forward-starting receive-variable, pay-fixed interest rate swap is an interest rate swap with settlements that will begin at a later date. They can be used to hedge interest payments associated with obligations that are expected to arise in the future. For example, if an entity intends to obtain a construction loan in two years, it could enter into a forward-starting interest rate swap with settlements that begin at the time the construction loan is expected to be entered into.

As the hedge is of future interest payments on a borrowing that is expected to be issued at a future date, the entity has to demonstrate that the future interest payments are probable. Probability is assessed at the same threshold level as required for non-private companies as explained in section 5.3.40. If the interest
When applying the simplified hedge accounting approach, a private company may elect to measure the interest rate swap at settlement value instead of at fair value. However, any amounts disclosed at settlement value need to be clearly stated as such and disclosed separately from amounts disclosed at fair value. [815-10-35-1A, 50-3]
Interpretive response: The primary difference between settlement value and fair value is that nonperformance risk is not considered in measuring settlement value. [815-10-35-1B]

A private company may elect to record the settlement value of the swap on the financial statements and in the required disclosures instead of recording the fair value of the swap. If a company elects to use the settlement value, it should be clearly stated.

Although a private company may choose to measure an interest rate swap at settlement value under simplified hedge accounting, the FASB noted that the guidance in Topic 815 requiring the consideration of counterparty credit risk still applies. To initially and subsequently qualify for simplified hedge accounting, a private company is required to satisfy the requirements of Topic 815 regarding the consideration of counterparty credit risk and the possibility of default by the counterparty to a hedging derivative. [ASU 2014-03.BC17, BC25]

If the likelihood that the counterparty to a hedging derivative will not default ceases to be probable, a private company will be unable to conclude that the cash flow hedging relationship is highly effective in offsetting cash flows. For further discussion on assessing counterparty credit risk when qualifying for cash flow hedge accounting, see section 9.2.60. [815-20-25-122, 35-14 – 35-15]

10.2.40 Discontinuation of simplified hedge accounting

Excerpt from ASC 815-10

35-1C If any of the conditions in paragraph 815-20-25-131D for applying the simplified hedge accounting approach subsequently cease to be met or the relationship otherwise ceases to qualify for hedge accounting, the General Subsections of this Topic shall apply at the date of change and on a prospective basis. For example, if the related variable-rate borrowing is prepaid without terminating the receive-variable, pay-fixed interest rate swap, the gain or loss on the swap in accumulated other comprehensive income shall be reclassified to earnings in accordance with paragraphs 815-30-40-1 through 40-6 with the swap measured at fair value on the date of change and subsequent changes in fair value reported in earnings in accordance with paragraph 815-10-35-2. Similarly, if the receive-variable, pay-fixed interest rate swap is terminated early without the related variable-rate borrowing being prepaid, the gain or loss on the swap in accumulated other comprehensive income shall be reclassified to earnings in accordance with paragraphs 815-30-40-1 through 40-6.

If the criteria to qualify for simplified hedge accounting cease to be met, a private company may no longer apply the approach. For example, a simplified
hedge accounting relationship involving a forecasted borrowing should be discontinued if the forecasted borrowing is no longer probable.

The subsequent accounting for the gains/losses on the interest rate swap depends on the reason for discontinuing the hedging relationship. For example, if it is probable that the forecasted borrowing will not occur, the gain/loss on the interest rate swap previously recognized in AOCI is reclassified into earnings immediately. [815-30-40-5]

The following diagram depicts scenarios in which simplified hedge accounting is discontinued and the related accounting effect.

For a discussion of the subsequent accounting for discontinued hedges when the hedged transactions are still probable, see section 6.5.

**Redesignation.** A private company that no longer meets the conditions to apply the simplified hedge accounting approach may choose to redesignate the interest rate swap in a new hedging relationship under the general hedge accounting guidance if the hedge qualifying criteria are met (see section 2.10.70).

**Question 10.2.110**

Can an entity voluntarily change from simplified hedge accounting to general hedge accounting?

**Interpretive response:** Yes, but the entity will have to redesignate the hedging relationship and redesignate the hedging relationship taking into account the general hedge accounting requirements (see section 2.10.70). However, the
swap may no longer have a zero fair value, which will impact the effectiveness assessment of the hedging relationship under the general hedge accounting guidance (see Question 2.10.120).

When an entity discontinues the simplified hedge accounting approach, the interest rate swap is measured at fair value on the date of the discontinuance and the difference between the fair value and settlement value is recognized in AOCI. [815-10-35-1C]

In addition, as discussed above, the entity has to consider the timing of reclassification of amounts recognized in AOCI related to the dedesignated hedging relationship.

### 10.2.50 Timing and extent of documentation

While the general hedge designation requirements in paragraph 815-20-25-3 apply to simplified hedge accounting (see chapter 2), the simplified approach extends the length of time a private company has to document its hedging relationship.

<table>
<thead>
<tr>
<th>Element of hedge documentation</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>All hedge designation documentation.</td>
<td>By the date on which the first annual financial statements are available to be issued after hedge inception. [815-20-25-138]</td>
</tr>
</tbody>
</table>

The hedge documentation, including assessment of the qualifying criteria for the simplified hedge accounting approach, should be completed with information applicable at inception of the hedge.

### 10.3 Additional relief for private companies when simplified hedge accounting is not applied

**Excerpt from ASC 815-20**

>> Timing of Hedge Documentation for Certain Private Companies If Simplified Hedge Accounting Approach Is Not Applied

>>> Concurrent Hedge Documentation

25-139 Concurrent with hedge inception, a **private company** that is not a financial institution as described in paragraph 942-320-50-1 shall document the following:

a. The hedging relationship in accordance with paragraph 815-20-25-3(b)(1)

b. The hedging instrument in accordance with paragraph 815-20-25-3(b)(2)(i)
c. The hedged item in accordance with paragraph 815-20-25-3(b)(2)(ii), including (if applicable) firm commitments or forecasted transactions in paragraph 815-20-25-3(c) or (d).

d. The nature of the risk being hedged in accordance with paragraph 815-20-25-3(b)(2)(iii).

25-140 A private company that is not a financial institution is not required to perform or document the following items concurrent with hedge inception but rather is required to perform or document them within the time periods discussed in paragraph 815-20-25-142:

a. The method of assessing hedge effectiveness at inception and on an ongoing basis in accordance with paragraph 815-20-25-3(b)(2)(iv) and (vi).

b. Initial hedge effectiveness assessments in accordance with paragraph 815-20-25-3(b)(2)(iv)(01) through (04).

25-141 Example 1A beginning in paragraph 815-20-55-80A illustrates hedge documentation when the critical terms of the hedging instrument and hedged forecasted transaction match. Although that Example illustrates the documentation of the method of assessing hedge effectiveness, private companies that are not financial institutions may complete hedge documentation requirements in accordance with paragraphs 815-20-25-139 through 25-140.

>>> Hedge Effectiveness Assessments

25-142 For a private company that is not a financial institution, the performance and documentation of the items listed in paragraph 815-20-25-140, as well as required subsequent quarterly hedge effectiveness assessments, may be completed before the date on which the next interim (if applicable) or annual financial statements are available to be issued. Even though the completion of the initial and ongoing assessments of effectiveness may be deferred to the date on which financial statements are available to be issued the assessments shall be completed using information applicable as of hedge inception and each subsequent quarterly assessment date when completing this documentation on a deferred basis. Therefore, the assessment should be performed to determine whether the hedge was highly effective at achieving offsetting changes in fair values or cash flows at inception and in each subsequent quarterly assessment period up to the reporting date.

> Hedge Accounting Provisions Applicable to Certain Not-for-Profit Entities

25-143 Not-for-profit entities (except for not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market) may apply the guidance on the timing of hedge documentation in paragraphs 815-20-25-139 through 25-142. Specifically, those entities shall document the items listed in paragraph 815-20-25-139 concurrent with hedge inception, but they may perform and document the items listed in paragraph 815-20-25-140 within the time periods discussed in paragraph 815-20-25-140.
10.3.10 Overview

If a private company does not elect simplified hedge accounting for its cash flow hedging relationships of interest rate risk, it may still take advantage of the following relief for such hedging relationships, as well as other hedging relationships:

<table>
<thead>
<tr>
<th>Hedge documentation</th>
<th>— relaxed timing of documentation requirements (see section 10.3.20); and</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedge effectiveness</td>
<td>— relaxed timing of initial and subsequent quarterly hedge effectiveness assessments (see section 10.3.30).</td>
</tr>
</tbody>
</table>

These relaxed requirements are also available to certain not-for-profit entities. Although the FASB granted additional time to prepare or perform certain hedge documentation and effectiveness assessments, they decided to continue requiring these entities to document certain elements of the hedging relationship at inception. This is because the FASB concluded that sound risk management practices support such information being considered and documented concurrently with derivative execution, and also to prevent retroactive designation (or dedesignation) of hedging relationships to achieve desired outcomes. [ASU 2017-12.BC179, BC186]

Question 10.3.10

Which private companies and not-for-profit entities may take advantage of the timing relief?

Interpretive response: The following types of private companies and not-for-profit entities may take advantage of the relaxed timing requirements discussed in sections 10.3.20 and 10.3.30:

— private companies that are not financial institutions, as that term is described in paragraph 942-320-50-1. A private company is an entity other than a public business entity, a not-for-profit entity or an employee benefit plan in the scope of Topics 960 through 965 on plan accounting. [815-20-25-139 – 25-140, 815-20 Glossary]

— not-for-profit entities other than those that have issued (or are a conduit bond obligor for) securities that are traded, listed or quoted on an exchange or an over-the-counter market. [815-20-25-143]

For a discussion of the timing of documentation for a private company that elects simplified hedge accounting, see section 10.2.50.

10.3.20 Documentation requirements

The documentation requirements for a private company not electing to apply simplified hedge accounting are the same as for an entity applying the general hedge accounting guidance. However, the timing of the preparation of
documentation is relaxed. This relaxed timing is also available to certain not-for-profit entities (see Question 10.3.10).

The following table summarizes the required timing of the elements of initial hedge documentation, including initial hedge effectiveness assessment.

<table>
<thead>
<tr>
<th>Element of hedge documentation</th>
<th>Certain private companies and certain not-for-profit entities (not applying simplified hedge accounting)</th>
<th>Entities applying general hedge accounting guidance (section 2.9)</th>
</tr>
</thead>
<tbody>
<tr>
<td>— The hedging relationship</td>
<td></td>
<td></td>
</tr>
<tr>
<td>— The hedging instrument</td>
<td></td>
<td></td>
</tr>
<tr>
<td>— The hedged item or transaction</td>
<td></td>
<td></td>
</tr>
<tr>
<td>— The nature of the risk being hedged</td>
<td></td>
<td></td>
</tr>
<tr>
<td>— Documentation applicable to fair value hedges only</td>
<td></td>
<td></td>
</tr>
<tr>
<td>— Documentation applicable to cash flow hedges only</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[815-20-25-3(b)(1) – 25-3(b)(2)(iii), 25-3(c) – 25-3(d)]</td>
<td></td>
</tr>
<tr>
<td><strong>Hedge effectiveness method.</strong> The method that will be used subsequently to retrospectively and prospectively assess hedge effectiveness. [815-20-25-3(b)(2)(i)(v)]</td>
<td>By the date on which the next interim (if applicable) or annual financial statements are available to be issued. [815-20-25-140, 25-142, 25-143]</td>
<td>Concurrent with hedge designation. [815-20-25-3]</td>
</tr>
<tr>
<td>— If subsequent hedge effectiveness assessments will be assessed qualitatively, how it will be carried out and which quantitative method will be used if required. The same quantitative method is required to be used for the initial and subsequent prospective hedge effectiveness assessments. [815-20-25-3(b)(2)(i)(v)(03)]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>— If the shortcut method is applied and, if the entity so elects, the quantitative method that will be used if it is later</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Element of hedge documentation

<table>
<thead>
<tr>
<th>Timing</th>
<th>Certain private companies and certain not-for-profit entities (not applying simplified hedge accounting)</th>
<th>Entities applying general hedge accounting guidance (section 2.9)</th>
</tr>
</thead>
<tbody>
<tr>
<td>determined that the shortcut method was not or is no longer appropriate. [815-20-25-3(b)(2)(iv)(04)]</td>
<td>Earlier of the following: [815-20-25-3(b)(2)(iv)(v)]</td>
<td></td>
</tr>
<tr>
<td></td>
<td>By the date on which the next interim (if applicable) or annual financial statements are available to be issued after hedge inception. [815-20-25-140, 25-142, 25-143]</td>
<td>— first quarterly hedge effectiveness assessment date;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>— date the financial statements that include the hedged transaction are available to be issued;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>— date any hedge accounting criterion is no longer met;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>— date the hedging instrument expires or is sold, terminated or exercised;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>— date the hedging relationship is redesignated; or</td>
</tr>
<tr>
<td></td>
<td></td>
<td>— for a cash flow hedge of a forecasted transaction (in accordance with 815-20-25-13(b)), the date the forecasted transaction occurs.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>See also section 2.9.40.</td>
</tr>
</tbody>
</table>

### Example 10.3.10

**Timing of preparing initial hedge documentation**

The following scenario illustrates the required timing for preparing initial hedge documentation for a private company hedging relationship that is not eligible for simplified hedge accounting. The example does not demonstrate the timing of performing quarterly hedge effectiveness assessments, which is discussed in section 10.3.30.
Fact pattern

PrivateCo is a private company that is not a financial institution, so it is not required to document certain additional elements of the hedging relationship until after hedge inception. PrivateCo does not prepare interim financial statements.

Hedging relationship begins earlier in the quarterly period

PrivateCo enters into a cash flow hedging relationship on March 15, Year 1, in which the hedged item is a forecasted transaction expected to occur in one year.

<table>
<thead>
<tr>
<th>Hedge inception</th>
<th>Date annual financial statements are available to be issued</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>March 15, Year 1</strong></td>
<td><strong>February 26, Year 2</strong></td>
</tr>
</tbody>
</table>

Hedged forecasted transaction occurs **January 15, Year 2**

A

On this date, the initial hedge documentation is required to include the following: the hedging relationship, hedging instrument, hedged transaction and nature of risk being hedged, as well as other documentation specifically applicable to a cash flow or fair value hedge, as applicable.

B

By this date, the following are required to be performed/documented:

- the method that will be used subsequently to retrospectively and prospectively assess hedge effectiveness; and
- the initial prospective quantitative effectiveness assessment.

10.3.30 Subsequent quarterly hedge effectiveness assessments

An entity applying hedge accounting is generally required to perform a prospective assessment at hedge inception to demonstrate that the hedging relationship is expected to be highly effective. [815-20-25-79(a)]

Additionally, subsequent to inception, the entity is generally required to perform both prospective and retrospective assessments of hedge effectiveness. These are referred to as ‘quarterly hedge effectiveness assessments’. [815-20-25-79]

Certain private companies and not-for-profit entities (see Question 10.3.10) may be eligible for the relief in the timing requirements relates to the ongoing hedge effectiveness assessments. The following table summarizes the required timing of the elements of the ongoing hedge effectiveness assessment.
Hedge accounting for private companies | Entities applying general hedge accounting guidance
---|---
**Additional relief for private companies when simplified hedge accounting is not applied**

**Hedge effectiveness.** Quarterly hedge effectiveness assessments need not be performed until the next interim or annual financial statements are available to be issued.

Hedge effectiveness testing performed on a quarterly basis (see section 9.2.20).

Although the timing of hedge effectiveness and quarterly effectiveness testing is relaxed, the testing should be performed with information available at each quarterly assessment date. [815-20-25-142]

---

**Question 10.3.20**

Are there downsides to delaying the quarterly hedge effectiveness assessments?

**Interpretive response:** Yes. Although the relaxed timing for hedge effectiveness assessments may initially seem advantageous, a private company may run into problems if the hedge effectiveness testing is not performed timely. For example, if the hedge is not highly effective throughout the entire year, the private company will not be able to maintain the hedge accounting treatment and will have to redesignate the hedging relationship from the last time period when it was highly effective.

---

**Question 10.3.30**

Why are certain entities without quarterly reporting requirements required to perform quarterly hedge effectiveness assessments?

**Interpretive response:** The FASB noted that Topic 815’s original intent was for hedge effectiveness to be continuously monitored on an ongoing basis. However, to make the model operable, the guidance required formal effectiveness assessments every three months. [ASU 2017-12.BC184]

One reason the FASB decided to provide certain private companies (and certain not-for-profit entities) with additional time to perform effectiveness assessments is because many do not have quarterly reporting requirements.

However, the FASB decided not to reduce the minimum quarterly frequency of effectiveness assessments. This is because if an entity only assesses effectiveness once before its annual financial statements are available to be issued and that assessment reveals the hedge to not be highly effective, it may be more difficult to determine when the hedge ceased to be highly effective than if effectiveness assessments were performed on a quarterly basis. [815-20-25-142 – 25-143, ASU 2017-12.BC184]
Example 10.3.20
Timing of performing quarterly hedge effectiveness assessments

The following scenarios illustrate the required timing for preparing quarterly hedge effectiveness assessments by certain private companies (and certain not-for-profit entities) for a hedging relationship that is not eligible for simplified hedge accounting.

PrivateCo is a private company that is not a financial institution. The same fact pattern as in Example 10.3.10 applies here.

The following additional assumptions are relevant to the given scenario.

— PrivateCo is required to perform an initial prospective effectiveness assessment quantitatively and ongoing hedge effectiveness assessments.
— PrivateCo performs prospective and retrospective quarterly hedge effectiveness assessments as of every three months on the last day of the quarter, with the first date being March 31, Year 1.
— PrivateCo is permitted to perform its assessments at later times, but is required to use information as of the quarterly hedge effectiveness assessment dates. (Scenario 1 only)

In both scenarios, assume the next quarterly effectiveness assessment date is March 31, Year 1.

Scenario 1: PrivateCo does not prepare interim financial statements

By the date PrivateCo’s annual financial statements are available to be issued, it is required to perform quarterly effectiveness assessments using information applicable as of each quarter-end date.

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Scenario 2: PrivateCo prepares interim financial statements

By the date PrivateCo’s quarterly and annual financial statements are available to be issued, it is required to perform quarterly effectiveness assessments using information applicable as of the related quarter-end date.
11. Effective dates and transition

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   Comparison to legacy US GAAP
   Summary of changes

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   11.2.10 Overview
   11.2.20 Early adoption considerations

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   11.2.20 If a public business entity early adopts ASU 2017-12 in an interim period, what are the relevant considerations?

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   11.3.30 New disclosure requirements
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   11.4.60 Transition elections related to assessing hedge effectiveness
Questions

11.4.10 What date is used to determine the cumulative basis adjustment when modifying the measurement methodology for a fair value hedge of interest rate risk?

11.4.20 What date is used to determine the benchmark rate if the current hedging relationship was previously dedesignated and redesignated?

11.4.30 When transitioning to measure a hedged item based on the benchmark rate component of the coupon, can an entity rebalance an existing hedging relationship?

11.4.40 What transition approach is required to apply the partial-term hedging guidance?

11.4.50 On what date in the period of adoption can an entity transfer securities from HTM to AFS?

11.4.60 Is there any restriction on selling AFS securities after transferring them from the HTM category on adoption?

11.4.70 Will transferring securities from HTM to AFS affect an entity’s pre-transition intent to hold the securities to maturity?

11.4.80 Are there any disclosure requirements for securities transferred from HTM to AFS?

11.4.90 What financial instruments are eligible to be transferred from HTM to AFS?

11.4.100 What is the transition guidance for an existing hedging relationship with a non-zero fair value derivative designated at hedge inception?

11.4.110 Can the transition provision for excluding cross-currency basis spreads in cross-currency swaps be applied to a cash flow or a net investment hedge?

11.4.120 What transition approach is required to change from a long-haul to the critical terms match method for an existing hedging relationship?

11.4.130 What transition approach is required to change the method used to assess effectiveness of a net investment hedge?

Examples

11.4.10 Dedesignating a portion of the hedged item

11.4.20 Hedged risk is changed to variability in contractually specified component
11.1 How the standard works

Chapters 2 to 10 of this Handbook assume that an entity has adopted ASU 2017-12.

This chapter discusses effective dates and transition guidance for applying ASU 2017-12, which is summarized below.

<table>
<thead>
<tr>
<th>Effective date:</th>
<th>Public business entities:</th>
<th>All other entities:</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Early adoption:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>[815-20-65-3(c)]</td>
<td></td>
<td>Permitted in any annual or interim period.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date of adoption and initial application date:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>[815-20-65-3(d) – 65-3(d)]</td>
<td>— The <strong>date of adoption</strong> is the date an entity elects to first apply the guidance in ASU 2017-12. This is the date used to determine existing hedging relationships.</td>
<td>— The <strong>initial application date</strong> means the beginning of the fiscal year of adoption. This is the date at which an entity records any transition adjustments.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Transition:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>[815-20-65-3(d) – 65-3(k)]</td>
<td>— Modified retrospective basis applied to existing hedging relationships as of the date of adoption, generally achieved through a cumulative-effect adjustment to AOCI with a corresponding adjustment to opening retained earnings as of the initial application date.</td>
<td>— Changes to income statement presentation and financial statement disclosures are applied prospectively.</td>
</tr>
<tr>
<td></td>
<td>— Specific transition guidance provided for fair value hedges of interest rate risk and risk component hedging.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>— One-time transition elections are available to modify existing hedge documentation.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>— One-time ability to transfer certain securities from the HTM to the AFS category. The securities must be eligible for the last-of-layer method.</td>
<td></td>
</tr>
</tbody>
</table>

### Comparison to legacy US GAAP

**Summary of changes**

The following table summarizes the key changes from legacy US GAAP related to specific transition provisions discussed in this chapter.

| Income statement presentation and | While not changing the requirement to determine whether a hedge is “highly effective”, the ASU eliminates the requirement to separately measure and disclose hedge ineffectiveness. |

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<table>
<thead>
<tr>
<th><strong>Hedging</strong></th>
<th>11. Effective dates and transition</th>
</tr>
</thead>
</table>
| **eliminating ineffectiveness** *(section 11.3.20)* | The ASU also updates income statement presentation for the following.  
- The entire change in fair value of the hedging instrument is included in the same income statement line item as the earnings effect of the hedged item or transaction.  
- For fair value and cash flow hedges, amounts related to excluded components are recognized in earnings in the same income statement line item as the earnings effect of the hedged item or transaction. |
| **Fair value hedges of interest rate risk** *(sections 11.4.20 and 11.4.30)* | The ASU provides opportunities for entities to apply fair value hedge accounting to hedging strategies that are either not allowed or impractical under legacy US GAAP. This includes the following.  
- Benchmark interest rate component *(section 3.3.70).*  
- Interest rate risk hedges of prepayable financial instruments *(section 3.4.10).*  
- Last-of-layer method *(section 3.3.100).*  
- Partial-term hedges *(section 3.3.80).*  
In addition, the SIFMA Municipal Swap Rate was added as an eligible benchmark interest rate *(see section 2.3.30).* |
| **Cash flow hedges** *(section 11.4.40)* | The ASU provides new alternatives for applying hedge accounting to additional hedging strategies. The ASU amends legacy US GAAP to permit an entity to apply hedge accounting for the following.  
- Contractually specified interest rate *(section 2.3.40).*  
- Contractually specified component price risk for nonfinancial transactions *(section 5.4.10).* |
| **Recognition and presentation of excluded components** *(section 11.4.50)* | The ASU introduces the option to recognize permissible excluded components using a systematic and rational method (amortization approach) as an alternative to recognizing all fair value changes in the excluded components in current earnings (mark-to-market approach).  
The ASU also allows an entity to exclude the portion of the change in fair value of a currency swap attributable to a cross-currency basis spread for fair value and cash flow hedges. |
| **Assessing hedge effectiveness** *(section 11.4.60)* | The ASU makes targeted improvements to the hedge effectiveness assessment process. These improvements include:  
- **Qualitative effectiveness assessments.** Subsequent quarterly effectiveness assessments (after an initial quantitative assessment) may be performed on a qualitative (rather than quantitative) basis if an entity can reasonably support an expectation that the hedge is highly effective at inception and in subsequent periods.  
- **Shortcut method.** An entity that inappropriately applied the ‘shortcut method’ may continue to apply hedge accounting if certain conditions are met.  
- **Critical terms match.** The ‘critical terms match’ method may be applied to groups of forecasted transactions in which the individual transactions occur, and the hedging derivative matures, within the same 31-day period or fiscal month. |
11.2 Effective dates

Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities:

a. For public business entities, the pending content that links to this paragraph shall be effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.
b. For all other entities, the pending content that links to this paragraph shall be effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.
c. Early adoption, including adoption in an interim period, of the pending content that links to this paragraph is permitted. If an entity early adopts the pending content that links to this paragraph in an interim period, any adjustments shall be reflected as of the beginning of the fiscal year that includes that interim period (that is, the initial application date).

11.2.10 Overview

If a calendar-year public business entity adopts ASU 2017-12 in accordance with the mandatory effective date, then these are the relevant dates.

<table>
<thead>
<tr>
<th>Beginning of earliest period presented</th>
<th>Effective date (date of adoption)</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 2017</td>
<td>January 1, 2019</td>
</tr>
<tr>
<td>Comparative period Legacy US GAAP</td>
<td>Current period ASU 2017-12</td>
</tr>
<tr>
<td>Cumulative-effect adjustment</td>
<td></td>
</tr>
</tbody>
</table>

11.2.20 Early adoption considerations

If an entity early adopts ASU 2017-12 in an interim period, any cumulative-effect adjustment for existing hedges should be reflected as of the beginning of the fiscal year that includes the interim period (i.e. the initial application date).

[815-20-65-3(c)]
Question 11.2.10
Is an entity required to adopt ASU 2017-12 at a certain point in time within an interim period?

Interpretive response: The ASU does not specify whether an entity is required to adopt the amendments at a certain point in time within an interim period – i.e. at the beginning or the end of a quarter, or on a date in between.

We believe an entity can elect to adopt the totality of these amendments on any single date within an interim period before the mandatory effective date. In other words, there cannot be different dates of adoption within an interim period for different provisions of the ASU.

Question 11.2.20
If a public business entity early adopts ASU 2017-12 in an interim period, what are the relevant considerations?

Background: For purposes of this Question, assume that a calendar year-end public business entity early adopts ASU 2017-12 on July 1, 2018.

Interpretive response: ASU 2017-12 provides transition guidance that differs from the general retrospective transition requirements of paragraphs 250-10-45-5 to 45-8. However, it does not provide specific guidance on how adoption in an interim period affects the results of the preceding interim periods in the fiscal year of adoption – e.g. January 1, 2018 to June 30, 2018 in the background example.

The general retrospective transition requirements in paragraphs 250-10-45-5 to 45-8 apply only when there are no transition requirements specific to a particular Codification update. Therefore, we believe there are two acceptable approaches for reporting changes to the preceding interim periods in the fiscal year of adoption.

— **Approach 1.** Record the prior-period impact related to the adoption of ASU 2017-12 in the interim period of adoption – e.g. the financial results for the three months ended September 30, 2018; or

— **Approach 2.** Retrospectively apply ASU 2017-12 to preceding interim periods, with the effect of any changes to those previous periods recorded in the year-to-date results before adoption.

These approaches should only be applied to hedging relationships existing at the date of adoption of July 1, 2018. An entity that early adopts ASU 2017-12 in an interim period should disclose which of these transition approaches was applied.

We believe an entity that early adopts in an interim period is not required to amend previous Form 10-Q filings. An entity should include disclosures required by paragraph 815-20-65-3(k) for the change in accounting principle in the interim period of adoption, and in the annual financial statement period (see section 11.3.40).
However, there are additional reporting considerations for an SEC filer that elects to retrospectively apply ASU 2017-12 to the preceding interim periods (Approach 2), including the following.

— The quarterly results of operations presented in the Form 10-K filed in the year of adoption should reflect the retrospectively adjusted interim amounts.

— In the year after adoption, comparative information and disclosures in the Form 10-Q filings should reflect the retrospectively adjusted interim amounts.

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**Example 11.2.10**

**Adopting ASU 2017-12 by retrospectively adjusting previous interim periods**

ABC Corp., a calendar year-end public business entity, early adopts the guidance on July 1, 2018 – i.e. in its third quarter reporting period.

**Interim reporting considerations in the year of adoption**

ABC records a cumulative-effect adjustment as of January 1, 2018 (the initial application date) in accordance with the transition requirements in ASU 2017-12. It also retrospectively adjusts the interim period results between the initial application date and the date of adoption to reflect the period-specific effects of applying ASU 2017-12.

ABC elects to modify the recognition model for the excluded component from a mark-to-market approach to an amortization approach. ABC elects the transition provision that allows it to modify an existing hedging relationship without dedesignating and redesignating the hedging relationship. Instead, ABC does not dedesignate its existing hedging relationships at the date of adoption (July 1, 2018), and it recognizes the cumulative-effect adjustment as of January 1, 2018. For guidance on elective transition guidance for excluded components, see section 11.4.50.

In the period between the initial application date and the date of adoption (January 1, 2018 to June 30, 2018) ABC previously recognized the excluded component using a mark-to-market approach. ABC calculates the effect of the change to an amortization approach during this period, and adjusts amounts previously recorded.

The adjusted amounts reflect what would have been recognized had the amortization approach been adopted on January 1, 2018. The effect of any changes from retrospectively adjusting the results of the previous interim periods are reflected in the third quarter 2018 Form 10-Q, within the financial results for the nine months ended September 30, 2018.
The graphic summarizes the interim reporting considerations for the third quarter of 2018.

Interim reporting considerations in the year after adoption

In its Form 10-Qs for the first and second quarters of 2019, ABC updates the comparative amounts for the quarterly periods ended March 31, 2018 and June 30, 2018 to reflect the retrospectively adjusted interim amounts.

Because the results of operations for periods presented have been adjusted retroactively subsequent to the initial reporting of such period, ABC needs to disclose the effect of the change. [S-X Rule 10-01(b)(7)]

Therefore, the Form 10-Qs for the first and second quarters of 2019 should include information to explain the effect of any changes made to the quarterly periods ended March 31, 2018 and June 30, 2018, from amounts previously reported in the Form 10-Qs for the first and second quarters of 2018.

11.3 Required transition provisions

11.3.10 Modified retrospective transition approach

Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities: …

d. For cash flow hedges and net investment hedges existing (that is, the hedging instrument has not expired, been sold, terminated, or exercised or the entity has not removed the designation of the hedging relationship) as of the date of adoption, an entity shall apply the pending content that links to this paragraph related to the elimination of the separate measurement of ineffectiveness by means of a cumulative-effect adjustment to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the initial application date.
An entity adopts ASU 2017-12 by applying a modified retrospective approach to existing hedging relationships. Under this method, an entity records the cumulative effect of applying certain amendments in ASU 2017-12 to the opening balance of retained earnings as of the initial application date.

This modified retrospective approach includes eliminating the separate measurement of ineffectiveness (see section 11.3.20), and other amendments available for adoption with elected transition provisions (see section 11.4).

**Existing hedging relationships**

The modified retrospective transition method applies only to existing hedging relationships as of the date of adoption.

The following table illustrates whether a cumulative-effect adjustment should be recorded based on whether the hedging relationship existed on the initial application date, the date of adoption or both.

<table>
<thead>
<tr>
<th>Hedging relationship existed at the:</th>
<th>Cumulative-effect adjustment recorded as of the initial application date?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial application date</td>
<td>Date of adoption</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

Notes:

1. For hedging relationships existing on the date of adoption, but not on the initial application date, any impact on adoption should be recorded in the year-to-date results. The impact should not be reflected in the cumulative-effect adjustment on the initial application date because the hedging relationship did not exist then.

2. For hedging relationships that did not exist at the date of adoption, there is no cumulative-effect adjustment. In addition, there is no retrospective adjustment to preceding interim periods in the year of adoption.

### 11.3.20 Income statement presentation and eliminating ineffectiveness

**Excerpt from ASC 815-20**

> Transition Related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities: …

j. On a prospective basis only for existing hedging relationships on the date of adoption (in all interim periods and fiscal years ending after the date of adoption), an entity shall:
1. Present the entire change in the fair value of the hedging instrument in the same income statement line item as the earnings effect of the hedged item when the hedged item affects earnings (with the exception of amounts excluded from the assessment of hedge effectiveness in a net investment hedge) in accordance with paragraphs 815-20-45-1A and 815-20-45-1C.

ASU 2017-12 replaces existing guidance with specific income statement requirements for the earnings effect of hedging instruments, and eliminates the requirement under legacy US GAAP to separately measure and disclose hedge ineffectiveness (see excluded components in section 11.4.50). The following table summarizes the transition requirements related to these amendments.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>ASU 2017-12</th>
<th>Required transition</th>
</tr>
</thead>
<tbody>
<tr>
<td>— Effective portion is recognized in AOCI and reclassified into earnings when the hedged transaction affects earnings. Ineffective portion is recognized in earnings.</td>
<td>— Entire change in fair value of components included in the effectiveness assessment is recognized in AOCI and reclassified into earnings when the hedged transaction affects earnings.</td>
<td>Reverse any ineffectiveness previously recorded in earnings on cash flow hedging relationships existing on the date of adoption in the cumulative-effect adjustment on the initial application date. [815-20-65-3(d)]</td>
</tr>
<tr>
<td>— Ineffective portion is separately measured and disclosed.</td>
<td>— Ineffective portion is not separately measured or disclosed.</td>
<td></td>
</tr>
<tr>
<td>Ineffective portion and excluded portion can be presented in an income statement line item different from the effective portion.</td>
<td>Entire change in fair value (including any excluded portion) is presented in the same income statement line item as the earnings effect of the hedged transaction.</td>
<td>Presentation guidance is applied prospectively. [815-20-65-3(j)]</td>
</tr>
<tr>
<td>Legacy US GAAP</td>
<td>ASU 2017-12</td>
<td>Required transition</td>
</tr>
<tr>
<td>---------------</td>
<td>-------------</td>
<td>---------------------</td>
</tr>
<tr>
<td><strong>Fair value hedges</strong>&lt;br&gt;<strong>(section 4.2.10)</strong></td>
<td><strong>Fair value hedges</strong>&lt;br&gt;** ASU 2017-12**</td>
<td><strong>Required transition</strong></td>
</tr>
<tr>
<td>— Entire change in fair value is recognized in earnings. [815-25-35-1 – 35-3]</td>
<td>— Entire change in fair value of components included in the effectiveness assessment is recognized in earnings. [815-20-35-1(d), 815-25-35-1]</td>
<td>For fair value hedging relationships existing on the date of adoption, the entire change in the fair value of the hedging instrument (including the ineffective portion) has been previously recorded in earnings. Therefore, no cumulative-effect adjustment is necessary on the initial application date.</td>
</tr>
<tr>
<td>— Ineffective portion is separately measured and disclosed. [815-10-50-4C, 815-25-50-1(a)]</td>
<td>— Ineffective portion is not separately measured or disclosed.</td>
<td></td>
</tr>
<tr>
<td><strong>Net investment hedges</strong>&lt;br&gt;<strong>(section 8.5)</strong></td>
<td><strong>Net investment hedges</strong>&lt;br&gt;** ASU 2017-12**</td>
<td><strong>Presentation guidance is applied prospectively. [815-20-65-3(i)]</strong></td>
</tr>
<tr>
<td>— Effective portion is recognized in CTA in AOCI and reclassified into earnings when the foreign operation is sold or substantially liquidated. [815-20-35-1(d), 815-35-35-1]</td>
<td>— Entire change in fair value of components included in the effectiveness assessment is recognized in CTA in AOCI and reclassified into earnings when the foreign operation is sold or substantially liquidated. [815-20-35-1(d), 815-35-35-1]</td>
<td>Reverse any ineffectiveness previously recorded on net investment hedging relationships existing on the date of adoption in the cumulative-effect adjustment on the initial application date. [815-20-65-3(d)]</td>
</tr>
<tr>
<td>— Ineffective portion is recognized in earnings. [815-35-35-4, 35-13]</td>
<td>— Ineffective portion is not separately measured or disclosed.</td>
<td></td>
</tr>
<tr>
<td>Ineffective portion or excluded portion can be presented in an income statement line item different from the effective portion. [815-20-45-1]</td>
<td>Entire change in fair value (including any excluded portion) is presented in the same income statement line item used to present the earnings effect of the hedged item. [815-20-45-1A]</td>
<td>Presentation guidance is applied prospectively. [815-20-65-3(i)]</td>
</tr>
<tr>
<td>Ineffective portion or excluded portion can be presented in a line item different from the effective portion. [815-20-45-1]</td>
<td>Entire change in fair value (including any excluded portion) is presented in the same income statement line item used to present the earnings effect of the hedged item. [815-20-45-1A]</td>
<td>Presentation guidance is applied prospectively. [815-20-65-3(i)]</td>
</tr>
<tr>
<td>Ineffective portion is separately measured and disclosed. [815-10-50-4C, 815-35-35-4, 35-13]</td>
<td>Ineffective portion is not separately measured or disclosed.</td>
<td>Presentation guidance is applied prospectively. [815-20-65-3(i)]</td>
</tr>
</tbody>
</table>
11.3.30 New disclosure requirements

Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities: …

j. On a prospective basis only for existing hedging relationships on the date of adoption (in all interim periods and fiscal years ending after the date of adoption), an entity shall: …
2. Disclose the items in the pending content that links to this paragraph in Subtopic 815-10.

The disclosure guidance amended by ASU 2017-12 should be applied prospectively for hedging relationships existing on the date of adoption. [815-20-65-3(j)]

11.3.40 Disclosures for accounting changes under Topic 250

Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities: …

k. An entity shall provide the following disclosures within Topic 250 on accounting changes and error corrections:
1. The nature of and reason for the change in accounting principle
2. The cumulative effect of the change on the opening balance of each affected component of equity or net assets in the statement of financial position as of the date of adoption
3. The disclosures in (1) through (2) above in each interim and annual financial statement period in the fiscal year of adoption.

In the interim and annual period of adoption, an entity should provide the disclosures required by Topic 250 (accounting changes and error corrections), which include: [815-20-65-3]

— the nature of and reason for the change in accounting principle; and
— the cumulative-effect adjustment for each affected component of equity or net assets on the date of adoption.
11.4 Elective transition principles

11.4.10 Overview

Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities: …

f. For private companies that are not financial institutions as described in paragraph 942-320-50-1 and not-for-profit entities (except for not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market), the elections in (e) above shall be determined before the next interim (if applicable) or annual financial statements are available to be issued.

g. For all other entities, the elections in (e) above shall be determined before the first quarterly effectiveness assessment date after the date of adoption.

The transition provisions offer several elections that can provide relief when applying the ASU 2017-12 amendments to existing hedging relationships. An entity may apply each election on a stand-alone basis. [ASU 2017-12.BC246, BC259]

The following types of entities have until the first quarterly effectiveness assessment date after the date of adoption to make these elections:

— public business entities;
— private companies that are financial institutions; and
— certain not-for-profit entities (that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or over-the-counter market).

All other entities have until their next interim (if applicable) or annual financial statements are available to be issued to make any of these elections. [815-20-65-3(f) – 65-3(g)]

If an entity does not elect a transition provision within the allotted timeframe, any hedging relationship existing at the date of adoption will not qualify for transition relief. Instead, an entity will have to redesignate and redesignate existing hedging relationships to change the critical terms (see section 2.10).
11.4.20 Transition elections for fair value hedges of interest rate risk

> Transition Related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities:

e. An entity may elect any of the following items upon adoption of the pending content that links to this paragraph:

1. For a fair value hedge of interest rate risk existing as of the date of adoption, an entity may modify the measurement methodology for a hedged item in accordance with either paragraph 815-20-25-6B or paragraph 815-25-35-13 without redesignation of the hedging relationship. The cumulative basis adjustment carried forward shall be adjusted to an amount that reflects what the cumulative basis adjustment would have been at the date of adoption had the modified measurement methodology been used in all past periods in which the hedging relationship was outstanding. When making this election, the benchmark rate component of the contractual coupon cash flows shall be determined as of the hedging relationship's original inception date. The cumulative effect of applying this election shall be recognized as an adjustment to the basis adjustment of the hedged item recognized on the balance sheet with a corresponding adjustment to the opening balance of retained earnings as of the initial application date.

2. For the fair value hedges of interest rate risk for which an entity modifies the measurement methodology for the hedged item based on the benchmark rate component of the contractual coupon cash flows in accordance with (1) above, an entity may elect to redesignate a portion of the hedged item and reclassify the basis adjustment associated with the portion of the hedged item redesignated to the opening balance of retained earnings as of the initial application date.

h. For fair value hedges existing as of the date of adoption in which the hedged item is a tax-exempt financial instrument, the hedged risk may be modified to interest rate risk related to the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate. The modification shall be considered a redesignation and immediate redesignation of the hedging relationship. In this situation, the cumulative basis adjustment of the hedged item from the redesignated hedging relationship shall be amortized to earnings on a level-yield basis over a period of time based on the applicable requirements in other Topics.
The following table summarizes the transition elections available for certain fair value hedges of interest rate risk existing as of the date of adoption, as well as a comparison of the changes from legacy US GAAP.

<table>
<thead>
<tr>
<th>Hedging portions of financial items: Benchmark interest rate component (section 3.3.70)</th>
<th>Legacy US GAAP</th>
<th>ASU 2017-12</th>
<th>Required transition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Measure the change in a hedged item’s fair value attributable to changes in the benchmark interest rate based on the entire contractual coupon cash flows. [815-25-35-13]</td>
<td>Measure the change in a hedged item’s fair value attributable to changes in the benchmark interest rate based on either the hedged item’s:</td>
<td>— Change in measurement methodology for the hedged item does not require a redesignation of the existing hedging relationship.</td>
<td></td>
</tr>
<tr>
<td>— entire contractual coupon cash flows; or</td>
<td>— the benchmark rate component of the contractual coupon cash flows determined at inception of the hedging relationship.</td>
<td>— The cumulative basis adjustment included in the amortized cost basis of the hedged item is adjusted as of initial application date based on the amount that would have been recorded as if the modified measurement methodology had been used since inception of the hedging relationship (see Question 11.4.10).</td>
<td></td>
</tr>
<tr>
<td>— Benchmark interest rate component of the hedged item determined as of the original hedge inception date.</td>
<td>— Dedesignate a portion of the hedged item and reclassify the basis adjustment associated with the portion of the hedged item redesignated to the opening balance of retained earnings as of</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate risk hedges of prepayable financial instruments (section 3.4.10)</td>
<td>Legacy US GAAP</td>
<td>ASU 2017-12</td>
<td>Required transition</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Consider the effect of all factors (e.g. credit risk, liquidity, interest rates) on the decision to prepay a financial instrument. [815-20-25-6]</td>
<td></td>
<td>Option to consider only the effect of changes in the benchmark interest rate on the decision to prepay a financial instrument. [815-20-25-6B]</td>
<td>— Change in measurement methodology for the hedged item does not require a redesignation of the existing hedging relationship. — The cumulative basis adjustment included in the amortized cost basis of the hedged item is adjusted as of the initial application date based on the amount that would have been recorded as if the modified measurement methodology had been used since inception of hedging relationship (see Question 11.4.10). [815-20-65-3(e)(1)]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Interest rate risk: Benchmark interest rate (section 2.3.30)</th>
<th>Legacy US GAAP</th>
<th>ASU 2017-12</th>
<th>Required transition</th>
</tr>
</thead>
<tbody>
<tr>
<td>In the United States, the following benchmark rates are eligible to be designated in a hedge: [815-20-25-6A] — US treasury rate; — LIBOR swap rate; and — Fed funds effective swap rate (Overnight index swap rate).</td>
<td></td>
<td>SIFMA Municipal Swap Rate added as eligible benchmark interest rate. [815-20-25-6A]</td>
<td>To change the hedged risk to interest rate risk related to the SIFMA Municipal Swap Rate: — dedesignate and immediately redesignate the hedging relationship if it is highly effective; and — amortize the basis adjustment from the dedesignated</td>
</tr>
</tbody>
</table>
Hedging

11. Effective dates and transition

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>ASU 2017-12</th>
<th>Required transition</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>hedging relationship into earnings on a level-yield basis over a period based on applicable requirements in other Topics (e.g. Subtopic 310-20 on receivables – nonrefundable fees and other costs).</td>
</tr>
</tbody>
</table>

Question 11.4.10

What date is used to determine the cumulative basis adjustment when modifying the measurement methodology for a fair value hedge of interest rate risk?

Interpretive response: Paragraph 815-20-65-3(e)(1) states that the cumulative basis adjustment carried forward is “adjusted to an amount that reflects what the cumulative basis adjustment would have been at the date of adoption had the modified measurement methodology been used in all past periods in which the hedging relationship was outstanding.”

This paragraph could be interpreted such that an entity calculates the basis adjustment as of the date of adoption. However, we believe it was the FASB’s intent for an entity to calculate the cumulative basis adjustment as of the initial application date, not the date of adoption. This approach is consistent with the modified retrospective transition approach used in other aspects of the transition guidance.

Question 11.4.20

What date is used to determine the benchmark rate if the current hedging relationship was previously dedesignated and redesignated?

Interpretive response: An entity that elects to use the transition relief related to the benchmark rate component is required to determine the benchmark rate component as of the original hedge inception date. [815-20-65-3(e)(1)]

For previously dedesignated and redesignated hedging relationships existing at the date of adoption, we believe the benchmark rate component should be determined as of the most recent date of redesignation, not as of the date that
the original hedged item was designated in a hedging relationship for the first time.

Question 11.4.30

When transitioning to measure a hedged item based on the benchmark rate component of the coupon, can an entity rebalance an existing hedging relationship?

**Background:** Legacy US GAAP requires an entity to measure the change in fair value of the hedged item in a fair value hedge based on the cash flows from the entire contractual coupon. This requirement has caused income statement volatility when an entity hedged interest rate risk with common hedging instruments, such as interest rate swaps based on LIBOR. [815-25-35-13]

Historically, some entities limited this income statement volatility by designating a hedge ratio of other than 1:1. In other words, an entity may have designated a notional amount of the hedging instrument that was greater than or less than the principal amount of the hedged item.

Under ASU 2017-12, an entity is allowed to measure the hedged item based on the benchmark rate component of the coupon, which eliminates the need to designate hedging relationships where the hedging instrument and the hedged item have different notional/principal amounts solely to meet the highly effective threshold. For existing hedging relationships with mismatched notional/principal amounts, electing to measure the hedged item based on the benchmark rate component of the coupon may cause the hedging relationship to no longer meet the highly effective threshold. Additionally, an earnings mismatch would be created because of the mismatched notional/principal amounts.

**Interpretive response:** Yes. The transition relief allows an entity to rebalance an existing hedging relationship that has different notional/principal amounts by dedesignating a portion of the hedged item. The related basis adjustment is recorded directly in retained earnings and therefore will not create earnings volatility. [815-20-65-3(e)(2), ASU 2017-12.BC257]

The transition guidance does not explicitly state whether a similar adjustment can be made to rebalance relationships by modifying the designated proportion of the hedging instrument or increasing the designated portion of the hedged item.

Based on discussions with the FASB staff, we believe an entity is allowed to rebalance the hedging relationship by increasing or decreasing the hedging instrument’s notional amount – or by increasing or decreasing the hedged item’s principal amount – without dedesignating existing hedging relationships. However, an entity may only designate an increased proportion of a hedging instrument or an increased portion of a hedged item if the hedging instrument or hedged item’s notional/principal was not fully designated at the inception of the hedge. This means an entity may rebalance only by using the existing hedged item or the existing hedging instrument and may not add new hedged items or hedging instruments.
For example, an entity cannot replace the hedging instrument with a different hedging instrument, modify the terms of the hedging instrument to increase the notional amount, or increase the principal amount of the hedged item by including additional debt instruments. In addition, a portion of the derivative could not have been concurrently designated as part of another hedging relationship.

**Example 11.4.10**

**Dedesignating a portion of the hedged item**

ABC Corp. issues a 20-year, $100 million debt instrument with a 7% interest coupon. On the same day it enters into a 20-year $100 million receive 3% fixed, pay LIBOR interest rate swap that converts a portion of the fixed interest rate on the debt instrument into a LIBOR-based floating interest rate.

Subsequently, on adopting ASU 2017-12, ABC decides to modify its measurement methodology to calculate the change in fair value of the debt instrument based on the benchmark rate component of the contractual coupon cash flows.

**Scenario 1: Previous hedge designation was 90% of the notional amount of the swap**

ABC previously designated 90% of the notional amount of the swap ($90 million notional) as a hedge of the $100 million debt to meet the highly effective threshold.

On transition to ASU 2017-12, ABC records a cumulative-effect adjustment to reflect the change in the measurement method of the hedged item on the basis of the benchmark rate component of the contractual coupon cash flows.

\[815-20-65-3(e)(1)\]

In addition, ABC has two options for rebalancing the existing hedging relationship.

<table>
<thead>
<tr>
<th>Rebalancing</th>
<th>Updated hedging relationship</th>
<th>Accounting considerations at transition specifically related to the rebalancing</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dedesignate a portion of the debt</strong></td>
<td>Principal amount: $90 million Swap notional amount: $90 million</td>
<td>The basis adjustment related to the $10 million dedesignated portion is recorded directly in the opening balance of retained earnings. [815-20-65-3(e)(2)]</td>
</tr>
<tr>
<td><strong>Designate the full notional amount of the existing swap</strong></td>
<td>Principal amount: $100 million Swap notional amount: $100 million</td>
<td>No incremental effect on the cumulative-effect adjustment because the amount of the hedged item has not changed. The incremental $10 million notional amount of the swap is included in the hedging relationship at adoption.</td>
</tr>
</tbody>
</table>

**Note:**

1. This assumes the remaining 10% of the notional amount of the swap ($10 million notional) is designated in a different hedging relationship.
Scenario 2: Previous hedge designation was 90% of principal amount of debt

ABC previously designated 90% of the principal amount of the debt ($90 million principal) against $100 million notional amount of the swap to meet the highly effective threshold.

On transition to ASU 2017-12, ABC records a cumulative-effect adjustment to reflect the change in the measurement method of the hedged item on the basis of the benchmark rate component of the contractual coupon cash flows.

[815-20-65-3(e)(1)]

In addition, ABC has two options for rebalancing the existing hedging relationship.

<table>
<thead>
<tr>
<th>Rebalancing</th>
<th>Updated hedging relationship</th>
<th>Accounting considerations at transition specifically related to the rebalancing</th>
</tr>
</thead>
</table>
| Dedesignate a portion of the notional amount of the swap | Principal amount: $90 million  
Swap notional amount: $90 million | No incremental effect on the cumulative-effect adjustment because the amount of the hedged item has not changed.  
$10 million of the notional amount of the swap will no longer be designated as part of this hedging relationship; however, it may be designated in a different hedging relationship. |
| Designate the full principal amount of the existing debt | Principal amount: $100 million  
Swap notional amount: $100 million | The $10 million principal amount of the debt is included in the hedging relationship at adoption, and a cumulative basis adjustment is recorded as of the initial application date. This is based on an assumption that the full principal amount of the debt had been designated at the inception of the hedging relationship. |

Question 11.4.40

What transition approach is required to apply the partial-term hedging guidance?

Interpretive response: Under ASU 2017-12, an entity may designate only part of a financial instrument’s remaining term as the hedged item (see section 3.3.80). There is no specific transition guidance for this new hedging strategy.

We believe making this change to an existing hedging relationship on adoption of ASU 2017-12 requires dedesignation and redesignation of the hedging relationship. Therefore, there would be no cumulative-effect adjustment recognized on transition.
11.4.30 Transition election to transfer securities from the HTM to the AFS portfolio

Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities:

e. An entity may elect any of the following items upon adoption of the pending content that links to this paragraph:

7. An entity may reclassify a debt security from held-to-maturity to available-for-sale if the debt security is eligible to be hedged under the last-of-layer method in accordance with paragraph 815-20-25-12A. Any unrealized gain or loss at the date of the transfer shall be recorded in accumulated other comprehensive income in accordance with paragraph 320-10-35-10(c).

An entity may reclassify HTM securities that qualify to be hedged under the last-of-layer method to the AFS category. Any unrealized gain or loss at the date of the transfer is recorded in AOCI. [815-20-65-3(e)(7)]

Question 11.4.50

On what date in the period of adoption can an entity transfer securities from HTM to AFS?

Interpretive response: Transition elections must be adopted within the timeframe outlined in paragraphs 815-20-65-3(f) to 65-3(g) (see section 11.4.10). This includes the transition election available for the transfer of eligible securities from the HTM to the AFS category.

An entity may elect to transfer securities from HTM to AFS on a specific date within the period of adoption. However, we believe all the transfers should be recorded as if they occurred on the date of adoption of the ASU, with any unrealized gain or loss – i.e. the difference between the fair value and the amortized cost of the transferred securities – on that date recorded in AOCI.

For example, a calendar year-end public business entity adopts ASU 2017-12 on January 1, 2019 and determines all of the transition elections it will apply on March 1, 2019, which is before any quarterly effectiveness assessments. The entity should record all transfers of securities and any related unrealized gains or losses as of January 1, 2019 (the date of adoption).
11.4.60 Is there any restriction on selling AFS securities after transferring them from the HTM category on adoption?

Interpretive response: No. We believe an entity is permitted to sell the securities immediately after transferring them from the HTM to the AFS category. There is no restriction requiring an entity to hold the AFS securities for a period of time after they are transferred.

11.4.70 Will transferring securities from HTM to AFS affect an entity’s pre-transition intent to hold the securities to maturity?

Interpretive response: No. We do not believe transferring securities from the HTM to the AFS category affects management’s intent and ability to hold the securities to maturity in the period before adopting ASU 2017-12. This is because the transfer will be due to a one-time transition election available through a new accounting standard. Management’s intention to sell the securities after transferring them to AFS does not alter this conclusion.

For example, a calendar year-end entity elects to adopt ASU 2017-12 on January 1, 2019 and transfers eligible securities from HTM to AFS. We believe management’s intent to imminently adopt ASU 2017-12 and transfer the securities to the AFS category does not affect the entity’s positive intent and ability to hold the securities to maturity at December 31, 2018. On December 31, 2018, the securities would remain eligible to be classified as HTM and recorded at amortized cost, based on the entity’s positive intent and ability to hold them to maturity.

11.4.80 Are there any disclosure requirements for securities transferred from HTM to AFS?

Interpretive response: There are no specific transition disclosure requirements for securities transferred from the HTM to the AFS category. However, we believe the SEC staff expects clear and transparent disclosures in the financial statements to help users understand the effects of adopting ASU 2017-12. Therefore, we believe an entity should make a materiality assessment and determine what, if any, disclosures are needed in addition to those required by paragraph 815-20-65-3(k) (see section 11.3.40).

We understand that the SEC staff expects disclosures similar to those required by paragraph 320-10-50-10 for sales or transfers of HTM securities, which include:

— the net carrying amount of the sold or transferred security;
— the related realized or unrealized gain or loss; and
— the circumstances leading to the decision to sell or transfer the security.

**Question 11.4.90**

**What financial instruments are eligible to be transferred from HTM to AFS?**

**Interpretive response:** An entity may reclassify a debt security from the HTM to the AFS category if the debt security is eligible to be hedged under the last-of-layer method (see section 3.3.100). Only financial instruments that are considered ‘prepayable’ can be included in the portfolio hedged under the last-of-layer method (see Question 3.3.310). [815-20-25-12A, 65-3(e)(7)]

We believe a financial instrument is not required to be designated in a last-of-layer hedge to be eligible for transfer from the HTM to the AFS category. Therefore, a financial instrument that is eligible for the last-of-layer method but is not designated in a hedge is eligible for transfer.

### 11.4.40 Transition elections for cash flow hedges

**Excerpt from ASC 815-20**

> Transition Related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities: …

e. An entity may elect any of the following items upon adoption of the pending content that links to this paragraph: …

6. For cash flow hedges existing as of the date of adoption in which the hedged risk is designated as the variability in total cash flows that meet the requirements to designate as the hedged risk the variability in cash flows attributable to changes in a **contractually specified component** or a contractually specified interest rate, an entity may:

i. Modify the hedging relationship, without dedesignation, to specify the hedged risk is the variability in the contractually specified component or contractually specified interest rate

ii. Create the terms of the instrument used to estimate changes in value of the hedged risk (either under the hypothetical derivative method or another acceptable method in Subtopic 815-30) in the assessment of effectiveness on the basis of market data as of the inception of the hedging relationship

iii. Consider any ineffectiveness previously recognized on the hedging relationship as part of the transition adjustment in accordance with (d) above.
The following table summarizes transition elections available for new hedging strategies related to certain types of cash flow hedges existing as of the date of adoption, as well as comparable guidance from legacy US GAAP.

<table>
<thead>
<tr>
<th>Interest rate risk: Contractually specified interest rate for cash flow hedges (section 2.3.40)</th>
<th>Legacy US GAAP</th>
<th>ASU 2017-12</th>
<th>Required transition</th>
</tr>
</thead>
<tbody>
<tr>
<td>For all financial instruments, interest rate risk relates to changes in the benchmark interest rate. [815-20-25-15(2)]</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Contractually specified component price risk for nonfinancial items (section 5.4.10)</td>
<td>For nonfinancial items, the following risks are eligible to be hedged: [815-20-25-15(i)]</td>
<td>For nonfinancial items, the following risks are eligible to be hedged: [815-20-25-15(ii)]</td>
<td>—</td>
</tr>
<tr>
<td>— all changes in the purchase price or sales</td>
<td>— all changes in the purchase price or sales</td>
<td>— An entity may modify the hedging relationship to specify the hedged risk as the variability in the contractually specified interest rate, without redesignating the hedging relationship.¹</td>
<td></td>
</tr>
<tr>
<td>Terms of the instrument used to estimate changes in value of the hedged transaction attributable to the hedged risk when assessing effectiveness should be based on market data as of the date of hedge inception.</td>
<td>— Consider any previously recognized ineffectiveness as part of the cumulative-effect adjustment recorded as of the initial application date (see section 11.3.20). [815-20-65-3(e)(6)]</td>
<td>— An entity may modify the hedging relationship to specify the hedged risk as the variability in the contractually specified interest rate, without redesignating the hedging relationship.¹</td>
<td></td>
</tr>
</tbody>
</table>

¹ Terms of the instrument used to estimate changes in value of the hedged transaction attributable to the hedged risk when assessing effectiveness should be based on market data as of the date of hedge inception.
### 11. Effective dates and transition

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>ASU 2017-12</th>
<th>Required transition</th>
</tr>
</thead>
<tbody>
<tr>
<td>price of the asset (i.e. price risk)</td>
<td>price of the asset (i.e. price risk)</td>
<td>specified component, without dedesignating the hedging relationship.¹</td>
</tr>
<tr>
<td>— foreign currency risk.</td>
<td>— changes in a contractually specified component (i.e. component price risk)</td>
<td>— Terms of the instrument used to estimate changes in value of the hedged item attributable to the hedged risk when assessing effectiveness should be based on market data as of the date of hedge inception.</td>
</tr>
<tr>
<td></td>
<td>— foreign currency risk.</td>
<td>— Consider any previously recognized ineffectiveness as part of the cumulative-effect adjustment recorded as of the initial application date (see section 11.3.20). [815-20-65-3(e)(6)]</td>
</tr>
</tbody>
</table>

Note:
1. As part of the transition relief, an entity does not need to assess effectiveness for similar hedges in a similar manner. An entity may continue designating the variability in total cash flows as the hedged risk for hedging relationships existing on the date of adoption, and designate the hedged risk as the variability in the contractually specified component or contractually specified interest rate for hedging relationships executed after the date of adoption (see Question 9.2.220). [815-20-65-3(ii)(2)]

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**Example 11.4.20**

**Hedged risk is changed to variability in contractually specified component**

Before adopting ASU 2017-12, Bakery purchased a contract to buy flour. The contract specifies the total price to be paid as (per unit of measure) the price of wheat index ABC, plus $1, plus transportation costs to Bakery’s location. Bakery also entered into a derivative contract with an underlying based on wheat index ABC.
**Hedge designation: legacy US GAAP**

Bakery designated the derivative as a cash flow hedge of the variability in the anticipated purchase price of flour (wheat index + $1 + transportation costs), with the expectation that the hedging relationship will be highly effective. Legacy US GAAP requires an entity to designate the risk of changes in cash flows related to all changes in the purchase price of the asset reflecting its actual location. [815-20-15(i)(2)]

Any ineffectiveness was previously recorded in earnings.

**Hedge designation: at transition**

Bakery elects to modify, without redesignation, the existing hedging relationship to specify the hedged risk as the variability in the contractually specified wheat index ABC component.

Any ineffectiveness previously recognized is included as part of the cumulative-effect adjustment to AOCI and opening retained earnings as of the initial application date.

To assess effectiveness, Bakery creates the terms of the instrument used to estimate changes in value of the hedged risk (e.g. a PEH derivative) using market data for wheat index ABC at the original inception date of the hedge, and compares to actual changes in the wheat index ABC derivative instrument.

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**Question 11.4.100**

What is the transition guidance for an existing hedging relationship with a non-zero fair value derivative designated at hedge inception?

**Interpretive response:** There is no transition guidance in ASU 2017-12 for existing cash flow hedging relationships where a non-zero fair value derivative was designated as the hedging instrument at hedge inception.

Under legacy US GAAP, the initial non-zero fair value of the hedging derivative may give rise to hedge ineffectiveness that is recorded in earnings throughout the life of the hedging relationship – e.g. an interest rate swap with periodic cash settlements and a non-zero fair value at hedge inception designated in a cash flow hedge of forecasted variable interest payments.

In this situation, ASU 2017-12 requires the following. [815-30-35-41A]

— As long as the hedge is highly effective, the entire change in fair value of the hedging instrument is included in OCI and subsequently reclassified into earnings when the hedged transaction affects earnings – i.e. there is no recognition of hedge ineffectiveness in earnings.

— The amounts related to the initial fair value that are recorded in OCI during the hedging relationship are reclassified from AOCI into earnings on a systematic and rational basis over the periods during which the hedged forecasted transactions affect earnings. Section 6.3.20 provides guidance on cash flow hedge accounting when a hedging instrument with periodic settlements has a non-zero fair value at hedge inception.
On transition to ASU 2017-12, an entity is required to reverse any ineffectiveness previously recognized through a cumulative-effect adjustment recorded in AOCI and the opening balance of retained earnings as of the initial application date.

As part of calculating the cumulative-effect adjustment, we believe an entity is also required to consider the effect of the amounts related to the initial fair value that would have been reclassified from AOCI into earnings for the period from the original hedge inception date to the initial application date of ASU 2017-12.

11.4.50 Transition elections for recognition and presentation of excluded components

Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities: …

e. An entity may elect any of the following items upon adoption of the pending content that links to this paragraph: …

3. For fair value hedges existing as of the date of adoption in which foreign exchange risk is the hedged risk or one of the hedged risks and a currency swap is the hedging instrument, an entity may, without redesignation, modify its hedge documentation to exclude the cross-currency basis spread component of the currency swap from the assessment of hedge effectiveness and recognize the excluded component through an amortization approach. The cumulative effect of applying this election shall be recognized as an adjustment to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the initial application date.

4. For hedges existing as of the date of adoption that exclude a portion of the hedging instrument from the assessment of effectiveness, an entity may modify the recognition model for the excluded component from a mark-to-market approach to an amortization approach without redesignation of the hedging relationship. The cumulative effect of applying this election shall be recognized as an adjustment to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the initial application date.
The following table summarizes the transition elections related to recognizing and presenting excluded components available for hedging relationships existing on adoption, as well as a comparison of applicable changes from legacy US GAAP.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>ASU 2017-12</th>
<th>Required transition</th>
</tr>
</thead>
</table>
| **Recognizing excluded components**<sup>(section 9.2.70)</sup> | Changes in excluded components are recognized currently in earnings, together with any ineffectiveness. [815-20-25-83] | The initial value of the excluded component is recognized in earnings using either: [815-20-25-83A – 25-83B, 815-35-35-5A – 35-5B]  
  — a systematic and rational method over the life of the hedging instrument (amortization approach); or  
  — currently in earnings (mark-to-market approach).  
  Under the amortization approach, any difference between the change in fair value of the excluded component and the amounts recognized in income are included in AOCI (the CTA section of AOCI for a net investment hedge). [815-20-25-83A, 815-35-35-5A]  
  This election is applied consistently to similar hedges. For fair value and cash flow hedges, if an entity elects to record the amounts currently in earnings, that election is disclosed. [815-10-50-4EEE, 815-20-25-83B, 815-35-35-5B] | An entity may:  
  — modify the recognition model for the excluded component from a mark-to-market approach to an amortization approach without dedesignating the hedging relationship;  
  and  
  — recognize a cumulative-effect adjustment as of the initial application date. [815-20-65-3(e)(4)] |
### Cross-currency basis spreads in currency swaps (section 9.2.70)

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>ASU 2017-12</th>
<th>Required transition</th>
</tr>
</thead>
</table>
| An entity may exclude: [815-20-25-82]  
  — time value of options  
  — forward points (spot-forward difference) in a forward contract. | An entity may exclude: [815-20-25-82]  
  — time value of options  
  — forward points (spot-forward difference) in a forward contract  
  — cross-currency basis spreads in currency swaps (for fair value and cash flow hedges only). | Fair value hedges.  
For fair value hedges existing at the date of adoption, an entity:  
  — can modify hedge documentation to exclude the cross-currency basis spread component of a cross-currency swap without redesiging the hedging relationship; and  
  — recognize a cumulative-effect adjustment as of the initial application date. [815-20-65-3(e)(3)] |

### Note:

1. As part of the transition relief, an entity does not need to assess effectiveness for similar hedges in a similar manner. An entity may continue recognizing excluded components using a mark-to-market approach for hedging relationships existing on the date of adoption, and elect an amortization approach for hedging relationships executed after the date of adoption (see Question 9.2.220). [815-20-65-3(i)(3)]

### Question 11.4.110

**Can the transition provision for excluding cross-currency basis spreads in cross-currency swaps be applied to a cash flow or a net investment hedge?**

**Interpretive response:** No. The FASB did not extend this transition provision to cash flow or net investment hedges.

- **Cash flow hedge.** In a cash flow hedge, cross-currency basis spread volatility does not affect earnings. All changes in fair value of the hedging instrument are deferred in OCI.

- **Net investment hedge.** For a net investment hedge, the excluded component model is different. If an entity has historically used cross-currency interest rate swaps as the hedging instrument and elected to assess effectiveness using the spot method, the hedging relationship implicitly excludes the cross-currency basis spread (along with any other component of the currency swap’s fair value excluded by the spot method...
of assessing effectiveness) from the assessment of effectiveness. If an entity determines that it now wishes to amortize the excluded component, rather than marking it to market, it can do so through the transition provision related to the recognition of excluded components. [ASU 2017-12.BC251]

### 11.4.60 Transition elections related to assessing hedge effectiveness

**Excerpt from ASC 815-20**

> Transition Related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities: …

e. An entity may elect any of the following items upon adoption of the pending content that links to this paragraph: …

5. An entity may modify documentation without dedesignating an existing hedging relationship to specify the following:

i. For hedging relationships that currently use a quantitative method to assess effectiveness, that subsequent prospective and retrospective effectiveness assessments shall be performed qualitatively in accordance with paragraph 815-20-25-3(b)(2)(iv)(03)

ii. For hedging relationships that currently use the shortcut method to assess effectiveness, the quantitative method that would be used to perform assessments of effectiveness in accordance with paragraph 815-20-25-117A if the entity determines at a later date that use of the shortcut method was not or no longer is appropriate.

The following table summarizes transition elections related to targeted improvements to the hedge effectiveness assessment process for hedges existing as of the date of adoption, as well as comparable guidance from legacy US GAAP.

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>ASU 2017-12</th>
<th>Required transition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualitative effectiveness assessments (section 9.5)</td>
<td>Subsequent prospective and retrospective assessments of hedge effectiveness are required to be quantitative, except for methods such as 'shortcut' or 'critical'</td>
<td>Subsequent quarterly effectiveness assessments (after an initial quantitative assessment) may be performed on a qualitative (rather than quantitative) basis if an entity can reasonably support</td>
</tr>
</tbody>
</table>

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### Hedging

#### 11. Effective dates and transition

<table>
<thead>
<tr>
<th>Legacy US GAAP</th>
<th>ASU 2017-12</th>
<th>Required transition</th>
</tr>
</thead>
<tbody>
<tr>
<td>terms match”. [815-20-25-79]</td>
<td>an expectation that the hedge is highly effective at inception and will continue to be in subsequent periods. [815-20-25-79, 815-20-35-2A]</td>
<td>performed qualitatively, without desigating the existing hedging relationships. [815-20-65-3(e)(5)(i)]</td>
</tr>
</tbody>
</table>

### Shortcut method (section 9.3)

An entity that determines it inappropriately used the shortcut method loses hedge accounting in all previous periods in which it had applied the method. [2005 AICPA Conf]

An entity that inappropriately applied the shortcut method may continue to apply hedge accounting to previous periods if it: [815-20-25-117A]

- documented at hedge inception which quantitative method it would use to assess hedge effectiveness in the event that the shortcut method was no longer appropriate; and

- when the quantitative method was identified as being applied in its hedge documentation, determines that the hedge was highly effective for the periods in which the shortcut method criteria were not met.

An entity is permitted to amend the hedge documentation for existing shortcut method hedging relationships without desigating the existing hedging relationships. [815-20-65-3(e)(5)(ii)]

### Note:

1. As part of the transition relief, an entity does not need to assess effectiveness for similar hedges in a similar manner. An entity may document a quantitative effectiveness method for new shortcut method hedging relationships executed after the date of adoption. This is regardless of whether an entity modifies its hedge documentation to include a quantitative effectiveness method for hedges existing at the date of adoption (see Question 9.2.220). [815-20-65-3(i)(1), ASU 2017-12.BC261]
Question 11.4.120

What transition approach is required to change from a long-haul to the critical terms match method for an existing hedging relationship?

**Background:** Under ASU 2017-12, the critical terms match method may be applied to groups of forecasted transactions in which the individual transactions occur, and the hedging derivative matures, within the same 31-day period or fiscal month (see section 9.4). Under legacy US GAAP, an entity would have applied a quantitative long-haul method instead of the critical terms match method to such relationships.

**Interpretive response:** There is no specific transition guidance in ASU 2017-12 if an entity changes from a quantitative long-haul method to the critical terms match method for an existing hedging relationship. Based on discussions with the FASB staff, we understand it was the FASB’s intent to allow entities to modify their documentation without redesiging and redesignating an existing hedging relationship to specify that the critical terms of the hedging instrument and the hedged item match in accordance with paragraphs 815-20-25-84 and 25-85.

Question 11.4.130

What transition approach is required to change the method used to assess effectiveness of a net investment hedge?

**Background:** The amendments in ASU 2017-12 allow an entity to change its method of assessing the effectiveness of its net investment hedges – from spot to forward, or vice versa (see section 8.4.40). Under legacy US GAAP, an entity was prohibited from changing its method of assessing hedge effectiveness. [815-35-35-4]

**Interpretive response:** The ASU does not provide transition guidance for changing the method used to assess effectiveness of a net investment hedge.

We believe making this change to an existing hedging relationship on adoption of ASU 2017-12 requires redesigation and redesignation of the hedging relationship. This is consistent with guidance for changing the effectiveness assessment method for net investment hedges in section 8.4.40. [815-20-55-56]
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FRV focuses on major new standards (including revenue recognition, leases and financial instruments) – and also covers existing US GAAP, IFRS, SEC matters, broad transactions and more.

Here are some of our other resources dealing with derivatives and hedging.

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