

# Statement of Financial Accounting Standards No. 133

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Accounting for Derivative Instruments  
and Hedging Activities

June 1998



Financial Accounting Standards Board  
of the Financial Accounting Foundation  
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# Statement of Financial Accounting Standards No. 133

## Accounting for Derivative Instruments and Hedging Activities

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## FAS 133: Accounting for Derivative Instruments and Hedging Activities

### FAS 133 Summary

This Statement establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) a hedge of the exposure to variable cash flows of a forecasted transaction, or (c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

- For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a fair value hedge), the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value.
- For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction (referred to as a cash flow hedge), the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately.
- For a derivative designated as hedging the foreign currency exposure of a net investment in a foreign operation, the gain or loss is reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment. The accounting for a fair value hedge described above applies to a derivative designated as a hedge of the foreign currency

exposure of an unrecognized firm commitment or an available-for-sale security. Similarly, the accounting for a cash flow hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of a foreign-currency-denominated forecasted transaction.

- For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

Under this Statement, an entity that elects to apply hedge accounting is required to establish at the inception of the hedge the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

This Statement applies to all entities. A not-for-profit organization should recognize the change in fair value of all derivatives as a change in net assets in the period of change. In a fair value hedge, the changes in the fair value of the hedged item attributable to the risk being hedged also are recognized. However, because of the format of their statement of financial performance, not-for-profit organizations are not permitted special hedge accounting for derivatives used to hedge forecasted transactions. This Statement does not address how a not-for-profit organization should determine the components of an operating measure if one is presented.

This Statement precludes designating a nonderivative financial instrument as a hedge of an asset, liability, unrecognized firm commitment, or forecasted transaction except that a nonderivative instrument denominated in a foreign currency may be designated as a hedge of the foreign currency exposure of an unrecognized firm commitment denominated in a foreign currency or a net investment in a foreign operation.

This Statement amends FASB Statement No. 52, *Foreign Currency Translation*, to permit special accounting for a hedge of a foreign currency forecasted transaction with a derivative. It supersedes FASB Statements No. 80, *Accounting for Futures Contracts*, No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*. It amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to include in Statement 107 the disclosure provisions about concentrations of credit risk from Statement 105. This Statement also nullifies or modifies the consensus reached in a number of issues addressed by the Emerging Issues Task Force.

This Statement is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Initial application of this Statement should be as of the beginning of an entity's fiscal quarter; on that date, hedging relationships must be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all of the provisions of this Statement is encouraged, but it is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. This Statement should not be applied retroactively to financial statements of prior periods.

## INTRODUCTION

1. This Statement addresses the accounting for **derivative instruments**,<sup>1</sup> including certain derivative instruments embedded in other contracts, and hedging activities.
2. Prior to this Statement, hedging activities related to changes in foreign exchange rates were addressed in FASB Statement No. 52, *Foreign Currency Translation*. FASB Statement No. 80, *Accounting for Futures Contracts*, addressed the use of futures contracts in other hedging activities. Those Statements addressed only certain derivative instruments and differed in the criteria required for hedge accounting. In addition, the Emerging Issues Task Force (EITF) addressed the accounting for various hedging activities in a number of issues.
3. In developing the standards in this Statement, the Board concluded that the following four fundamental decisions should serve as cornerstones underlying those standards:
  - a. Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.
  - b. **Fair value** is the most relevant measure for **financial instruments** and the only relevant measure for derivative instruments. Derivative instruments should be measured at fair value, and adjustments to the carrying amount of hedged items should reflect changes in their fair value (that is, gains or losses) that are attributable to the risk being hedged and that arise while the hedge is in effect.
  - c. Only items that are assets or liabilities should be reported as such in financial statements.
  - d. Special accounting for items designated as being hedged should be provided only for qualifying items. One aspect of qualification should be an assessment of the expectation of effective offsetting changes in fair values or cash flows during the term of the hedge for the risk being hedged.

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

4. This Statement standardizes the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, by requiring that an entity recognize those items as assets or liabilities in the statement of financial position and measure them at fair value. If certain conditions are met, an entity may elect to designate a derivative instrument as follows:
  - a. A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized **firm commitment**,<sup>2</sup> that are attributable to a particular risk (referred to as a fair value hedge)
  - b. A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk (referred to as a cash flow hedge)

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

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

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

### Scope and Definition

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

### Derivative Instruments

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

- a. It has (1) one or more **underlyings** and (2) one or more **notional amounts** <sup>3</sup> or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required. <sup>4</sup>
- b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

7. *Underlying, notional amount, and payment provision.* An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other

variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

8. *Initial net investment.* Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for time value (for example, a premium on an option) or for terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price). Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged. A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying.

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

- a. Neither party is required to deliver an asset that is associated with the underlying or that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.
- b. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.
- c. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but that asset is readily convertible to cash <sup>5</sup> or is itself a derivative instrument. An example of that type of contract is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash. Another example is a swaption—an option to require delivery of a swap contract, which is a derivative.

Derivative instruments embedded in other contracts are addressed in paragraphs 12–16.

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

- a. *“Regular-way” security trades.* Regular-way security trades are contracts with no net settlement provision and no market mechanism to facilitate net settlement (as described in

paragraphs 9(a) and 9(b)). They provide for delivery of a security within the time generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed.

- b. *Normal purchases and normal sales.* Normal purchases and normal sales are contracts with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9(a) and 9(b)). They provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business.
- c. *Certain insurance contracts.* Generally, contracts of the type that are within the scope of FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, are not subject to the requirements of this Statement whether or not they are written by insurance enterprises. That is, a contract is not subject to the requirements of this Statement if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. The following types of contracts written by insurance enterprises or held by the insureds are not subject to the requirements of this Statement for the reasons given:
  - (1) *Traditional life insurance contracts.* The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.
  - (2) *Traditional property and casualty contracts.* The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.However, insurance enterprises enter into other types of contracts that may be subject to the provisions of this Statement. In addition, some contracts with insurance or other enterprises combine derivative instruments, as defined in this Statement, with other insurance products or nonderivative contracts, for example, indexed annuity contracts, variable life insurance contracts, and property and casualty contracts that combine traditional coverages with foreign currency options. Contracts that consist of both derivative portions and nonderivative portions are addressed in paragraph 12.
- d. *Certain financial guarantee contracts.* Financial guarantee contracts are not subject to this Statement if they provide for payments to be made only to reimburse the guaranteed party for a loss incurred because the debtor fails to pay when payment is due, which is an identifiable insurable event. In contrast, financial guarantee contracts are subject to this Statement if they provide for payments to be made in response to changes in an underlying (for example, a decrease in a specified debtor's creditworthiness).
- e. Certain contracts that are not traded on an exchange. Contracts that are not exchange-traded are not subject to the requirements of this Statement if the underlying on which the settlement is based is one of the following:
  - (1) A climatic or geological variable or other physical variable
  - (2) The price or value of (a) a nonfinancial asset of one of the parties to the contract

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

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

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

- f. *Derivatives that serve as impediments to sales accounting.* A derivative instrument (whether freestanding or embedded in another contract) whose existence serves as an impediment to recognizing a related contract as a sale by one party or a purchase by the counterparty is not subject to this Statement. For example, the existence of a guarantee of the residual value of a leased asset by the lessor may be an impediment to treating a contract as a sales-type lease, in which case the contract would be treated by the lessor as an operating lease. Another example is the existence of a call option enabling a transferor to repurchase transferred assets that is an impediment to sales accounting under FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

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

- a. Contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position
- b. Contracts issued by the entity in connection with stock-based compensation arrangements addressed in FASB Statement No. 123, *Accounting for Stock-Based Compensation*
- c. Contracts issued by the entity as contingent consideration from a business combination. The accounting for contingent consideration issued in a business combination is addressed in APB Opinion No. 16, *Business Combinations*. In applying this paragraph, the issuer is considered to be the entity that is accounting for the combination using the purchase method.

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

### **Embedded Derivative Instruments**

12. Contracts that do not in their entirety meet the definition of a derivative instrument (refer to paragraphs 6–9), such as bonds, insurance policies, and leases, may contain “embedded”

derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this Statement if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract. Additional guidance on applying this criterion to various contracts containing embedded derivative instruments is included in Appendix A of this Statement.
- b. The contract (“the hybrid instrument”) that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.
- c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

13. For purposes of applying the provisions of paragraph 12, an embedded derivative instrument in which the underlying is an interest rate or interest rate index <sup>6</sup> that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following conditions exist:

- a. The hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover *substantially all* of its initial recorded investment.
- b. The embedded derivative could at least double the investor’s initial rate of return on the host contract and could also result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality.

Even though the above conditions focus on the investor’s rate of return and the investor’s recovery of its investment, the existence of either of those conditions would result in the embedded derivative instrument not being considered clearly and closely related to the host contract by both parties to the hybrid instrument. Because the existence of those conditions is assessed at the date that the hybrid instrument is acquired (or incurred) by the reporting entity, the acquirer of a hybrid instrument in the secondary market could potentially reach a different conclusion than could the issuer of the hybrid instrument due to applying the conditions in this paragraph at different points in time.

14. However, interest-only strips and principal-only strips are not subject to the requirements of this Statement provided they (a) initially resulted from separating the rights to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative that otherwise would have been accounted for separately as a derivative pursuant to the provisions of paragraphs 12 and 13 and (b) do not incorporate any terms not present in the original financial instrument described above.

15. An embedded foreign currency derivative instrument shall *not* be separated from the host contract and considered a derivative instrument under paragraph 12 if the host contract is not a financial instrument and it requires payment(s) denominated in (a) the currency of the primary economic environment in which any substantial party to that contract operates (that is, its functional currency) or (b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions). Unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both denominated in a foreign currency are subject to the requirement in Statement 52 to recognize any foreign currency transaction gain or loss in earnings and shall not be considered to contain embedded foreign currency derivative instruments under this Statement. The same proscription applies to available-for-sale or trading securities that have cash flows denominated in a foreign currency.

16. In subsequent provisions of this Statement, both (a) a derivative instrument included within the scope of this Statement by paragraphs 6–11 and (b) an embedded derivative instrument that has been separated from a host contract as required by paragraph 12 are collectively referred to as derivative instruments. If an embedded derivative instrument is separated from its host contract, the host contract shall be accounted for based on generally accepted accounting principles applicable to instruments of that type that do not contain embedded derivative instruments. If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement.

### **Recognition of Derivatives and Measurement of Derivatives and Hedged Items**

17. An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights or obligations under the contracts. All derivative instruments shall be measured at fair value. The guidance in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended, shall apply in determining the fair value of a financial instrument (derivative or hedged item). If expected future cash flows are used to estimate fair value, those expected cash flows shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be

verified objectively. If a range is estimated for either the amount or the timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

18. The accounting for changes in the fair value (that is, gains or losses) of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Either all or a proportion of a derivative may be designated as the hedging instrument. The proportion must be expressed as a percentage of the entire derivative so that the profile of risk exposures in the hedging portion of the derivative is the same as that in the entire derivative. (Thus, an entity is prohibited from separating a compound derivative into components representing different risks and designating any such component as the hedging instrument, except as permitted at the date of initial application by the transition provisions in paragraph 49.) Subsequent references in this Statement to a derivative as a hedging instrument include the use of only a proportion of a derivative as a hedging instrument. Two or more derivatives, or proportions thereof, may also be viewed in combination and jointly designated as the hedging instrument. Gains and losses on derivative instruments are accounted for as follows:

- a. *No hedging designation.* The gain or loss on a derivative instrument not designated as a hedging instrument shall be recognized currently in earnings.
- 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 22 and 23.
- c. *Cash flow hedge.* The effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument shall be reported as a component of other **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 30 and 31. The remaining gain or loss on the derivative instrument, if any, shall be recognized currently in earnings, as provided in paragraph 30.
- d. *Foreign currency hedge.* The gain or loss on a derivative instrument or nonderivative financial instrument designated and qualifying as a foreign currency hedging instrument shall be accounted for as follows:
  - (1) The gain or loss on the hedging derivative or nonderivative instrument in a hedge of a foreign-currency-denominated firm commitment and the offsetting loss or gain on the hedged firm commitment shall be recognized currently in earnings in the same accounting period, as provided in paragraph 37.
  - (2) The gain or loss on the hedging derivative instrument in a hedge of an available-for-sale security and the offsetting loss or gain on the hedged available-for-sale security shall be recognized currently in earnings in the same accounting period, as provided in paragraph 38.
  - (3) The effective portion of the gain or loss on the hedging derivative instrument in a hedge

of a forecasted foreign-currency-denominated transaction shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraph 41. The remaining gain or loss on the hedging instrument shall be recognized currently in earnings.

- (4) The gain or loss on the hedging derivative or nonderivative instrument in a hedge of a net investment in a foreign operation shall be reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment to the extent it is effective as a hedge, as provided in paragraph 42.

19. In this Statement, the *change in the fair value* of an entire financial asset or liability for a period refers to the difference between its fair value at the beginning of the period (or acquisition date) and the end of the period adjusted to exclude (a) changes in fair value due to the passage of time and (b) changes in fair value related to any payments received or made, such as in partially recovering the asset or partially settling the liability.

### **Fair Value Hedges**

#### ***General***

20. An entity may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof (“hedged item”) that is attributable to a particular risk. Designated hedging instruments and hedged items qualify for fair value hedge accounting if all of the following criteria and those in paragraph 21 are met:

- a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness.
  - (1) For a fair value hedge of a firm commitment, the entity’s formal documentation at the inception of the hedge must include a reasonable method for recognizing in earnings the asset or liability representing the gain or loss on the hedged firm commitment.
  - (2) An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.
- b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three

months. If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, the increases (or decreases) in the fair value of the hedging instrument must be expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship (in accordance with paragraph 20(a) above).

- c. If a written option is designated as hedging a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for gains as a result of a favorable change in the fair value of the combined instruments <sup>7</sup> as exposure to losses from an unfavorable change in their combined fair value. That test is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide at least as much gain as the loss that would be incurred from an unfavorable change in the underlying of the same percentage.
  - (1) A combination of options (for example, an interest rate collar) entered into contemporaneously shall be considered a written option if either at inception or over the life of the contracts a net premium is received in cash or as a favorable rate or other term. (Thus, a collar can be designated as a hedging instrument in a fair value hedge without regard to the test in paragraph 20(c) unless a net premium is received.) Furthermore, a derivative instrument that results from combining a written option and any other nonoption derivative shall be considered a written option.

A nonderivative instrument, such as a Treasury note, shall not be designated as a hedging instrument, except as provided in paragraphs 37 and 42 of this Statement.

#### ***The Hedged Item***

21. An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following criteria are met:

- a. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. <sup>8</sup> The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof).
  - (1) If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10 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 this provision. In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate: loan type, loan size, nature and location of collateral, interest rate type (fixed or variable) and the coupon interest rate (if fixed), scheduled maturity, prepayment history of the loans (if seasoned), and expected prepayment performance in varying interest rate scenarios.<sup>9</sup>

- (2) If the hedged item is a specific portion of an asset or liability (or of a portfolio of similar assets or a portfolio of similar liabilities), the hedged item is one of the following:
  - (a) A percentage of the entire asset or liability (or of the entire portfolio)
  - (b) One or more selected contractual cash flows (such as the portion of the asset or liability representing the present value of the interest payments in the first two years of a four-year debt instrument)
  - (c) A put option, a call option, an interest rate cap, or an interest rate floor embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 12 of this Statement
  - (d) The residual value in a lessor's net investment in a direct financing or sales-type lease.

If the entire asset or liability is an instrument with variable cash flows, the hedged item cannot be deemed to be an implicit fixed-to-variable swap (or similar instrument) perceived to be embedded in a host contract with fixed cash flows.

- b. The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings. The reference to affecting reported earnings does not apply to an entity that does not report earnings as a separate caption in a statement of financial performance, such as a not-for-profit organization, as discussed in paragraph 43.
- c. The hedged item is not (1) an asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings (for example, if foreign exchange risk is hedged, a foreign-currency-denominated asset for which a foreign currency transaction gain or loss is recognized in earnings), (2) an investment accounted for by the equity method in accordance with the requirements of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, (3) a minority interest in one or more consolidated subsidiaries, (4) an equity investment in a consolidated subsidiary, (5) a firm commitment either to enter into a business combination or to acquire or dispose of a subsidiary, a minority interest, or an equity method investee, or (6) an equity instrument issued by the entity and classified in stockholders' equity in the statement of financial position.
- 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 FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, the designated risk being hedged is the risk of changes in its fair value attributable to changes in the obligor's creditworthiness or if the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component. (The designated hedged risk for a

held-to-maturity security may not be the risk of changes in its fair value attributable to changes in market interest rates or foreign exchange rates. If the hedged item is other than an option component that permits its prepayment, the designated hedged risk also may not be the risk of changes in its overall fair value.)

- 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 may not be the hedged risk. Thus, in hedging the exposure to changes in the fair value of gasoline, an entity may not designate the risk of changes in the price of crude oil as the risk being hedged for purposes of determining effectiveness of the fair value hedge of gasoline
- 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 (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 market interest rates, (3) the risk of changes in its fair value attributable to changes in the related foreign currency exchange rates (refer to paragraphs 37 and 38), or (4) the risk of changes in its fair value attributable to changes in the obligor's creditworthiness. If the risk designated as being hedged is not the risk in paragraph 21(f)(1) above, two or more of the other risks (market interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged. An entity may not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the fair value of that "prepayment" option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of market interest rate risk.

22. Gains and losses on a qualifying fair value hedge shall be accounted for as follows:

- a. The gain or loss on the hedging instrument shall be recognized currently in earnings.
- b. The gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized currently in earnings.

If the fair value hedge is fully effective, the gain or loss on the hedging instrument, adjusted for the component, if any, of that gain or loss that is excluded from the assessment of effectiveness under the entity's defined risk management strategy for that particular hedging relationship (as discussed in paragraph 63 in Section 2 of Appendix A), would exactly offset the loss or gain on the hedged item attributable to the hedged risk. Any difference that does arise would be the effect of hedge ineffectiveness, which consequently is recognized currently in earnings. The measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent

with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 20(a). Nevertheless, the amount of hedge ineffectiveness recognized in earnings is based on the extent to which exact offset is not achieved. Although a hedging relationship must comply with an entity's established policy range of what is considered "highly effective" pursuant to paragraph 20(b) in order for that relationship to qualify for hedge accounting, that compliance does not assure zero ineffectiveness. Section 2 of Appendix A illustrates assessing hedge effectiveness and measuring hedge ineffectiveness. Any hedge ineffectiveness directly affects earnings because there will be no offsetting adjustment of a hedged item's carrying amount for the ineffective aspect of the gain or loss on the related hedging instrument.

23. If a hedged item is otherwise measured at fair value with changes in fair value reported in other comprehensive income (such as an available-for-sale security), the adjustment of the hedged item's carrying amount discussed in paragraph 22 shall be recognized in earnings rather than in other comprehensive income in order to offset the gain or loss on the hedging instrument.

24. The adjustment of the carrying amount of a hedged asset or liability required by paragraph 22 shall be accounted for in the same manner as other components of the carrying amount of that asset or liability. For example, an adjustment of the carrying amount of a hedged asset held for sale (such as inventory) would remain part of the carrying amount of that asset until the asset is sold, at which point the entire carrying amount of the hedged asset would be recognized as the cost of the item sold in determining earnings. An adjustment of the carrying amount of a hedged interest-bearing financial instrument shall be amortized to earnings; amortization shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

25. An entity shall discontinue prospectively the accounting specified in paragraphs 22 and 23 for an existing hedge if any one of the following occurs:

- a. Any criterion in paragraphs 20 and 21 is no longer met.
- b. The derivative expires or is sold, terminated, or exercised.
- c. The entity removes the designation of the fair value hedge.

In those circumstances, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in paragraphs 25(a) and 25(c) above, a different hedged item or a hedged transaction if the hedging relationship meets the criteria specified in paragraphs 20 and 21 for a fair value hedge or paragraphs 28 and 29 for a cash flow hedge.

26. In general, if a periodic assessment indicates noncompliance with the effectiveness criterion in paragraph 20(b), an entity shall not recognize the adjustment of the carrying amount of the hedged item described in paragraphs 22 and 23 after the last date on which compliance with the effectiveness criterion was established. However, if the event or change in circumstances that caused the hedging relationship to fail the effectiveness criterion can be

identified, the entity shall recognize in earnings the changes in the hedged item's fair value attributable to the risk being hedged that occurred prior to that event or change in circumstances. If a fair value hedge of a firm commitment is discontinued because the hedged item no longer meets the definition of a firm commitment, the entity shall derecognize any asset or liability previously recognized pursuant to paragraph 22 (as a result of an adjustment to the carrying amount for the firm commitment) and recognize a corresponding loss or gain currently in earnings.

### ***Impairment***

27. An asset or liability that has been designated as being hedged and accounted for pursuant to paragraphs 22–24 remains subject to the applicable requirements in generally accepted accounting principles for assessing impairment for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 22 of this Statement. Because the 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 requirements to the hedged asset or liability.

### **Cash Flow Hedges**

#### ***General***

28. An entity may designate a derivative instrument as hedging the exposure to variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction (such as a forecasted purchase or sale). **10** Designated hedging instruments and hedged items or transactions qualify for cash flow hedge accounting if all of the following criteria and those in paragraph 29 are met:

- a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged transaction, the nature of the risk being hedged, and how the hedging instrument's effectiveness in hedging the exposure to the hedged transaction's variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness.
  - (1) An entity's defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative's change in fair value from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.
  - (2) Documentation shall include all relevant details, including the date on or period within which the forecasted transaction is expected to occur, the specific nature of asset or

liability involved (if any), and the expected currency amount or quantity of the forecasted transaction.

- (a) The phrase *expected currency amount* refers to hedges of foreign currency exchange risk and requires specification of the exact amount of foreign currency being hedged.
- (b) The phrase *expected . . . quantity* refers to hedges of other risks and requires specification of the physical quantity (that is, the number of items or units of measure) encompassed by the hedged forecasted transaction. If a forecasted sale or purchase is being hedged for price risk, the hedged transaction cannot be specified solely in terms of expected currency amounts, nor can it be specified as a percentage of sales or purchases during a period. The current price of a forecasted transaction also should be identified to satisfy the criterion in paragraph 28(b) for offsetting cash flows.

The hedged forecasted transaction shall be described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. Thus, the forecasted transaction could be identified as the sale of either the first 15,000 units of a specific product sold during a specified 3-month period or the first 5,000 units of a specific product sold in each of 3 specific months, but it could not be identified as the sale of the last 15,000 units of that 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).

- b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28(d) below. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. If the hedging instrument, such as an at-the-money option contract, provides only one-sided offset against the hedged risk, the cash inflows (outflows) from the hedging instrument must be expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.
- c. If a written option is designated as hedging the variability in cash flows for a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for favorable cash flows as exposure to unfavorable cash flows. That test is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide at least as much favorable cash flows as the unfavorable cash flows that would be incurred from an unfavorable change in the underlying of the same percentage. (Refer to paragraph 20(c)(1).)
- d. If a hedging instrument is used to modify the interest receipts or payments associated with a recognized financial asset or liability from one variable rate to another variable rate, the hedging instrument must be a link between an existing designated asset (or group of similar assets) with variable cash flows and an existing designated liability (or group of similar liabilities) with variable cash flows and be highly effective at achieving offsetting cash

flows. A link exists if the basis (that is, the rate index on which the interest rate is based) of one leg of an interest rate swap is the same as the basis of the interest receipts for the designated asset and the basis of the other leg of the swap is the same as the basis of the interest payments for the designated liability. In this situation, the criterion in the first sentence in paragraph 29(a) is applied separately to the designated asset and the designated liability.

A nonderivative instrument, such as a Treasury note, shall not be designated as a hedging instrument for a cash flow hedge.

***The Hedged Forecasted Transaction***

29. 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 a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.
- b. The occurrence of the forecasted transaction is probable.
- c. The forecasted transaction is a transaction with a party external to the reporting entity (except as permitted by paragraph 40) and presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.
- 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 (for example, if foreign exchange risk is hedged, the forecasted acquisition of a foreign-currency-denominated asset for which a foreign currency transaction gain or loss will be recognized in earnings). However, forecasted sales on credit and the forecasted accrual of royalties on probable future sales by third-party licensees are not considered the forecasted acquisition of a receivable. 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.
- e. If the variable cash flows of the forecasted transaction relate to a debt security that is classified as held-to-maturity under Statement 115, the risk being hedged is the risk of changes in its cash flows attributable to default or changes in the obligor's creditworthiness. For those variable cash flows, the risk being hedged cannot be the risk of changes in its cash flows attributable to changes in market interest rates.
- f. The forecasted transaction does not involve a business combination subject to the provisions of Opinion 16 and is not a transaction (such as a forecasted purchase, sale, or dividend) involving (1) a parent company's interests in consolidated subsidiaries, (2) a minority interest in a consolidated subsidiary, (3) an equity-method investment, or (4) an entity's own equity instruments.
- g. If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the

designated risk being hedged is (1) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient. Thus, for example, in hedging the exposure to changes in the cash flows relating to the purchase of its bronze bar inventory, an entity may not designate the risk of changes in the cash flows relating to purchasing the copper component in bronze as the risk being hedged for purposes of assessing offset as required by paragraph 28(b).

- h. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is (1) the risk of changes in the cash flows of the entire asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in market interest rates, (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates (refer to paragraph 40), or (4) the risk of changes in its cash flows attributable to default or changes in the obligor's creditworthiness. Two or more of the above risks may be designated simultaneously as being hedged. An entity may not designate prepayment risk as the risk being hedged (refer to paragraph 21(f)).

30. The effective portion of the gain or loss on a derivative designated as a cash flow hedge is reported in other comprehensive income, and the ineffective portion is reported in earnings. More specifically, a qualifying cash flow hedge shall be accounted for as follows:

- a. If an entity's defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in paragraph 63 in Section 2 of Appendix A), that excluded component of the gain or loss shall be recognized currently in earnings. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option's intrinsic value, the changes in the option's time value would be recognized in earnings. Time value is equal to the fair value of the option less its intrinsic value.
- b. Accumulated other comprehensive income associated with the hedged transaction shall be adjusted to a balance that reflects the *lesser* of the following (in absolute amounts):
  - (1) The cumulative gain or loss on the derivative from inception of the hedge less (a) the excluded component discussed in paragraph 30(a) above and (b) the derivative's gains or losses previously reclassified from accumulated other comprehensive income into earnings pursuant to paragraph 31
  - (2) The portion of the cumulative gain or loss on the derivative necessary to offset the cumulative change in expected future cash flows on the hedged transaction from inception of the hedge less the derivative's gains or losses previously reclassified from

accumulated other comprehensive income into earnings pursuant to paragraph 31.

That adjustment of accumulated other comprehensive income shall incorporate recognition in other comprehensive income of part or all of the gain or loss on the hedging derivative, as necessary.

- c. A gain or loss shall be recognized in earnings, as necessary, for any remaining gain or loss on the hedging derivative or to adjust other comprehensive income to the balance specified in paragraph 30(b) above.

Section 2 of Appendix A illustrates assessing hedge effectiveness and measuring hedge ineffectiveness. Examples 6 and 9 of Section 1 of Appendix B illustrate the application of this paragraph.

31. Amounts in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings (for example, when a forecasted sale actually occurs). If the hedged transaction results in the acquisition of an asset or the incurrence of a liability, the gains and losses in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the asset acquired or liability incurred affects earnings (such as in the periods that depreciation expense, interest expense, or cost of sales is recognized). However, if an entity expects at any time that continued reporting of a loss in accumulated other comprehensive income would lead to recognizing a net loss on the combination of the hedging instrument and the hedged transaction (and related asset acquired or liability incurred) in one or more future periods, a loss shall be reclassified immediately into earnings for the amount that is not expected to be recovered. For example, a loss shall be reported in earnings for a derivative that is designated as hedging the forecasted purchase of inventory to the extent that the cost basis of the inventory plus the related amount reported in accumulated other comprehensive income exceeds the amount expected to be recovered through sales of that inventory. (Impairment guidance is provided in paragraphs 34 and 35.)

32. An entity shall discontinue prospectively the accounting specified in paragraphs 30 and 31 for an existing hedge if any one of the following occurs:

- a. Any criterion in paragraphs 28 and 29 is no longer met.
- b. The derivative expires or is sold, terminated, or exercised.
- c. The entity removes the designation of the cash flow hedge.

In those circumstances, the net gain or loss shall remain in accumulated other comprehensive income and be reclassified into earnings as specified in paragraph 31. Furthermore, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in paragraphs 32(a) and 32(c), a different hedged transaction or a hedged item if the hedging relationship meets the criteria specified in paragraphs 28 and 29 for a cash flow hedge or paragraphs 20 and 21 for a fair value hedge.

33. If a cash flow hedge is discontinued because it is probable that the original forecasted transaction will not occur, the net gain or loss in accumulated other comprehensive income shall be immediately reclassified into earnings.

34. Existing requirements in generally accepted accounting principles for assessing asset impairment or recognizing an increased obligation apply to an asset or liability that gives rise to variable cash flows (such as a variable-rate financial instrument), for which the variable cash flows (the forecasted transactions) have been designated as being hedged and accounted for pursuant to paragraphs 30 and 31. Those impairment requirements shall be applied each period after hedge accounting has been applied for the period, pursuant to paragraphs 30 and 31 of this Statement. The fair value or expected cash flows of a hedging instrument shall not be considered in applying those requirements. The gain or loss on the hedging instrument in accumulated other comprehensive income shall, however, be accounted for as discussed in paragraph 31.

35. If, under existing requirements in generally accepted accounting principles, an impairment loss is recognized on an asset or an additional obligation is recognized on a liability to which a hedged forecasted transaction relates, any offsetting net gain related to that transaction in accumulated other comprehensive income shall be reclassified immediately into earnings. Similarly, if a recovery is recognized on the asset or liability to which the forecasted transaction relates, any offsetting net loss that has been accumulated in other comprehensive income shall be reclassified immediately into earnings.

#### **Foreign Currency Hedges**

36. Consistent with the functional currency concept in Statement 52, an entity may designate the following types of hedges of foreign currency exposure, as specified in paragraphs 37-42:

- a. A fair value hedge of an unrecognized firm commitment or an available-for-sale security
- b. A cash flow hedge of a forecasted foreign-currency-denominated transaction or a forecasted intercompany foreign-currency-denominated transaction
- c. A hedge of a net investment in a foreign operation.

The criterion in paragraph 21(c)(1) requires that a recognized asset or liability that may give rise to a foreign currency transaction gain or loss under Statement 52 (such as a foreign-currency-denominated receivable or payable) not be the hedged item in a foreign currency fair value or cash flow hedge because it is remeasured with the changes in the carrying amount attributable to what would be the hedged risk (an exchange rate change) reported currently in earnings. Similarly, the criterion in paragraph 29(d) requires that the forecasted acquisition of an asset or the incurrence of a liability that may give rise to a foreign currency transaction gain or loss under Statement 52 not be the hedged item in a foreign currency cash flow hedge because, subsequent to acquisition or incurrence, the asset or liability will be remeasured with changes in the carrying amount attributable to what would be the hedged risk reported currently in earnings. A foreign currency derivative instrument that has been entered into with another member of a consolidated group can be a hedging instrument in the

consolidated financial statements only if that other member has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge.

### *Foreign Currency Fair Value Hedges*

37. *Unrecognized firm commitment.* A derivative instrument or a nonderivative financial instrument <sup>11</sup> that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in paragraphs 22–27 if all the fair value hedge criteria in paragraphs 20 and 21 are met.

38. *Available-for-sale security.* A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of an available-for-sale security. A derivative instrument can be designated as hedging the changes in the fair value of an available-for-sale *debt* security (or a specific portion thereof) attributable to changes in foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in paragraphs 22–27 if all the fair value hedge criteria in paragraphs 20 and 21 are met. An available-for-sale *equity* security can be hedged for changes in the fair value attributable to changes in foreign currency exchange rates and qualify for the accounting specified in paragraphs 22–27 only if the fair value hedge criteria in paragraphs 20 and 21 are met and the following two conditions are satisfied:

- a. The security is not traded on an exchange (or other established marketplace) on which trades are denominated in the investor's functional currency.
- b. Dividends or other cash flows to holders of the security are all denominated in the same foreign currency as the currency expected to be received upon sale of the security.

The change in fair value of the hedged available-for-sale equity security attributable to foreign exchange risk is reported in earnings pursuant to paragraph 23 and not in other comprehensive income.

39. Gains and losses on a qualifying foreign currency fair value hedge shall be accounted for as specified in paragraphs 22–27. The gain or loss on a nonderivative hedging instrument attributable to foreign currency risk is the foreign currency transaction gain or loss as determined under Statement 52. <sup>12</sup> 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.

### *Foreign Currency Cash Flow Hedges*

40. A nonderivative financial instrument shall not be designated as a hedging instrument in a foreign currency cash flow hedge. A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with either a forecasted foreign-currency-denominated transaction (for example, a forecasted export sale to an unaffiliated entity with the price to be denominated in a foreign currency) or a forecasted intercompany foreign-currency-denominated transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary) qualifies for hedge accounting if all of the following criteria are met:

- a. The operating unit that has the foreign currency exposure is a party to the hedging instrument (which can be an instrument between a parent company and its subsidiary—refer to paragraph 36).
- b. The hedged transaction is denominated in a currency other than that unit's functional currency.
- c. All of the criteria in paragraphs 28 and 29 are met, except for the criterion in paragraph 29(c) that requires that the forecasted transaction be with a party external to the reporting entity.
- d. If the hedged transaction is a group of individual forecasted foreign-currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.

41. A qualifying foreign currency cash flow hedge shall be accounted for as specified in paragraphs 30–35.

### *Hedges of the Foreign Currency Exposure of a Net Investment in a Foreign Operation*

42. A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging the foreign currency exposure of a net investment in a foreign operation. The gain or loss on a hedging derivative instrument (or the foreign currency transaction gain or loss on the nonderivative hedging instrument) that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation shall be reported in the same manner as a translation adjustment to the extent it is effective as a hedge. The hedged net investment shall be accounted for consistent with Statement 52; the provisions of this Statement for recognizing the gain or loss on assets designated as being hedged in a fair value hedge do not apply to the hedge of a net investment in a foreign operation.

### **Accounting by Not-for-Profit Organizations and Other Entities That Do Not Report Earnings**

43. An entity that does not report earnings as a separate caption in a statement of financial

performance (for example, a not-for-profit organization or a defined benefit pension plan) shall recognize the gain or loss on a hedging instrument and a nonhedging derivative instrument as a change in net assets in the period of change unless the hedging instrument is designated as a hedge of the foreign currency exposure of a net investment in a foreign operation. In that case, the provisions of paragraph 42 of this Statement shall be applied. Entities that do not report earnings shall recognize the changes in the carrying amount of the hedged item pursuant to paragraph 22 in a fair value hedge as a change in net assets in the period of change. Those entities are not permitted to use cash flow hedge accounting because they do not report earnings separately. Consistent with the provisions of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, this Statement does not prescribe how a not-for-profit organization should determine the components of an operating measure, if one is presented.

## Disclosures

44. An entity that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 37 and 42) shall disclose its objectives for holding or issuing those instruments, the context needed to understand those objectives, and its strategies for achieving those objectives. The description shall distinguish between derivative instruments (and nonderivative instruments) designated as fair value hedging instruments, derivative instruments designated as cash flow hedging instruments, derivative instruments (and nonderivative instruments) designated as hedging instruments for hedges of the foreign currency exposure of a net investment in a foreign operation, and all other derivatives. The description also shall indicate the entity's risk management policy for each of those types of hedges, including a description of the items or transactions for which risks are hedged. For derivative instruments not designated as hedging instruments, the description shall indicate the purpose of the derivative activity. Qualitative disclosures about an entity's objectives and strategies for using derivative instruments may be more meaningful if such objectives and strategies are described in the context of an entity's overall risk management profile. If appropriate, an entity is encouraged, but not required, to provide such additional qualitative disclosures.

45. An entity's disclosures for every reporting period for which a complete set of financial statements is presented also shall include the following:

### *Fair value hedges*

- a. For derivative instruments, as well as nonderivative instruments that may give rise to foreign currency transaction gains or losses under Statement 52, that have been designated and have qualified as fair value hedging instruments and for the related hedged items:
  - (1) The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges' ineffectiveness and (b) the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness, and a description of where the net gain or loss is reported in the statement of income or other statement of financial performance

- (2) The amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge.

#### *Cash flow hedges*

- b. For derivative instruments that have been designated and have qualified as cash flow hedging instruments and for the related hedged transactions:
  - (1) The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges' ineffectiveness and (b) the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness, and a description of where the net gain or loss is reported in the statement of income or other statement of financial performance
  - (2) A description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in accumulated other comprehensive income, and the estimated net amount of the existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months
  - (3) The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments
  - (4) The amount of gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur.

#### *Hedges of the net investment in a foreign operation*

- c. For derivative instruments, as well as nonderivative instruments that may give rise to foreign currency transaction gains or losses under Statement 52, that have been designated and have qualified as hedging instruments for hedges of the foreign currency exposure of a net investment in a foreign operation, the net amount of gains or losses included in the cumulative translation adjustment during the reporting period.

The quantitative disclosures about derivative instruments may be more useful, and less likely to be perceived to be out of context or otherwise misunderstood, if similar information is disclosed about other financial instruments or nonfinancial assets and liabilities to which the derivative instruments are related by activity. Accordingly, in those situations, an entity is encouraged, but not required, to present a more complete picture of its activities by disclosing that information.

### **Reporting Changes in the Components of Comprehensive Income**

46. An entity shall display as a separate classification within other comprehensive income the net gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments that are reported in comprehensive income pursuant to paragraphs 30 and 41.

47. As part of the disclosures of accumulated other comprehensive income, pursuant to paragraph 26 of FASB Statement No. 130, *Reporting Comprehensive Income*, an entity shall

separately disclose the beginning and ending accumulated derivative gain or loss, the related net change associated with current period hedging transactions, and the net amount of any reclassification into earnings.

### **Effective Date and Transition**

48. This Statement shall be effective for all fiscal quarters of all fiscal years beginning after June 15, 1999. Initial application of this Statement shall be as of the beginning of an entity's fiscal quarter; on that date, hedging relationships shall be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all of the provisions of this Statement is encouraged but is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. Earlier application of selected provisions of this Statement is not permitted. This Statement shall not be applied retroactively to financial statements of prior periods.

49. At the date of initial application, an entity shall recognize all freestanding derivative instruments (that is, derivative instruments other than embedded derivative instruments) in the statement of financial position as either assets or liabilities and measure them at fair value, pursuant to paragraph 17. **13** The difference between a derivative's previous carrying amount and its fair value shall be reported as a transition adjustment, as discussed in paragraph 52. The entity also shall recognize offsetting gains and losses on hedged assets, liabilities, and firm commitments by adjusting their carrying amounts at that date, as discussed in paragraph 52(b). Any gains or losses on derivative instruments that are reported independently as deferred gains or losses (that is, liabilities or assets) in the statement of financial position at the date of initial application shall be derecognized from that statement; that derecognition also shall be reported as transition adjustments as indicated in paragraph 52. Any gains or losses on derivative instruments reported in other comprehensive income at the date of initial application because the derivative instruments were hedging the fair value exposure of available-for-sale securities also shall be reported as transition adjustments; the offsetting losses and gains on the securities shall be accounted for pursuant to paragraph 52(b). Any gain or loss on a derivative instrument reported in accumulated other comprehensive income at the date of initial application because the derivative instrument was hedging the *variable cash flow exposure* of a forecasted (anticipated) transaction related to an available-for-sale security shall remain in accumulated other comprehensive income and shall *not* be reported as a transition adjustment. The accounting for any gains and losses on derivative instruments that arose prior to the initial application of the Statement and that were previously added to the carrying amount of recognized hedged assets or liabilities is not affected by this Statement. Those gains and losses shall not be included in the transition adjustment.

50. At the date of initial application, an entity also shall recognize as an asset or liability in the statement of financial position any embedded derivative instrument that is required pursuant to paragraphs 12–16 to be separated from its host contract if the hybrid instrument in which it is embedded was issued, acquired, or substantively modified by the entity after December 31,

1997. For all of its hybrid instruments that exist at the date of initial application and were issued or acquired before January 1, 1998 and not substantively modified thereafter, an entity may choose either (a) not to apply this Statement to any of those hybrid instruments or (b) to recognize as assets or liabilities all the derivative instruments embedded in those hybrid instruments that would be required pursuant to paragraphs 12–16 to be separated from their host contracts. That choice is not permitted to be applied to only some of an entity’s individual hybrid instruments and must be applied on an all-or-none basis.

51. If an embedded derivative instrument is to be separated from its host contract in conjunction with the initial application of this Statement, the entity shall consider the following in determining the related transition adjustment:

- a. The carrying amount of the host contract at the date of initial application shall be based on its fair value on the date that the hybrid instrument was issued or acquired by the entity and shall reflect appropriate adjustments for subsequent activity, such as subsequent cash receipts or payments and the amortization of any premium or discount on the host contract arising from the separation of the embedded derivative.
- b. The carrying amount of the embedded derivative instrument at the date of initial application shall be its fair value.
- c. The transition adjustment shall be the difference at the date of initial application between (1) the previous carrying amount of the hybrid instrument and (2) the sum of the new net carrying amount of the host contract and the fair value of the embedded derivative instrument. The entity shall not retroactively designate a hedging relationship that could have been made had the embedded derivative instrument initially been accounted for separate from the host contract.

52. The transition adjustments resulting from adopting this Statement shall be reported in net income or other comprehensive income, as appropriate, as the effect of a change in accounting principle and presented in a manner similar to the cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, *Accounting Changes*. Whether a transition adjustment related to a specific derivative instrument is reported in net income, reported in other comprehensive income, or allocated between both is based on the hedging relationships, if any, that had existed for that derivative instrument and that were the basis for accounting under generally accepted accounting principles before the date of initial application of this Statement.

- a. If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment shall be reported as a cumulative-effect-type adjustment of accumulated other comprehensive income.
- b. If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the fair value exposure of an asset, a liability, or a firm commitment, the transition adjustment for the derivative shall be reported as a cumulative-effect-type adjustment of net income. Concurrently, any gain or loss on the

hedged item (that is, difference between the hedged item's fair value and its carrying amount) shall be recognized as an adjustment of the hedged item's carrying amount at the date of initial application, but only to the extent of an offsetting transition adjustment for the derivative. That adjustment of the hedged item's carrying amount shall also be reported as a cumulative-effect-type adjustment of net income. The transition adjustment related to the gain or loss reported in accumulated other comprehensive income on a derivative instrument that hedged an available-for-sale security, together with the loss or gain on the related security (to the extent of an offsetting transition adjustment for the derivative instrument), shall be reclassified to earnings as a cumulative-effect-type adjustment of both net income and accumulated other comprehensive income.

- c. If a derivative instrument had been designated in multiple hedging relationships that addressed both the fair value exposure of an asset or a liability and the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment for the derivative shall be allocated between the cumulative-effect-type adjustment of net income and the cumulative-effect-type adjustment of accumulated other comprehensive income and shall be reported as discussed in paragraphs 52(a) and 52(b) above. Concurrently, any gain or loss on the hedged item shall be accounted for at the date of initial application as discussed in paragraph 52(b) above.
- d. Other transition adjustments not encompassed by paragraphs 52(a), 52(b), and 52(c) above shall be reported as part of the cumulative-effect-type adjustment of net income.

53. Any transition adjustment reported as a cumulative-effect-type adjustment of accumulated other comprehensive income shall be subsequently reclassified into earnings in a manner consistent with paragraph 31. For those amounts, an entity shall disclose separately in the year of initial application the amount of gains and losses reported in accumulated other comprehensive income and associated with the transition adjustment that are being reclassified into earnings during the 12 months following the date of initial application.

54. At the date of initial application, an entity may transfer any held-to-maturity security into the available-for-sale category or the trading category. An entity will then be able in the future to designate a security transferred into the available-for-sale category as the hedged item, or its variable interest payments as the cash flow hedged transactions, in a hedge of the exposure to changes in market interest rates, changes in foreign currency exchange rates, or changes in its overall fair value. (Paragraph 21(d) precludes a held-to-maturity security from being designated as the hedged item in a fair value hedge of market interest rate risk or the risk of changes in its overall fair value. Paragraph 29(e) similarly precludes the variable cash flows of a held-to-maturity security from being designated as the hedged transaction in a cash flow hedge of market interest rate risk.) The unrealized holding gain or loss on a held-to-maturity security transferred to another category at the date of initial application shall be reported in net income or accumulated other comprehensive income consistent with the requirements of paragraphs 15(b) and 15(c) of Statement 115 and reported with the other transition adjustments discussed in paragraph 52 of this Statement. Such transfers from the held-to-maturity category at the date of initial adoption shall not call into question an entity's intent to hold other debt securities to

maturity in the future.<sup>14</sup>

55. At the date of initial application, an entity may transfer any available-for-sale security into the trading category. After any related transition adjustments from initially applying this Statement have been recognized, the unrealized holding gain or loss remaining in accumulated other comprehensive income for any transferred security at the date of initial application shall be reclassified into earnings (but not reported as part of the cumulative-effect-type adjustment for the transition adjustments), consistent with paragraph 15(b) of Statement 115. If a derivative instrument had been hedging the variable cash flow exposure of a forecasted transaction related to an available-for-sale security that is transferred into the trading category at the date of initial application and the entity had reported a gain or loss on that derivative instrument in other comprehensive income (consistent with paragraph 115 of Statement 115), the entity also shall reclassify those derivative gains and losses into earnings (but not report them as part of the cumulative-effect-type adjustment for the transition adjustments).

56. At the date of initial application, mortgage bankers and other servicers of financial assets may choose to restratify their servicing rights pursuant to paragraph 37(g) of Statement 125 in a manner that would enable individual strata to comply with the requirements of this Statement regarding what constitutes “a portfolio of similar assets.” As noted in footnote 9 of this Statement, mortgage bankers and other servicers of financial assets that designate a hedged portfolio by aggregating servicing rights within one or more risk strata used under paragraph 37(g) of Statement 125 would not necessarily comply with the requirement in paragraph 21(a) of this Statement for portfolios of similar assets, since the risk stratum under paragraph 37(g) of Statement 125 can be based on any predominant risk characteristic, including date of origination or geographic location. The restratification of servicing rights is a change in the application of an accounting principle, and the effect of that change as of the initial application of this Statement shall be reported as part of the cumulative-effect-type adjustment for the transition adjustments.

**The provisions of this Statement need  
not be applied to immaterial items.**

*This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:*

Edmund L. Jenkins, *Chairman*  
Joseph V. Anania  
Anthony T. Cope  
John M. Foster  
Gaylen N. Larson  
James J. Leisenring  
Gerhard G. Mueller

## Appendix A: IMPLEMENTATION GUIDANCE

### Section 1: Scope and Definition

#### Application of Paragraphs 6–11

57. The following discussion further explains the three characteristics of a derivative instrument discussed in paragraphs 6–9.

- a. *Underlying.* An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative. An underlying usually is one or a combination of the following:
- (1) A security price or security price index
  - (2) A commodity price or commodity price index
  - (3) An interest rate or interest rate index
  - (4) A credit rating or credit index
  - (5) An exchange rate or exchange rate index
  - (6) An insurance index or catastrophe loss index
  - (7) A climatic or geological condition (such as temperature, earthquake severity, or rainfall), another physical variable, or a related index.

However, an underlying may be any variable whose changes are observable or otherwise objectively verifiable. Paragraph 10(e) specifically excludes a contract with settlement based on certain variables unless the contract is exchange-traded. A contract based on any variable that is not specifically excluded is subject to the requirements of this Statement if it has the other two characteristics identified in paragraph 6 (which also are discussed in paragraphs 57(b) and paragraphs 57(c) below).

- b. *Initial net investment.* A derivative requires no initial net investment or a smaller initial net investment than other types of contracts that have a similar response to changes in market factors. For example, entering into a commodity futures contract generally requires no net investment, while purchasing the same commodity requires an initial net investment equal to its market price. However, both contracts reflect changes in the price of the commodity in the same way (that is, similar gains or losses will be incurred). A swap or forward contract also generally does not require an initial net investment unless the terms favor one party over the other. An option generally requires that one party make an initial net investment (a premium) because that party has the rights under the contract and the other party has the obligations. The phrase *initial net investment* is stated from the perspective of only one party to the contract, but it determines the application of the Statement for both parties. **15**
- c. *Net settlement.* A contract that meets any one of the following criteria has the characteristic described as net settlement:
- (1) Its terms implicitly or explicitly require or permit net settlement. For example, a penalty for nonperformance in a purchase order is a net settlement provision if the amount of the penalty is based on changes in the price of the items that are the subject

of the contract. Net settlement may be made in cash or by delivery of any other asset, whether or not it is readily convertible to cash. A fixed penalty for nonperformance is not a net settlement provision.

- (2) There is an established market mechanism that facilitates net settlement outside the contract. The term market mechanism is to be interpreted broadly. Any institutional arrangement or other agreement that enables either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost is considered net settlement.
- (3) It requires delivery of an asset that is readily convertible to cash. The definition of *readily convertible to cash* in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, includes, for example, a security or commodity traded in an active market and a unit of foreign currency that is readily convertible into the functional currency of the reporting entity. A security that is publicly traded but for which the market is not very active is readily convertible to cash if the number of shares or other units of the security to be exchanged is small relative to the daily transaction volume. That same security would not be readily convertible if the number of shares to be exchanged is large relative to the daily transaction volume. The ability to use a security that is not publicly traded or an agricultural or mineral product without an active market as collateral in a borrowing does not, in and of itself, mean that the security or the commodity is readily convertible to cash.

58. The following discussion further explains some of the exceptions discussed in paragraph 10.

- a. *“Regular-way” security trades.* The exception in paragraph 10(a) applies only to a contract that requires delivery of securities that are readily convertible to cash. <sup>16</sup> To qualify, a contract must require delivery of such a security within the period of time after the trade date that is customary in the market in which the trade takes place. For example, a contract to purchase or sell a publicly traded equity security in the United States customarily requires settlement within three business days. If a contract for purchase of that type of security requires settlement in three business days, the regular-way exception applies, but if the contract requires settlement in five days, the regular-way exception does not apply. This Statement does not change whether an entity recognizes regular-way security trades on the trade date or the settlement date. However, trades that do not qualify for the regular-way exception are subject to the requirements of this Statement regardless of the method an entity uses to report its security trades.
- b. *Normal purchases and normal sales.* The exception in paragraph 10(b) applies only to a contract that requires future delivery of assets (other than financial instruments or derivative instruments) that are readily convertible to cash <sup>17</sup> and only if there is no market mechanism to facilitate net settlement outside the contract. To qualify for the exception, a contract’s terms also must be consistent with the terms of an entity’s normal purchases or normal sales, that is, the quantity purchased or sold must be reasonable in relation to the entity’s business

needs. Determining whether or not the terms are consistent will require judgment. In making those judgments, an entity should consider all relevant factors, such as (1) the quantities provided under the contract and the entity's need for the related assets, (2) the locations to which delivery of the items will be made, (3) the period of time between entering into the contract and delivery, and (4) the entity's prior practices with regard to such contracts. Evidence such as past trends, expected future demand, other contracts for delivery of similar items, an entity's and industry's customs for acquiring and storing the related commodities, and an entity's operating locations should help in identifying contracts that qualify as normal purchases or normal sales.

- c. *Certain contracts that are not traded on an exchange.* A contract that is not traded on an exchange is not subject to the requirements of this Statement if the underlying is:
- (1) A climatic or geological variable or other physical variable. Climatic, geological, and other physical variables include things like the number of inches of rainfall or snow in a particular area and the severity of an earthquake as measured by the Richter scale.
  - (2) The price or value of (a) a nonfinancial asset of one of the parties to the contract unless that asset is readily convertible to cash or (b) a nonfinancial liability of one of the parties to the contract unless that liability requires delivery of an asset that is readily convertible to cash.
  - (3) Specified volumes of sales or service revenues by one of the parties. That exception is intended to apply to contracts with settlements based on the volume of items sold or services rendered, for example, royalty agreements. It is not intended to apply to contracts based on changes in sales or revenues due to changes in market prices.

If a contract's underlying is the combination of two or more variables, and one or more would not qualify for one of the exceptions above, the application of this Statement to that contract depends on the predominant characteristics of the combined variable. The contract is subject to the requirements of this Statement if the changes in its combined underlying are highly correlated with changes in one of the component variables that would not qualify for an exception.

59. The following discussion illustrates the application of paragraphs 6–11 in several situations.

- a. *Forward purchases or sales of to-be-announced securities or securities when-issued, as-issued, or if-issued.* A contract for the purchase and sale of a security when, as, or if issued or to be announced is excluded from the requirements of this Statement as a regular-way security trade if (1) there is no other way to purchase or sell that security and (2) settlement will occur within the shortest period possible for that security.
- b. *Credit-indexed contracts (often referred to as credit derivatives).* Many different types of contracts are indexed to the creditworthiness of a specified entity or group of entities, but not all of them are derivative instruments. Credit-indexed contracts that have certain characteristics described in paragraph 10(d) are guarantees and are not subject to the requirements of this Statement. Credit-indexed contracts that do not have the characteristics necessary to qualify for the exception in paragraph 10(d) are subject to the requirements of

this Statement. One example of the latter is a credit-indexed contract that requires a payment due to changes in the creditworthiness of a specified entity even if neither party incurs a loss due to the change (other than a loss caused by the payment under the credit-indexed contract).

- c. *Take-or-pay contracts.* Under a take-or-pay contract, an entity agrees to pay a specified price for a specified quantity of a product whether or not it takes delivery. Whether a take-or-pay contract is subject to this Statement depends on its terms. For example, if the product to be delivered is not readily convertible to cash and there is no net settlement option, the contract fails to meet the criterion in paragraph 6(c) and is not subject to the requirements of this Statement. However, a contract that meets all of the following conditions is subject to the requirements of this Statement: (1) the product to be delivered is readily convertible to cash, (2) the contract does not qualify for the normal purchases and normal sales exception in paragraph 10(b), and (3) little or no initial net investment in the contract is required.
- d. *Short sales (sales of borrowed securities).* <sup>18</sup> Short sales typically involve the following activities:
- (1) Selling a security (by the short seller to the purchaser)
  - (2) Borrowing a security (by the short seller from the lender)
  - (3) Delivering the borrowed security (by the short seller to the purchaser)
  - (4) Purchasing a security (by the short seller from the market)
  - (5) Delivering the purchased security (by the short seller to the lender).
- Those five activities involve three separate contracts. A contract that distinguishes a short sale involves activities (2) and (5), borrowing a security and replacing it by delivering an identical security. Such a contract has two of the three characteristics of a derivative instrument. The settlement is based on an underlying (the price of the security) and a notional amount (the face amount of the security or the number of shares), and the settlement is made by delivery of a security that is readily convertible to cash. However, the other characteristic, little or no initial net investment, is not present. The borrowed security is the lender's initial net investment in the contract. Consequently, the contract relating to activities (2) and (5) is not a derivative instrument. The other two contracts (one for activities (1) and (3) and the other for activity (4)) are routine and do not generally involve derivative instruments. However, if a forward purchase or sale is involved, and the contract does not qualify for the exception in paragraph 10(a), it is subject to the requirements of this Statement.
- e. *Repurchase agreements and "wash sales"* (accounted for as sales as described in paragraphs 68 and 69 of Statement 125). A transfer of financial assets accounted for as a sale under Statement 125 in which the transferor is both obligated and entitled to repurchase the transferred asset at a fixed or determinable price contains two separate features, one of which may be a derivative. The initial exchange of financial assets for cash is a sale-purchase transaction—generally not a transaction that involves a derivative instrument. However, the accompanying forward contract that gives the transferor the right and obligation to repurchase the transferred asset involves an underlying and a notional amount (the price of the security and its denomination), and it does not require an initial net

investment in the contract. Consequently, if the forward contract requires delivery of a security that is readily convertible to cash or otherwise meets the net settlement criterion in paragraph 9, it is subject to the requirements of this Statement.

#### **Application of the Clearly-and-Closely-Related Criterion in Paragraphs 12–16**

60. In discussing whether a hybrid instrument contains an embedded derivative instrument (also simply referred to as an *embedded derivative*) that warrants separate accounting, paragraph 12 focuses on whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. If the host contract encompasses a residual interest in an entity, then its economic characteristics and risks should be considered that of an equity instrument and an embedded derivative would need to possess principally equity characteristics (related to the same entity) to be considered clearly and closely related to the host contract. However, most commonly, a financial instrument host contract will not embody a claim to the residual interest in an entity and, thus, the economic characteristics and risks of the host contract should be considered that of a debt instrument. For example, even though the overall hybrid instrument that provides for repayment of principal may include a return based on the market price (the underlying as defined in this Statement) of XYZ Corporation common stock, the host contract does not involve any existing or potential residual interest rights (that is, rights of ownership) and thus would not be an equity instrument. The host contract would instead be considered a debt instrument, and the embedded derivative that incorporates the equity-based return would not be clearly and closely related to the host contract. If the embedded derivative is considered *not* to be clearly and closely related to the host contract, the embedded derivative must be separated from the host contract and accounted for as a derivative instrument *by both parties* to the hybrid instrument, except as provided by paragraph 11(a).

61. The following guidance is relevant in deciding whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract.

- a. *Interest rate indexes.* An embedded derivative in which the underlying is an interest rate or interest rate index and a host contract that is considered a debt instrument are considered to be clearly and closely related unless, as discussed in paragraph 13, the embedded derivative contains a provision that (1) permits any possibility whatsoever that the investor's (or creditor's) undiscounted net cash inflows over the life of the instrument would not recover substantially all of its initial recorded investment in the hybrid instrument under its contractual terms or (2) could under any possibility whatsoever at least double the investor's initial rate of return on the host contract and also result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality. The requirement to separate the embedded derivative from the host contract applies to *both parties* to the hybrid instrument even though the above tests focus on the investor's net cash inflows. Plain-vanilla servicing rights, which involve an obligation to perform servicing and the right

to receive fees for performing that servicing, do not contain an embedded derivative that would be separated from those servicing rights and accounted for as a derivative.

- b. *Inflation-indexed interest payments.* The interest rate and the rate of inflation in the economic environment for the currency in which a debt instrument is denominated are considered to be clearly and closely related. Thus, nonleveraged inflation-indexed contracts (debt instruments, capitalized lease obligations, pension obligations, and so forth) would *not* have the inflation-related embedded derivative separated from the host contract.
- c. *Credit-sensitive payments.* The creditworthiness of the debtor and the interest rate on a debt instrument are considered to be clearly and closely related. Thus, for debt instruments that have the interest rate reset in the event of (1) default (such as violation of a credit-risk-related covenant), (2) a change in the debtor's published credit rating, or (3) a change in the debtor's creditworthiness indicated by a change in its spread over Treasury bonds, the related embedded derivative would *not* be separated from the host contract.
- d. *Calls and puts on debt instruments.* Call options (or put options) that can accelerate the repayment of principal on a debt instrument are considered to be clearly and closely related to a debt instrument that requires principal repayments unless both (1) the debt involves a substantial premium or discount (which is common with zero-coupon bonds) and (2) the put or call option is only contingently exercisable. Thus, if a substantial premium or discount is not involved, embedded calls and puts (including contingent call or put options that are not exercisable unless an event of default occurs) would *not* be separated from the host contract. However, for contingently exercisable calls and puts to be considered clearly and closely related, they can be indexed only to interest rates or credit risk, not some extraneous event or factor. In contrast, call options (or put options) that do not accelerate the repayment of principal on a debt instrument but instead require a cash settlement that is equal to the price of the option at the date of exercise would *not* be considered to be clearly and closely related to the debt instrument in which it is embedded and would be separated from the host contract. In certain unusual situations, a put or call option may have been subsequently added to a debt instrument in a manner that causes the investor (creditor) to be exposed to performance risk (default risk) by different parties for the embedded option and the host debt instrument, respectively. In those unusual situations, the embedded option and the host debt instrument are *not* clearly and closely related.
- e. *Calls and puts on equity instruments.* A put option that enables the holder to require the issuer of an equity instrument to reacquire that equity instrument for cash or other assets is *not* clearly and closely related to that equity instrument. Thus, such a put option embedded in the equity instrument to which it relates should be separated from the host contract by the holder of the equity instrument. That put option also should be separated from the host contract by the issuer of the equity instrument except in those cases in which the put option is not considered to be a derivative instrument pursuant to paragraph 11(a) because it is classified in stockholders' equity. A purchased call option that enables the issuer of an equity instrument (such as common stock) to reacquire that equity instrument would not be considered to be a derivative instrument by the issuer of the equity instrument pursuant to paragraph 11(a). Thus, if the call option were embedded in the related equity instrument, it would not be separated from the host contract by the issuer. However, for the holder of the

related equity instrument, the embedded written call option would *not* be considered to be clearly and closely related to the equity instrument and should be separated from the host contract.

- f. *Floors, caps, and collars.* Floors or caps (or collars, which are combinations of caps and floors) on interest rates and the interest rate on a debt instrument are considered to be clearly and closely related, provided the cap is at or above the current market price (or rate) and the floor is at or below the current market price (or rate) at issuance of the instrument. Thus, the derivative embedded in a variable-rate debt instrument that has a floor on the interest rate (that is, the floor option) would not be separated from the host contract and accounted for separately even though, in a falling interest rate environment, the debt instrument may have a return to the investor that is a significant amount above the market return of a debt instrument without the floor provision (refer to paragraph 13(b)).
- g. *Term-extending options.* An embedded derivative provision that either (1) unilaterally enables one party to extend significantly the remaining term to maturity or (2) automatically extends significantly the remaining term triggered by specific events or conditions is *not* clearly and closely related to the interest rate on a debt instrument unless the interest rate is concurrently reset to the approximate current market rate for the extended term and the debt instrument initially involved no significant discount. Thus, if there is no reset of interest rates, the embedded derivative must be separated from the host contract and accounted for as a derivative instrument. That is, a term-extending option cannot be used to circumvent the restriction in paragraph 61(a) regarding the investor's not recovering substantially all of its initial recorded investment.
- h. *Equity-indexed interest payments.* The changes in fair value of an equity interest and the interest yield on a debt instrument are *not* clearly and closely related. Thus, an equity-related derivative embedded in an equity-indexed debt instrument (whether based on the price of a specific common stock or on an index that is based on a basket of equity instruments) must be separated from the host contract and accounted for as a derivative instrument.
- i. *Commodity-indexed interest or principal payments.* The changes in fair value of a commodity (or other asset) and the interest yield on a debt instrument are *not* clearly and closely related. Thus, a commodity-related derivative embedded in a commodity-indexed debt instrument must be separated from the noncommodity host contract and accounted for as a derivative instrument.
- j. *Indexed rentals:*
  - (1) *Inflation-indexed rentals.* Rentals for the use of leased assets and adjustments for inflation on similar property are considered to be clearly and closely related. Thus, unless a significant leverage factor is involved, the inflation-related derivative embedded in an inflation-indexed lease contract would *not* be separated from the host contract.
  - (2) *Contingent rentals based on related sales.* Lease contracts that include contingent rentals based on certain sales of the lessee would *not* have the contingent-rental-related embedded derivative separated from the host contract because, under paragraph 10(e)(3), a non-exchange-traded contract whose underlying is specified volumes of

sales by one of the parties to the contract would not be subject to the requirements of this Statement.

- (3) *Contingent rentals based on a variable interest rate.* The obligation to make future payments for the use of leased assets and the adjustment of those payments to reflect changes in a variable-interest-rate index are considered to be clearly and closely related. Thus, lease contracts that include contingent rentals based on changes in the prime rate would *not* have the contingent-rental-related embedded derivative separated from the host contract.
- k. *Convertible debt.* The changes in fair value of an equity interest and the interest rates on a debt instrument are not clearly and closely related. Thus, for a debt security that is convertible into a specified number of shares of the debtor's common stock or another entity's common stock, the embedded derivative (that is, the conversion option) must be separated from the debt host contract and accounted for as a derivative instrument provided that the conversion option would, as a freestanding instrument, be a derivative instrument subject to the requirements of this Statement. (For example, if the common stock was not readily convertible to cash, a conversion option that requires purchase of the common stock would not be accounted for as a derivative.) That accounting applies only to the holder (investor) if the debt is convertible to the debtor's common stock because, under paragraph 11(a), a separate option with the same terms would not be considered to be a derivative for the issuer.
- l. *Convertible preferred stock.* Because the changes in fair value of an equity interest and interest rates on a debt instrument are not clearly and closely related, the terms of the preferred stock (other than the conversion option) must be analyzed to determine whether the preferred stock (and thus the potential host contract) is more akin to an equity instrument or a debt instrument. A typical cumulative fixed-rate preferred stock that has a mandatory redemption feature is more akin to debt, whereas cumulative participating perpetual preferred stock is more akin to an equity instrument.

## **Section 2: Assessment of Hedge Effectiveness**

### **Hedge Effectiveness Requirements of This Statement**

62. This Statement requires that an entity define at the time it designates a hedging relationship the method it will use to assess the hedge's effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged. It also requires that an entity use that defined method consistently throughout the hedge period (a) to assess at inception of the hedge and on an ongoing basis whether it expects the hedging relationship to be highly effective in achieving offset and (b) to measure the ineffective part of the hedge. If the entity identifies an improved method and wants to apply that method prospectively, it must discontinue the existing hedging relationship and designate the relationship anew using the improved method. This Statement does not specify a single method for either assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness. The appropriateness of a given method

of assessing hedge effectiveness can depend on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, however, an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.

63. In defining how hedge effectiveness will be assessed, an entity must specify whether it will include in that assessment all of the gain or loss on a hedging instrument. This Statement permits (but does not require) an entity to 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 contract is assessed based on changes in the option's intrinsic value, the change in the time value of the contract would be excluded from the assessment of hedge effectiveness.
- b. If the effectiveness of a hedge with an option contract is assessed based on changes in the option's minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract would be excluded from the assessment of hedge effectiveness.
- c. If the effectiveness of a hedge with a forward 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 would be excluded from the assessment of hedge effectiveness.

In each circumstance above, changes in the excluded component would be included currently in earnings, together with any ineffectiveness that results under the defined method of assessing ineffectiveness. As noted in paragraph 62, the effectiveness of similar hedges generally should be assessed similarly; that includes whether a component of the gain or loss on a derivative is excluded in assessing effectiveness. No other components of a gain or loss on the designated hedging instrument may be excluded from the assessment of hedge effectiveness.

64. In assessing the effectiveness of a cash flow hedge, an entity generally will need to consider the time value of money if significant in the circumstances. Considering the effect of the time value of money is especially important if the hedging instrument involves periodic cash settlements. An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures 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.

65. Whether a hedging relationship qualifies as highly effective sometimes will be easy to assess, and there will be no ineffectiveness to recognize in earnings during the term of the hedge. If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) 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 highly effective and that there will be no ineffectiveness to be recognized in earnings if:

- 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.
- b. The fair value of the forward contract at inception is zero.
- c. Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and included directly in earnings pursuant to paragraph 63 or the change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

66. Assessing hedge effectiveness and measuring the ineffective part of the hedge, however, can be more complex. For example, hedge ineffectiveness would result from the following circumstances, among others:

- a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction (such as a Deutsche mark–based hedging instrument and Dutch guilder–based hedged item), 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 notional amounts, maturities, quantity, location, or delivery dates.

Ineffectiveness also would result if part of the change in the fair value of a derivative is attributable to a change in the counterparty’s creditworthiness.

67. A hedge that meets the effectiveness test specified in paragraphs 20(b) and 28(b) (that is, both at inception and on an ongoing basis, the entity expects the hedge to be highly effective at achieving offsetting changes in fair values or cash flows) also must meet the other hedge accounting criteria to qualify for hedge accounting. If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test and also would measure any ineffectiveness during the hedge period. 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. The discussions of measuring hedge ineffectiveness in the examples in the remainder of this section of Appendix A assume that the hedge satisfied all of the criteria for hedge accounting at inception.

***Assuming No Ineffectiveness in a Hedge with an Interest Rate Swap***

68. An assumption of no ineffectiveness is especially important in a hedging relationship involving an interest-bearing financial instrument and an interest rate swap because it significantly simplifies the computations necessary to make the accounting entries. An entity may assume no ineffectiveness in a hedging relationship of interest rate risk involving an

interest-bearing asset or liability and an interest rate swap if all of the applicable conditions in the following list are met:

*Conditions applicable to both fair value hedges and cash flow hedges*

- a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability.
- b. The fair value of the swap at its inception is zero.
- c. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)
- d. The interest-bearing asset or liability is not prepayable.
- e. Any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.

*Conditions applicable to fair value hedges only*

- f. The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.
- g. There is no floor or ceiling on the variable interest rate of the swap.
- h. The interval between repricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).

*Conditions applicable to cash flow hedges only*

- i. All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged.
- j. There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap's variable rate is LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the asset.)
- k. The repricing dates match those of the variable-rate asset or liability.
- l. The index on which the variable rate is based matches the index on which the asset or liability's variable rate is based.

69. The fixed rate on a hedged item need not exactly match the fixed rate on a swap designated as a fair value hedge. Nor does the variable rate on an interest-bearing asset or liability need to be the same as the variable rate on a swap designated as a cash flow hedge. A swap's fair value comes from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount. That is, a 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 a swap with a payment based on LIBOR plus 1 percent and a receipt based on a fixed rate of 6 percent.

70. Comparable credit risk at inception is not a condition for assuming no ineffectiveness 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 to assume no ineffectiveness in a hedge of interest rate risk.

#### *After-Tax Hedging of Foreign Currency Risk*

71. Statement 52 permitted hedging of foreign currency risk on an after-tax basis. The portion of the gain or loss on the hedging instrument that exceeded the loss or gain on the hedged item was required to be included as an offset to the related tax effects in the period in which those tax effects are recognized. This Statement continues those provisions.

#### **Illustrations of Assessing Effectiveness and Measuring Ineffectiveness**

72. The following examples illustrate some ways in which an entity may assess hedge effectiveness and measures hedge ineffectiveness 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 Statement. This section also discusses some methods of assessing hedge effectiveness and determining hedge ineffectiveness that are not consistent with this Statement and thus may not be used.

#### *Example 1: Fair Value Hedge of Natural Gas Inventory with Futures Contracts*

73. Company A has 20,000 MMBTU's of natural gas stored at its location in West Texas. To hedge the fair value exposure of the natural gas, the company sells the equivalent of 20,000 MMBTU's of natural gas futures contracts on a national mercantile exchange. The futures prices are based on delivery of natural gas at the Henry Hub gas collection point in Louisiana.

#### **Assessing the hedge's expected effectiveness**

74. The price of Company A's natural gas inventory in West Texas and the price of the natural gas that is the underlying for the futures it sold will differ as a result of regional factors (such as location, pipeline transmission costs, and supply and demand). <sup>19</sup> Company 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.

75. Both at inception of the hedge and on an ongoing basis, Company A might assess the hedge's expected effectiveness 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. <sup>20</sup> If those prices have been and are expected to continue to be highly correlated, Company 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, Company A must take into account actual changes in spot prices in West Texas and at the Henry Hub.

76. Company 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, the company 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 Statement 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, Company 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.

#### **Measuring hedge ineffectiveness**

77. Consistent with the company's method of assessing whether the hedge is expected to be highly effective, the hedge would be ineffective to the extent that (a) 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 (b) the actual change in the spot price of natural gas in West Texas per MMBTU multiplied by 20,000. 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 determining ineffectiveness. The excluded amount would be reported directly in earnings.

#### ***Example 2: Fair Value Hedge of Tire Inventory with a Forward Contract***

78. Company 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. The company 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.

#### **Assessing the hedge's expected effectiveness**

79. Company B decides to base its assessment of hedge effectiveness 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, Company 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. Company 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, Company 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 (paragraph 21(e)). Both at inception of the hedge and during its term, the company 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.

#### **Measuring hedge ineffectiveness**

80. It is unlikely that this transaction would be highly effective in achieving offsetting changes in fair value. However, if Company B concludes that the hedge will be highly effective and the hedge otherwise qualifies for hedge accounting, the ineffective part of the hedge would be measured consistent with the company's method of assessing whether the hedge is expected to be highly effective. Based on that method, the hedge would be ineffective to the extent that the actual changes in (a) the fair value of the forward contract attributable to the change in the spot price of rubber and (b) the market price of steel-belted radials multiplied by the number of tires in inventory did not offset. Because Company 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 measure of effectiveness and reported directly in earnings.

#### ***Example 3: Fair Value Hedge of Growing Wheat with Futures Contracts***

81. Company C has a tract of land on which it is growing wheat. Historically, Company C has harvested at least 40,000 bushels of wheat from that tract of land. Two months before its expected harvest, the company 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.

#### **Assessing the hedge's expected effectiveness and measuring ineffectiveness**

82. Even though the futures contracts are for the same type of wheat that Company 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. The company therefore may not automatically assume that the hedge will be highly effective in achieving offsetting changes in fair value.

83. To determine whether the futures contracts are expected to be highly effective in providing

offsetting changes in fair value for the growing wheat, Company 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. Company 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. The company 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.

84. It is unlikely that wheat futures would be highly effective in offsetting the changes in value of growing wheat. However, if Company C concludes that the hedge qualifies as highly effective, it would use the same method for measuring actual hedge effectiveness that it uses initially and on an ongoing basis to assess whether the hedge is expected to be highly effective. The hedge would be ineffective to the extent that the actual changes in fair value of the futures contract and of the growing wheat crop did not offset.

***Example 4: Fair Value Hedge of Equity Securities with Option Contracts***

85. Company D holds 10,000 shares of XYZ stock. It purchases put option contracts on 20,000 shares of XYZ stock with a strike price equal to the current price of the stock to hedge its exposure to changes in the fair value of its investment position attributable to changes in the price of XYZ stock. Company D manages the position using a “delta-neutral” strategy. That is, it monitors the option’s “delta”—the ratio of changes in the option’s price to changes in the price of XYZ stock. As the delta ratio changes, Company D buys or sells put options so that the next change in the fair value of all of the options held can be expected to counterbalance the next change in the value of its investment in XYZ stock. For put options, the delta ratio moves closer to one as the share price of the stock falls and moves closer to zero as the share price rises. The delta ratio also changes as the exercise period decreases, as interest rates change, and as expected volatility changes. Company D designates the put options as a fair value hedge of its investment in XYZ stock.

**Assessing the hedge’s expected effectiveness and measuring ineffectiveness**

86. Because Company D plans to change the number of options that it holds to the extent necessary to maintain a delta-neutral position, it may not automatically assume that the hedge will be highly effective at achieving offsetting changes in fair value. Also, because the “delta-neutral” hedging strategy is based on expected changes in the option’s fair value, the company may not assess effectiveness based on changes in the option’s intrinsic value. Instead, Company D would estimate (a) the gain or loss on the option position that would result from various decreases or increases in the market price of XYZ stock and (b) the loss or gain on its investment in XYZ stock for the same market price changes. To assess the effectiveness of the hedge both at inception and on an ongoing basis, the company could compare the respective gains and losses from different market price changes. The ongoing assessment of effectiveness also must consider the actual changes in the fair value of the put options held and of the investment in XYZ stock during the hedge period.

87. Consistent with the company's method of assessing effectiveness, the hedge would be ineffective to the extent that the actual realized and unrealized gains or losses from changes in the fair value of the options held is greater or less than the change in value of the investment in XYZ stock. The underlying for the put option contracts is the market price of XYZ stock. Therefore, if Company D continually monitors the delta ratio and adjusts the number of options held accordingly, the changes in the fair value of the options and of the hedged item may almost completely offset, resulting in only a small amount of ineffectiveness to be recognized in earnings.

***Example 5: Fair Value Hedge of a Treasury Bond with a Put Option Contract***

88. Company E owns a Treasury bond and wants to protect itself against the fair value exposure to declines in the price of the bond. The company purchases an at-the-money put option on a Treasury security with the same terms (remaining maturity, notional amount, and interest rate) as the Treasury bond held and designates the option as a hedge of the fair value exposure of the Treasury bond. Company E plans to hold the put option until it expires.

**Assessing the hedge's expected effectiveness and measuring ineffectiveness**

89. Because Company 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 Treasury bond for different possible market prices. In assessing the expectation of effectiveness on an ongoing basis, the company also must consider the actual changes in the fair value of the Treasury bond and in the intrinsic value of the option during the hedge period.

90. However, because the pertinent critical terms of the option and the bond are the same in this example, the company could expect the changes in value of the bond attributable to changes in market 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, there will be no ineffectiveness because the company has chosen to exclude changes in the option's time value from the effectiveness test. Because of that choice, Company E must recognize changes in the time value of the option directly in earnings.

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

91. Company 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. Company F designates the written option as a fair value hedge of the embedded prepayment option component of the fixed-rate debt.

**Assessing the hedge's expected effectiveness and measuring ineffectiveness**

92. To assess whether the hedge is expected to be highly effective in achieving offsetting changes in fair value, Company F could estimate and compare the changes in fair values of the two options for different market interest rates. Because this Statement does not permit derivatives, including embedded derivatives whether or not they are required to be accounted for separately, to be separated into components, Company 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; any ineffectiveness thus will be automatically reflected in earnings. (The hedge is likely to have some ineffectiveness because the premium for the written call option is unlikely to be the same as the premium for the embedded purchased call option.)

***Example 7: Cash Flow Hedge of a Forecasted Purchase of Inventory with a Forward Contract***

93. Company G forecasts the purchase of 500,000 pounds of Brazilian coffee for U.S. dollars in 6 months. It wants to hedge the cash flow exposure associated with changes in the U.S. dollar price of Brazilian coffee. Rather than acquire a derivative based on Brazilian coffee, the company 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 cash flow hedge of its forecasted purchase of Brazilian coffee. All other terms of the forward contract and the forecasted purchase, such as delivery locations, are the same.

**Assessing the hedge's expected effectiveness and measuring ineffectiveness**

94. Company G bases its assessment of hedge effectiveness and measure of ineffectiveness on changes in forward prices, with the resulting gain or loss discounted to reflect the time value of money. Because of the difference in the bases of the forecasted transaction (Brazilian coffee) and forward contract (Colombian coffee), Company G may not assume that the hedge will automatically be highly effective in achieving offsetting cash flows. Both at inception and on an ongoing basis, Company 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 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.)

95. In assessing hedge effectiveness on an ongoing basis, Company G also must consider the extent of offset between the change in expected cash flows on its Colombian coffee contract and the change in expected cash flows for the forecasted purchase of Brazilian coffee. Both changes would be measured on a cumulative basis for actual changes in the forward price of the respective coffees during the hedge period.

96. Because the only difference between the forward contract and forecasted purchase relates

to the type of coffee (Colombian versus Brazilian), Company 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, Company 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:

	<b>Estimate of Change in Cash Flows</b>	
	<i>Hedging Instrument:</i>	<i>Estimate of Forecasted Transaction:</i>
	<b>Forward Contract on Colombian Coffee</b>	<b>Forward Contract on Brazilian Coffee</b>
Forward price of Colombian and Brazilian coffee:		
At hedge inception—6-month price	\$ 2.54	\$ 2.43
3 months later—3-month price	<u>2.63</u>	<u>2.53</u>
Cumulative change in price—gain	\$ .09	\$ .10
× 500,000 pounds of coffee	<u>× 500,000</u>	<u>× 500,000</u>
Estimate of change in cash flows	<u>\$ 45,000</u>	<u>\$ 50,000</u>

97. Using the above amounts, Company G could evaluate effectiveness 3 months into the hedge 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. The hedge would be ineffective to the extent that there was a difference between the changes in the present value of the expected cash flows on (a) the company’s Colombian coffee contract and (b) a comparable forward contract for Brazilian coffee (the equivalent of the present value of \$5,000 in the numerical example).

**Example 8: Cash Flow Hedge with a Basis Swap**

98. Company 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 Company H at the end of each month based on LIBOR as of the tenth day of the month (the liability’s anniversary date). The company 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. Company H designates the

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.

**Assessing the hedge's expected effectiveness and measuring ineffectiveness**

99. Company 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 swap differs from the reset date on the corresponding variable-rate liability. Both at hedge inception and on an ongoing basis, the company's assessment of expected effectiveness could be based on the extent to which changes in LIBOR have occurred during comparable 10-day periods in the past. Company H's ongoing assessment of expected effectiveness and measurement of actual ineffectiveness would be on a cumulative basis and would incorporate the actual interest rate changes to date. The hedge would be ineffective to the extent that the cumulative change in cash flows on the prime leg of the 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 swap did not offset the change in expected cash flows on the hedged portion of the liability. The terms of the 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 swap. Thus, the hedge will only be ineffective to the extent that LIBOR has changed between the first of the month (the reset date for the swap) and the tenth of the month (the reset date for the liability).

***Example 9: Cash Flow Hedge of Forecasted Sale with a Forward Contract***

100. Company I, a U.S. dollar functional currency company, forecasts the sale of 10,000 units of its principal product in 6 months to French customers for FF500,000 (French francs). The company wants to hedge the cash flow exposure of the French franc sale related to changes in the US\$-FF exchange rate. It enters into a 6-month forward contract to exchange the FF500,000 it expects to receive in the forecasted sale for the U.S. dollar equivalent specified in the forward contract and designates the forward contract as a cash flow hedge of the forecasted sale.

**Assessing the hedge's expected effectiveness and measuring ineffectiveness**

101. Company I chooses to assess hedge effectiveness at inception and during the term of the hedge based on (a) changes in the fair value of the forward contract attributable to changes in the US\$-FF spot rate and (b) changes in the present value of the current U.S. dollar equivalent of the forecasted receipt of FF500,000. Because the critical terms of the forward contract and the forecasted transaction are the same, presumably there would be no ineffectiveness unless there is a reduction in the expected sales proceeds from the forecasted sales. Because Company I is assessing effectiveness based on spot rates, it would exclude the change in the fair value of the forward contract attributable to changes in the difference between the forward rate and spot rate from the measure of hedge ineffectiveness and report it directly in earnings.

***Example 10: Attempted Hedge of a Forecasted Sale with a Written Call Option***

102. Company J forecasts the sale in 9 months of 100 units of product with a current market

price of \$95 per unit. The company's objective is to sell the upside potential associated with the forecasted sale by writing a call option for a premium. The company 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, Company 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.

103. Company J's objective of using the premium from the written call option as an offset to any decrease in future cash inflows would not meet the notion of effectiveness in this Statement. Future changes in the market price of the company's product will not affect the premium that Company J received, which is all related to time value in this example and thus is the maximum amount by which Company J can benefit. That is, the company could not 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.

## **Appendix B: EXAMPLES ILLUSTRATING APPLICATION OF THIS STATEMENT**

### **Section 1: Hedging Relationships**

104. This appendix presents examples that illustrate the application of this Statement. The examples do not address all possible uses of derivatives as hedging instruments. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated in an example. It is also assumed in each example that there are no changes in creditworthiness that would alter the effectiveness of any of the hedging relationships.

#### **Example 1: Fair Value Hedge of a Commodity Inventory**

105. This example illustrates the accounting for a fair value hedge of a commodity inventory. In the first scenario, the terms of the hedging derivative have been negotiated to produce no ineffectiveness in the hedging relationship. In the second scenario, there is ineffectiveness in the hedging relationship. To simplify the illustration and focus on basic concepts, the derivative in these two scenarios is assumed to have no time value. In practice, a derivative 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 would be recognized in earnings as they occur, either because they represent ineffectiveness or because they are excluded from the assessment of effectiveness (as discussed in paragraph 63). Other examples in this section illustrate accounting for the time value component of a derivative.

**Scenario 1—No Ineffectiveness in the Hedging Relationship**

106. ABC Company 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 contract, Derivative Z. On the first day of period 1, ABC enters into Derivative Z and neither receives nor pays a premium (that is, the fair value at inception is zero). ABC designates the derivative as a hedge of the changes in fair value of the inventory due to changes in the price of Commodity A during period 1. The hedging relationship qualifies for fair value hedge accounting. ABC will assess effectiveness by comparing the entire change in fair value of Derivative Z with the change in the market price of the hedged commodity inventory. ABC expects no ineffectiveness because (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 ABC designated as hedged) and (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.

107. 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 above.

	<b>Debit (Credit)</b>			
	<u>Cash</u>	<u>Derivative</u>	<u>Inventory</u>	<u>Earnings</u>
<b>Period 1</b>				
Recognize change in fair value of derivative		\$ 25,000		\$ (25,000)
Recognize change in fair value of inventory			\$ (25,000)	25,000
Recognize revenue from sale	\$1,075,000			(1,075,000)
Recognize cost of sale of inventory			(975,000)	975,000
Recognize settlement of derivative	<u>25,000</u>	<u>(25,000)</u>		
Total	<u>\$ 1,100,000</u>	<u>\$ 0</u>	<u>\$(1,000,000)</u>	<u>\$(100,000)</u>

108. If ABC had sold the hedged inventory at the inception of the hedge, its gross profit on that sale would have been \$100,000. The above example illustrates that, by hedging the risk of changes in the overall fair value of its inventory, 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.

**Scenario 2—Ineffectiveness in the Hedging Relationship**

109. No ineffectiveness was recognized in earnings in the above situation because the gain on Derivative Z exactly offsets the loss on the inventory. However, if the terms of Derivative Z did not perfectly match the inventory and its fair value had increased by \$22,500 as compared with the decline in fair value of the inventory of \$25,000, then ineffectiveness of \$2,500 would have been recognized in earnings. The following table illustrates that situation (all other facts are assumed to be the same as in Scenario 1).

	<u>Debit (Credit)</u>			
	<u>Cash</u>	<u>Derivative</u>	<u>Inventory</u>	<u>Earnings</u>
<b>Period 1</b>				
Recognize change in fair value of derivative		\$ 22,500		
Recognize change in fair value of inventory			\$ (25,000)	\$ (22,500) 25,000
Recognize revenue from sale	\$1,075,000			(1,075,000)
Recognize cost of sale of inventory			(975,000)	975,000
Recognize settlement of derivative	<u>22,500</u>	<u>(22,500)</u>		
Total	<u>\$1,097,500</u>	<u>\$ 0</u>	<u>\$(1,000,000)</u>	<u>\$ (97,500)</u>

110. The difference between the effect on earnings in this scenario and the effect on earnings in Scenario 1 is the \$2,500 of hedge ineffectiveness.

**Example 2: Fair Value Hedge of Fixed-Rate Interest-Bearing Debt**

**Purpose of the Example**

111. This example demonstrates 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 in the example easier to understand without detracting from the purpose of the example.

112. The fair values of the swap in this example are determined using the “zero-coupon method.” That method 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. 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 derivatives.

113. 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 swap match the current yield curve, and the sum of the present values of the expected net settlements is zero at inception. Thus, paragraph 68 of this Statement permits the reporting entity to assume that there will be no ineffectiveness. Assessment of effectiveness at one of the swap's repricing dates would confirm the validity of that assumption.

114. A shortcut method 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 no ineffectiveness is appropriate. <sup>21</sup> The steps in the shortcut method are as follows:

- a. Determine the difference between the fixed rate to be received on the swap and the fixed rate to be paid on the bonds.
- b. Combine that difference with the variable rate to be paid on the 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 swap to its fair value and adjust the carrying amount of the liability by an offsetting amount.

Amounts determined using the shortcut method and the facts in this example will match the amounts in paragraph 117 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.

#### *Assumptions*

115. On July 1, 20X1, ABC Company borrows \$1,000,000 to be repaid on June 30, 20X3. On that same date, ABC also enters into a two-year receive-fixed, pay-variable interest rate swap. 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 market interest rates. The terms of the interest rate swap and the

debt are as follows:

	<b><u>Interest Rate Swap</u></b>	<b><u>Fixed-Rate Debt</u></b>
Trade date and borrowing date*	July 1, 20X1	July 1, 20X1
Termination date and maturity date	June 30, 20X3	June 30, 20X3
Notional amount and principal amount	\$1,000,000	\$1,000,000
Fixed interest rate*	6.41%	6.41%
Variable interest rate	3-month US\$ LIBOR	Not applicable
Settlement dates and interest payment dates*	End of each calendar quarter	End of each calendar quarter
Reset dates	End of each calendar quarter through March 31, 20X3	Not applicable

\*These terms need not match for the assumption of no ineffectiveness to be appropriate. (Refer to paragraphs 68 and 69.)

116. The US\$ 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:

<b><u>Reset Date</u></b>	<b><u>3-Month LIBOR Rate</u></b>
7/1/X1	6.41%
9/30/X1	6.48%
12/31/X1	6.41%
3/31/X2	6.32%
6/30/X2	7.60%
9/30/X2	7.71%
12/31/X2	7.82%
3/31/X3	7.42%

*Amounts to Be Reported*

117. The following table summarizes the fair values of the debt and the 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 swap are made using LIBOR. (A discussion of the appropriate discount rate appears in paragraph 70.)

	<b>Fixed-Rate Debt</b>	<b>Interest Rate Swap</b>	<b>Expense</b>	<b>Net Payment</b>
July 1, 20X1	\$(1,000,000)	\$ 0		
Interest accrued	(16,025)	0	\$(16,025)	
Payments (receipts)	16,025	0		\$ 16,025
Effect of change in rates	<u>1,149</u>	<u>(1,149)</u>	<u>0</u>	
September 30, 20X1	(998,851)	(1,149)	<u>\$(16,025)</u>	<u>\$ 16,025</u>
Interest accrued	(16,025)	(19)	\$(16,044)	
Payments (receipts)	16,025	175		\$ 16,200
Amortization of basis adjustments	(156)	0	(156)	
Effect of change in rates	<u>(993)</u>	<u>993</u>	<u>0</u>	
December 31, 20X1	(1,000,000)	0	<u>\$(16,200)</u>	<u>\$ 16,200</u>
Interest accrued	(16,025)	0	\$(16,025)	
Payments (receipts)	16,025	0		\$ 16,025
Amortization of basis adjustments	0	0	0	
Effect of change in rates	<u>(1,074)</u>	<u>1,074</u>	<u>0</u>	
March 31, 20X2	(1,001,074)	1,074	<u>\$(16,025)</u>	<u>\$ 16,025</u>
Interest accrued	(16,025)	17	\$(16,008)	
Payments (receipts)	16,025	(225)		\$ 15,800
Amortization of basis adjustments	208	0	208	
Effect of change in rates	<u>12,221</u>	<u>(12,221)</u>	<u>0</u>	
June 30, 20X2	(988,645)	(11,355)	<u>\$(15,800)</u>	<u>\$ 15,800</u>
Interest accrued	(16,025)	(216)	\$(16,241)	
Payments (receipts)	16,025	2,975		\$ 19,000
Amortization of basis adjustments	(2,759)	0	(2,759)	
Effect of change in rates	<u>789</u>	<u>(789)</u>	<u>0</u>	
September 30, 20X2	(990,615)	(9,385)	<u>\$(19,000)</u>	<u>\$ 19,000</u>
Interest accrued	(16,025)	(181)	\$(16,206)	
Payments (receipts)	16,025	3,250		\$ 19,275
Amortization of basis adjustments	(3,069)	0	(3,069)	
Effect of change in rates	<u>532</u>	<u>(532)</u>	<u>0</u>	
December 31, 20X2	(993,152)	(6,848)	<u>\$(19,275)</u>	<u>\$ 19,275</u>
Interest accrued	(16,025)	(134)	\$(16,159)	
Payments (receipts)	16,025	3,525		\$ 19,550
Amortization of basis adjustments	(3,391)	0	(3,391)	
Effect of change in rates	<u>(978)</u>	<u>978</u>	<u>0</u>	
March 31, 20X3	(997,521)	(2,479)	<u>\$(19,550)</u>	<u>\$ 19,550</u>
Interest accrued	(16,025)	(46)	\$(16,071)	
Payments (receipts)	1,016,025	2,525		\$1,018,550
Amortization of basis adjustments	<u>(2,479)</u>	<u>0</u>	<u>(2,479)</u>	
June 30, 20X3	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$(18,550)</u>	<u>\$1,018,550</u>

118. The table demonstrates two important points that explain why the shortcut method described in paragraph 114 produces the same results as the computation in the above table when there is no ineffectiveness in the hedging relationship.

- a. In every quarter, the effect of changes in rates on the swap completely offsets the effect of changes in rates on the debt. That is as expected because there is no ineffectiveness.
- b. In every quarter except the last when the principal is repaid, the expense equals the cash payment.

119. The following table illustrates the computation of interest expense using the shortcut method described in paragraph 114. The results are the same as the results computed in the above table.

<b>Quarter Ended</b>	<b>(a) Difference between Fixed Rates</b>	<b>(b) Variable Rate on Swap</b>	<b>(c) Sum (a) + (b)</b>	<b>(d) Debt's Principal Amount</b>	<b>(e) Interest Expense ((c) × (d))/4</b>
September 30, 20X1	0.00%	6.41%	6.41%	\$1,000,000	\$16,025
December 31, 20X1	0.00%	6.48%	6.48%	1,000,000	16,200
March 31, 20X2	0.00%	6.41%	6.41%	1,000,000	16,025
June 30, 20X2	0.00%	6.32%	6.32%	1,000,000	15,800
September 30, 20X2	0.00%	7.60%	7.60%	1,000,000	19,000
December 31, 20X2	0.00%	7.71%	7.71%	1,000,000	19,275
March 31, 20X3	0.00%	7.82%	7.82%	1,000,000	19,550
June 30, 20X3	0.00%	7.42%	7.42%	1,000,000	18,550

120. 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 116 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 112). However, the basic principles are the same. As long as there is no ineffectiveness in the hedging relationship, the shortcut method is appropriate.

**Example 3: Fair Value Hedge—Using a Forward Contract to Purchase Foreign Currency to Hedge a Firm Commitment Denominated in a Different Foreign Currency**

121. This example illustrates 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, the hedge is not perfectly effective, and ineffectiveness is recognized immediately in earnings. (The entity in the

example could have designed a hedge with no ineffectiveness 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.)

122. MNO Company's functional currency is the U.S. dollar. On February 3, 20X7, 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 Dutch guilders (Dfl270,000). Also on February 3, 20X7, MNO enters into a forward contract to purchase 240,000 Deutsche marks (DM240,000) on May 1, 20X7. MNO will pay \$0.6125 per DM1 (a total of \$147,000), which is the current forward rate for an exchange on May 1, 20X7. 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 U.S. dollar–Dutch guilder forward exchange rate.

123. MNO will assess effectiveness by comparing the overall changes in the fair value of the forward contract to the changes in fair value in U.S. dollars of the firm commitment due to changes in U.S. dollar–Dutch guilder forward exchange rates. MNO expects the forward contract to be highly effective as a hedge because:

- a. DM240,000 is approximately equal to Dfl270,000 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 U.S. dollars of Deutsche marks over three-month periods have been highly correlated with changes in the value in U.S. dollars of Dutch guilders over those same periods.

Ineffectiveness will result from the difference between changes in the U.S. dollar equivalent of DM240,000 (the notional amount of the forward contract) and changes in the U.S. dollar equivalent of Dfl270,000 (the amount to be paid for the machine). The difference between the spot rate and the forward exchange rate is not excluded from the hedging relationship because changes in the fair value of the firm commitment are being measured using forward exchange rates. <sup>22</sup>

124. The forward exchange rates in effect on certain key dates are assumed to be as follows:

<b>Date</b>	<b>\$-DM Forward Exchange Rate for Settlement on 5/1/X7</b>	<b>\$-Dfl Forward Exchange Rate for Settlement on 5/1/X7</b>
Inception of the hedge—2/3/X7	\$0.6125 = DM1	\$0.5454 = Dfl1
Quarter end—3/31/X7	\$0.5983 = DM1	\$0.5317 = Dfl1
Machine purchase—5/1/X7	\$0.5777 = DM1	\$0.5137 = Dfl1

125. The U.S. dollar equivalent and changes in the U.S. dollar equivalent of the forward contract and the firm commitment, the changes in fair value of the forward contract and the firm commitment, and the ineffectiveness of the hedge on those same key dates are shown in the following table. A 6 percent discount rate is used in this example.

	<u>2/3/X7</u>	<u>3/31/X7</u>	<u>5/1/X7</u>
<b>Forward contract</b>			
\$-DM forward exchange rate for settlement on May 1, 20X7	\$ 0.6125	\$ 0.5983	\$ 0.5777
Units of currency (DM)	× 240,000	× 240,000	× 240,000
Forward price of DM240,000 in dollars	147,000	143,592	138,648
Contract price in dollars	<u>(147,000)</u>	<u>(147,000)</u>	<u>(147,000)</u>
Difference	<u>\$ 0</u>	<u>\$ (3,408)</u>	<u>\$ (8,352)</u>
Fair value (present value of the difference)	<u>\$ 0</u>	<u>\$ (3,391)</u>	<u>\$ (8,352)</u>
Change in fair value during the period		<u>\$ (3,391)</u>	<u>\$ (4,961)</u>
<b>Firm commitment</b>			
\$-Dfl forward exchange rate for settlement on May 1, 20X7	\$ 0.5454	\$ 0.5317	\$ 0.5137
Units of currency (Dfl)	× 270,000	× 270,000	× 270,000
Forward price of Dfl270,000 in dollars	(147,258)	(143,559)	(138,699)
Initial forward price in dollars	<u>147,258</u>	<u>147,258</u>	<u>147,258</u>
Difference	<u>\$ 0</u>	<u>\$ 3,699</u>	<u>\$ 8,559</u>
Fair value (present value of the difference)	<u>\$ 0</u>	<u>\$ 3,681</u>	<u>\$ 8,559</u>
Change in fair value during the period		<u>\$ 3,681</u>	<u>\$ 4,878</u>
Hedge ineffectiveness (difference between changes in fair values of the forward contract denominated in Deutsche marks and the firm commitment denominated in Dutch guilders)		<u>\$ 290</u>	<u>\$ (83)</u>

This Statement requires that MNO recognize immediately in earnings all changes in fair values of the forward contract. Because MNO is hedging the risk of changes in fair value of the firm commitment attributable to changes in the forward exchange rates, this Statement also requires recognizing those changes immediately in earnings.

126. On May 1, 20X7, 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 below.

	<u>Debit (Credit)</u>				
	<u>Cash</u>	<u>Firm Commitment</u>	<u>Forward Contract</u>	<u>Machine</u>	<u>Earnings</u>
March 31, 20X7					
Recognize change in fair value of firm commitment		\$ 3,681			\$(3,681)
Recognize change in fair value of forward contract			\$(3,391)		<u>3,391</u>
					<u>(290)</u>
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)		<u>4,961</u>
					<u>83</u>
May 1, 20X7					
Recognize settlement of forward contract	\$ (8,352)		8,352		
Recognize purchase of machine	<u>(138,699)</u>	<u>(8,559)</u>	<u>      </u>	<u>\$147,258</u>	
Total	<u>\$ (147,051)</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$147,258</u>	<u>\$ (207)</u>

**Note:** 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 MNO (for example, shipping costs and installation costs) have been ignored.

The effect of the hedge is to recognize the machine at its price in Dutch guilders (Dfl270,000) translated at the forward rate in effect at the inception of the hedge (\$0 .5454 per Dfl1).

**Example 4: Cash Flow Hedge of the Forecasted Sale of a Commodity Inventory**

127. This example illustrates 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. Thus, there is no ineffectiveness. The assumptions in this example are similar to those in Example 1, including the assumption that there is no time value in the

derivative. However, the entity 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.

128. ABC Company decides to hedge the risk of changes in its cash flows relating to a forecasted sale of 100,000 bushels of Commodity A by entering into a derivative contract, Derivative Z. 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, ABC enters into Derivative Z and designates it as a cash flow hedge of the forecasted sale. ABC neither pays nor receives a premium on Derivative Z (that is, its fair value is zero). The hedging relationship qualifies for cash flow hedge accounting. ABC expects that there will be no ineffectiveness from the hedge because (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 ABC expects to sell (assuming delivery to ABC's selling point), and (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.

129. 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 impact on earnings and other comprehensive income (OCI), for the situation described above.

	<u>Debit (Credit)</u>			
	<u>Cash</u>	<u>Derivative</u>	<u>OCI</u>	<u>Earnings</u>
Recognize change in fair value of derivative		\$ 25,000	\$(25,000)	
Recognize revenue from sale	\$1,075,000			\$(1,075,000)
Recognize settlement of derivative	25,000	(25,000)		
Reclassify change in fair value of derivative to earnings			25,000	(25,000)
Total	<u>\$1,100,000</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$(1,100,000)</u>

130. At the inception of the hedge, ABC anticipated that it would receive \$1,100,000 from the sale of 100,000 bushels of Commodity A. The above example illustrates that by hedging the risk of changes in its cash flows relating to the forecasted sale of 100,000 bushels of Commodity A, ABC still received a total of \$1,100,000 in cash flows even though the sales price of Commodity A declined during the period.

## Example 5: Cash Flow Hedge of Variable-Rate Interest-Bearing Asset

### *Purpose of the Example*

131. This example demonstrates the mechanics of accounting for an interest rate swap used as a cash flow hedge of variable interest receipts. It is not intended to demonstrate how to compute the fair value of an interest rate swap. As in Example 2, the zero-coupon method <sup>23</sup> is used to determine the fair values. (Unlike Example 2, 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 68 and 69), so it has a zero value at inception. Thus, the reporting entity is permitted to assume that there will be no ineffectiveness.

132. A shortcut method can be used to produce the same reporting results as the method illustrated in this example. This shortcut is only appropriate if the assumption of no ineffectiveness 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: <sup>24</sup>

- a. Determine the difference between the variable rate to be paid on the swap and the variable rate to be received on the bonds.
- b. Combine that difference with the fixed rate to be received on the 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 swap to its fair value and adjust other comprehensive income by an offsetting amount.

### *Background and Assumptions*

133. On July 1, 20X1, XYZ Company invests \$10,000,000 in variable-rate corporate bonds that pay interest quarterly at a rate equal to the 3-month US\$ LIBOR rate plus 2.25 percent. The \$10,000,000 principal will be repaid on June 30, 20X3.

134. Also on July 1, 20X1, XYZ enters into a two-year receive-fixed, pay-variable interest rate swap and designates it as a cash flow hedge of the variable-rate interest receipts on the corporate bonds. The risk designated as being hedged is the risk of changes in cash flows attributable to changes in market interest rates. The terms of the interest rate swap and the corporate bonds are shown below.

	<b><u>Interest Rate Swap</u></b>	<b><u>Corporate Bonds</u></b>
Trade date and borrowing date*	July 1, 20X1	July 1, 20X1
Termination date	June 30, 20X3	June 30, 20X3
Notional amount	\$10,000,000	\$10,000,000
Fixed interest rate	6.65%	Not applicable
Variable interest rate †	3-month US\$ LIBOR	3-month US\$ LIBOR + + 2.25%
Settlement dates and interest payment dates*	End of each calendar quarter	End of each calendar quarter
Reset dates	End of each calendar quarter through March 31, 20X3	End of each calendar quarter through March 31, 20X3

\*These terms need not match for the assumption of no ineffectiveness to be appropriate. (Refer to paragraphs 68 and 69.)

†Only the interest rate basis (for example, LIBOR) must match. The spread over LIBOR does not invalidate the assumption of no ineffectiveness.

135. Because the conditions described in paragraph 68 are met, XYZ is permitted to assume that there is no ineffectiveness in the hedging relationship and to recognize in other comprehensive income the entire change in the fair value of the swap.

136. The three-month US\$ 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:

<b><u>Reset Date</u></b>	<b><u>3-Month LIBOR Rate</u></b>
7/1/X1	5.56%
9/30/X1	5.63%
12/31/X1	5.56%
3/31/X2	5.47%
6/30/X2	6.75%
9/30/X2	6.86%
12/31/X2	6.97%
3/31/X3	6.57%

### ***Amounts to Be Reported***

137. 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 131, 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 (OCI) for each quarter are as follows:

	<b>Swap</b>	<b>OCI</b>	<b>Earnings</b>	<b>Cash</b>
	<b><u>Debit (Credit)</u></b>	<b><u>Debit (Credit)</u></b>	<b><u>Debit (Credit)</u></b>	<b><u>Debit (Credit)</u></b>
July 1, 20X1	\$ 0			
Interest accrued	0			
Payment (receipt)	(27,250)			\$27,250
Effect of change in rates	52,100	\$(52,100)		
Reclassification to earnings	<u>          </u>	<u>27,250</u>	<u>\$(27,250)</u>	<u>          </u>
September 30, 20X1	24,850	(24,850)	<u>\$(27,250)</u>	<u>\$27,250</u>
Interest accrued	330	(330)		
Payment (receipt)	(25,500)			\$25,500
Effect of change in rates	74,120	(74,120)		
Reclassification to earnings	<u>          </u>	<u>25,500</u>	<u>\$(25,500)</u>	<u>          </u>
December 31, 20X1	73,800	(73,800)	<u>\$(25,500)</u>	<u>\$25,500</u>
Interest accrued	1,210	(1,210)		
Payment receipt	(27,250)			\$27,250
Effect of change in rates	38,150	(38,150)		
Reclassification to earnings	<u>          </u>	<u>27,250</u>	<u>\$(27,250)</u>	<u>          </u>
March 31, 20X2	85,910	(85,910)	<u>\$(27,250)</u>	<u>\$27,250</u>
Interest accrued	1,380	(1,380)		
Payment (receipt)	(29,500)			\$29,500
Effect of change in rates	(100,610)	100,610		
Reclassification to earnings	<u>          </u>	<u>29,500</u>	<u>\$(29,500)</u>	<u>          </u>
June 30, 20X2	(42,820)	42,820	<u>\$(29,500)</u>	<u>\$29,500</u>
Interest accrued	(870)	870		
Payment (receipt)	2,500			\$(2,500)
Effect of change in rates	8,030	(8,030)		
Reclassification to earnings	<u>          </u>	<u>(2,500)</u>	<u>\$ 2,500</u>	<u>          </u>
September 30, 20X2	(33,160)	33,160	<u>\$ 2,500</u>	<u>\$(2,500)</u>
Interest accrued	(670)	670		
Payment (receipt)	5,250			\$(5,250)
Effect of change in rates	6,730	(6,730)		
Reclassification to earnings	<u>          </u>	<u>(5,250)</u>	<u>\$ 5,250</u>	<u>          </u>
December 31, 20X2	(21,850)	21,850	<u>\$ 5,250</u>	<u>\$(5,250)</u>
Interest accrued	(440)	440		
Payment (receipt)	8,000			\$(8,000)
Effect of change in rates	16,250	(16,250)		

Reclassification to earnings		<u>(8,000)</u>	<u>\$ 8,000</u>	
March 31, 20X3	1,960	(1,960)	<u>\$ 8,000</u>	<u>\$(8,000)</u>
Interest accrued	40	(40)		
Payment (receipt)	(2,000)			\$ 2,000
Reclassification to earnings		<u>2,000</u>	<u>\$(2,000)</u>	
June 30, 20X3	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$(2,000)</u>	<u>\$ 2,000</u>

138. The 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 swap is shown below.

<b>For the Quarter</b>	<b>Earnings</b>		
		<b>Gains (Losses)</b>	
<u>Ending</u>	<u>Interest on Bonds</u>	<u>Reclassified from OCI</u>	<u>Net Effect</u>
9/30/X1	\$ 195,250	\$27,250	\$ 222,500
12/31/X1	197,000	25,500	222,500
3/31/X2	195,250	27,250	222,500
6/30/X2	193,000	29,500	222,500
9/30/X2	225,000	(2,500)	222,500
12/31/X2	227,750	(5,250)	222,500
3/31/X3	230,500	(8,000)	222,500
6/30/X3	<u>220,500</u>	<u>2,000</u>	<u>222,500</u>
Totals	<u>\$1,684,250</u>	<u>\$95,750</u>	<u>\$1,780,000</u>

139. In this example, the shortcut method described in paragraph 132 works as follows. The difference between the variable rate on the 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 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 paragraph 138.

**Example 6: Accounting for a Derivative's Gain or Loss in a Cash Flow Hedge—Effectiveness Based on the Entire Change in the Derivative's Fair Value**

140. This example has been designed to illustrate application of the guidance for cash flow hedges described in paragraph 30 of this Statement. At the beginning of period 1, XYZ Company enters into a qualifying cash flow hedge of a transaction forecasted to occur early in period 6. XYZ's documented policy is to assess hedge effectiveness by comparing the changes in present value of the expected future cash flows on the forecasted transaction to all of the hedging derivative's gain or loss (that is, no time value component will be excluded as discussed in paragraph 63). In this hedging relationship, XYZ has designated changes in cash flows related to the forecasted transaction attributable to any cause as the hedged risk.

141. The following table includes the assumptions for this example and details the steps necessary to account for a cash flow hedge that is not perfectly effective.

Period	Fair Value of Derivative Increase (Decrease)		Present Value of Expected Future Cash Flows on Hedged Transaction Increase (Decrease)		Lesser of the Two Cumulative Changes	Adjustment to OCI
	(A)	(B)	(C)	(D)		
	Change during the Period	Cumulative Change	Change during the Period	Cumulative Change		
1	\$100	\$100	\$ (96)	\$ (96)	\$ 96	\$ 96
2	94	194	(101)	(197)	194	98
3	(162)	32	160	(37)	32	(162)
4	(101)	(69)	103	66	(66)	(98)
5	30	(39)	(32)	34	(34)	32

- Step 1: Determine the change in fair value of the derivative and the change in present value of the cash flows on the hedged transaction (columns A and C).
- Step 2: Determine the cumulative changes in fair value of the derivative and the cumulative changes in present value of the cash flows on the hedged transaction (columns B and D).
- Step 3: Determine the lesser of the absolute values of the two amounts in Step 2 (column E).
- Step 4: Determine the change during the period in the lesser of the absolute values (column F).
- Step 5: Adjust the derivative to reflect its change in fair value and adjust other comprehensive income by the amount determined in Step 4. Balance the entry, if necessary, with an adjustment to earnings.

142. The following are the entries required to account for the above cash flow hedge.

Period	Description	Debit (Credit)		
		Derivative	Earnings	OCI
1	Adjust derivative to fair value and OCI by the calculated amount	\$ 100	\$(4)	\$(96)
2	Adjust derivative to fair value and OCI by the calculated amount	94	4	(98)
3	Adjust derivative to fair value and OCI by the calculated amount	(162)	0	162

4	Adjust derivative to fair value and OCI by the calculated amount	(101)	3	98
5	Adjust derivative to fair value and OCI by the calculated amount	30	2	(32)

143. The following table reconciles the beginning and ending balances in accumulated other comprehensive income.

<u>Period</u>	<u>Accumulated Other Comprehensive Income—Debit (Credit)</u>			
	<u>Beginning Balance</u>	<u>Change in Fair Value</u>	<u>Reclassification</u>	<u>Ending Balance</u>
1	\$ 0	\$(96)	\$ 0	\$ (96)
2	(96)	(94)	(4)	(194)
3	(194)	162	0	(32)
4	(32)	98	0	66
5	66	(30)	(2)	34

The reclassification column relates to reclassifications between earnings and other comprehensive income. In period 2, the \$(4) in that column relates to the prior period's derivative gain that was previously recognized in earnings. That amount is reclassified to other comprehensive income in period 2 because the cumulative gain on the derivative is less than the amount necessary to offset the cumulative change in the present value of expected future cash flows on the hedged transaction. In period 5, the \$(2) in the reclassification column relates to the derivative loss that was recognized in other comprehensive income in a prior period. At the end of period 4, the derivative's cumulative loss of \$69 was greater in absolute terms than the \$66 increase in the present value of expected future cash flows on the hedged transaction. That \$3 excess had been recognized in earnings during period 4. In period 5, the value of the derivative increased (and reduced the cumulative loss) by \$30. The present value of the expected cash flows on the hedged transaction decreased (and reduced the cumulative increase) by \$32. The gain on the derivative in period 5 was \$2 smaller, in absolute terms, than the decrease in the present value of the expected cash flows on the hedged transaction. Consequently, the entire gain on the derivative is recognized in other comprehensive income. In addition, in absolute terms, the \$3 cumulative excess of the loss on the derivative over the increase in the present value of the expected cash flows on the hedged transaction (which had previously been recognized in earnings) increased to \$5. As a result, \$2 is reclassified from other comprehensive income to earnings so that the \$5 cumulative excess has been recognized in earnings.

**Example 7: Designation and Discontinuance of a Cash Flow Hedge of the Forecasted Purchase of Inventory**

144. This example illustrates the effect on earnings and other comprehensive income of discontinuing a cash flow hedge by dedesignating the hedging derivative 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.

145. On February 3, 20X1, JKL Company forecasts the purchase of 100,000 bushels of corn on May 20, 20X1. It expects to sell finished products produced from the corn on May 31, 20X1. On February 3, 20X1, 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 immediately designates those contracts as a hedge of the forecasted purchase of corn.

146. JKL chooses to assess effectiveness by comparing the entire change in fair value of the futures contracts to changes in the cash flows on the forecasted transaction. JKL estimates its 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. JKL does not choose to use a tailing strategy (as described in paragraph 64). 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 (a) the futures contracts are for the same variety and grade of corn that JKL plans to purchase and (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 be perfectly effective. 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. If the difference between the price of corn delivered to Chicago and the price of corn delivered to Minneapolis changes during the period of the hedge, the effect of that change will be included currently in earnings according to the provisions of paragraph 30 of this Statement.

147. 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.

148. On May 1, 20X1, JKL dedesignates the related futures contracts and closes them out by entering into offsetting contracts on the same exchange. As of that date, JKL had recognized in accumulated other comprehensive income gains on the futures contracts of \$26,250. JKL still plans to purchase 100,000 bushels of corn on May 20, 20X1. Consequently, the gains that occurred prior to dedesignation will remain in other comprehensive income until the finished product is sold. If JKL had not closed out the futures contracts when it dedesignated them, any further gains or losses would have been recognized in earnings.

149. On May 20, 20X1, JKL purchases 100,000 bushels of corn, and on May 31, 20X1, JKL sells the finished product.

150. The futures prices of corn that are in effect on key dates are assumed to be as follows:

<b><u>Date</u></b>	<b><u>Futures Price per Bushel for Delivery to Chicago on May 20, 20X1</u></b>	<b><u>Futures Price Adjusted for Delivery to Minneapolis on May 20, 20X1</u></b>
Inception of hedging relationship—February 3, 20X1	\$2.6875	\$2.7375
End of quarter—March 31, 20X1	3.1000	3.1500
Discontinue hedge—May 1, 20X1	2.9500	3.0000
Purchase of corn—May 20, 20X1	2.8500	2.9000

151. 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:

	<b><u>February 3– March 31, 20X1</u></b>	<b><u>April 1– May 1, 20X1</u></b>
Futures price at beginning of period	\$ 2.6875	\$ 3.1000
Futures price at end of period	<u>3.1000</u>	<u>2.9500</u>
Change in price per bushel	0.4125	(0.1500)
Bushels under contract (20 contracts @ 5,000 bushels each)	<u>× 100,000</u>	<u>× 100,000</u>
Change in fair value—gain (loss)	<u>\$ 41,250</u>	<u>(15,000)</u>

152. The following table displays the entries to recognize the effects of (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, and (d) selling the finished products produced from the corn. Because the difference in prices between corn delivered to Chicago and corn delivered to Minneapolis (\$.05 per bushel, as illustrated in paragraph 150) did not change during the period of the hedge, no ineffectiveness is recognized in earnings. If that difference had changed, the resulting ineffectiveness would have been recognized immediately in earnings.

	<u>Debit (Credit)</u>			
	<u>Cash</u>	<u>Inventory</u>	<u>OCI</u>	<u>Earnings</u>
March 31, 20X1 (end of quarter)				
Recognize change in fair value of futures contracts	\$ 41,250		\$(41,250)	
May 1, 20X1 (discontinue hedge)				
Recognize change in fair value of futures contracts	(15,000)		15,000	
May 20, 20X1				
Recognize purchase of corn	(290,000)	\$290,000		
May 31, 20X1				
Recognize cost of sale of product		(290,000)		\$290,000
Reclassify changes in fair value of futures contracts to earnings			26,250	(26,250)
Total	<u>\$(263,750)</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$263,750</u>

Note: 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 JKL's inventory (for example, additional costs of production, selling costs, and sales revenue) have been ignored.

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, JKL would have recognized \$290,000, which was the price of corn delivered to Minneapolis at the time it was purchased.

### **Example 8: Changes in a Cash Flow Hedge of Forecasted Interest Payments with an Interest Rate Swap**

#### ***Background***

153. This example describes the effects on earnings and other comprehensive income of certain changes in a cash flow hedging relationship. It presents two different scenarios. In the first, the variability of the hedged interest payments is eliminated before the hedging derivative expires. In the second, the interest rate index that is the basis for the hedged interest payments is changed to a different index before the hedging derivative expires.

154. MNO Company enters into an interest rate swap (Swap 1) and designates it as a hedge of the variable interest payments on a series of \$5 million notes with 90-day terms. MNO plans to continue issuing new 90-day notes over the next five years as each outstanding note matures.

The interest on each note will be determined based on LIBOR 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. MNO pays a fixed rate of interest (6.5 percent) and receives interest at LIBOR. 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.

155. Because Swap 1 meets all of the conditions discussed in paragraph 68, MNO is permitted to assume that there will be no ineffectiveness in the hedging relationship and to use the shortcut method illustrated in Example 2.

***Scenario 1—Two Undesignated Interest Rate Swaps***

156. At the end of the second year of the 5-year hedging relationship, MNO discontinues its practice of issuing 90-day notes. Instead, 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 paragraph 31).<sup>25</sup>

157. Rather than liquidate the pay-fixed, receive-variable Swap 1, MNO enters into a pay-variable, receive-fixed interest rate swap (Swap 2) with a 3-year term and a notional amount of \$5 million. 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 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, MNO will receive a fixed rate of 7.25 percent and pay interest at LIBOR.

158. 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.

***Scenario 2—Two Interest Rate Swaps Designated as a Hedge of Future Variable Interest Payments***

159. At the end of the second year of the 5-year hedging relationship, MNO discontinues its practice of issuing 90-day notes and issues a 3-year, \$5 million note with a rate of interest that adjusts every 90 days to the prime rate quoted on that day. Swap 1 is no longer effective as a cash flow hedge because the receive-variable rate on the swap is LIBOR, and the prime rate and LIBOR are expected to change differently. Thus, the cash flows from the swap will not

effectively offset changes in cash flows from the three-year note.

160. The net gain or loss on Swap 1 in accumulated other comprehensive income as of the date MNO issues the three-year note is not reclassified into earnings immediately. Immediate reclassification would be required only if it becomes probable that the hedged transactions (future interest payments) will not occur. The expected amounts of those payments have changed (because they will be based on prime 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.

161. Rather than liquidate Swap 1 and obtain a separate derivative to hedge the variability of the prime-rate-based interest payments, MNO enters into a pay-LIBOR, receive-prime basis swap. The basis swap has a \$5 million notional amount and a 3-year term and requires a settlement every 90 days. MNO designates Swap 1 and the basis swap in combination as the hedging instrument in a cash flow hedge of the variable interest payments on the three-year note. On the three-year note, MNO pays interest at prime. On the basis swap, MNO receives interest at prime and pays interest at LIBOR. On Swap 1, MNO receives interest at LIBOR and pays interest at 6.5 percent. Together, the cash flows from the two derivatives are effective at offsetting changes in the interest payments on the three-year note. Changes in fair values of the two swaps are recognized in other comprehensive income and are reclassified to earnings when the hedged forecasted transactions (the variable interest payments) affect earnings (as required by paragraph 31). Because the two swaps in combination meet the conditions discussed in paragraph 68, MNO is permitted to assume no ineffectiveness and use the shortcut method illustrated in Example 5.

**Example 9: Accounting for a Derivative's Gain or Loss in a Cash Flow Hedge—Effectiveness Based on Changes in Intrinsic Value**

162. This example illustrates application of the accounting guidance for cash flow hedges described in paragraph 30 of this Statement. At the beginning of period 1, XYZ Company 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 purchase of 1 unit of that commodity projected to occur early in period 5. XYZ's documented policy is to assess hedge effectiveness by comparing changes in cash flows on the hedged transaction (based on changes in the 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 price increases by \$6.50 and the

option's intrinsic value increases by \$5.75.

	<u>Period 1</u>	<u>Period 2</u>	<u>Period 3</u>	<u>Period 4</u>
<b>Assumptions</b>				
Ending market price of Commodity X	<u>\$127.25</u>	<u>\$125.50</u>	<u>\$124.25</u>	<u>\$130.75</u>
Ending fair value of option:				
Time value	\$ 7.50	\$ 5.50	\$ 3.00	\$ 0.00
Intrinsic value	<u>2.25</u>	<u>0.50</u>	<u>0.00</u>	<u>5.75</u>
Total	<u>\$ 9.75</u>	<u>\$ 6.00</u>	<u>\$ 3.00</u>	<u>\$ 5.75</u>
Change in time value	\$ (1.75)	\$ (2.00)	\$ (2.50)	\$ (3.00)
Change in intrinsic value	<u>2.25</u>	<u>(1.75)</u>	<u>(0.50)</u>	<u>5.75</u>
Total current-period gain (loss) on derivative	<u>\$ 0.50</u>	<u>\$ (3.75)</u>	<u>\$ (3.00)</u>	<u>\$ 2.75</u>
Gain (loss) on derivative, adjusted to remove the component excluded from effectiveness test:				
For the current period	\$ 2.25	\$ (1.75)	\$ (0.50)	\$ 5.75
Cumulative	2.25	0.50	0.00	5.75
Change in expected future cash flows on hedged transaction:				
For the current period	(2.25)	1.75	1.25	(6.50)
Cumulative	(2.25)	(0.50)	0.75	(5.75)
<b>Balance to be reflected in accumulated other comprehensive income (paragraph 30(b))</b>				
Lesser (in absolute amounts) of derivative's cumulative gain (loss) or amount necessary to offset the offset the cumulative offset the cumulative change in expected future cash flows on hedged transaction	<u>\$ 2.25</u>	<u>\$ 0.50</u>	<u>\$ 0.00</u>	<u>\$ 5.75</u>

163. The following are the entries required to account for the above cash flow hedge. The steps involved in determining the amounts are the same as in Example 6.

<u>Period</u>	<u>Description</u>	<u>Debit (Credit)</u>		
		<u>Derivative</u>	<u>Earnings</u>	<u>OCI</u>
1	Adjust derivative to fair value and OCI by the calculated amount	\$ 0.50	\$1.75	\$(2.25)

2	Adjust derivative to fair value and OCI by the calculated amount	(3.75)	2.00	1.75
3	Adjust derivative to fair value and OCI by the calculated amount	(3.00)	2.50	0.50
4	Adjust derivative to fair value and OCI by the calculated amount	2.75	3.00	(5.75)

164. The following table reconciles the beginning and ending balances in accumulated other comprehensive income.

<u>Accumulated Other Comprehensive Income—Debit (Credit)</u>			
<u>Period</u>	<u>Beginning Balance</u>	<u>Change in Intrinsic Value</u>	<u>Ending Balance</u>
1	\$ 0.00	\$(2.25)	\$(2.25)
2	(2.25)	1.75	(0.50)
3	(0.50)	0.50	0.00
4	0.00	(5.75)	(5.75)

The amount reflected in earnings relates to the component excluded from the effectiveness test, that is, the time value component. No reclassifications between other comprehensive income and earnings of the type illustrated in Example 6 are required because no hedge ineffectiveness is illustrated in this example. (The change in cash flows from the hedged transaction was not fully offset in period 3. However, that is not considered ineffectiveness. As described in paragraph 20(b), a purchased call option is considered effective if it provides one-sided offset.)

**Example 10: Cash Flow Hedge of the Foreign Currency Exposure in a Royalty Arrangement**

165. This example illustrates the accounting for 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.

166. DEF Company's functional currency is the U.S. dollar. ZYX's functional currency is the Deutsche mark (DM). Effective January 1, 20X1, DEF enters into a royalty agreement with ZYX Company that gives ZYX the right to use DEF's technology in manufacturing Product X. On April 30, 20X1, ZYX will pay DEF a royalty of DM1 million for each unit of Product X sold by that date. DEF expects 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 ZYX has identified a demand for Product X and no other supplier has the capacity to fill that demand.

167. Also on January 1, 20X1, DEF enters into a forward contract to sell DM3 million on April 30, 20X1 for a price equal to the forward price of \$0.6057 per Deutsche mark. 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 Deutsche mark–U.S. dollar exchange rates related to the forecasted receipt of DM3 million from the royalty agreement. The spot price and forward price of Deutsche marks at January 1, 20X1 and the U.S. dollar equivalent of DM3 million at those prices are assumed to be as follows:

<u>Prices at January 1, 20X1</u>	<u>\$ per DM</u>	<u>\$ Equivalent of DM3 Million</u>
Spot price	\$0.6019	\$1,805,700
4-month forward price	0.6057	1,817,100

168. 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). That is, DEF will recognize changes in that portion of the derivative's fair value in earnings but will not consider those changes to represent ineffectiveness. DEF will estimate the cash flows on the forecasted transactions based on the current spot exchange rate and will discount that amount. Thus, DEF will assess effectiveness by comparing (a) changes in the fair value of the forward contract attributable to changes in the dollar spot price of Deutsche marks and (b) changes in the present value of the forecasted cash flows based on the current spot exchange rate. 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 DEF dedesignates a proportion of the forward contract each time a royalty is earned (as described in the following paragraph), the hedging relationship will meet the “highly effective” criterion.

169. As each royalty is earned, DEF recognizes a receivable and royalty income. The forecasted transaction (the earning of royalty income) has occurred. The receivable is an asset, not a forecasted transaction, and is not eligible for cash flow hedge accounting. Nor is it eligible for fair value hedge accounting of the foreign exchange risk because changes in the receivable's fair value due to exchange rate changes are recognized immediately in earnings. (Paragraph 21(c) prohibits hedge accounting in that situation.) Consequently, DEF will dedesignate a proportion of the forward contract corresponding to the earned royalty. As the royalty is recognized in earnings and each proportion of the derivative is dedesignated, the related derivative gain or loss in accumulated other comprehensive income is reclassified into earnings. After that date, any gain or loss on the dedesignated proportion of the derivative and any transaction loss or gain on the royalty receivable <sup>26</sup> will be recognized in earnings and will substantially offset each other.

170. 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:

	<u>\$ per DM</u>	
	<u>Spot Price</u>	<u>Forward Price for Settlement on 4/30/X1</u>
January 1	\$0.6019	\$0.6057
January 31	0.5970	0.6000
February 28	0.5909	0.5926
March 31	0.5847	0.5855
April 30	0.5729	0.5729

171. 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. The fair value of the forward is the present value of the difference between the U.S. dollars to be received on the forward (\$1,817,100) and the U.S. dollar equivalent of DM3 million based on the current forward rate. A 6 percent discount rate is used in this example.

	<u>Debit (Credit)</u>		
	<u>Forward Contract</u>	<u>Earnings</u>	<u>OCI</u>
Fair value on January 1	\$ 0		
Period ended January 31:			
Change in spot-forward difference	2,364	\$ (2,364)	
Change in fair value of dedesignated proportion	0	0	
Change in fair value of designated proportion	14,482		\$(14,482)
Reclassification of gain	<u>0</u>	(4,827)	4,827
Fair value on January 31	16,846		
Period ended February 28:			
Change in spot-forward difference	3,873	(3,873)	
Change in fair value of dedesignated proportion	6,063	(6,063)	
Change in fair value of designated proportion	12,127		(12,127)
Reclassification of gain	<u>0</u>	(10,891)	10,891



**Example 11: Reporting Cash Flow Hedges in Comprehensive Income and Accumulated Other Comprehensive Income**

173. TUV Company's cash flow hedge transactions following adoption of this Statement through the end of 20X4 are as follows:

- a. It continually purchases pork belly futures contracts to hedge its anticipated purchases of pork belly inventory.
- b. In 20X2, it entered into a Deutsche mark 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 French franc forward exchange contract to hedge a forecasted export sale (denominated in French francs, expected to occur in December 20X5) of hot dogs to a large customer in France. In June 20X4, it closed the forward contract, but the forecasted transaction is still expected to occur.

174. 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 Statement 130, as amended by this Statement. 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.

	<b>Other Comprehensive Income—Debit (Credit)</b>			
	<b>Accumulated Other Comprehensive Income as of 1/1/X4</b>	<b>Changes in Fair Value Recognized in 20X4</b>	<b>Reclassification Adjustments</b>	<b>Accumulated Other Comprehensive Income as of 12/31/X4</b>
Derivatives designated as hedges of:				
Inventory purchases	\$ 230	\$ 85	\$(270)	\$ 45
Equipment purchase	120		(30)	90
Variable interest rate payments	(40)	10	5	(25)
Export sale	<u>0</u>	<u>(50)</u>	<u>0</u>	<u>(50)</u>
Before-tax totals	<u>\$ 310</u>	<u>\$ 45</u>	<u>\$(295)</u>	<u>\$ 60</u>
After-tax totals	<u>\$ 217</u>	<u>\$ 32</u>	<u>\$(207)</u>	<u>\$ 42</u>

175. The following table illustrates an acceptable method, under the provisions of Statement 130

as amended by this Statement, of reporting the transactions described in paragraphs 173 and 174 in earnings, comprehensive income, and shareholders' equity.

**Effect of Selected Items on Earnings and Comprehensive Income**  
**Year Ended December 31, 20X4**

		<b>Debit (Credit)</b>
Effect on earnings before taxes:		
Cost of goods sold	\$ 270	
Depreciation	30	
Interest	<u>(5)</u>	
Total	295	
Income tax effect	<u>(88)*</u>	
Effect on earnings after taxes		\$ 207
Other comprehensive income, net of tax:		
Cash flow hedges:		
Net derivative losses, net of tax effect of \$13	32	
Reclassification adjustments, net of tax effect of \$88	(207)	
Net change		<u>(175)</u>
Effect on total comprehensive income		<u>\$ 32</u>

\*This example assumes that it is appropriate under the circumstances, in accordance with FASB Statement No. 109, *Accounting for Income Taxes*, to recognize the related income tax benefit in the current year.

**Effect of Selected Items on Shareholders' Equity**  
**Year Ended December 31, 20X4**  
**Debit (Credit)**

Accumulated other comprehensive income:	
Balance on December 31, 20X3	\$ 217
Net change during the year related to cash flow hedges	<u>(175)</u>
Balance on December 31, 20X4	\$ 42

**Section 2: Examples Illustrating Application of the Clearly-and-Closely-Related Criterion to Derivative Instruments Embedded in Hybrid Instruments**

176. The following examples discuss instruments that contain a variety of embedded derivative instruments. They illustrate how the provisions of paragraphs 12–16 of this Statement would be applied to contracts with the described terms. If the terms of a contract are different from the described terms, the application of this Statement by either party to the contract may be affected.

The illustrative instruments and related assumptions in Examples 12–27 are based on examples in Exhibit 96-12A of EITF Issue No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structured Notes."

177. Specifically, each example (a) provides a brief discussion of the terms of an instrument that contains an embedded derivative and (b) analyzes the instrument (as of the date of inception) in relation to the provisions of paragraphs 12–16 that require an embedded derivative to be accounted for according to this Statement if it is not clearly and closely related to the host contract. Unless otherwise stated, the examples are based on the assumptions (1) that if the embedded derivative and host portions of the contract are not clearly and closely related, a separate instrument with the same terms as the embedded derivative would meet the scope requirements in paragraphs 6–11 and (2) that the contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value currently included in earnings.

178. **Example 12: Inverse Floater.** A bond with a coupon rate of interest that varies inversely with changes in specified general interest rate levels or indexes (for example, LIBOR).

*Example:* Coupon = 5.25 percent for 3 months to July 1994; thereafter at 8.75 percent – 6-month U.S. \$ LIBOR to January 1995. "Stepping" option allows for spread and caps to step semiannually to maturity.

*Scope Application:* An inverse floater contains an embedded derivative (a fixed-for-floating interest rate swap) that is referenced to an interest rate index (in this example, LIBOR) that alters net interest payments that otherwise would be paid by the debtor or received by the investor on an interest-bearing host contract. If the embedded derivative could potentially result in the investor's not recovering substantially all of its initial recorded investment in the bond (that is, if the inverse floater contains no floor to prevent any erosion of principal due to a negative interest rate), the embedded derivative is not considered to be clearly and closely related to the host contract (refer to paragraph 13(a)). In that case, the embedded derivative should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement. (In this example, there appears to be no possibility of the embedded derivative increasing the investor's rate of return on the host contract to an amount that is at least double the initial rate of return on the host contract [refer to paragraph 13(b)].) In contrast, if the embedded derivative could not potentially result in the investor's failing to recover substantially all of its initial recorded investment in the bond, the embedded derivative is considered to be clearly and closely related to the host contract and separate accounting for the derivative is neither required nor permitted.

179. **Example 13: Levered Inverse Floater.** A bond with a coupon that varies indirectly with

changes in general interest rate levels and applies a multiplier (greater than 1.00) to the specified index in its calculation of interest.

*Example:* Accrues at 6 percent to June 1994; thereafter at 14.55 percent –  $(2.5 \times 3\text{-month U.S. } \$ \text{ LIBOR})$ .

*Scope Application:* A levered inverse floater can be viewed as an inverse floater in which the embedded interest rate swap is leveraged. Similar to Example 12, the embedded derivative would not be clearly and closely related to the host contract if it potentially could result in the investor's not recovering substantially all of its initial recorded investment in the bond (refer to paragraph 13(a)) because there is no floor to the interest rate. In that case, the embedded derivative (the leveraged interest rate swap) should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement. In contrast, if an embedded derivative could not potentially result in the investor's failing to recover substantially all of its initial recorded investment in the bond and if there was no possibility of the embedded derivative increasing the investor's rate of return on the host contract to an amount that is at least double the initial rate of return on the host contract (refer to paragraph 13(b)), the embedded derivative is considered to be clearly and closely related to the host contract and no separate accounting for the derivative is required or permitted.

180. **Example 14: Delevered Floater.** A bond with a coupon rate of interest that lags overall movements in specified general interest rate levels or indices.

*Example:* Coupon =  $(.5 \times 10\text{-year constant maturity treasuries (CMT)}) + 1.25$  percent.

*Scope Application:* A delevered floater may be viewed as containing an embedded derivative (a deleveraged swap or a series of forward agreements) that is referenced to an interest rate index (for example, 50 percent of 10-year CMT) that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract but could not potentially result in the investor's failing to recover substantially all of its initial recorded investment in the bond (refer to paragraph 13(a)). (In this example, there appears to be no possibility of the embedded derivative increasing the investor's rate of return on the host contract to an amount that is at least double the initial rate of return on the host contract [refer to paragraph 13(b)].) The embedded derivative is considered to be clearly and closely related to the host contract as described in paragraph 13 of this Statement. Therefore, the embedded derivative should *not* be separated from the host contract.

181. **Example 15: Range Floater.** A bond with a coupon that depends on the *number of days*

that a reference rate stays within a preestablished collar; otherwise, the bond pays either zero percent interest or a below-market rate.

*Example:* Standard range floater—The investor receives 5.5 percent on *each day* that 3-month US\$ LIBOR is between 3 percent and 4 percent, with the upper limit increasing annually after a specified date. The coupon will be equal to zero percent for each day that 3-month US\$ LIBOR is *outside* that range.

*Scope Application:* A range floater may be viewed as containing embedded derivatives (two written conditional exchange option contracts with notional amounts equal to the par value of the fixed-rate instrument) that are referenced to an interest rate index (in this example, LIBOR) that alter net interest payments that otherwise would be paid by the debtor or received by the investor on an interest-bearing host contract but could not potentially result in the investor's failing to recover substantially all of its initial recorded investment in the bond (refer to paragraph 13(a)). In this example, there appears to be no possibility of increasing the investor's rate of return on the host contract to an amount that is at least double the initial rate of return on the host contract (refer to paragraph 13(b)). The embedded derivatives are considered to be clearly and closely related to the host contract as described in paragraph 13 of this Statement. Therefore, the embedded derivatives should *not* be separated from the host contract.

182. **Example 16: Ratchet Floater.** A bond that pays a floating rate of interest and has an adjustable cap, adjustable floor, or both that move in sync with each new reset rate.

*Example:* Coupon = 3-month U.S. \$ LIBOR + 50 basis points. In addition to having a lifetime cap of 7.25 percent, the coupon will be collared each period between the previous coupon and the previous coupon plus 25 basis points.

*Scope Application:* A ratchet floater may be viewed as containing embedded derivatives (combinations of purchased and written options that create changing caps and floors) that are referenced to an interest rate index (in this example, LIBOR) that alter net interest payments that otherwise would be paid by the debtor or received by the investor on an interest-bearing host contract but could not potentially result in the investor's failing to recover substantially all of its initial recorded investment in the bond (refer to paragraph 13(a)). In this example, there appears to be no possibility of increasing the investor's rate of return on the host contract to an amount that is at least double the initial rate of return on the host contract (refer to paragraph 13(b)). The embedded derivatives are considered to be clearly and closely related to the host contract as described in paragraph 13 of this Statement. Therefore, the embedded derivatives should *not* be separated from the host contract.

183. **Example 17: Fixed-to-Floating Note.** A bond that pays a varying coupon (first-year coupon is fixed; second- and third-year coupons are based on LIBOR, Treasury bills, or prime rate).

*Scope Application:* A fixed-to-floating note may be viewed as containing an embedded derivative (a forward-starting interest rate swap) that is referenced to an interest rate index (such as LIBOR) that alters net interest payments that otherwise would be paid by the debtor or received by the investor on an interest-bearing host instrument but could not potentially result in the investor's failing to recover substantially all of its initial recorded investment in the bond (refer to paragraph 13(a)). Likewise, there is no possibility of increasing the investor's rate of return on the host contract to an amount that is both at least double the initial rate of return on the host contract and at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality (refer to paragraph 13(b)). The embedded derivative is considered to be clearly and closely related to the host contract as described in paragraph 13 of this Statement. Therefore, the embedded derivative should *not* be separated from the host contract.

184. **Example 18: Indexed Amortizing Note.** A bond that repays principal based on a predetermined amortization schedule or target value. The amortization is linked to changes in a specific mortgage-backed security index or interest rate index. The maturity of the bond changes as the related index changes. This instrument includes a varying maturity. (It is assumed for this example that the bond's terms could not potentially result in the investor's failing to recover substantially all of its initial recorded investment in the bond [refer to paragraph 13(a)] nor is there the possibility of increasing the investor's rate of return on the host contract to an amount that is both at least double the initial rate of return on the host contract and at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality [refer to paragraph 13(b)].)

*Scope Application:* An indexed amortizing note can be viewed as a fixed-rate amortizing note combined with a conditional exchange option contract that requires partial or total "early" payment of the note based on changes in a specific mortgage-backed security index or a specified change in an interest rate index. Because the requirement to prepay is ultimately tied to changing interest rates, the embedded derivative is considered to be clearly and closely related to a fixed-rate note. Therefore, the embedded derivative should *not* be separated from the host contract.

185. **Example 19: Equity-Indexed Note.** A bond for which the return of interest, principal, or both is tied to a specified equity security or index (for example, the Standard and Poor's 500 [S&P 500] index). This instrument may contain a fixed or varying coupon rate and may place all or a portion of principal at risk.

*Scope Application:* An equity-indexed note essentially combines an interest-bearing instrument with a series of forward exchange contracts or option contracts. Often, a portion of the coupon interest rate is, in effect, used to purchase options that provide some form of floor on the potential loss of principal that would result from a decline in the referenced equity index. Because forward or option contracts for which the underlying is an equity index are not clearly and closely related to an investment in an interest-bearing note, those embedded derivatives should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement.

**186. Example 20: Variable Principal Redemption Bond.** A bond whose principal redemption value at maturity depends on the change in an underlying index over a predetermined observation period. A typical example would be a bond that guarantees a minimum par redemption value of 100 percent and provides the potential for a supplemental principal payment at maturity as compensation for the below-market rate of interest offered with the instrument.

*Example:* A supplemental principal payment will be paid to the investor, at maturity, if the final S&P 500 closing value (determined at a specified date) is less than its initial value at date of issuance *and* the 10-year CMT is greater than 2 percent as of a specified date. In all cases, the minimum principal redemption will be 100 percent of par.

*Scope Application:* A variable principal redemption bond essentially combines an interest-bearing investment with an option that is purchased with a portion of the bond's coupon interest payments. Because the embedded option entitling the investor to an additional return is partially contingent on the S&P 500 index closing above a specified amount, it is not clearly and closely related to an investment in a debt instrument. Therefore, the embedded option should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement.

**187. Example 21: Crude Oil Knock-in Note.** A bond that has a 1 percent coupon and guarantees repayment of principal with upside potential based on the strength of the oil market.

*Scope Application:* A crude oil knock-in note essentially combines an interest-bearing instrument with a series of option contracts. A significant portion of the coupon interest rate is, in effect, used to purchase options that provide the investor with potential gains resulting from increases in specified crude oil prices. Because the option contracts are indexed to the price of crude oil, they are not clearly and closely related to an investment in an interest-bearing note. Therefore, the embedded option contract should be separated from the host contract and accounted for by both parties pursuant to the provisions of this

Statement.

188. **Example 22: Gold-Linked Bull Note.** A bond that has a fixed 3 percent coupon and guarantees repayment of principal with upside potential if the price of gold increases.

*Scope Application:* A gold-linked bull note can be viewed as combining an interest-bearing instrument with a series of option contracts. A portion of the coupon interest rate is, in effect, used to purchase call options that provide the investor with potential gains resulting from increases in gold prices. Because the option contracts are indexed to the price of gold, they are not clearly and closely related to an investment in an interest-bearing note. Therefore, the embedded option contracts should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement.

189. **Example 23: Step-up Bond.** A bond that provides an introductory above-market yield and steps up to a new coupon, which will be below then-current market rates or, alternatively, the bond may be called in lieu of the step-up in the coupon rate.

*Scope Application:* A step-up bond can be viewed as a fixed-rate bond with an embedded call option and a changing interest rate feature. The bond pays an initial above-market interest rate to compensate for the call option and the future below-market rate (that is, below the forward yield curve, as determined at issuance based on the existing upward-sloping yield curve). Because the call option is related to changes in interest rates, it is clearly and closely related to an investment in a fixed-rate bond. Therefore, the embedded derivatives should *not* be separated from the host contract.

190. **Example 24: Credit-Sensitive Bond.** A bond that has a coupon rate of interest that resets based on changes in the issuer's credit rating.

*Scope Application:* A credit-sensitive bond can be viewed as combining a fixed-rate bond with a conditional exchange contract (or an option) that entitles the investor to a higher rate of interest if the credit rating of the issuer declines. Because the creditworthiness of the debtor and the interest rate on a debt instrument are clearly and closely related, the embedded derivative should *not* be separated from the host contract.

191. **Example 25: Inflation Bond.** A bond with a contractual principal amount that is indexed to the inflation rate but cannot decrease below par; the coupon rate is typically below that of traditional bonds of similar maturity.

*Scope Application:* An inflation bond can be viewed as a fixed-rate bond for which a portion of the coupon interest rate has been exchanged for a conditional

exchange contract (or option) indexed to the consumer price index, or other index of inflation in the economic environment for the currency in which the bond is denominated, that entitles the investor to payment of additional principal based on increases in the referenced index. Such rates of inflation and interest rates on the debt instrument are considered to be clearly and closely related. Therefore, the embedded derivative should *not* be separated from the host contract.

192. **Example 26: Disaster Bond.** A bond that pays a coupon above that of an otherwise comparable traditional bond; however, all or a substantial portion of the principal amount is subject to loss if a specified disaster experience occurs.

*Scope Application:* A disaster bond can be viewed as a fixed-rate bond combined with a conditional exchange contract (an option). The investor receives an additional coupon interest payment in return for giving the issuer an option indexed to industry loss experience on a specified disaster. Because the option contract is indexed to the specified disaster experience, it cannot be viewed as being clearly and closely related to an investment in a fixed-rate bond. Therefore, the embedded derivative should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement.

However, if the “embedded derivative” entitles the holder of the option (that is, the issuer of the disaster bond) to be compensated only for changes in the value of specified assets or liabilities for which the holder is at risk (including the liability for insurance claims payable due to the specified disaster) as a result of an identified insurable event (refer to paragraph 10(c)(2)), a separate instrument with the same terms as the “embedded derivative” would *not* meet the Statement's definition of a derivative in paragraphs 6–11. In that circumstance, because the criterion in paragraph 12(c) would not be met, there is no embedded derivative to be separated from the host contract, and the disaster bond would not be subject to the requirements of this Statement. The investor is essentially providing a form of insurance or reinsurance coverage to the issuer.

193. **Example 27: Specific Equity-Linked Bond.** A bond that pays a coupon slightly below that of traditional bonds of similar maturity; however, the principal amount is linked to the stock market performance of an equity investee of the issuer. The issuer may settle the obligation by delivering the shares of the equity investee or may deliver the equivalent fair value in cash.

*Scope Application:* A specific equity-linked bond can be viewed as combining an interest-bearing instrument with, depending on its terms, a series of forward exchange contracts or option contracts based on an equity instrument. Often, a portion of the coupon interest rate is used to purchase options that provide some form of floor on the loss of principal due to a decline in the price of the referenced equity instrument. The forward or option contracts do not qualify for the

exception in paragraph 10(e)(2) because the shares in the equity investee owned by the issuer meet the definition of a *financial instrument*. Because forward or option contracts for which the underlying is the price of a specific equity instrument are not clearly and closely related to an investment in an interest-bearing note, the embedded derivative should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement.

**194. Example 28: Dual Currency Bond.** A bond providing for repayment of principal in U.S. dollars and periodic interest payments denominated in a foreign currency. In this example, a U.S. entity with the dollar as its functional currency is borrowing funds from an independent party with those repayment terms as described.

*Scope Application:* Because the portion of this instrument relating to the periodic interest payments denominated in a foreign currency is subject to the requirement in Statement 52 to recognize the foreign currency transaction gain or loss in earnings, the instrument should not be considered as containing an embedded foreign currency derivative instrument pursuant to paragraph 15 of this Statement. In this example, the U.S. entity has the dollar as the functional currency and is making interest payments in a foreign currency. Remeasurement of the liability is required using future equivalent dollar interest payments determined by the current spot exchange rate and discounted at the historical effective interest rate.

**195. Example 29: Short-Term Loan with a Foreign Currency Option.** A U.S. lender issues a loan at an above-market interest rate. The loan is made in U.S. dollars, the borrower's functional currency, and the borrower has the option to repay the loan in U.S. dollars or in a fixed amount of a specified foreign currency.

*Scope Application:* This instrument can be viewed as combining a loan at prevailing market interest rates and a foreign currency option. The lender has written a foreign currency option exposing it to changes in foreign currency exchange rates during the outstanding period of the loan. The premium for the option has been paid as part of the interest rate. Because the borrower has the option to repay the loan in U.S. dollars or in a fixed amount of a specified foreign currency, the provisions of paragraph 15 are not relevant to this example. Paragraph 15 addresses foreign-currency-denominated interest or principal payments but does not apply to foreign currency options. Because a foreign currency option is not clearly and closely related to issuing a loan, the embedded option should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement. In contrast, if both the principal payment and the interest payments on the loan had been payable only in a fixed amount of a specified foreign currency, there would be no embedded foreign currency derivative pursuant to this Statement.

**196. Example 30: Lease Payment in Foreign Currency.** A U.S. company's operating lease with a Japanese lessor is payable in yen. The functional currency of the U.S. company is the U.S. dollar.

*Scope Application:* Paragraph 15(a) provides that contracts, other than financial instruments, that specify payments denominated in the currency of the primary economic environment in which any substantial party to that contract operates shall *not* be separated from the host contract and considered a derivative instrument for purposes of this Statement. Using available information about the lessor and its operations, the U.S. company may decide it is reasonable to conclude that the yen would be the currency of the primary economic environment in which the Japanese lessor operates, consistent with the functional currency notion in Statement 52. (That decision can be based on available information and reasonable assumptions about the counterparty; representations from the counterparty are not required.) Thus, the lease should *not* be viewed as containing an embedded swap converting U.S. dollar lease payments to yen. Alternatively, if the lease payments are specified in a currency seemingly unrelated to each party's functional currency, such as drachmas (assuming the leased property is not in Greece), the embedded foreign currency swap should be separated from the host contract and accounted for as a derivative for purposes of this Statement because the provisions of paragraph 15 would not apply and a separate instrument with the same terms would meet the definition of a derivative instrument in paragraphs 6–11.

**197. Example 31: Certain Purchases in a Foreign Currency.** A U.S. company enters into a contract to purchase corn from a local American supplier in six months for yen; the yen is the functional currency of neither party to the transaction. The corn is expected to be delivered and used over a reasonable period in the normal course of business.

*Scope Application:* Paragraph 10(b) excludes contracts that require future delivery of commodities that are readily convertible to cash from the accounting for derivatives if the commodities will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. However, the corn purchase contract must be examined to determine whether it contains an embedded derivative that warrants separate accounting. The corn purchase contract can be viewed as a forward contract for the purchase of corn and an embedded foreign currency swap from the purchaser's functional currency (the U.S. dollar) to yen. Because the yen is the functional currency of neither party to the transaction and the purchase of corn is transacted internationally in many different currencies, the contract does not qualify for the exception in paragraph 15 that precludes separating the embedded foreign currency derivative from the host contract. The embedded foreign currency swap should be separated from the host contract and accounted for as a derivative for purposes of this

Statement because a separate instrument with the same terms would meet the definition of a derivative instrument in paragraphs 6–11.

**198. Example 32: Participating Mortgage.** A mortgage in which the investor receives a below-market interest rate and is entitled to participate in the appreciation in the market value of the project that is financed by the mortgage upon sale of the project, at a deemed sale date, or at the maturity or refinancing of the loan. The mortgagor must continue to own the project over the term of the mortgage.

*Scope Application:* This instrument has a provision that entitles the investor to participate in the appreciation of the referenced real estate (the “project”). However, a separate contract with the same terms would be excluded by the exception in paragraph 10(e)(2) because settlement is based on the value of a nonfinancial asset of one of the parties that is not readily convertible to cash. (This Statement does not modify the guidance in AICPA Statement of Position 97-1, *Accounting by Participating Mortgage Loan Borrowers*.)

**199. Example 33: Convertible Debt.** An investor receives a below-market interest rate and receives the option to convert its debt instrument into the equity of the issuer at an established conversion rate. The terms of the conversion require that the issuer deliver shares of stock to the investor.

*Scope Application:* This instrument essentially contains a call option on the issuer’s stock. Under the provisions of this Statement, the accounting by the issuer and investor can differ. The issuer’s accounting depends on whether a separate instrument with the same terms as the embedded written option would be a derivative instrument pursuant to paragraphs 6–11 of this Statement. Because the option is indexed to the issuer’s own stock and a separate instrument with the same terms would be classified in stockholders’ equity in the statement of financial position, the written option is not considered to be a derivative instrument for the issuer under paragraph 11(a) and should *not* be separated from the host contract.

In contrast, if the terms of the conversion allow for a cash settlement rather than delivery of the issuer’s shares at the investor’s option, the exception in paragraph 11(a) for the issuer does not apply because the contract would not be classified in stockholders’ equity in the issuer’s statement of financial position. In that case, the issuer should separate the embedded derivative from the host contract and account for it pursuant to the provisions of this Statement because (a) an option based on the entity’s stock price is not clearly and closely related to an interest-bearing debt instrument and (b) the option would not be considered an equity instrument of the issuer.

Similarly, if the convertible debt is indexed to another entity's publicly traded common stock, the issuer should separate the embedded derivative from the host contract and account for it pursuant to the provisions of this Statement because (a) an option based on another entity's stock price is not clearly and closely related to an investment in an interest-bearing note and (b) the option would not be considered an equity instrument of the issuer.

The exception in paragraph 11 does not apply to the investor's accounting. Therefore, in both cases described above, the investor should separate the embedded option contract from the host contract and account for the embedded option contract pursuant to the provisions of this Statement because the option contract is based on the price of another entity's equity instrument and thus is not clearly and closely related to an investment in an interest-bearing note. However, if the terms of conversion do not allow for a cash settlement and if the common stock delivered upon conversion is privately held (that is, is not readily convertible to cash), the embedded derivative would not be separated from the host contract because it would not meet the criteria in paragraph 9.

**200. Example 34: Variable Annuity Products.** These products are investment contracts as contemplated in Statements 60 and 97. Similar to variable life insurance products, policyholders direct their investment account asset mix among a variety of mutual funds composed of equities, bonds, or both, and assume the risks and rewards of investment performance. The funds are generally maintained in separate accounts by the insurance company. Contract terms provide that if the policyholder dies, the greater of the account market value or a minimum death benefit guarantee will be paid. The minimum death benefit guarantee is generally limited to a return of premium plus a minimum return (such as 3 or 4 percent); this life insurance feature represents the fundamental difference from the life insurance contracts that include significant (rather than minimal) levels of life insurance. The investment account may have various payment alternatives at the end of the accumulation period. One alternative is the right to purchase a life annuity at a fixed price determined at the initiation of the contract.

*Scope Application:* Variable annuity product structures as contemplated in Statement 97 are generally not subject to the scope of this Statement (except for payment options at the end of the accumulation period), as follows:

- *Death benefit component.* Paragraph 10(c)(1) excludes a death benefit from the scope of this Statement because the payment of the death benefit is the result of an identifiable insurable event instead of changes in an underlying. The death benefit in this example is limited to the floor guarantee of the investment account, calculated as the premiums paid into the investment account plus a guaranteed rate of return, less the account market value. Statement 60 remains the applicable guidance for the insurance-related liability accounting.

- *Investment component.* The policyholder directs certain premium investments in the investment account that includes equities, bonds, or both, which are held in separate accounts that are owned by the policyholder and separate from the insurer's general account assets. This component is viewed as a direct investment because the policyholder directs and owns these investments. This component is not a derivative because the policyholder has invested the premiums in acquiring those investments. Furthermore, any embedded derivatives within those investments should not be separated from the host contract by the insurer because the separate account assets are already marked-to-market under Statement 60. In contrast, if the product were an equity-index-based interest annuity (rather than a variable annuity), the investment component would not be viewed as a direct investment because the policyholder does not own those investments, which are assets recorded in the general account of the insurance company. As a result, the host contract would be a debt instrument, and the equity-index-based derivative should be separated and accounted for as a derivative instrument.
- *Investment account surrender right at market value.* Because this right is exercised only at the fund market value (without the insurer's floor guarantee) and relates to an investment owned by the insured, this right is not within the scope of this Statement.
- *Payment alternatives at the end of the accumulation period.* Payment alternatives are options subject to the requirements of this Statement if interest rates or other underlying variables affect the value.

### Section 3: Examples Illustrating Application of the Transition Provisions

201. Assume that at December 31, 1999, a calendar-year entity has the following derivatives and hedging relationships in place (for simplicity, income tax effects are ignored):

(a) <u>Item</u>	Before Transition Adjustment—December 31, 1999				
	<u>Asset (Liability)</u>		(d) GAAP Classification prior <u>to Transition</u>	(e) Previous Hedge <u>Resembles</u>	(f) Assumed Post- Transition-Date Accounting under <u>This Statement</u>
	(b) Carrying <u>Amount</u>	(c) Fair <u>Value</u>			
A.			Hedges existing inventory (though fair value changes have not been recognized)	Fair value hedge	Fair value hedge of inventory
Forward contract	\$ 0	\$(1,500)			

	Inventory	5,000	6,400	Hedged by forward contract		
B.						Would not qualify as a hedge of the held-to-maturity security—account for swap as a nonhedging derivative*
	Interest rate swap	0	180	Hedges fixed-rate bond	Fair value hedge	
	Fixed-rate bond (classified as held-to-maturity)	1,000	800	Hedged by interest rate swap		
C.	Interest rate swap	0	(350)	Hedges fixed-rate bond	Fair value hedge	Fair value hedge of the fixed-rate bond
	Fixed-rate bond (classified as available-for-sale)	1,000	1,000	Hedged by interest rate swap (cost basis is \$650; unrealized holding gain is \$350)		
	Other comprehensive income (Statement 115)	(350)	N/A			
D.	Foreign currency forward contracts	1,000	1,200	Hedges firm purchase commitment	Fair value hedge	Fair value hedge of the firm commitment
	Deferred credit	(1,000)	N/A	Deferred gain related to foreign currency forward contract		
	Firm commitment to pay foreign currency to purchase machinery	0	(1,200)	Hedged by foreign currency forward contract		
E.	Swap (no longer held)	—	—	Swap that was hedging a probable forecasted transaction was terminated prior to 12/31/99 and the related gain was deferred	Cash flow hedge	Since the swap is no longer held, there is no new designation
	Deferred credit	(1,000)	N/A			
F.				Hedges a probable forecasted transaction		Forward could possibly

2-year forward contract	0	1,000	projected to occur in 1 year	Cash flow hedge	qualify as a hedging instrument
G. 6-month futures contract (cash settled daily)	0	0	Hedges a probable forecasted transaction projected to occur in 6 months	Cash flow hedge	Cash flow hedge
Deferred debit	500	N/A	Deferred loss related to futures contract		N/A

\*Prior to the effective date of Statement 133, generally accepted accounting principles did not prohibit hedge accounting for a hedge of the interest rate risk in a held-to-maturity security. Thus, transition adjustments may be necessary for hedges of that type because that type of hedging relationship will no longer qualify for hedge accounting under the provisions of this Statement. At the date of initial application, an entity may reclassify any held-to-maturity security into the available-for-sale or trading category (refer to paragraph 54).

202. To determine transition accounting, existing hedge relationships must be identified as either a fair value *type* of hedge or a cash flow *type* of hedge as identified pursuant to this Statement. They do not have to meet the hedge criteria of this Statement. That identification is indicated in column (e) of the above table.

203. At transition, an entity has an opportunity to redesignate hedging relationships. This example makes certain assumptions regarding post-transition-date accounting pursuant to this Statement as indicated in column (f) of the above table that cannot necessarily be determined from the information provided in this example. The appropriate conditions in this Statement must be met to continue hedge accounting for periods subsequent to transition. However, determining whether a potential hedging relationship meets the conditions of this Statement does not impact the transition accounting. For purposes of determining transition adjustments, existing hedging relationships are categorized as fair value or cash flow hedges based on their general characteristics, without assessing whether all of the applicable conditions would be met.

204. After applying the transition provisions, the above items would be reflected in the financial statements as follows:

**After Transition Adjustment—January 1, 2000**

<u>Item</u>	<u>Statement of Financial Position</u>		<u>Income Statement</u>	<u>Explanation of Accounting at Transition</u>
	<u>Asset (Liability)</u>	<u>Other Comprehensive Income</u>	<u>Transition Adjustment Gain (Loss)</u>	

A. Adjust to fair value by

Forward contract	\$(1,500)	N/A	\$ (1,500)	recognizing \$1,500 loss as a transition adjustment
Inventory	6,400	N/A	<u>1,400</u>	Recognize offsetting \$1,400 gain as a transition adjustment*
Net impact			<u>\$ (100)</u>	
<hr/>				
B.				Adjust to fair value by recognizing \$180 gain as a transition adjustment
Interest rate swap	180	N/A	\$ 180	
Fixed-rate bond (classified as held-to-maturity)	820	N/A	<u>(180)</u>	Recognize offsetting \$180 loss as a transition adjustment
Net impact			<u>\$ 0</u>	
<hr/>				
C.				Adjust to fair value by recognizing a \$350 loss as a transition adjustment
Interest rate swap	(350)	N/A	\$ (350)	
Fixed-rate bond (classified as available-for-sale)	1,000	N/A	—	Remove offsetting \$350 gain previously reported in OCI (Statement 115) and recognize as a transition adjustment
Other comprehensive income (OCI)	N/A—		<u>350</u>	
Net impact			<u>\$ 0</u>	
<hr/>				
D.				Adjust to fair value by recognizing \$200 gain as a transition adjustment
Foreign currency forward contract	1,200	N/A	\$ 200	
Deferred credit	0	N/A	1,000	Remove deferred credit and recognize as a transition adjustment
Firm commitment to pay foreign currency to purchase machinery	(1,200)	N/A	<u>(1,200)</u>	Recognize offsetting \$1,200 loss as a transition adjustment
Net impact			<u>\$ 0</u>	

E.					No asset exists for the terminated swap
	Terminated swap	—	—	\$ —	
					Remove the deferred credit and recognize in OCI—to be reclassified into earnings consistent with the earnings effect of the hedged forecasted transaction
	Deferred credit	—	N/A	—	
	OCI	N/A	\$(1,000)	—	
	Net impact			<u>\$ 0</u>	
F.					Adjust to fair value by recognizing \$1,000 gain in OCI—to be reclassified into earnings consistent with the earnings effect of the hedged forecasted transaction
	Forward contract	1,000	(1,000)	<u>\$ 0</u>	
G.					Asset already reported at fair value—no adjustment necessary
	Futures contract	0	N/A	—	
					Remove deferred debit and recognize in OCI—to be reclassified into earnings consistent with the earnings effect of the hedged forecasted transaction
	Deferred debit	—	N/A	—	
	OCI	N/A	500	—	
	Net impact			<u>\$ 0</u>	

\*The transition adjustment for the gain on the hedged inventory is limited to the amount that is offset by the loss on the hedging derivative. The entire \$1,400 gain is recognized in this example because it is less than the \$1,500 loss on the derivative. If the inventory gain had been more than \$1,500, only \$1,500 would have been recognized as a transition adjustment.

205. In the initial year of application, an entity would also disclose the amounts of deferred gains and losses included in other comprehensive income that are expected to be reclassified into earnings within the next 12 months.

## Appendix C

### BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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## Appendix C: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

### Introduction

206. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

### Background Information

207. The Board is addressing the accounting for derivative instruments<sup>27</sup> and hedging activities as part of its broad project on financial instruments. That project was added to the Board's agenda in 1986 to address financial reporting issues that were arising, or that were given a new sense of urgency, as a result of financial innovation. The project initially focused on disclosures and resulted in the issuance of FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, in March 1990, and No. 107, *Disclosures about Fair Value of Financial Instruments*, in December 1991. This Statement supersedes Statement 105 and amends Statement 107.

208. An FASB staff-authored Research Report, *Hedge Accounting: An Exploratory Study of the Underlying Issues*, was published in September 1991.<sup>28</sup> An FASB Discussion Memorandum, *Recognition and Measurement of Financial Instruments*, was issued in November 1991 as a basis for considering the financial accounting and reporting issues of recognition and measurement raised by financial instruments. The recognition and measurement phase of the financial instruments project, which began with the issuance of that Discussion Memorandum, resulted in the issuance of FASB Statements No. 114, *Accounting by Creditors for Impairment of a Loan*, and No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, in May 1993, FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, in October 1994, and FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, in June 1996.

209. Concern about financial reporting for derivative instruments and hedging activities is an international phenomenon. In October 1995, an FASB staff-authored Special Report, *Major Issues Related to Hedge Accounting*, was published jointly with representatives of the accounting standards-setting bodies of the United Kingdom, Canada, and Australia and the International Accounting Standards Committee.<sup>29</sup> That Special Report discusses many of the issues that needed to be resolved in developing a hedge accounting model.

210. The Board began deliberating issues relating to derivatives and hedging activities in January 1992. From then until June 1996, the Board held 100 public meetings to discuss various issues and proposed accounting approaches, including 74 Board meetings, 10 meetings with members of the Financial Accounting Standards Advisory Council, 7 meetings with members of the Financial Instruments Task Force and its subgroup on hedging, and 9 meetings with outside representatives. In addition, individual Board members and staff visited numerous companies in a variety of fields and participated in meetings with different representational groups, both nationally and internationally, to explore how different entities manage risk and how those risk management activities should be accounted for.

211. In June 1993, the Board issued a report, "A Report on Deliberations, Including Tentative Conclusions on Certain Issues, related to Accounting for Hedging and Other Risk-adjusting Activities." That report included background information about the Board's deliberations and some tentative conclusions on accounting for derivatives and hedging activities. It also solicited comments from constituents and provided the basis for two public meetings in September 1993.

212. Concern has grown about the accounting and disclosure requirements for derivatives and hedging activities as the extent of use and the complexity of derivatives and hedging activities have rapidly increased in recent years. Changes in global financial markets and related financial innovations have led to the development of new derivatives used to manage exposures to risk, including interest rate, foreign exchange, price, and credit risks. Many believe that accounting standards have not kept pace with those changes. Derivatives can be useful risk management tools, and some believe that the inadequacy of financial reporting may have discouraged their use by contributing to an atmosphere of uncertainty. Concern about inadequate financial reporting also was heightened by the publicity surrounding large derivative losses at a few companies. As a result, the Securities and Exchange Commission, members of Congress, and others urged the Board to deal expeditiously with reporting problems in this area. For example, a report of the General Accounting Office prepared for Congress in 1994 recommended, among other things, that the FASB "proceed expeditiously to develop and issue an exposure draft that provides comprehensive, consistent accounting rules for derivative products. . . ." <sup>30</sup> In addition, some users of financial statements asked for improved disclosures and accounting for derivatives and hedging. For example, one of the recommendations in the December 1994 report published by the AICPA Special Committee on Financial Reporting, *Improving Business Reporting—A Customer Focus*, was to address the disclosures and accounting for innovative financial instruments.

213. Because of the urgency of improved financial information about derivatives and related activities, the Board decided, in December 1993, to redirect some of its efforts toward enhanced disclosures and, in October 1994, issued FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*. This Statement supersedes Statement 119.

214. In June 1996, the Board issued an Exposure Draft, *Accounting for Derivative and Similar Financial Instruments and for Hedging Activities*. Approximately 300 organizations and individuals responded to the Exposure Draft, some with multiple letters. In November 1996, 36 individuals and organizations presented their views at 4 days of public hearings. In addition, six enterprises participated in a limited field test of the provisions of the Exposure Draft. In December 1996, the Board's Financial Instruments Task Force met to discuss the issues raised during the comment letter process and during the public hearings. The Board considered the comments and field test results during its redeliberations of the issues addressed by the Exposure Draft in 21 public meetings in the first 7 months of 1997. The Financial Instruments Task Force met again with the Board in April 1997 and discussed, among other things, proposed changes to the Exposure Draft reflected in a draft of a Statement. As a consequence of the comments received, the Board made certain changes to the proposals in the Exposure Draft.

215. In August 1997, a draft of the standards section of this Statement and related examples was made available to the Financial Instruments Task Force and other interested parties for comment on its clarity and operability. The Board received approximately 150 comment letters on that draft and discussed those comments in 10 open Board meetings. Those comments also led to changes to the requirements, intended to make the Statement clearer and more operational.

216. This Statement is an additional step in the Board's project on financial instruments and is intended to address the immediate problems about the recognition and measurement of derivatives while the Board's vision of having all financial instruments measured at fair value in the statement of financial position is pursued. Certain provisions of this Statement will be reconsidered as the Board continues to address the issues in its broad project on financial instruments.

### **Fundamental Decisions Underlying the Statement**

217. The Board made four fundamental decisions about how to account for derivatives and hedging activities; those decisions became the cornerstones of this Statement:

- a. Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.
- b. Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Derivative instruments should be measured at fair value, and adjustments to the carrying amounts of hedged items should reflect changes in their fair value (that is, gains or losses) that are attributable to the risk being hedged and that arise while the hedge is in effect.
- c. Only items that are assets or liabilities should be reported as such in financial statements.
- d. Special accounting for items designated as being hedged should be provided only for qualifying items. One aspect of qualification should be an assessment of the expectation of effective offsetting changes in fair values or cash flows during the term of the hedge for the risk being hedged.

218. *Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.* Derivatives are assets or liabilities because they represent rights or obligations. FASB Concepts Statement No. 6, *Elements of Financial Statements*, describes the characteristics of assets and liabilities as follows:

An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. . . .

A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. [paragraphs 26 and 36]

219. The ability to settle a derivative in a gain position by receiving cash, another financial asset, or a nonfinancial asset is evidence of a right to a future economic benefit and is compelling evidence that the instrument is an asset. Similarly, the payment of cash, a financial asset, or a nonfinancial asset that is required to settle a derivative in a loss position is evidence of a duty to sacrifice assets in the future and indicates that the instrument is a liability. The Board believes that recognizing those assets and liabilities will make financial statements more complete and more informative. Before the issuance of this Statement, many derivatives were "off-balance-sheet" because, unlike conventional financial instruments such as stocks, bonds, and loans, derivatives often reflect at their inception only a mutual exchange of promises with little or no transfer of tangible consideration.

220. *Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Derivative instruments should be measured at fair value, and adjustments to the carrying amounts of hedged items should reflect changes in their fair value (that is, gains or losses) that are attributable to the risk being hedged and that arise while the hedge is in effect.* In 1991, with the issuance of Statement 107, the Board concluded that disclosure of fair value information about financial instruments is useful to present and potential investors, creditors, and other users of financial statements in making rational investment, credit, and other decisions. Statement 107 describes the Board's rationale:

Fair values of financial instruments depict the market's assessment of the present value of net future cash flows directly or indirectly embodied in them, discounted to reflect both current interest rates and the market's assessment of the

risk that the cash flows will not occur. Investors and creditors are interested in predicting the amount, timing, and uncertainty of future net cash inflows to an entity, as those are the primary sources of future cash flows from the entity to them. Periodic information about the fair value of an entity's financial instruments under current conditions and expectations should help those users both in making their own predictions and in confirming or correcting their earlier expectations.

Information about fair value better enables investors, creditors, and other users to assess the consequences of an entity's investment and financing strategies, that is, to assess its performance. For example, information about fair value shows the effects of a decision to borrow using fixed-rate rather than floating-rate financial instruments or of a decision to invest in long-term rather than short-term instruments. Also, in a dynamic economy, information about fair value permits continuous reassessment of earlier decisions in light of current circumstances. [paragraphs 40 and 41]

221. The Board believes fair values for financial assets and liabilities provide more relevant and understandable information than cost or cost-based measures. In particular, the Board believes that fair value is more relevant to financial statement users than cost for assessing the liquidity or solvency of an entity because fair value reflects the current cash equivalent of the entity's financial instruments rather than the price of a past transaction. With the passage of time, historical prices become irrelevant in assessing present liquidity or solvency.

222. The Board also believes fair value measurement is practical for most financial assets and liabilities. Fair value measurements can be observed in markets or estimated by reference to markets for similar instruments. If market information is not available, fair value can be estimated using other measurement techniques, such as discounted cash flow analyses and option or other pricing models, among others.

223. The Board believes fair value is the *only* relevant measurement attribute for derivatives. Amortized cost is not a relevant measure for derivatives because the historical cost of a derivative often is zero, yet a derivative generally can be settled or sold at any time for an amount equivalent to its fair value. Statement 115 provides reasoning for the belief that amortized cost may be relevant for debt securities that will be held to maturity. In the absence of default, that cost will be realized at maturity, and any interim unrealized gains or losses will reverse. That reasoning does not hold for derivatives or for other financial instruments. The volatility of derivatives' fair values and the irrelevance of amortized cost for derivatives convinced the Board that fair value is the only relevant measure for derivatives and that all derivatives should be reported in financial statements at fair value. (The latter part of the Board's second fundamental decision, which deals with the mechanics of hedge accounting, is discussed in paragraphs 362 and 363.)

224. Some of the Board's constituents contend that reporting derivatives at fair value will not

result in more useful information than results from present practice. Some also say that reporting derivatives at fair value will result in reported gains or losses and increases or decreases in reported equity that are "artificial" because they do not reflect economic benefits or detriments. Some of those concerns are based in part on concerns about using different measurement attributes for derivatives and for other financial instruments. The Board agrees that financial statements would be even more useful if all financial instruments were reported at fair value, and that is its long-term goal. However, some of the arguments against reporting derivatives at fair value are made in the context of assertions that fair value measurements do not provide useful information for either derivatives or other instruments. The following simple example illustrates why the Board does not agree with that view.

225. Bank A and Bank B have identical financial positions at December 31, 20X1, as follows:

Loans	\$10 billion	Liabilities	\$ 9 billion
		Equity	<u>1 billion</u>
Total assets	<u>\$10 billion</u>	Total liabilities and equity	<u>\$10 billion</u>

Both banks' assets consist entirely of variable-rate loans. Both also have fixed-rate debt at 9 percent.

226. In January of 20X2, Bank A becomes concerned that market interest rates will fall below the current level of 10 percent, and it therefore enters into a pay-variable, receive-fixed-at-10-percent interest rate swap. Bank B, on the other hand, chooses not to hedge its variable-rate loans. Bank A's swap will reprice every three months, beginning on April 15, 20X2. By March 31, 20X2, interest rates have fallen significantly, and the fair value of Bank A's swap is \$1 billion.

227. For simplicity, the example assumes that each bank's interest income for the first quarter of 20X2 was exactly offset by expenses so that both had earnings of zero. The effects of deferred taxes also are ignored. Thus, if the change in fair value of Bank A's interest rate swap is excluded from its financial statements, as was general practice before this Statement, both banks' balance sheets at March 31, 20X2 would continue to appear as presented in paragraph 225. However, the two banks are not in the same economic position—Bank A has a \$1 billion asset that Bank B does not.

228. The following statement of financial position, which reflects the requirements of this Statement if Bank A accounts for the swap as a cash flow hedge, better reflects Bank A's economic position at March 31, 20X2:

Loans	\$10 billion	Liabilities	<u>\$ 9 billion</u>
Interest rate swap	<u>1 billion</u>	Equity:	
		Beginning equity	1 billion
		Gain on swap	<u>1 billion</u>
		Total equity	<u>2 billion</u>
Total assets	<u>\$11 billion</u>	Total liabilities and equity	<u>\$11 billion</u>

Bank A's statement of comprehensive income for the quarter ending March 31, 20X2 will report a gain of \$1 billion. Bank B's comprehensive income for the same period will be reported as zero. Under previous accounting for swaps, Bank A would only accrue periodic cash receipts or payments on the swap as the swap reprices and those receipts or payments become due. In contrast, the financial statements of Banks A and B at March 31, 20X2 presented in accordance with this Statement signal to investors and creditors that the future reported earnings and cash flows of the banks will be different. If interest rates remain below 10 percent during the remainder of the term of the loans, Bank A will report higher earnings and will receive higher cash inflows than Bank B. Indeed, whatever happens to interest rates in the future, the two banks are likely to be affected differently. Under previous reporting practices for interest rate swaps and many other derivatives, Bank A and Bank B would have looked exactly alike at March 31, 20X2. However, the two banks are not in the same economic position at March 31, 20X2, and Bank A's increase in reported equity reflects the real difference in the position of the two banks. That increase in equity is by no means "artificial."

229. *Only items that are assets or liabilities should be reported as such in financial statements.* Derivatives are assets or liabilities, and the Board decided that they should be reported in financial statements (fundamental decision 1) and measured at fair value (fundamental decision 2). If derivatives are measured at fair value, the losses or gains that result from changes in their fair values must be reported in the financial statements. However, those losses or gains are not separate assets or liabilities because they have none of the essential characteristics of assets or liabilities as described in paragraph 218. The act of designating a derivative as a hedging instrument does not convert a subsequent loss or gain into an asset or a liability. A loss is not an asset because no future economic benefit is associated with it. The loss cannot be exchanged for cash, a financial asset, or a nonfinancial asset used to produce something of value, or used to settle liabilities. Similarly, a gain is not a liability because no obligation exists to sacrifice assets in the future. Consequently, the Board concluded that losses or gains on derivatives should not be reported as assets or liabilities in a statement of financial position.

230. *Special accounting for items designated as being hedged should be provided only for qualifying items. One aspect of qualification should be an assessment of the expectation of effective offsetting changes in fair values or cash flows during the term of the hedge for the risk being hedged.* Because hedge accounting is elective and relies on management's intent, it should be limited to transactions that meet reasonable criteria. The Board concluded that hedge

accounting should not be permitted in all cases in which an entity might assert that a relationship exists between items or transactions. A primary purpose of hedge accounting is to link items or transactions whose changes in fair values or cash flows are expected to offset each other. The Board therefore decided that one of the criteria for qualification for hedge accounting should focus on the extent to which offsetting changes in fair values or cash flows on the derivative and the hedged item or transaction during the term of the hedge are expected and ultimately achieved.

231. The offset criterion 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 for Japanese yen as a hedge of its U.S. dollar sales would fail the requirement that the cash flows of the derivative are expected to be highly effective in achieving offsetting cash flows on the hedged transaction. A weakened yen might allow a competitor to sell goods imported from Japan more cheaply, undercutting the domestic manufacturer's prices and reducing its sales volume and revenues. 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. 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 under this Statement. Hedge accounting in this Statement is limited to the direct effects of price changes of various kinds (commodity prices, interest rates, and so on) on fair values of assets and liabilities and the cash flows from transactions, including qualifying forecasted transactions.

### **Benefits and Costs of This Statement**

232. In accomplishing its mission, the Board follows certain precepts, including the precept to promulgate standards only when the expected benefits of the information exceed the perceived cost. The Board works to determine that a proposed standard will fill a significant need and that the costs imposed to meet the standard, as compared to other alternatives, are justified in relation to the overall benefits of the resulting information.

### **Problems with Previous Accounting and Reporting Practices**

233. The first step in considering whether the benefits of a new accounting standard will justify the related costs is to identify the problems in the existing accounting guidance that a new standard seeks to resolve. The problems with previous accounting and reporting practices for derivatives and hedging activities are discussed below.

234. *The effects of derivatives were not transparent in the basic financial statements.* Under the varied accounting practices that existed before the issuance of this Statement, some derivatives were recognized in financial statements, others were not. If recognized in financial statements,

some realized and unrealized gains and losses on derivatives were deferred from earnings recognition and reported as part of the carrying amount (or "basis") of a related item or as if they were freestanding assets and liabilities. Users of financial statements found it difficult to determine what an entity had or had not done with derivatives and the related effects because the basic financial statements often did not report the rights or obligations associated with derivative instruments.

235. *The accounting guidance for derivative instruments and hedging activities was incomplete.* Before the issuance of this Statement, accounting standards specifically addressed only a few types of derivatives. Statement 52 addressed foreign exchange forward contracts, and Statement 80 addressed exchange-traded futures contracts. Only those two Statements specifically provided for "hedge accounting." That is, only those Statements provided special accounting to permit a gain or loss on a derivative to be deferred beyond the period in which it otherwise would be recognized in earnings because it was designated as a hedging instrument. The EITF addressed the accounting for some derivatives and for some hedging activities not covered in either Statement 52 or Statement 80. However, that effort was on an ad hoc basis and gaps remained in the authoritative literature. Accounting practice filled some gaps on specific issues, such as with "synthetic instrument accounting" as described in paragraph 349, but without commonly understood limitations on the appropriate use of that accounting. The result was that (a) many derivative instruments were carried "off-balance-sheet" regardless of whether they were formally part of a hedging strategy, (b) practices were inconsistent among entities, and (c) users of financial reports had inadequate information.

236. *The accounting guidance for derivative instruments and hedging activities was inconsistent.* Under previous accounting guidance, the required accounting treatment differed depending on the type of instrument used in a hedge and the type of risk being hedged. For example, an instrument hedging an anticipated transaction may have qualified for special accounting if it was a purchased option with certain characteristics or an interest rate futures contract, but not if it was a foreign currency forward or futures contract. Derivatives also were measured differently under previous standards—futures contracts were reported at fair value, foreign currency forward contracts were reported at amounts that reflected changes in foreign exchange spot rates but not changes in forward rates and that were not discounted for the time value of money, and other derivatives often were unrecognized or were reported at nominal amounts not closely related to the fair value of the derivatives (for example, reported at the net cash due that period). Accounting standards also were inconsistent on whether qualification for hedge accounting was based on risk assessment at an entity-wide or an individual-transaction level.

237. *The accounting guidance for derivatives and hedging was difficult to apply.* The lack of a single, comprehensive approach to accounting for derivatives and hedging made the accounting guidance difficult to apply. The incompleteness of FASB Statements on derivatives and hedging forced entities to look to a variety of different sources, including the numerous EITF issues and nonauthoritative literature, to determine how to account for specific instruments or transactions.

Because there often was nothing directly on point, entities analogized to other existing guidance. Different sources of analogy often conflicted, and a wide range of answers sometimes was deemed supportable, but those answers often were subject to later challenge.

### **This Statement Mitigates Those Problems**

238. This Statement mitigates those four problems. It increases the visibility, comparability, and understandability of the risks associated with derivatives by requiring that all derivatives be reported as assets or liabilities and measured at fair value. It reduces the inconsistency, incompleteness, and difficulty of applying previous accounting guidance and practice by providing comprehensive guidance for all derivatives and hedging activities. The comprehensive guidance in this Statement also eliminates some accounting practices, such as "synthetic instrument accounting," that had evolved beyond the authoritative literature.

239. In addition to mitigating the previous problems, this Statement accommodates a range of hedge accounting practices by (a) permitting hedge accounting for most derivative instruments, (b) permitting hedge accounting for cash flow hedges of forecasted transactions for specified risks, and (c) eliminating the requirement in Statement 80 that an entity demonstrate risk reduction on an entity-wide basis to qualify for hedge accounting. The combination of accommodating a range of hedge accounting practices and removing the uncertainty about the accounting requirements for certain strategies should facilitate, and may actually increase, entities' use of derivatives to manage risks.

240. The benefits of improving financial reporting for derivatives and hedging activities come at a cost. Even though much of the information needed to implement this Statement is substantially the same as was required for prior accounting standards for many hedges, and therefore should be available, many entities will incur one-time costs for requisite systems changes. But the benefits of more credible and more understandable information will be ongoing.

241. The Board believes that accounting requirements should be neutral and should not encourage or discourage the use of particular types of contracts. That desire for neutrality must be balanced with the need to reflect substantive economic differences between different instruments. This Statement is the product of a series of many compromises made by the Board to improve financial reporting for derivatives and hedging activities while giving consideration to cost-benefit issues, as well as current practice. The Board believes that most hedging strategies for which hedge accounting is available in current practice have been reasonably accommodated. The Board recognizes that this Statement does not provide special accounting that accommodates some risk management strategies that certain entities wish to use, such as hedging a portfolio of dissimilar items. However, this Statement clarifies and accommodates hedge accounting for more types of derivatives and different views of risk, and provides more consistent accounting for hedges of forecasted transactions than did the limited guidance that existed before this Statement.

242. Some constituents have said that the requirements of this Statement are more complex than

existing guidance. The Board disagrees. It believes that compliance with previous guidance was more complex because the lack of a single, comprehensive framework forced entities to analogize to different and often conflicting sources of guidance. The Board also believes that some constituents' assertions about increased complexity may have been influenced by some entities' relatively lax compliance with previous guidance. For example, the Board understands that not all entities complied with Statement 80's entity-wide risk reduction criterion to qualify for hedge accounting, and that also may have been true for requirements for hedging a portfolio of dissimilar items. The Board also notes that some of the more complex requirements of this Statement, such as reporting the gain or loss on a cash flow hedge in earnings in the periods in which the hedged transaction affects earnings, are a direct result of the Board's efforts to accommodate respondents' wishes.

243. The Board took several steps to minimize the incremental costs of the accounting and disclosure requirements of this Statement. For example, this Statement relies on the valuation guidance provided in Statement 107, which most entities have been applying for several years. The Board also decided not to continue the previously required assessment of risk at an entity-wide level, which constituents said is very difficult and costly to make. This Statement also reduces the disclosure requirements that previously were required for derivatives. Some of the previous disclosure requirements for derivatives were intended to partially compensate for inadequate accounting; improving the information provided in the basic financial statements makes possible a reduction in such disclosures.

### **Scope and Definition**

244. As already discussed, the Board decided that derivative instruments should be measured at fair value. The Board also decided that accounting for gains or losses that result from measuring derivatives at fair value should depend on whether or not the derivative instrument is designated and qualifies as a hedging instrument. Those decisions require that the Board clearly identify (a) those instruments to which this Statement applies and (b) the criteria that must be met for a relationship to qualify for hedge accounting.

245. The Board decided that this Statement should apply to many, but not all, instruments that are often described as derivatives. In reaching that decision, the Board observed that prior accounting standards did not clearly distinguish derivative instruments from other financial and nonfinancial instruments. Financial statement preparers, users, and other interested parties often have trouble clearly distinguishing between instruments that are commonly considered derivatives and other instruments. Accordingly, they often do not agree on whether certain instruments are derivatives. This Statement defines derivative instruments based on their characteristics; the resulting definition may not always coincide with what some market participants consider to be derivatives.

## Why Hedging Instruments Are Limited to Derivatives

246. This Statement limits hedge accounting to those relationships in which derivative instruments and certain foreign-currency-denominated nonderivative instruments are designated as hedging instruments and the necessary qualifying criteria are met. The Board recognizes that there may be valid reasons for entering into transactions intended to be hedges using nonderivative instruments, but the Board continues to believe that permitting nonderivative instruments to be designated as hedging instruments would be inappropriate.

247. Achieving the Board's long-term objective of having all financial instruments—both derivative and nonderivative—measured at fair value would eliminate the need for hedge accounting for the risks inherent in existing financial instruments. Both the hedging instrument and the hedged item would be measured at fair value. Accounting for the gains and losses on each in the same way would leave no measurement anomalies to which to apply hedge accounting. As further discussed in paragraphs 326 and 327, the Board considers hedge accounting for forecasted transactions to be inappropriate from a conceptual perspective. In practice, hedge accounting for forecasted (anticipated) transactions has been limited to derivatives, and the Board does not think it would be appropriate to extend hedge accounting for what is not a conceptually defensible practice to nonderivative instruments. To include nonderivative financial instruments, other than in circumstances already permitted by existing accounting pronouncements, as hedging instruments also would add complexity and delay issuing guidance on accounting for derivative instruments. The Board therefore decided to limit hedge accounting to derivatives. Consequently, items such as securities, trade receivables and payables, and deposit liabilities at banks may not be designated as hedging instruments except that, consistent with existing provisions in Statement 52, nonderivative instruments that give rise to transaction gains or losses may be designated as hedges of certain foreign currency exposures.

## Defining Characteristics of a Derivative Instrument

248. The Board considered defining a *derivative instrument* in this Statement by merely referencing those instruments commonly understood to be derivatives. That would be similar to the method used in paragraph 5 of Statement 119, which said that ". . . a *derivative financial instrument* is a futures, forward, swap, or option contract, or other financial instrument with similar characteristics." However, the expansion of financial markets and continued development of innovative financial instruments and other contracts could ultimately render obsolete a definition based solely on examples. Currently, contracts often referred to as derivatives have characteristics similar to other contracts that often are *not* considered to be derivative instruments. For example, purchase orders for certain raw materials have many similarities to forward contracts that are referenced to those same raw materials. The Board is concerned that the existing distinctions between many types of contracts are likely to become even more blurred as new innovative instruments are developed. Therefore, to distinguish between similar contracts and to deal with new instruments that may be developed in the future, this Statement provides a definition of derivative instruments based on distinguishing

characteristics rather than merely referring to classes of instruments or titles used to describe them.

249. For purposes of this Statement, a derivative instrument is a financial instrument or other contract that has all three of the following characteristics:

- a. It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both.
- b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

The Board believes those three characteristics capture the essence of instruments, such as futures and options, that have long been considered derivatives and instruments that are sufficiently similar to those traditional derivatives that they should be accounted for similarly. The following paragraphs discuss each characteristic in more depth. Section 1 of Appendix A provides additional discussion of the three characteristics of a derivative instrument.

#### *Underlyings and Notional Amounts or Payment Provisions*

250. Derivative instruments typically permit the parties to participate in some or all of the effects of changes in a referenced price, rate, or other variable, which is referred to as the *underlying*, for example, an interest rate or equity index or the price of a specific security, commodity, or currency. As the term is used in this Statement, a referenced asset or liability, if any, is not itself the *underlying* of a derivative contract. Instead, the *price* or *rate* of the associated asset or liability, which is used to determine the settlement amount of the derivative instrument, is the underlying.

251. By itself, an underlying cannot determine the value or settlement of a derivative. Most derivatives also refer to a *notional amount*, which is a number of units specified in the contract. The multiplication or other arithmetical interaction of the notional amount and the underlying determines the settlement of the derivative. However, rather than referring to a notional amount, some derivatives instead contain a *payment provision* that requires settlement if an underlying changes in a specified way. For example, a derivative might require a specified payment if a referenced interest rate increases by 300 basis points. Reference to either a notional amount or a payment provision is needed to compute the contract's periodic settlements and resulting changes in fair value.

252. In concept, any observable variable, including physical as well as financial variables, may be the underlying for a derivative instrument. For example, a contract might specify a payment to be made if it rains more than one inch on a specified day. However, throughout the project

that led to this Statement, discussion focused on more traditional derivatives for which the underlying is some form of price, including an interest rate or exchange rate. For example, paragraph 6 of the Exposure Draft referred to "a rate, an index of prices, or another market indicator" in describing an underlying. Relatively late in the process that led to this Statement, the Board considered expanding its scope to include all derivatives based on physical variables but decided not to do so. It was concerned that constituents had not had sufficient opportunity to consider the implications and potential measurement difficulties of including contracts based on physical variables. The Board believes many contracts for which the underlying is a physical variable are currently accounted for as insurance contracts, and it considers that accounting to be adequate for now. However, the Board decided that any derivative instrument that is traded on an exchange, including one based on a physical variable, should be subject to the requirements of this Statement. Accordingly, any derivative based on a physical variable that eventually becomes exchange traded will automatically become subject to the requirements of this Statement. The Board does not believe that measurement or other implementation problems exist for exchange-traded instruments.

253. This Statement also excludes from its scope a derivative instrument for which the underlying is the price or value of a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash. Similarly excluded is a derivative instrument for which the underlying is the price or value of a nonfinancial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is not readily convertible to cash. A contract for which the underlying is specified volumes of sales or service revenues by one of the parties also is excluded. Many such contracts are insurance contracts. An example is a contract based on the condition or value of a building. Others contain an element of compensation for service or for use of another entity's asset. An example is a royalty agreement based on sales of a particular product.

254. Because a derivative may have an underlying that is a combination of variables, the Board added a requirement to clarify the application of paragraph 10(e). Some of the variables in an underlying that is a combination of variables may be subject to the exceptions in paragraph 10(e) and others may not. The Board did not intend for all contracts with those types of underlyings to be excluded automatically from the scope of this Statement. A contract with a combined underlying is subject to the requirements of this Statement if its settlement is expected to change in a way that is highly correlated with the way it would change if it was based on an underlying that would not be eligible for one of the exceptions in paragraph 10(e).

#### ***Initial Investment in the Contract***

255. The second characteristic of a derivative instrument refers to the relative amount of the initial net investment in the contract. Providing the opportunity to participate in the price changes of an underlying without actually having to own an associated asset or owe an associated liability is the basic feature that distinguishes most traditional derivative instruments from nonderivative instruments. Therefore, the Board decided that a contract that at inception requires the holder or writer to invest or receive an amount approximating the notional amount

of the contract is not a derivative instrument. The following example illustrates that fundamental difference between a derivative instrument and a nonderivative instrument.

256. A party that wishes to participate in the changes in the fair value of 10,000 shares of a specific marketable equity security can, of course, do so by purchasing 10,000 shares of that security. Alternatively, the party may enter into a forward purchase contract with a notional amount of 10,000 shares of that security and an underlying that is the price of that security. Purchasing the shares would require an initial investment equal to the current price for 10,000 shares and would result in benefits such as the receipt of dividends (if any) and the ability to vote the shares. A simple forward contract entered into at the current forward price for 10,000 shares of the equity instrument would not require an initial investment equal to the notional amount but would offer the same opportunity to benefit or lose from changes in the price of that security.

257. Some respondents to the Exposure Draft suggested that the definition of a derivative instrument should include contracts that require gross exchanges of currencies (for example, currency swaps that require an exchange of different currencies at both inception and maturity). They noted that those contracts are commonly viewed as derivatives, are used in the same manner as derivatives, and therefore should be included in the definition of a derivative instrument. The Board agreed and notes that this Statement's definition of a derivative instrument, as revised from the Exposure Draft, explicitly includes such currency swaps. The Board observes that the initial exchange of currencies of equal fair values in those arrangements does not constitute an initial net *investment* in the contract. Instead, it is the exchange of one kind of *cash* for another kind of *cash* of equal value. The balance of the agreement, a forward contract that obligates and entitles both parties to exchange specified currencies, on specified dates, at specified prices, is a derivative instrument.

258. Paragraphs 6–11 of this Statement address only those contracts that in their entirety are derivative instruments. A contract that requires a relatively large initial net investment may include one or more embedded derivative instruments. The Board's conclusions on embedded derivatives are discussed in paragraphs 293–311.

#### ***Net Settlement***

259. The third distinguishing characteristic of a derivative instrument as defined in this Statement is that it can be readily settled with only a net delivery of assets. Therefore, a derivative contract must meet one of the following criteria:

- a. It does not require either party to deliver an asset that is associated with its underlying or that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount).
- b. It requires one of the parties to deliver such an asset, but there is a market mechanism that facilitates net settlement.
- c. It requires one of the parties to deliver such an asset, but that asset either is readily

convertible to cash or is itself a derivative instrument.

260. The Exposure Draft proposed that derivative instruments be distinguished from other instruments by determining whether (a) the holder could settle the contract with only a net cash payment, either by its contractual terms or by custom, and (b) the net payment was determined by reference to changes in the underlying. <sup>31</sup> Under the Exposure Draft, a contract that required ownership or delivery of an asset associated with the underlying would have been a derivative instrument if a mechanism existed in the market to enter into a closing contract with only a net settlement or if the contract was customarily settled with only a net cash payment based on changes in the underlying. The Board focused in the Exposure Draft on whether there is a mechanism in the market for net settlement because it observed that many derivative instruments are actively traded and can be closed or settled before the contract's expiration or maturity by net settlement in active markets. The Board included the requirement for customary settlement in the Exposure Draft for two reasons: (a) to prevent circumvention of the requirements of this Statement by including nonsubstantive delivery provisions in a contract that otherwise would be considered a derivative and (b) to include in the definition of a derivative all contracts that are typically settled net even if the ability to settle net is not an explicit feature of the contract.

261. Several respondents to the Exposure Draft requested clarification of its net settlement provisions. Respondents observed that the phrase *mechanism in the market* was unclear and could lead to different interpretations in practice. They asked whether *only* an organized exchange would constitute the type of market mechanism that the Board had in mind, or whether a willingness of market participants to enter into such a contract in the over-the-counter or other markets would require that the contract be viewed as a derivative instrument. This Statement responds to those questions by indicating in paragraph 57(c)(2) that the Board intends *market mechanism* to be interpreted broadly to include any institutional arrangement or side agreement that permits either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost.

262. Respondents also questioned whether *customary* referred to the customs of the reporting entity or the customs of the marketplace. They said that it would be difficult to discern the custom of the marketplace for a non-exchange-traded instrument for which settlement information is not publicly available. They also observed that market customs vary by industry and over time. A criterion based on such customs therefore might lead to different answers at different points in time (for example, customs that currently require gross settlement might subsequently change) and for different participants to the contracts (for example, a bank might customarily settle a certain type of contract with only a net payment of cash, while a manufacturing entity might customarily settle the same type of contract by delivering the assets associated with the underlying). The definition of a derivative in this Statement does not refer to customary settlement. The Board decided that the provisions of paragraph 9 would achieve the objective of the Exposure Draft.

263. During its redeliberations, the Board discussed whether the definition of a derivative

instrument should depend on whether net settlement occurs in cash or for another asset. The Board also discussed whether this Statement should apply to a derivative instrument in which at least one of the items to be exchanged in the future is something other than a financial instrument. The Board decided that the medium of exchange used in the net settlement of a derivative contract should not determine whether the instrument is within the scope of this Statement. A contract that can readily be settled net, whether the settlement is for cash or another asset, should be within the scope of this Statement. As a result of that decision, the Board also decided to delete *financial* from the term *derivative financial instruments* in describing the instruments that are within the scope of this Statement.

#### **Assets that are readily convertible to cash**

264. The Board decided that a contract that requires delivery of an asset associated with the underlying in a denomination equal to the notional amount should qualify as a derivative instrument if the asset is readily convertible to cash. (Paragraphs 271 and 272 and 275 and 276, respectively, discuss two exceptions to that provision.) As indicated in footnote 5, the term *readily convertible to cash* refers to assets that “have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.”

265. Net settlement is an important characteristic that distinguishes a derivative from a nonderivative because it permits a contract to be settled without either party's accepting the risks and costs customarily associated with owning and delivering the asset associated with the underlying (for example, storage, maintenance, and resale). However, if the assets to be exchanged or delivered are themselves readily convertible to cash, those risks are minimal or nonexistent. Thus, the parties generally should be indifferent as to whether they exchange cash or the assets associated with the underlying. The Board recognizes that determining whether assets are readily convertible to cash will require judgment and sometimes will lead to different applications in practice. However, the Board believes that the use of *readily convertible to cash* permits an appropriate amount of flexibility and describes an important characteristic of the derivative instruments addressed by this Statement.

266. The Board considered using the idea of *readily obtainable elsewhere* as is used in Statement 125 to determine whether a derivative instrument that requires that the holder or writer own or deliver the asset or liability that is associated with the underlying is within the scope of this Statement. However, the Board noted that readily obtainable elsewhere relates to the availability of an asset; not necessarily its liquidity. The Board decided that *readily convertible to cash* is the appropriate criterion because it addresses whether the asset can be converted to cash with little effort, not just whether the asset is readily available in the marketplace.

#### **Commodity Contracts**

267. Statements 105, 107, and 119 did not address commodity-based contracts because those contracts require or permit future delivery of an item that is not a financial instrument.

Statement 105 explained that for a commodity-based contract ". . . the future economic benefit is receipt of goods or services instead of a right to receive cash or an ownership interest in an entity and the economic sacrifice is delivery of goods or services instead of an obligation to deliver cash or an ownership interest in an entity" (paragraph 32). Some respondents to the Exposure Draft that preceded Statement 119 suggested that the scope be expanded to include commodity-based contracts. The Board decided not to expand the scope at that time principally because of that project's accelerated timetable.

268. The Exposure Draft proposed that the definition of *derivative* include only *financial instruments*. Nevertheless, the Exposure Draft would have included certain commodity contracts because they often have many of the same characteristics as other derivative contracts. They often are used interchangeably with other derivatives, and they present risks similar to other derivatives. The Board initially proposed to resolve that apparent conflict by amending the definition of *financial instrument* in Statement 107 to include contracts that permit a choice of settlement by delivering either a commodity or cash. As discussed in paragraph 263, the Board decided to change the scope of this Statement to address the accounting for *derivative instruments* rather than just derivative *financial* instruments. Therefore, it was not necessary to amend the definition of a financial instrument in Statement 107 to include certain commodity-based contracts in the scope of this Statement.

269. Changing the scope of this Statement from derivative *financial* instruments to derivative instruments results in including some contracts that settle net for a commodity or other nonfinancial asset. The Board believes that including commodity-based contracts with the essential characteristics of a derivative instrument within the scope of this Statement will help to avoid accounting anomalies that result from measuring similar contracts differently. The Board also believes that including those commodity-based contracts in this Statement will provide worthwhile information to financial statement users and will resolve concerns raised by some respondents to the Exposure Drafts that preceded Statements 107 and 119.

270. The Exposure Draft would have included only commodity-based contracts that permitted net cash settlement, either by their contractual terms or by custom. For the reasons discussed in paragraphs 264–266, the Board decided, instead, to include a contract that requires delivery of an asset associated with the underlying if that asset is readily convertible to cash (for example, gold, silver, corn, and wheat). Different accounting will result depending on whether or not the assets associated with the underlying for a contract are readily convertible to cash. The Board considers that difference to be appropriate because contracts that settle net or by delivering assets readily convertible to cash provide different benefits and pose different risks than those that require exchange of cash or other assets for an asset that is not readily convertible to cash.

#### ***Normal Purchases and Normal Sales***

271. The Board decided that contracts that require delivery of nonfinancial assets that are readily convertible to cash need not be accounted for as derivative instruments under this Statement if the assets constitute *normal purchases* or *normal sales* of the reporting entity unless

those contracts can readily be settled net. The Board believes contracts for the acquisition of assets in quantities that the entity expects to use or sell over a reasonable period in the normal course of business are not unlike binding purchase orders or other similar contracts to which this Statement does not apply. The Board notes that the normal purchases and normal sales exemption is necessary only for contracts based on assets that are readily convertible to cash.

272. The Board understands that the normal purchases and normal sales provision sometimes will result in different parties to a contract reaching different conclusions about whether the contract is required to be accounted for as a derivative instrument. For example, the contract may be for ordinary sales by one party (and therefore not a derivative instrument) but not for ordinary purchases by the counterparty (and therefore a derivative instrument). The Board considered requiring both parties to account for a contract as a derivative instrument if the purchases or sales by either party were other than ordinary in the normal course of business. However, that approach would have required that one party to the contract determine the circumstances of the other party to that same contract. Although the Board believes that the accounting by both parties to a contract generally should be symmetrical, it decided that symmetry would be impractical in this instance and that a potential asymmetrical result is acceptable.

### **Financial Instruments**

273. Some contracts require the holder or writer to deliver a financial asset or liability that is associated with the underlying and that has a denomination equal to the notional amount of the contract. Determining whether those contracts are derivative instruments depends, at least in part, on whether the related financial assets or liabilities are readily convertible to cash.

#### ***Trade Date versus Settlement Date Accounting***

274. Existing accounting practice is inconsistent about the timing of recognition of transfers of various financial instruments. Some transfers of securities are recognized as of the date of trade (often referred to as trade date accounting). Other transfers are recognized as of the date the financial instrument is actually transferred and the transaction is settled (often referred to as settlement date accounting). During the period between trade and settlement dates, the parties essentially have entered into a forward contract that might meet the definition of a derivative if the financial instrument is readily convertible to cash. Requiring that all forward contracts for purchases and sales of financial instruments that are readily convertible to cash be accounted for as derivatives would effectively require settlement date accounting for all such transactions. Resolving the issue of trade date versus settlement date accounting was not an objective of the project that led to this Statement. Therefore, the Board decided to explicitly exclude forward contracts for "regular-way" security trades from the scope of this Statement.

### **Regular-way security trades**

275. Regular-way security trades are those that are completed (or settled) within the time period generally established by regulations and conventions in the marketplace or by the exchange on

which the transaction is being executed. The notion of a regular-way security trade is based on marketplace regulations or conventions rather than on the normal practices of an individual entity. For example, if it is either required or customary for certain securities on a specified exchange to settle within three days, a contract that requires settlement in more than three days is not a regular-way security trade even if the entity customarily enters into contracts to purchase such securities more than three days forward. The Board considered other approaches that focused on reasonable settlement periods or customary settlement periods for the specific parties to a transfer. The Board decided that those approaches were inferior because they lacked the consistency and discipline that are provided by focusing on regular-way security trades. The Board also believes that participants can reasonably determine settlement periods required by the regulations or conventions of an active marketplace. Regulations or conventions may be more difficult to determine for foreign or less active exchanges. However, the provisions in paragraph 10(a) apply only if the holder or writer of the contract is required to deliver assets that are readily convertible to cash. Therefore, the regulations or conventions of the marketplace should be reasonably apparent because the related market must be active enough to rapidly absorb the quantities involved without significantly affecting the price.

276. The Board considered limiting the exclusion for regular-way security trades to purchases or sales of *existing* securities. A forward contract for a regular-way trade of an existing security entitles the purchaser to receive and requires the seller to deliver a specific security. The delay is a matter of market regulations and conventions for delivery. In contrast, a forward contract for a when-issued or other security that does not yet exist does not entitle or obligate the parties to exchange a specific security. Instead, it entitles the issuer and holder to participate in price changes that occur before the security is issued. For that reason, the Board would have preferred that a forward contract on a security that does not yet exist be subject to the requirements of this Statement. However, the Board was concerned that including, for example, to-be-announced (TBA) Government National Mortgage Association (GNMA) forward contracts and other forward contracts for when-issued securities within the scope of this Statement might subject some entities to potentially burdensome regulatory requirements for transactions in derivatives. On balance, the Board decided to extend the regular-way exemption to purchases and sales of when-issued and TBA securities. However, the exemption applies only if (a) there is no other way to purchase or sell the security and (b) the trade will settle within the shortest period permitted for the security.

#### ***Insurance Contracts***

277. The Exposure Draft explicitly excluded insurance contracts, as defined in Statements 60, 97, and 113, from its definition of a derivative financial instrument. The insurance contracts described in those Statements also were excluded from the scope of Statement 107, which states:

The Board concluded that disclosures about fair value should not be required for insurance contracts. . . . The Board believes that definitional and valuation difficulties are present to a certain extent in those contracts and obligations, and that further consideration is required before decisions can be made about whether

to apply the definition to components of those contracts and whether to require disclosures about fair value for the financial components. [paragraph 74]

278. During the deliberations before issuance of the Exposure Draft, the Board decided to specifically preclude an insurance contract from qualifying as a derivative because it believed definitional and valuation difficulties still existed. The Exposure Draft observed that the insurance industry and the accounting and actuarial professions have not reached a common understanding about how to estimate the fair value of insurance contracts. Developing measurement guidance for them might have delayed the issuance of guidance on accounting for derivatives. The Board intends to reconsider the accounting for insurance contracts in other phases of its financial instruments project.

279. Although the term *insurance contract* is frequently used in Statements 60, 97, and 113, it is not clearly defined in those or other accounting pronouncements. As a result, the Exposure Draft's provision that insurance contracts and reinsurance contracts generally are not derivative instruments may not have been workable. The Board was concerned that the phrase *insurance contracts* might be interpreted quite broadly to encompass most agreements or contracts issued by insurance enterprises as part of their ongoing operations.

280. The accounting provisions for insurance contracts in Statements 60, 97, and 113 are significantly different from the accounting provisions for derivative instruments in this Statement. The Board was concerned that contracts that are substantially the same as other derivative instruments might, instead, be accounted for as insurance contracts. The Board therefore decided to eliminate the Exposure Draft's proposed scope exclusion for insurance contracts and, instead, require that those contracts be included in or excluded from the scope of this Statement based on their characteristics.

281. Insurance contracts often have some of the same characteristics as derivative instruments that are within the scope of this Statement. Often, however, they lack one or more of those characteristics. As a result, most traditional insurance contracts will not be derivative instruments as defined in this Statement. They will be excluded from that definition because they entitle the holder to compensation only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. However, contracts that in their entirety meet this Statement's definition of a derivative instrument, whether issued by an insurance enterprise or another type of enterprise, must be accounted for as such. The Board does not believe that a decision on whether a contract must be accounted for as a derivative should depend on the identity of the issuer. To help in applying the provisions of this Statement, paragraph 10(c) provides some examples illustrating the application of the definition to insurance contracts.

282. The Board acknowledges that many of the problems with determining the fair value of traditional insurance liabilities are still unresolved. The Board notes, however, that many of the

issues of how to measure the fair value of insurance contracts do not apply to instruments issued by insurance enterprises that, in their entirety, qualify as derivative instruments under this Statement. Instead, the methods for estimating the fair values of those contracts should be similar to the methods used for derivative instruments with similar characteristics issued by other types of enterprises.

283. Although many contracts issued by insurance enterprises will not, in their entirety, meet the definition of a derivative instrument, some may include embedded derivatives that are required by this Statement to be accounted for separately from the host contract. Contracts that may include embedded derivatives include, but are not limited to, annuity contracts that promise the policyholder a return based on selected changes in the S&P 500 index, variable life and annuity contracts, and property and casualty contracts that combine protection for property damage and changes in foreign currency exchange rates. Section 2 of Appendix B provides additional guidance on insurance contracts with embedded derivative instruments.

***Exception for Derivatives That Serve as Impediments to Recognition of a Sale***

284. The existence of certain derivatives affects the accounting for the transfer of an asset or a pool of assets. For example, a call option that enables a transferor to repurchase transferred financial assets that are not readily available would prevent accounting for that transfer as a sale. The consequence is that to recognize the call option would be to count the same thing twice. The holder of the option already recognizes in its financial statements the assets that it has the option to purchase. Thus those types of derivatives are excluded from the scope of this Statement.

***Exception for Instruments Classified in Stockholders' Equity***

285. As noted in paragraph 3(a) of this Statement, derivative instruments are assets or liabilities. Consequently, items appropriately classified in stockholders' equity in an entity's statement of financial position are not within the scope of this Statement. The Board decided to clarify that point by explicitly excluding from the scope of this Statement the accounting for such equity instruments.

286. The Board considered whether this Statement also should exclude instruments that an entity either can or must settle by issuing its own stock but that are indexed to something else. For example, the Board discussed whether an instrument that requires settlement in the issuer's or holder's common stock but that is indexed to changes in the S&P 500 index should be excluded from the scope of this Statement. The Board currently has a project on its agenda that considers whether certain instruments are equity or liabilities. That project will address the issue of whether instruments to be settled in the entity's stock but indexed to something other than its stock are liabilities or equity. The Board will reconsider the application of this Statement to such contracts as necessary when that project is completed. Until that time, contracts that provide for settlement in shares of an entity's stock but that are indexed in part or in full to something other than the entity's stock are to be accounted for as derivative instruments if the contracts satisfy the

criteria in paragraphs 6–10 of this Statement. Those contracts are to be classified as assets or liabilities and not as part of stockholders' equity.

#### ***Stock-Based Compensation Contracts***

287. Paragraph 11(b) of this Statement excludes the issuer's accounting for derivative instruments issued in connection with stock-based compensation arrangements addressed in FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Many such instruments would be excluded by paragraph 11(a) because they are classified in stockholders' equity. However, Statement 123 also addresses stock-based compensation arrangements that are derivatives and that qualify as a liability of the issuer. The Board decided that the issuer's accounting for those contracts is adequately addressed by Statement 123. As with the other exclusions in paragraph 11, the holder's accounting for a derivative instrument in a compensation arrangement addressed by Statement 123 is subject to this Statement.

#### ***Contingent Consideration in a Business Combination***

288. Opinion 16 addresses the purchaser's (issuer's) accounting for contingent consideration provided in a purchase business combination. The effect of a contingent consideration arrangement on the accounting for a business combination often is significant and depends on the terms and conditions of both the business combination and the contingent consideration arrangement. Although contingent consideration arrangements may share at least some of the characteristics of derivative instruments addressed by this Statement, the Board decided that without further study it would be inappropriate to change the accounting for them by the entity that accounts for the business combination. The Board currently has a project on its agenda to reconsider the accounting for business combinations. It will consider this issue as part of that project.

289. This Statement does apply to contracts that are similar to, but not accounted for as, contingent consideration under the provisions of Opinion 16 if those contracts satisfy the scope provisions either for a derivative instrument (paragraphs 6–10) or for a contract with an embedded derivative instrument (paragraphs 12–16). In addition, this Statement applies to a seller's (holder's) accounting for contingent consideration that meets its definition of a derivative. For example, assume that a purchaser of a business issues to the seller a freestanding financial instrument (as addressed in EITF Issue No. 97-8, "Accounting for Contingent Consideration Issued in a Purchase Business Combination") that provides contingent consideration in a purchase business combination under Opinion 16. That freestanding instrument is assumed to meet this Statement's definition of a derivative instrument. The purchaser's accounting for the instrument is explicitly excluded from the scope of this Statement, but the seller who receives the instrument must account for it according to the requirements of this Statement.

#### ***Application to Specific Contracts***

290. Several respondents to the Exposure Draft asked the Board for specific guidance about whether some contracts meet the definition of a derivative instrument, including sales of

securities not yet owned ("short sales"), take-or-pay contracts, and contracts with liquidating damages or other termination clauses. The Board cannot definitively state whether those types of contracts will always (or never) meet the definition because their terms and related customary practices vary. In addition, the terms of the contracts or customary practices may change over time, thereby affecting the determination of whether a particular type of contract meets the definition of a derivative instrument. Appendix A provides examples illustrating how the definition of a derivative instrument applies to certain specific situations.

### **The Scope of Statement 119**

291. This Statement's definition of derivative contracts excludes certain contracts that were included in the scope of Statement 119. For example, a loan commitment would be excluded if it (a) requires the holder to deliver a promissory note that would not be readily convertible to cash and (b) cannot readily be settled net. Other conditional and executory contracts that were included in the scope of Statement 119 may not qualify as derivative instruments under the definition in this Statement. The Board decided that some change in scope from Statement 119 is an appropriate consequence of defining derivative instruments based on their primary characteristics.

292. This Statement supersedes Statement 119. Therefore, one result of excluding instruments that were included in the scope of Statement 119 from the scope of this Statement is that some disclosures previously required for those excluded contracts will no longer be required. The Board considers that result to be acceptable. Moreover, Statement 107 continues to require disclosure of the fair value of all financial instruments by the entities to which it applies.

### **Embedded Derivatives**

293. The Board considers it important that an entity not be able to avoid the recognition and measurement requirements of this Statement merely by embedding a derivative instrument in a nonderivative financial instrument or other contract. Therefore, certain embedded derivatives are included in the scope of this Statement if they would be subject to the Statement on a freestanding basis. However, the Board also decided that some derivatives embedded in host contracts, such as many of the prepayment or call options frequently included as part of mortgage loans and other debt instruments, should be excluded from the scope of this Statement.

### ***Approaches Considered***

294. The Board considered a number of approaches for determining which contracts with embedded derivatives should be included in the scope of this Statement. Some approaches focused either on an instrument's yield or on its predominant characteristics. The Board decided that those approaches would likely include callable or prepayable debt and perhaps other instruments that often are not thought of as including an embedded derivative, even though they do. The Board also was concerned about the operationality of those approaches.

295. The scope of the Exposure Draft included a contract with both nonderivative and derivative

characteristics if some or all of its contractually required cash flows were determined by reference to changes in one or more underlyings in a manner that multiplied or otherwise exacerbated the effect of those changes. That scope was intended to incorporate embedded forwards, swaps, and options with a notional amount that was greater than the face value of the "host" contract or that otherwise "leveraged" the effect of changes in one or more underlyings. Numerous respondents to the Exposure Draft asked for clarification of the phrase *multiplies or otherwise exacerbates* and said that they did not understand why certain instruments were included in the scope of the Exposure Draft while others were not.

296. The Board agreed with respondents that the approach in the Exposure Draft was difficult to apply in a consistent manner. The Board also concluded that the Exposure Draft inappropriately excluded some instruments from its scope and inappropriately included others. For example, an instrument that paid a simple multiple of a market interest rate (for example, 120 percent of U.S. dollar LIBOR) might be considered to have an embedded derivative that requires separate accounting. In contrast, a structured note that paid a return based on 100 percent of the appreciation in the fair value of an equity instrument would not be considered to have an embedded derivative that requires separate accounting.

297. Some respondents to the Exposure Draft suggested that all financial instruments with embedded derivatives be excluded from the scope of this Statement because existing accounting standards for nonderivative instruments provide adequate guidance for those compound financial instruments. The Board rejected that suggestion for three reasons. First, applying existing accounting standards for nonderivative instruments would not necessarily achieve the Board's goal of increasing the transparency of derivatives in the financial statements. For example, existing guidance for the issuer's accounting for indexed debt instruments is incomplete and would not necessarily result in recognition of changes in the fair value of the embedded derivative in either the balance sheet or the income statement. Second, a derivative can be embedded in a contract other than a financial instrument, such as a purchase order. The existing accounting pronouncements for such contracts do not adequately address the accounting for embedded derivatives in those contracts. Third, excluding all compound instruments from its scope would make it possible to circumvent the provisions of this Statement. One apparent reason that structured notes have become prevalent is that combining various features of derivative and nonderivative instruments produces different accounting results than accounting for each component separately, and participants in transactions involving structured notes sometimes considered the accounting results attractive. Excluding all instruments that embed derivative instruments in nonderivative host contracts from the scope of this Statement would likely increase the incentive to combine those instruments to avoid accounting for derivative instruments according to the provisions of this Statement.

298. Under the approach in the Exposure Draft, contracts designed to result in a rate of return that differs in a nontrivial way from the change in price that would be realized from a direct investment (or obligation) in the referenced asset(s) or other item(s) of an amount comparable to the notional amount or par value of the contract would have been accounted for as derivative

instruments. Clarifying the phrase *multiplies or otherwise exacerbates* would have addressed some of the problems raised by respondents to the Exposure Draft, but it still would have focused solely on whether the derivative feature resulted in a meaningful amount of positive or negative leverage. It would not have addressed whether the derivative component and host contract are of the type generally expected to be combined. The results still seemed counterintuitive in that an instrument that paid interest of 120 percent of LIBOR (assuming that 120 percent was not deemed to be a trivial amount of leverage) would be accounted for as a derivative instrument, but a note indexed to 100 percent of the S&P 500 index would not.

#### *Accounting for Embedded Derivatives Separately from the Host Contract*

299. The Exposure Draft would have required that both a host contract and an embedded derivative feature, *together*, be accounted for as a derivative instrument if prescribed criteria were met. As a result, some contracts with embedded derivative features would have been accounted for like derivatives and could have been designated as hedging instruments. Some respondents to the Exposure Draft were concerned that its approach would permit an entity to use a cash instrument as a hedging instrument, which was generally precluded by the Exposure Draft, simply by embedding an insignificant leverage factor in the interest formula. The Board agreed with those respondents and decided that (a) it was inappropriate to treat instruments that include both nonderivative and derivative components entirely as derivative instruments and (b) nonderivative instruments should only be eligible as hedging instruments in selected circumstances.

300. For several reasons, the Board decided to change the accounting for instruments with embedded derivatives. Most importantly, accounting for the entire instrument as a derivative or nonderivative is inconsistent with the accounting for hedged items required by this Statement. For a fair value hedge, the Exposure Draft would have required that all or a proportionate part of the total changes in fair value of a hedged item be recognized. However, this Statement requires recognizing at its fair value only the portion or proportion of a hedged item attributable to the risk being hedged. That change to a "separation-by-risk" approach is consistent with accounting for a derivative separately from the host contract in which it is embedded. Accounting for the derivative separately from the host contract also is more consistent with the objective of measuring derivative instruments at fair value and does not result in measuring derivative instruments differently simply because they are combined with other instruments.

301. The Board recognizes that there may be circumstances in which an embedded derivative cannot be reliably identified and measured for separation from the host contract. In those circumstances, this Statement requires that the entire contract, including both its derivative and nonderivative portions, be measured at fair value with changes in fair value recognized currently in earnings. The Board expects that an entity that enters into sophisticated investment and funding strategies such as structured notes or other contracts with embedded derivatives will be able to obtain the information necessary to reliably identify and measure the separate components. Accordingly, the Board believes it should be unusual that an entity would conclude that it cannot reliably separate an embedded derivative from its host contract.

302. Instruments that include embedded derivatives that are not accounted for separately from the host contract because the entity is unable to reliably identify and measure the derivative may not be designated as hedging instruments. That prohibition applies to the entire contract, as well as any portion of it, and addresses some of respondents' concerns about designating nonderivative instruments as hedging instruments. Prohibiting an entire contract with an embedded derivative from being designated as a hedging instrument will avoid the inappropriate use of nonderivative instruments as hedging instruments. It also should serve as an incentive to identify and separate derivative features from their host contracts.

303. Measuring an embedded derivative separately from its host contract will require judgment, and sometimes such measurements may be difficult. The Board considered providing specific guidelines for making such measurements but decided that such guidance could be unduly restrictive and could not address all relevant concerns. Instead, the Board decided only to clarify that the objective is to estimate the fair value of the derivative features separately from the fair value of the nonderivative portions of the contract. Estimates of fair value should reflect all relevant features of each component and their effect on a current exchange between willing parties. For example, an embedded purchased option that expires if the contract in which it is embedded is prepaid would have a different value than an option whose term is a specified period that is not subject to truncation.

*The Clearly-and-Closely-Related Approach*

304. This Statement requires that an embedded derivative be accounted for separately from a nonderivative host contract if (a) the derivative, considered on a freestanding basis, would be accounted for as a derivative instrument under this Statement and (b) the economic characteristics of the derivative and the host contract are *not clearly and closely related* to one another. The first of those criteria ensures that only derivative instruments as defined by, and subject to the requirements of, this Statement are accounted for separately. For example, the issuer would not account separately for an option embedded in a hybrid instrument if, on a freestanding basis, that option would be an equity instrument of the entity that is properly classified in stockholders' equity. Whether the issuer should account separately for an equity instrument embedded in an asset or a liability is an issue in the Board's project on liabilities and equity.

305. The second criterion listed in paragraph 304 focuses on whether an embedded derivative bears a close economic relationship to the host contract. As a practical matter, the Board decided that not all embedded derivative features should be required to be accounted for separately from the host contract. Many hybrid instruments with embedded derivatives that bear a close economic relationship to the host contract were developed many years ago, for reasons that clearly were not based on achieving a desired accounting result. Prepayable mortgages and other prepayable debt instruments are examples of such familiar compound instruments with embedded derivatives. The accounting for those types of hybrid instruments is well established and generally has not been questioned. However, other embedded derivatives, such as an equity-

or commodity-linked return included in a debt instrument that may cause the value of the instrument to vary inversely with changes in interest rates, do not bear a close economic relationship to the host contract. Even though conceptually all embedded derivatives should be accounted for separately, the Board decided, as a practical accommodation, that only an embedded derivative that is not considered to be clearly and closely related to its host contract should be accounted for separately.

306. The Board expects the clearly-and-closely-related approach to affect a significant number and wide variety of structured notes and other contracts that include embedded derivatives. Applying the approach will require judgment, which may lead to different accounting for similar instruments. To reduce that possibility, Appendix B provides examples illustrating how to apply the approach.

307. The clearly-and-closely-related approach sometimes will result in different accounting by the parties to a contract. For example, the issuer of convertible debt would not account for the embedded derivative feature separately from the host contract if the derivative component, on a freestanding basis, would not be subject to the requirements of this Statement because of the exclusion in paragraph 11(a). However, an investor in the convertible debt instrument would not be afforded that exclusion and would be required to account for the conversion feature separately from the host contract if the criteria in paragraph 12 are met.

308. The holder and issuer of an equity instrument with an embedded put, such as puttable common stock, would not, however, necessarily treat the embedded derivative differently. A put option embedded in an equity security has the potential to convert the equity security to cash or another asset, and conversion to cash according to the terms of the instrument is not a usual characteristic of an equity security. Accordingly, a put option embedded in an equity security is not clearly and closely related to the host contract if exercise of the put option would result in the payment of cash or delivery of another asset by the issuer of a security (except in those circumstances in which the put option is not considered to be a derivative pursuant to paragraph 11(a) because it is classified in shareholders' equity). Because the embedded put is more closely related to a liability than an equity security, both the issuer and the holder would account for it separately if the criteria in paragraph 12 are met. However, if exercise of the put would result in the issuance of additional equity instruments rather than paying cash or delivering another asset, the put is considered to be clearly and closely related to the equity security.

309. Paragraphs 13–15 of this Statement discuss some common relationships between interest rate features and host contracts, and foreign currency exchange rate features and host contracts. That guidance is provided to simplify the analysis of whether some of the more common types of contracts include embedded derivatives that require separate accounting. Paragraph 13 clarifies that most interest-bearing instruments that include derivative features that serve only to alter net interest payments that otherwise would be made on an interest-bearing host contract are considered to be clearly and closely related to the host contract. However, an embedded derivative that affects interest rates in such a way that the investor might not recover

substantially all of its initial recorded investment is not considered to be clearly and closely related to the host contract and therefore should be accounted for separately. Similarly, an embedded derivative that could at least double the investor's initial rate of return on the host contract and also could result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with similar credit quality is not considered to be clearly and closely related and should be accounted for separately. The test for separate accounting pursuant to paragraph 13 should be applied based on what is possible under the contractual terms and not on a probability basis. For example, an embedded derivative that could under any circumstances result in the hybrid instrument's being settled in such a way that the holder does not recover substantially all of its initial recorded investment would not be considered to be clearly and closely related to the host contract even though the possibility that such a situation would occur is remote.

310. The Board recognizes that the provisions of paragraph 13(a) might raise the question of whether an interest-only strip is subject to the provisions of this Statement because the holder of an interest-only strip may not recover substantially all of its initial recorded investment. The Board notes that accounting for interest-only and principal-only strips is related to issues concerning accounting for retained interests in securitizations that the Board is currently reconsidering in conjunction with the implementation of Statement 125. Accordingly, the Board decided to exclude from the scope of this Statement interest-only and principal-only strips that meet the criteria in paragraph 14 and further consider the accounting for them in conjunction with its consideration of accounting for retained interests in securitization.

311. Paragraph 15 provides that an embedded foreign currency derivative is not to be separated from the host contract and considered a derivative pursuant to paragraph 12 if the host contract is not a financial instrument and specifies payments denominated in either of the following currencies:

- a. The currency of the primary economic environment in which any substantial party to the contract operates (that is, its functional currency)
- b. The currency in which the price of the related good or service is routinely denominated in international commerce (such as the U.S. dollar for crude oil transactions).

For example, a lease of U.S. real estate with payments denominated in Deutsche marks contains an embedded derivative that should be viewed as clearly and closely related to the host lease contract and thus does not require separate accounting if the Deutsche mark is the functional currency of at least one substantial party to the lease. The Board decided that it was important that the payments be denominated in the functional currency of at least one *substantial* party to the transaction to ensure that the foreign currency is integral to the arrangement and thus considered to be clearly and closely related to the terms of the lease. A contract with payments denominated in a currency that is not the functional currency of any substantial party to that contract includes an embedded derivative that is not considered to be clearly and closely related to the host contract and should be accounted for separately under the provisions of this

Statement. The second exclusion in paragraph 15 also permits contractual payments to be denominated in the currency in which the price of the related commodity or service is routinely stated in international commerce without requiring separate accounting for an embedded derivative. The Board decided that it would be appropriate to consider the currency in which contracts for a given commodity are routinely denominated to be clearly and closely related to those contracts, regardless of the functional currency of the parties to that contract.

### **Fair Value Measurement Guidance**

312. The definition of fair value in this Statement is derived from paragraphs 42–44 of Statement 125. The definition originated in paragraphs 5, 6, and 18–29 of Statement 107.

313. This Statement refers to Statement 107 for guidance in applying the definition of fair value. Some respondents to the Exposure Draft asked either for additional guidance on estimating the fair value of financial instruments or for amendments of part of the guidance in Statement 107. They said that the guidance in Statement 107 is not robust enough for recognition purposes (as opposed to disclosure) and allows too much variability in the estimates of fair value, especially for items not traded on a public exchange. The Board decided for several reasons to retain the guidance provided by Statement 107. Statement 107 has been in effect for several years, and entities are familiar with its measurement guidance. In addition, Board members were concerned that reevaluating and making the fair value guidance more prescriptive would significantly delay issuance of this Statement. On balance, the Board decided that the measurement guidance in Statement 107 is sufficient for use in applying this Statement. The Board will consider measurement issues and likely provide additional guidance or change Statement 107's guidance in some areas, perhaps including the areas discussed in the following paragraphs in the course of its project on the fair value measurement of financial instruments.

314. Respondents to the Exposure Draft also provided comments on specific measurement issues, focusing on the following three areas: (a) consideration of a discount or premium in the valuation of a large position, (b) consideration of changes in creditworthiness in valuing a debtor's liabilities, and (c) the valuation of deposit liabilities. Those areas are discussed below.

#### **Consideration of a Discount or Premium in the Valuation of a Large Position**

315. Consistent with Statement 107, the definition of fair value in this Statement precludes an entity from using a "blockage" factor (that is, a premium or discount based on the relative size of the position held, such as a large proportion of the total trading units of an instrument) in determining the fair value of a large block of financial instruments. The definition of fair value requires that fair value be determined as the product of the number of trading units of an asset times a quoted market price if available. Statement 107 further clarifies the issue:

Under the definition of fair value in paragraph 5, the quoted price for a single trading unit in the most active market is the basis for determining market price

and reporting fair value. This is the case even if placing orders to sell all of an entity's holdings of an asset or to buy back all of a liability might affect the price, or if a market's normal volume for one day might not be sufficient to absorb the quantity held or owed by an entity. [paragraph 6]

Some respondents to the Exposure Draft indicated that the guidance in Statement 107 (and implicitly the definition of *fair value* in this Statement) should be revised to require or permit consideration of a discount in valuing a large asset position. They asserted that an entity that holds a relatively large amount (compared with average trading volume) of a traded asset and liquidates the entire amount at one time likely would receive an amount less than the quoted market price. Although respondents generally focused on a discount, holding a relatively large amount of an asset might sometimes result in a premium over the market price for a single trading unit. The Board currently believes that the use of a blockage factor would lessen the reliability and comparability of reported estimates of fair value.

### **Valuation of Liabilities**

316. Some respondents to the Exposure Draft noted that Statement 107 permits an entity to choose whether to consider changes in its own creditworthiness in determining the fair value of its debt and asked for further guidance on that issue. The definition of fair value in Statement 125 says that in measuring liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction. However, the FASB's pronouncements to date have not broadly addressed whether changes in a debtor's creditworthiness after incurrence of a liability should be reflected in measuring its fair value. Pending resolution of the broad issue of the effect of a debtor's creditworthiness on the fair value of its liabilities, the Board decided to use the definition in Statement 125 but not to provide additional guidance on reflecting the effects of changes in creditworthiness.

### ***Valuation of Deposit Liabilities***

317. The guidance in Statement 107 precludes an entity from reflecting a long-term relationship with depositors, commonly known as a core deposit intangible, in determining the fair value of a deposit liability. Paragraph 12 of Statement 107 states, in part:

In estimating the fair value of deposit liabilities, a financial entity shall not take into account the value of its long-term relationships with depositors, commonly known as core deposit intangibles, which are separate intangible assets, not financial instruments. For deposit liabilities with no defined maturities, the fair value to be disclosed under this Statement is the amount payable on demand at the reporting date.

Some respondents to the Exposure Draft requested that this Statement permit the fair value of deposit liabilities to reflect the effect of the core deposit intangible. The Board decided to make

no change to the guidance in Statement 107 on that issue because it will be addressed as part of the Board's current project on measuring financial instruments at fair value. Issues of whether the fair values of certain liabilities (or assets) should reflect their values as if they were settled immediately or whether they should be based on their expected settlement dates, as well as issues of whether or when it would be appropriate to measure portfolios of assets or liabilities rather than individual items in those portfolios, are central to that project.

### **Other Fair Value Measurement Guidance**

318. Statement 107 requires disclosure of the fair value of financial instruments "for which it is *practicable* to estimate that value" (emphasis added). Unlike Statement 107, this Statement provides no *practicability* exception that would permit an entity to avoid the required fair value measurements. The Board believes that prudent risk management generally would require an entity to measure the fair value of any derivative that it holds as well as any item (or the portion of the item attributable to the identified risk) designated as being hedged in a fair value hedge.

319. This Statement requires that in measuring the change in fair value of a forward contract by discounting future cash flows, the estimate of future cash flows be based on changes in forward rates rather than spot rates. Thus, the gain or loss on, for example, a foreign currency forward contract would be based on the change in the forward rate, discounted to reflect the time value of money until the settlement date. The Board notes that the accounting literature in effect before the issuance of this Statement discusses different methods of estimating the value of a foreign currency forward contract. The Board decided that the valuation of a foreign currency forward contract should consider that (a) currencies will be exchanged at a future date, (b) relative interest rates determine the difference between spot and forward rates, and (c) valuation is affected by the time value of money. The net present value technique is the only method that considers all three items as well as the current settlement of present gains or losses that arise from changes in the spot rate.

### **Demand for Hedge Accounting**

320. The Report on Deliberations describes hedge accounting as a "special accounting treatment that alters the normal accounting for one or more components of a hedge so that counterbalancing changes in the fair values of hedged items and hedging instruments, from the date the hedge is established, are not included in earnings in different periods" (paragraph 28). Demand for special accounting for hedges of the fair value exposure associated with assets and liabilities arises, in part, because of accounting anomalies—that is, differences in the way hedged items and hedging instruments are recognized and measured. Recognition anomalies arise because some assets and liabilities are recognized in the statement of financial position, while others, such as many firm commitments, are not. Measurement anomalies arise because existing accounting standards use different measurement attributes for different assets and liabilities. Some assets and liabilities are measured based on historical costs, others are measured based on current values, and still others are measured at the lower of cost or market value, which is a

combination of historical costs and current values. Accounting recognition and measurement decisions generally have been made independently for each kind of asset or liability without considering relationships with other assets or liabilities. Hedge accounting for assets and liabilities initially arose as a means of compensating for situations in which measurement anomalies between a hedged item and hedging instrument result in recognizing offsetting gains and losses in earnings in different periods.

### **Hedges of Fair Value Exposures**

321. For hedges of fair value exposures, this Statement provides for certain gains and losses on designated assets and liabilities to be recognized in earnings in the same period as the losses and gains on the related derivative hedging instrument. Accounting for all financial instruments at fair value with all changes in fair value recognized similarly, such as in earnings, would eliminate the need for special accounting to accommodate the current mixed-attribute measurement model for fair value hedges of financial assets and liabilities. Fair value accounting for all financial instruments would not, however, affect either the perceived need for special accounting for fair value hedges of nonfinancial assets and liabilities or constituents' desire for special accounting for cash flow hedges of forecasted transactions.

### **Hedges of Cash Flow Exposures**

322. Although accounting anomalies do not exist for cash flow hedges of forecasted transactions, many constituents want special accounting for transactions designed to manage cash flow risk associated with forecasted transactions. Entities often hedge the cash flow risk of forecasted transactions by using a derivative to "lock in" or "fix" the price of the future transaction, or to mitigate the cash flow risk for a certain period of time. They want to recognize the gain or loss on the derivative hedging instrument in earnings in the period or periods in which the forecasted transaction will affect earnings. If the hedging instrument is held until the forecasted transaction occurs, that accounting would base the earnings effect of the transaction on the "fixed price."

323. Some constituents suggested that there is little distinction between forecasted transactions and firm commitments and, consequently, that hedges of forecasted transactions should be accounted for in the same way as hedges of firm commitments. They said that (a) some forecasted transactions may be as probable as, if not more probable than, some firm commitments, (b) it is often difficult to distinguish between forecasted transactions and firm commitments, and (c) entities do not view forecasted transactions and firm commitments separately for risk management purposes.

324. The Board believes there are several differences between firm commitments and forecasted transactions, irrespective of the probability of occurrence, that make it possible to distinguish between them. Firm commitments and forecasted transactions create different exposures to risk. Firm commitments are fixed-price contracts that expose an entity to a risk of a change in fair value. For example, an increase in the market price of a commodity will not affect the cash to be

paid to purchase that commodity under a firmly committed contract; however, it will affect the value of that contract. In contrast, forecasted transactions do not have a fixed price and do expose an entity to a risk of a change in the cash to be paid to purchase the commodity in the future. Because firm commitments and forecasted transactions give rise to different exposures, different hedging strategies must be used. For example, an entity that hedges a firm commitment to purchase an item (a long position) would generally enter into a derivative to "undo" that fixed price (such as an offsetting short position). In contrast, an entity that hedges a forecasted purchase of an item would generally enter into a derivative (such as a contract to purchase the item—a long position) to "fix" the price.

325. Although many firm commitments are not recognized in financial statements, they qualify as assets or liabilities with determinable values, which makes them different from forecasted transactions. The value of a firm commitment is equal to the unrealized gain or loss on the commitment. In contrast, a forecasted transaction has no value and cannot give rise to a gain or loss. Regardless of their probability of occurrence, forecasted transactions are not present rights or obligations of the entity.

326. The Board recognizes that hedging is used to cope with uncertainty about the future and that the risks associated with forecasted transactions may appear to be similar to those associated with assets and liabilities, including firm commitments. However, the fundamental purpose of financial statements is to present relevant measures of *existing* assets and liabilities and changes in them. The Board believes there is no conceptual justification for providing special accounting for the effects of transactions that have already occurred based solely on management's assertions about other transactions expected to occur in the future. The Board believes it would be conceptually preferable to provide descriptive information about intended links between current and forecasted future transactions in accompanying notes than to let those intended links directly affect the financial statements. As indicated by the Board's third fundamental decision, deferring a derivative gain or loss as a separate asset or liability in the statement of financial position is conceptually inappropriate because the gain or loss neither is itself a liability or an asset nor is it associated with the measurement of another existing asset or liability.

327. To the extent that hedge accounting is justifiable conceptually, it is for the purpose of dealing with anomalies caused by the mixed-attribute accounting model. The lack of an associated asset, liability, gain, or loss to be recognized in the financial statements means that there are no measurement anomalies for a forecasted transaction. Gains and losses on derivative instruments designated as hedges of forecasted transactions can be distinguished from gains and losses on other derivatives only on the basis of management intent. That makes hedge accounting for forecasted transactions problematic from a practical, as well as a conceptual, perspective. Furthermore, it generally is more difficult to assess the effectiveness of a hedge of a forecasted transaction than of a hedge of an existing asset or liability, because a forecasted transaction reflects expectations and intent, not measurable present rights or obligations.

328. Regardless of those conceptual and practical questions, the Board decided to accommodate

certain hedges of forecasted transactions because of the current widespread use of and demand for special accounting for forecasted transactions. However, because the Board does not consider hedge accounting for forecasted transactions to be conceptually supportable, the Board chose to impose limits on that accounting, as discussed further in paragraphs 382 and 383.

329. This Statement provides for gains and losses on derivatives designated as cash flow hedges of forecasted transactions to be initially recognized in other comprehensive income and reclassified into earnings in the period(s) that the forecasted transaction affects earnings. As the Board pursues its long-term objective of measuring all financial instruments at fair value in the statement of financial position, it will reconsider whether special accounting for hedges of forecasted transactions should continue to be permitted. Special accounting for hedges of forecasted financial instrument transactions would serve no purpose if all financial instruments were measured at fair value both at initial recognition and subsequently, with changes in fair value reported in earnings. This Statement consequently prohibits hedge accounting for the acquisition or incurrence of financial instruments that will be subsequently measured at fair value, with changes in fair value reported in earnings.

### **Hedge Accounting Approaches Considered**

330. Over its six years of deliberations, the Board considered four broad approaches, and combinations of those approaches, in addition to the one proposed in the Exposure Draft, as a way to resolve issues related to hedge accounting. Those four broad approaches are discussed below. The hedge accounting approach proposed in the Exposure Draft is discussed in conjunction with the hedge accounting adopted in this Statement (which is discussed beginning at paragraph 351).

### **Measure All Financial Instruments at Fair Value**

331. Consistent with its conclusion that fair value is the most relevant measure for all financial instruments, the Board considered measuring all financial instruments at fair value. Using that single measurement attribute for initial recognition and subsequent measurement would have resolved problems caused by the current mixed-attribute measurement model, at least for financial instruments, and would have been relatively simple and more readily understandable to financial statement users. It also would have increased comparability for identical balance sheet positions between entities, and it would have obviated the need for special accounting for hedges of financial instruments.

332. Several respondents to the Exposure Draft said that fair value measurement should be expanded to all financial instruments, and a few respondents suggested expanding fair value measurement to all assets and liabilities. Some respondents said that it is inconsistent or inappropriate to expand fair value measurement to derivatives before it is expanded to all financial instruments. Other respondents said that fair value measurement for all financial instruments is not a desirable goal.

333. The Board believes changing the accounting model so that all financial instruments are measured at fair value in the statement of financial position is the superior conceptual solution to hedging issues. However, the Board decided that it was not appropriate at this time to require fair value measurement for all financial instruments. Board members decided that they must first deliberate and reach agreement on conceptual and practical issues related to the valuation of certain financial instruments, including liabilities, and portfolios of financial instruments. The Board is pursuing issues related to fair value measurement of all financial assets and liabilities in a separate project.

334. The Board is committed to work diligently toward resolving, in a timely manner, the conceptual and practical issues related to determining the fair values of financial instruments and portfolios of financial instruments. Techniques for refining the measurement of the fair values of all financial instruments continue to develop at a rapid pace, and the Board believes that all financial instruments should be carried in the statement of financial position at fair value when the conceptual and measurement issues are resolved. For now, the Board believes it is a significant improvement in financial reporting that this Statement requires that all derivatives be measured at fair value in the statement of financial position.

#### **Mark-to-Fair-Value Hedge Accounting**

335. Having concluded that its long-term objective of measuring all financial instruments at fair value was not attainable at this time, the Board decided that it needed to permit some form of hedge accounting. One alternative, termed mark-to-fair-value hedge accounting, would have required that an entity measure both the derivative and the hedged item at fair value and report the changes in the fair value of both items in earnings as they occur. Similar to measuring all financial instruments at fair value, that approach would have accommodated a wide variety of risk management strategies and would have overcome the problems attributable to the mixed-attribute measurement model by using a common measurement attribute for both the derivative and the hedged item. Additionally, that approach would have been relatively easy for entities to apply and for financial statement users to understand because hedged items would be reported at fair value and the net ineffectiveness of a hedge would be reported in earnings. There would have been no need to specify which risks could be separately hedged or how to reflect basis risk. However, like measuring all financial instruments at fair value, mark-to-fair-value hedge accounting would not have addressed constituents' desire for special accounting for cash flow hedges of forecasted transactions.

336. Although the Board liked the idea of extending fair value measurement by marking hedged items to fair value with changes in fair value reported in earnings, it ultimately decided not to adopt mark-to-fair-value hedge accounting for two main reasons. First, measuring hedged items at fair value would have recognized, at the inception of a hedge, unrealized gains and losses on the hedged item that occurred before the hedge period ("preexisting" gains and losses). The Board believes that preexisting gains and losses on the hedged item are unrelated to the hedge

and should not provide earnings offset for derivative gains and losses (consistent with its second fundamental decision [paragraphs 220–228]). Recognizing those gains and losses at the inception of a hedge would result in recognizing a gain or loss simply because the hedged item was designated as part of a hedge. That ability to selectively recognize preexisting gains and losses caused some Board members to reject the mark-to-fair-value approach.

337. Another reason the Board rejected that approach is that constituents objected to its effect on earnings—that is, earnings would have reflected changes in the fair value of a hedged item unrelated to the risk being hedged. For example, a hedge of one risk (such as interest rate risk) could have caused recognition in earnings of gains and losses from another risk (such as credit risk) because the mark-to-fair-value approach would have required recognition of the full change in fair value of the hedged item, including the changes in fair value attributable to risk components *not* being hedged. The hedge accounting approach proposed in the Exposure Draft also could have resulted in recognition of the change in fair value of a hedged item attributable to risk components not being hedged. However, the approach in the Exposure Draft would have (a) limited how much of those fair value changes were recognized in earnings and (b) prevented the change in the fair value of the hedged item that is not offset by the change in fair value on the hedging instrument from being recognized in earnings.

### **Comprehensive Income Approach**

338. The Board considered another hedge accounting approach, referred to as the comprehensive income approach, that would have required that derivatives be measured at fair value and classified in one of two categories, *trading* or *risk management*. Gains and losses on derivatives classified as trading would be recognized in earnings in the periods in which they occur. Unrealized gains and losses on risk management derivatives would be reported as a component of other comprehensive income until realized. Realized gains and losses on risk management derivatives would be reported in earnings.

339. That approach would have been relatively easy to apply, it would have made derivatives and related risks transparent, and it would have accommodated some risk management strategies. Hedges of assets, liabilities, and some forecasted transactions would have been accommodated if the duration of the derivative was structured by management to achieve recognition, in the desired period, of any realized gains or losses. Also, because the approach would not have permitted deferral of derivative gains or losses as liabilities or assets, it would not have violated the fundamental decision that only assets and liabilities should be reported as such.

340. The Board rejected the comprehensive income approach for three main reasons. First, the Board does not believe that the distinction between realized and unrealized gains and losses that is the basis for the comprehensive income approach is relevant for financial instruments. The Board acknowledges that the current accounting model often distinguishes between realized and unrealized gains and losses. That distinction, however, is inappropriate for financial instruments. The occurrence of gains and losses on financial instruments—not the act of settling

them—affects an entity’s economic position and thus should affect its reported financial performance. The Board is concerned that the comprehensive income approach would provide an opportunity for an entity to manage its reported earnings, per-share amounts, and other comprehensive income. Financial instruments generally are liquid, and an entity can easily sell or settle a financial instrument, realize a gain or loss, and maintain the same economic position as before the sale by reacquiring the same or a similar instrument.

341. Second, under the comprehensive income approach, offsetting gains and losses often would not have been reported in earnings at the same time. For example, if an entity used a series of short-term derivatives as a fair value hedge of a long-term fixed-rate loan, the gains and losses on the derivatives would have been recognized in earnings over the life of the loan each time an individual derivative expired or was terminated. However, the offsetting unrealized losses and gains on the loan would not have been recognized in those same periods. Similarly, offsetting gains and losses on a derivative and a nonfinancial asset or liability would have been recognized together in earnings only if both transactions were specially structured to be realized in the same period. The Board decided on the approach in this Statement, in part, because offsetting gains and losses on fair value hedges would be recognized in earnings in the same period.

342. The third reason the Board did not adopt the comprehensive income approach is that all unrealized gains and losses on derivatives classified as risk management would have been reported in other comprehensive income without offsetting losses or gains, if any, on the hedged item. Thus, the resulting other comprehensive income could have implied a change in net assets when net assets did not change or when they changed in the opposite direction. For example, a \$1,000 increase in the fair value of a derivative would have increased other comprehensive income and the carrying amount of the derivative by \$1,000. If there was also an offsetting \$1,000 loss on the hedged asset or liability, which would not have been reflected in other comprehensive income, the change in other comprehensive income would have implied that net assets had increased by \$1,000 when there had been no real change.

343. The hedge accounting approach in this Statement also may result in reporting some derivative gains and losses in other comprehensive income. However, the Board notes that the approach in this Statement limits the amounts reported in other comprehensive income to gains and losses on derivatives designated as hedges of cash flow exposures. The transactions that will give rise to cash flow exposures do not provide offsetting changes in fair value when the related price or rate changes. Consequently, the gains and losses reported in other comprehensive income under this Statement are a faithful representation of the actual volatility of comprehensive income. The Board's reasoning for recognizing in other comprehensive income gains and losses on derivatives designated as hedges of cash flow exposures is further discussed in paragraph 377.

344. Only a few respondents to the Exposure Draft advocated the comprehensive income approach. Although they did not specifically comment on that approach, many respondents objected to recognizing derivative gains and losses in earnings in a period other than the one in

which the hedged item affects earnings. Some opposed reporting derivative gains and losses in other comprehensive income because of the potential for volatility in reported stockholders' equity or net assets, which they considered undesirable.

### **Full-Deferral Hedge Accounting**

345. The Board considered maintaining the approach outlined in Statement 80. Statement 80 permitted deferral of the entire change in the fair value of a derivative used as a hedging instrument by adjusting the basis of a hedged asset or liability, or by recognizing a separate liability or asset associated with a hedge of an unrecognized firm commitment or a forecasted transaction, if the appropriate hedge criteria were met. Many respondents to the Exposure Draft advocated a full-deferral approach. They noted that a full-deferral approach would have been familiar to entities that have applied hedge accounting in the past. That approach also would have provided a mechanism to moderate the earnings "mismatch" that is attributable to the mixed-attribute measurement model. By deferring the earnings recognition of a derivative's gain or loss until the loss or gain on the hedged item has been recognized, offsetting gains or losses on the derivative and hedged item would be recognized in earnings at the same time.

346. However, the full-deferral approach goes beyond correcting for the anomalies created by using different attributes to measure assets and liabilities. The Board rejected that approach for three reasons. First, full-deferral hedge accounting inappropriately permits gains or losses on derivatives designated as hedging the cash flow exposure of forecasted transactions to be reported as separate liabilities or assets in the statement of financial position. Those gains and losses do not represent probable future sacrifices or benefits, which are necessary characteristics of liabilities and assets. Thus, reporting deferred gains or losses as separate liabilities or assets is inconsistent with the Board's conceptual framework.

347. Second, a full-deferral approach is inconsistent with the Board's long-term goal of reporting all financial instruments at fair value in the statement of financial position. For fair value hedges, a full-deferral approach could only have been described as deferring the derivative gain or loss as an adjustment of the basis of the hedged item. For a cash flow hedge of a forecasted purchase of an asset or incurrence of an obligation, a full-deferral approach would have resulted in systematically adjusting the initial carrying amount of the acquired asset or incurred liability away from its fair value.

348. Finally, the full-deferral approach permits a derivative's gain or loss for a period to be deferred regardless of whether there is a completely offsetting decrease or increase in the fair value of the hedged item for that period. The Board believes it is inappropriate to treat that portion of a hedge that does not achieve its objective as if it had been effective.

### **Synthetic Instrument Accounting**

349. A number of respondents to the Exposure Draft suggested that a different kind of special accounting be provided for "synthetic instrument" strategies. Synthetic instrument accounting,

which evolved in practice, views two or more distinct financial instruments (generally a cash instrument and a derivative instrument) as having synthetically created another single cash instrument. The objective of synthetic instrument accounting is to present those multiple instruments in the financial statements as if they were the single instrument that the entity sought to create. Some respondents to the Exposure Draft advocated a synthetic instrument accounting approach for interest rate swaps that are used to modify the interest receipts or payments associated with a hedged financial instrument. That approach, which its advocates also refer to as "the accrual approach," would require the accrual of only the most imminent net cash settlement on the swap. It would not require recognition of the swap itself in the financial statements.

350. The Board decided not to allow synthetic instrument accounting because to do so would be inconsistent with (a) the fundamental decision to report all derivatives in the financial statements, (b) the fundamental decision to measure all derivatives at fair value, (c) the Board's objective to increase the transparency of derivatives and derivative activities, and (d) the Board's objective of providing consistent accounting for all derivative instruments and for all hedging strategies. Synthetic instrument accounting also is not conceptually defensible because it results in netting assets against liabilities (or vice versa) for no reason other than an asserted "connection" between the netted items.

### **Hedge Accounting in This Statement**

351. The hedge accounting approach in this Statement combines elements from each of the approaches considered by the Board. The Board believes the approach in this Statement is consistent with all four of its fundamental decisions and is a significant improvement in financial reporting. It is also more consistent than the approach in the Exposure Draft with what many respondents said was necessary to accommodate their risk management strategies.

352. Some respondents suggested that the financial statement results of applying this Statement will not reflect what they perceive to be the economics of certain hedging and risk management activities. However, there is little agreement about just what the "economics" of hedging and risk management activities are. Because entities have different and often conflicting views of risk and manage risk differently, the Board does not think that a single approach to hedge accounting could fully reflect the hedging and risk management strategies of all entities. The Board also believes that some aspects of "risk management" are hard to distinguish from speculation or "position taking" and that speculative activities should not be afforded special accounting. Thus, providing hedge accounting to the whole range of activities undertaken by some under the broad heading of "risk management" would be inconsistent with improving the usefulness and understandability of financial reporting.

### **Exposures to Changes in Fair Value or Changes in Cash Flow**

353. The accounting prescribed by this Statement is based on two types of risk exposures. One

reflects the possibility that a change in price will result in a change in the fair value of a particular asset or liability—a *fair value exposure*. The other reflects the possibility that a change in price will result in variability in expected future cash flows—a *cash flow exposure*.

354. Fair value exposures arise from existing assets or liabilities, including firm commitments. Fixed-rate financial assets and liabilities, for example, have a fair value exposure to changes in market rates of interest and changes in credit quality. Nonfinancial assets and liabilities, on the other hand, have a fair value exposure to changes in the market price of a particular item or commodity. Some assets and liabilities have fair value exposures arising from more than one type of risk.

355. Some cash flow exposures relate to forecasted transactions. For example, a change in the market price of an asset will change the expected cash outflows for a future purchase of the asset and may affect the subsequent earnings impact from its use or sale. Similarly, a change in market interest rates will change the expected cash flows for the future interest payments resulting from the forecasted issuance of fixed-rate debt (for which the interest rate has not yet been fixed). Other cash flow exposures relate to existing assets and liabilities. For example, a change in market interest rates will affect the future cash receipts or payments associated with a variable-rate financial asset or liability.

356. Fair value exposures and cash flow exposures often are mutually exclusive, and hedging to reduce one exposure generally increases the other. For example, hedging the variability of interest receipts on a variable-rate loan with a receive-fixed, pay-variable swap "fixes" the interest receipts on the loan and eliminates the exposure to risk of a change in cash flows, but it creates an exposure to the risk of a change in the fair value of the swap. The net cash flows on the loan and the swap will not change (or will change minimally) with market rates of interest, but the combined fair value of the loan and the swap will fluctuate. Additionally, the changes in the fair value of an asset or liability are inseparable from its expected cash flows because those cash flows are a major factor in determining fair value.

### **Hedge Accounting in This Statement and Risk Reduction**

357. The Board believes that entity-wide risk reduction should be a criterion for hedge accounting; it therefore would have preferred to require an entity to demonstrate that a derivative reduces the risk to the entity as a criterion for hedge accounting. However, requiring that a derivative contribute to entity-wide risk reduction would necessitate a single, restrictive definition of risk, such as *either* fair value risk *or* cash flow risk. Actions to mitigate the risk of a change in fair value generally exacerbate the variability of cash flows. Likewise, actions to mitigate the variability of cash flows of existing assets and liabilities necessitate "fixing" cash flows, which in turn generally exacerbates an entity's exposure to changes in fair value. Because this Statement provides hedge accounting for both fair value risk and cash flow risk, an objective assessment of entity-wide risk reduction would be mechanically impossible in most situations. Therefore, the Board did not continue the requirement in Statement 80 that a hedging transaction

must contribute to reducing risk at the entity-wide level to qualify for hedge accounting.

358. As discussed in paragraph 322, a hedge of a forecasted transaction can be described as "fixing" the price of the item involved in the transaction if the hedging instrument is held until the hedged transaction occurs. "Fixing" the price of an expected future transaction is a form of risk management on an individual-transaction basis. The Exposure Draft would have provided cash flow hedge accounting only for derivative instruments with a contractual maturity or repricing date that was on or about the date of the hedged forecasted transaction. However, as discussed further in paragraph 468, the Board removed that criterion for cash flow hedge accounting principally because of respondents' objections to it. This Statement also places no limitations on an entity's ability to prospectively designate, dedesignate, and redesignate a qualifying hedge of the same forecasted transaction. The result of those provisions is that this Statement permits an entity to exclude derivative gains or losses from earnings and recognize them in other comprehensive income even if its objective is to achieve a desired level of risk based on its view of the market rather than to reduce risk. If an entity enters into and then discontinues a derivative transaction designated as a hedge of a forecasted transaction for which the exposure has not changed, one of those actions—either the hedge or the discontinuance of it—must increase, rather than reduce, risk.

359. The considerations just discussed, together with the intense focus on the part of many investors on earnings as a measure of entity performance, lead some Board members to prefer that the gain or loss on a derivative designated as a hedge of a forecasted transaction but not intended to be held until the transaction occurs be recognized directly in earnings. However, those Board members also consider comprehensive income to be a measure of an entity's financial performance that is at least as, if not more, important as earnings. Consequently, those Board members found it acceptable to recognize in other comprehensive income the gain or loss on a derivative designated as a hedge of a forecasted transaction, regardless of whether that derivative is held until the hedged transaction occurs. Those Board members observe, however, that recognizing such gains and losses in other comprehensive income rather than in earnings creates additional pressure concerning the method and prominence of the display of both the items in other comprehensive income and total comprehensive income.

#### **A Compound Derivative May Not Be Separated into Risk Components**

360. The Exposure Draft would have prohibited separating a derivative into either separate *proportions* or separate *portions* and designating any component as a hedging instrument or designating different components as hedges of different exposures. Some respondents objected to both prohibitions. They said that either a pro rata part of a derivative, such as 60 percent, or a portion of a derivative, such as the portion of the change in value of a combined interest rate and currency swap deemed to be attributable to changes in interest rates, should qualify for separate designation as a hedging instrument. The Board decided to permit designation of a pro rata part of a derivative as a hedge. Example 10 in Appendix B illustrates that situation.

361. The Board decided to retain the prohibition against separating a compound derivative into components representing different risks. This Statement permits separation of a hedged item or transaction by risk and also places the burden on management to design an appropriate effectiveness test, including a means of measuring the change in fair value or cash flows attributable to the risk being hedged. In view of those requirements, the Board decided that it was especially important that, to the extent possible, the gain or loss on the derivative be an objectively determined market-based amount rather than an amount "separated out" of an overall gain or loss on the derivative as a whole. Otherwise, even for a derivative for which a quoted price is available, the effectiveness test would compare two computed amounts of gain or loss deemed to be "attributable to the risk being hedged" with no tie to a total gain or loss separately observable in the market, which would make the effectiveness test less meaningful. To permit that would have required that the Board provide guidance on how to compute the fair value of the "synthetic" derivative that is separated out of a compound derivative, both at inception and during the term of the hedge. That would have added complexity to the requirements in this Statement without, in the Board's view, adding offsetting benefits to justify the additional complexity. However, the Board decided to permit separation of the foreign currency component of a compound derivative at the date of initial application of this Statement, as discussed in paragraph 524.

### **Fair Value Hedges**

362. As discussed in paragraph 320, the demand for special accounting for hedges of existing assets and liabilities, including unrecognized firm commitments, arises because of differences in the way derivatives and hedged assets and liabilities are measured. This Statement requires derivatives designated as part of a fair value hedge to be measured at fair value with changes in fair value reported in earnings as they occur. Without special accounting, the gain or loss on a derivative that hedges an item not measured at fair value would be reported in earnings without also reporting the potentially offsetting loss or gain on the item being hedged. Those who engage in hedging transactions do not consider that result to appropriately reflect the relationship between a derivative and hedged item or how they manage risk. Accordingly, this Statement permits gains and losses on designated assets and liabilities to be recognized in earnings in the same period as the losses and gains on related derivative hedging instruments.

#### ***Accelerated Recognition of the Gain or Loss on a Hedged Item***

363. Similar to the Exposure Draft, this Statement (a) requires that the gains or losses on a derivative used as a fair value hedging instrument be recognized in earnings as they occur and (b) permits earnings offset by accelerating the recognition of the offsetting losses or gains attributable to the risk being hedged and adjusting the carrying amount of the hedged item accordingly. That notion is consistent with part of the Board's second fundamental decision, namely, that adjustments to the carrying amount of hedged items should reflect offsetting changes in their fair value arising while the hedge is in effect. This Statement modifies the proposals in the Exposure Draft for recognizing the gains and losses on the hedged item in two ways, which are explained below.

### **Attributable to the risk being hedged**

364. The Exposure Draft proposed that the gain or loss on the hedged item that would be recognized under fair value hedge accounting incorporate all risk factors and, therefore, reflect the full change in fair value of the hedged item to the extent of an offsetting gain or loss on the hedging instrument. That focus was intended to prevent a hedged asset or liability from being adjusted farther away from its fair value than it was at inception of the hedge. For example, if the fair value of a hedged asset increased due to a change in interest rates but simultaneously decreased due to a change in credit quality, the Exposure Draft would have prevented an entity that was hedging only interest rate risk from accelerating recognition of the interest rate gain without also effectively accelerating the credit quality loss. Accelerating only the interest rate gain would adjust the hedged asset away from its fair value.

365. Respondents to the Exposure Draft opposed the proposed approach for the very reason that the Board originally favored it—the approach would not have segregated the sources of the change in a hedged item's fair value. Respondents focused on the earnings impact and expressed concern about recognizing in earnings the fair value changes on the hedged item related to an unhedged risk. They said that recognizing the changes in fair value of the hedged item attributable to all risks would cause unrepresentative earnings volatility and would be misleading in reflecting the results of the entity's hedging activities.

366. The Board believes that the earnings effect of the approach proposed in the Exposure Draft would have reflected an exacerbation of the mixed-attribute measurement model, rather than "unrepresentative earnings volatility." However, because of the concerns expressed by respondents, the Board reconsidered the proposed requirements. The Board generally focuses on the appropriate recognition and measurement of assets and liabilities in developing accounting standards. However, the principal purpose of providing special accounting for hedging activities is to mitigate the effects on earnings of different existing recognition and measurement attributes. Consequently, in this instance, the Board found the focus of respondents on the earnings impact of the approach to hedge accounting to be persuasive and decided to modify the Exposure Draft to focus on the risk being hedged. The Board decided to adopt an approach that accelerates the earnings recognition of the portion of the hedged item's gain or loss attributable to the risk being hedged for the following reasons:

- a. It provides the matching of gains and losses on the hedging instrument and the hedged item that respondents desire.
- b. It accounts for all or a portion of the change in fair value of the hedged item, and, consequently, it is not inconsistent with the Board's long-term objective of measuring all financial instruments at fair value.

### **Entire gain or loss attributable to risk being hedged**

367. The Exposure Draft proposed that the gain or loss on the hedged item be recognized in

earnings only to the extent that it provided offset for the loss or gain on the hedging instrument. Under that proposal, earnings would have reflected hedge ineffectiveness to the extent that the derivative gain or loss exceeded an offsetting loss or gain on the hedged item. It would not have reflected hedge ineffectiveness to the extent that the gain or loss on the derivative was less than the loss or gain on the hedged item. For example, ineffectiveness of \$10 would have been recognized if the gain on the derivative was \$100 and the corresponding loss on the hedged item was \$90, but not if the gain on the derivative was \$90 and the loss on the hedged item was \$100. The Board would have preferred to reflect all hedge ineffectiveness in earnings. However, the Exposure Draft did not propose that the excess gain or loss on the hedged item be reflected in earnings because that could have resulted in reporting in earnings a gain or loss on the hedged item attributable to changes in unhedged risks.

368. When the Board modified the Exposure Draft to focus only on the gain or loss on the hedged item attributable to the risk being hedged, it decided to report all hedge ineffectiveness in earnings. Recognizing the hedged item's gain or loss due only to the hedged risk will not result in earnings recognition of gains or losses related to unhedged risks.

#### *Measurement of Hedged Item's Gain or Loss*

369. In this Statement, the gain or loss on the hedged item that is accelerated and recognized in earnings is the portion of the gain or loss that is attributable to the risk being hedged. Although the Board considered several approaches to measuring the gain or loss attributable to the risk being hedged, it decided not to provide detailed guidance on how that gain or loss should be measured. The Board believes that the appropriate measurement of the gain or loss on a hedged item may depend on how an entity manages the hedged risk. Consistent with its decision to require an entity to define at inception how it will assess hedge effectiveness, the Board decided that an entity also should define at inception how it will measure the gain or loss on a hedged item attributable to the risk being hedged. The measurement of that gain or loss should be consistent with the entity's approach to managing risk, assessing hedge effectiveness, and determining hedge ineffectiveness. It follows that the gain or loss on the hedged item attributable to the risk being hedged can be based on the loss or gain on the derivative, adjusted in certain ways that will be identified during the assessment of hedge effectiveness. Both Section 2 of Appendix A and Appendix B discuss and illustrate situations in which the gain or loss on a hedging derivative must be adjusted to measure the loss or gain on the hedged item.

#### *The Exposure Draft's Exception for Certain Firm Commitments*

370. The Exposure Draft proposed a specific exception for a derivative that hedges the foreign currency exposure of a firm commitment to purchase a nonfinancial asset for a fixed amount of foreign currency. That exception would have permitted an entity to consider separately the financial aspect and the nonfinancial aspect of the firm commitment for purposes of designating the hedged item and thus to record the purchased asset at a fixed-dollar (or other functional currency) equivalent of the foreign currency price. The exception is no longer necessary because this Statement permits separate consideration of financial and nonfinancial risks for all fair value

hedges of firm commitments.

### **Cash Flow Hedges**

371. As discussed in paragraphs 322–329, the Board decided to permit hedge accounting for certain hedges of forecasted transactions because of the widespread use of and demand for that accounting. The "need" for special accounting for cash flow hedges arises because the hedged transactions are recognized in periods after the one in which a change in the fair value of the derivative occurs and is recognized. Without special accounting, gains and losses on derivatives would be reported in a period different from the earnings impact of the hedged transaction or the related asset acquired or liability incurred.

372. In developing a hedge accounting approach for hedges of cash flow exposures, the Board identified four objectives: (a) to avoid the recognition of the gain or loss on a derivative hedging instrument as a liability or an asset, (b) to make gains and losses not yet recognized in earnings visible, (c) to reflect hedge ineffectiveness, and (d) to limit the use of hedge accounting for cash flow hedges.

#### ***First Two Objectives—Avoid Conceptual Difficulties and Increase Visibility***

373. The Board believes that recognizing gains or losses on derivatives in other comprehensive income, rather than as liabilities or assets, best meets the first two objectives. Many respondents to the Exposure Draft objected to that approach because of the potential for volatility in reported equity. Instead, they advocated reporting a derivative's gain or loss as a freestanding liability or asset. The Board did not change its decision for several reasons. First, the Board believes that reporting a derivative's gain or loss as a liability or an asset is inappropriate and misleading because a gain is not a liability and a loss is not an asset. Second, the Board believes the volatility in other comprehensive income that results from gains and losses on derivatives that hedge cash flow exposures properly reflects what occurred during the hedge period. There are no gains or losses to offset the losses or gains on the derivatives that are reported in other comprehensive income because the hedged transaction has not yet occurred. Third, the Board believes the advantages of reporting all derivatives at fair value, together with recognizing gains and losses on derivatives that hedge cash flow exposures in other comprehensive income, outweigh any perceived disadvantages of potential equity volatility.

#### ***Third and Fourth Objectives—Reflect Ineffectiveness and Impose Limitations***

374. The Board proposed in the Exposure Draft that the best way to meet the last two objectives (reflect ineffectiveness and impose limitations) would be to reclassify a gain or loss on a derivative designated as a hedging instrument into earnings on the projected date of the hedged forecasted transaction. Effectiveness thus would have been reflected at the date the forecasted transaction was projected to occur. In addition, there would have been little, if any, opportunity for earnings management because gains and losses would not have been reclassified into earnings when realized, when a forecasted transaction actually occurs, or when a forecasted transaction's occurrence is no longer considered probable. The Exposure Draft explained that

requiring recognition at the date the forecasted transaction is initially expected to occur emphasizes the importance of carefully evaluating and forecasting future transactions before designating them as being hedged with specific derivatives.

375. Respondents generally opposed the approach in the Exposure Draft because it often would not have matched the derivative gain or loss with the earnings effect of the forecasted transaction, thereby making earnings appear volatile. Respondents generally advocated recognizing a derivative gain or loss in earnings in the same period or periods as the earnings effect of (a) the forecasted transaction (such as a forecasted sale) or (b) the subsequent accounting for the asset acquired or liability incurred in conjunction with the forecasted transaction. To accomplish that result, many respondents advocated deferring the gain or loss on the derivative beyond the date of the forecasted transaction as an adjustment of the basis of the asset acquired or liability incurred in the forecasted transaction.

376. The Board considered two approaches that would have provided basis adjustment for assets acquired or liabilities incurred in conjunction with a forecasted transaction. One approach would have initially deferred a derivative gain or loss as a separate (freestanding) liability or asset and later reported it as an adjustment of the basis of the acquired asset or incurred liability when it was recorded. The Board rejected that approach because a deferred loss is not an asset and a deferred gain is not a liability; reporting them as if they were would be misleading. The other approach would have initially recognized the derivative gain or loss in other comprehensive income and later reported it as an adjustment of the basis of the acquired asset or incurred liability when it was recorded. The Board rejected that approach because it would have distorted reported periodic comprehensive income. For example, removing a gain from other comprehensive income and reporting it as an adjustment of the basis of an acquired asset would result in a decrease in periodic comprehensive income (and total stockholders' equity) caused simply by the acquisition of an asset at its fair value—a transaction that should have no effect on comprehensive income. Additionally, both approaches would have systematically measured the acquired asset or incurred liability at an amount other than fair value at the date of initial recognition. That is, the adjustment would have moved the initial carrying amount of the acquired asset or incurred liability away from its fair value.

377. The Board decided to require that the gain or loss on a derivative be reported initially in other comprehensive income and reclassified into earnings when the forecasted transaction affects earnings. That requirement avoids the problems caused by adjusting the basis of an acquired asset or incurred liability and provides the same earnings impact. The approach in this Statement, for example, provides for (a) recognizing the gain or loss on a derivative that hedged a forecasted purchase of a machine in the same periods as the depreciation expense on the machine and (b) recognizing the gain or loss on a derivative that hedged a forecasted purchase of inventory when the cost of that inventory is reflected in cost of sales.

378. The Board was concerned that recognizing all derivative gains and losses in other comprehensive income and reclassifying them into earnings in the future, perhaps spread out

over a number of years, would not meet its third objective of reflecting hedge ineffectiveness, if any. The Board therefore decided to require that, in general, the ineffective part of a cash flow hedge be immediately recognized in earnings.

#### **Measure of hedge ineffectiveness**

379. The Board believes that, in principle, earnings should reflect (a) the component of a derivative gain or loss that is excluded from the defined assessment of hedge effectiveness and (b) any hedge ineffectiveness. However, the Board had concerns about the effect of that approach on other comprehensive income and earnings for a period in which the change in the present value of the future expected cash flows on the hedged transaction exceeds the change in the present value of the expected cash flows on the derivative. In that circumstance, the result would be to defer in other comprehensive income a nonexistent gain or loss on the derivative and to recognize in earnings an offsetting nonexistent loss or gain. For example, if the derivative hedging instrument had a \$50 loss for a period in which the change in the present value of the expected cash flows on the hedged transaction was a \$55 gain, an approach that reflected all hedge ineffectiveness in earnings would result in reflecting a \$55 loss in other comprehensive income and reporting a \$5 gain in earnings.

380. To avoid that result, the Board decided that only ineffectiveness due to excess expected cash flows on the derivative should be reflected in earnings. The Board discussed whether that approach should be applied period by period or cumulatively and decided that the ineffectiveness of a cash flow hedge should be determined on a cumulative basis since the inception of the hedge.

381. To illustrate the difference between the period-by-period and cumulative approaches, consider a derivative that had gains (expected cash inflows) of \$75 in period 1 and \$70 in period 2. The derivative hedges a forecasted transaction for which expected cash outflows increased by \$70 and \$75 in the same periods, respectively. At the end of period 2, the changes in expected cash flows on the hedge are completely offsetting on a cumulative basis. That is, the derivative has expected cash inflows of \$145 and the hedged transaction has an offsetting increase in expected cash outflows of \$145. If hedge ineffectiveness is measured and accounted for on a cumulative basis, the \$5 excess derivative gain reported in earnings in period 1 would be reversed in period 2. At the end of period 2, retained earnings would reflect zero gain or loss, and comprehensive income would reflect \$145 of derivative gain. However, measuring and accounting for hedge ineffectiveness on a period-by-period basis would give a different result because earnings and comprehensive income would be affected for the \$5 excess derivative gain in period 1 but not the \$5 excess hedged transaction loss in period 2. As a result, at the end of period 2, retained earnings would reflect a \$5 gain, even though actual ineffectiveness since hedge inception was a zero gain or loss. Other comprehensive income would reflect a gain of \$140, even though the derivative's actual effectiveness since the inception of the hedge was a gain of \$145. Thus, in a situation like the one illustrated, retained earnings under the cumulative approach will more accurately reflect total hedge ineffectiveness since the inception of the

hedge, and comprehensive income will more accurately reflect total hedge effectiveness for the hedge period. The Board rejected a period-by-period approach because, under that approach, retained earnings would not reflect total hedge ineffectiveness, and comprehensive income would not reflect total hedge effectiveness. Section 2 of Appendix A provides some examples of how the ineffective portion of a derivative gain or loss might be estimated, and Section 1 of Appendix B further illustrates application of the cumulative approach.

#### **Limitations on cash flow hedges**

382. Because hedge accounting for forecasted transactions is not conceptually supportable and is not necessary to compensate for recognition or measurement anomalies, the Board decided that this Statement should provide only limited hedge accounting for hedges of forecasted transactions (the Board's fourth objective). In the Exposure Draft, the Board concluded that the best way to limit hedge accounting for a hedge of a forecasted transaction was to require that the gain or loss on a derivative that hedges a forecasted transaction be reclassified into earnings on the projected date of the forecasted transaction and to limit hedge accounting to the life of the hedging instrument. In formulating this Statement, the Board decided that, because of current practice, it was acceptable to provide for an earnings effect that is more consistent with the entity's objective in entering into a hedge. Consequently, the Board decided to provide limitations on hedges of forecasted transactions through the criteria for qualification for cash flow hedge accounting. The Board believes the criteria discussed in paragraphs 458–473 provide sufficient limitations.

383. The Board also considered limiting hedge accounting for hedges of cash flow exposures based on pragmatic, but arbitrary, limitations. The pragmatic approaches that were considered included limitations based on the length of time until the expected occurrence of the forecasted transaction, the amount of the gain or loss reflected in other comprehensive income, and specific linkage to existing assets or liabilities. For example, a limitation might have required that cash flows occur within five years to qualify as hedgeable. The Board decided that it was more appropriate to rely on specified criteria for cash flow hedges than to apply arbitrary, pragmatic limitations.

#### **General Criteria to Qualify for Designation as a Hedge**

384. This Statement requires that certain criteria be met for a hedge to qualify for hedge accounting. The criteria are intended to ensure that hedge accounting is used in a reasonably consistent manner for transactions and exposures that qualify as hedgeable pursuant to this Statement. The criteria discussed in this section are required for both fair value hedges and cash flow hedges. Criteria that are unique to either fair value hedges or cash flow hedges are discussed separately.

#### **Designation, Documentation, and Risk Management**

385. The Board decided that 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 measuring effectiveness to achieve a desired accounting result. The Board also decided that identifying the nature of the risk being hedged and using a hedging derivative consistent with an entity's established policy for risk management are essential components of risk management and are necessary to add verifiability to the hedge accounting model.

### **Highly Effective in Achieving Offsetting Changes in Fair Values or Cash Flows**

386. To qualify for hedge accounting, this Statement requires that an entity must expect a hedging relationship to be highly effective in achieving offsetting changes in fair value or cash flows for the risk being hedged. That requirement is consistent with the Board's fourth fundamental decision, which is that one aspect of qualification for special hedge accounting should be an assessment of the effectiveness of a derivative in offsetting the entity's exposure to changes in fair value or variability of cash flows. This Statement does not specify how effectiveness should be assessed; assessment of effectiveness should be based on the objective of management's risk management strategy. However, this Statement does require that the method of assessing effectiveness be reasonable and that the same method be used for similar hedges unless different methods are explicitly justified. The Board considers it essential that an entity document at the inception of the hedge how effectiveness will be assessed for each hedge and then apply that effectiveness test on a consistent basis for the duration of the designated hedge. However, if an entity identifies an improved method for assessing effectiveness, it may discontinue the existing hedging relationship and then designate and document a new hedging relationship using the improved method prospectively.

387. In formulating this Statement, the Board would have preferred specific effectiveness tests for fair value hedges and for cash flow hedges to (a) provide limitations on hedge accounting, (b) result in consistent application of hedge accounting guidance, and (c) increase the comparability of financial statements. The Exposure Draft therefore proposed specific effectiveness tests that would have required an expectation that the changes in fair value or net cash flows of the derivative would "offset substantially all" of the changes in fair value of the hedged item or the variability of cash flows of the hedged transaction attributable to the risk being hedged. Those proposed offset tests were intended to be similar to, though more stringent than, the related requirements of Statement 80:

At the inception of the hedge and throughout the hedge period, high correlation of changes in (1) the market value of the futures contract(s) and (2) the fair value of, or interest income or expense associated with, the hedged item(s) shall be probable so that the results of the futures contract(s) will substantially offset the effects of price or interest rate changes on the exposed item(s).  
[Paragraph 4(b); footnote reference omitted.]

388. Respondents to the Exposure Draft commented that the proposed effectiveness tests for fair value and cash flow hedges would have precluded certain risk management strategies from

qualifying for hedge accounting because those tests were based on singular objectives for fair value and cash flow hedges. For example, the effectiveness tests in the Exposure Draft would have prohibited delta-neutral hedging strategies, partial-term hedging strategies, rollover hedging strategies, and hedging based on changes in the intrinsic value of options. Respondents also noted that risk management objectives and strategies differ between entities as well as between different types of hedges within an entity. Based on those concerns, the Board reconsidered the effectiveness tests proposed in the Exposure Draft.

389. The Board attempted to develop a workable effectiveness test that would appropriately deal with the variety of risk management objectives and strategies that exist in practice. It ultimately decided to remove the specific effectiveness tests and, instead, to require that a hedge be expected to be highly effective in achieving offsetting changes in either fair value or cash flows, consistent with an entity's documented risk management objectives and strategy. The Board intends "highly effective" to be essentially the same as the notion of "high correlation" in Statement 80.

390. Because that modification places more emphasis on each entity's approach to risk management, the Board decided to require an expanded description and documentation of an entity's risk management objectives and strategy, including how a derivative's effectiveness in hedging an exposure will be assessed. It also decided that the description of how an entity plans to assess effectiveness must (a) include identification of whether all of the gain or loss on the derivative hedging instrument will be included in the assessment and (b) have a reasonable basis. Those limitations, along with examples of different ways to assess hedge effectiveness in a variety of circumstances, are discussed in Section 2 of Appendix A. The Board may need to revisit the idea of more specific effectiveness tests if an evaluation of the application of this Statement indicates either too great a disparity in the techniques used for assessing effectiveness or widespread abuse of the flexibility provided.

#### ***Basis Swaps***

391. Basis swaps are derivative instruments that are used to modify the receipts or payments associated with a recognized, variable-rate asset or liability from one variable amount to another variable amount. They do not eliminate the variability of cash flows; instead, they change the basis or index of variability. The Exposure Draft would have required that an entity expect the net cash flows of a derivative to "offset substantially all" of the variability of cash flows associated with the asset or liability to qualify for cash flow hedge accounting. That requirement would have precluded basis swaps from qualifying as hedging instruments.

392. Some respondents to the Exposure Draft criticized its prohibition of hedge accounting for basis swaps. They commented that it should not matter whether an interest rate swap, for example, is used to change the interest receipts or payments associated with a hedged asset or liability from fixed to variable, variable to fixed, or variable to variable. They noted that the fair value and cash flow criteria accommodated only fixed-to-variable and variable-to-fixed swaps. Additionally, some respondents commented that basis swaps should be eligible for hedge

accounting treatment because they are an effective means of creating comparable asset-liability positions. For example, if an entity holds a variable-rate, LIBOR-based asset and a variable-rate, prime-based liability, an easy way to match that asset and liability position is to "swap" either the LIBOR asset to prime or the prime liability to LIBOR.

393. Many respondents advocating the use of basis swaps as hedging instruments suggested accommodating basis swaps by accounting for all swaps on a synthetic instrument basis. For the reasons discussed in paragraphs 349 and 350, the Board decided not to provide special accounting based on the creation of synthetic instruments. The Board recognizes, however, that basis swaps can provide offsetting cash flows when they are used to hedge a combined asset-liability position in which the asset and liability have different rate bases. For that reason, this Statement provides an exception for a basis swap that is highly effective as a link between an asset (or group of similar assets) with variable cash flows and a liability (or a group of similar liabilities) with variable cash flows.

394. Some respondents to the Task Force Draft objected to what they saw as stricter requirements for a basis swap to qualify for hedge accounting than for other derivatives. They noted that to qualify for hedge accounting, other strategies need not link an asset and a liability. The Board notes that the requirement that a basis swap link the cash flows of an asset and a liability is necessary for a basis swap to qualify under the general criterion that a derivative must provide offsetting cash flows to an exposure to qualify for cash flow hedge accounting. That is, one leg of the basis swap that links an asset and a liability will provide offsetting cash flows for the asset, and the other leg will provide offsetting cash flows for the liability. Thus, the criteria for basis swaps are essentially the same as—not stricter than—the criteria for other strategies to qualify for hedge accounting.

395. To ensure that a basis swap does, in fact, result in offsetting cash flows, this Statement also requires that the basis of one leg of the swap be the same as the basis of the identified asset and that the basis of the other leg of the swap be the same as the basis of the identified liability. Some respondents to the Task Force Draft suggested that the only requirement should be that one leg of the basis swap be highly effective in offsetting the variable cash flows of the asset and the other leg be highly effective in offsetting the variable cash flows of the liability. The Board noted that such a provision could have an additive effect if neither leg is entirely effective. The sum of the two amounts of ineffectiveness might not satisfy the effectiveness test that other derivatives must meet to qualify for hedge accounting. The Board therefore decided to retain the requirement that the basis of one leg of the basis swap be the same as that of a recognized asset and that the basis of the other leg be the same as that of a recognized liability. Section 2 of Appendix A provides an example of assessing the effectiveness of a hedge with a basis swap.

#### ***Written Options***

396. A written option exposes its writer to the possibility of unlimited loss but limits the gain to the amount of premium received. The Board is concerned about permitting written options to be designated as hedging instruments because a written option serves only to reduce the potential

for gain in the hedged item or hedged transaction. It leaves the potential for loss on the hedged item or hedged transaction unchanged except for the amount of premium received on the written option. Consequently, on a net basis, an entity may be worse off as a result of trying to hedge with a written option. Because of those concerns, the Exposure Draft proposed prohibiting a written option from being eligible for designation as a hedging instrument.

397. Respondents to the Exposure Draft objected to categorically prohibiting written options from being designated as hedging instruments. A number of respondents specifically referred to the use of a written option to hedge the call option feature in a debt instrument. They explained that it may be more cost-effective to issue fixed-rate, callable debt and simultaneously enter into a receive-fixed, pay-variable interest rate swap with an embedded written call option than to directly issue variable-rate, noncallable debt. The Board agreed that hedge accounting should be available for that use of written options. Consequently, this Statement permits designation of a written option as hedging the purchased option embedded in a financial instrument. The Board notes that if the option features in both instruments are exactly opposite, any gains or losses on the two options generally will offset. Section 2 of Appendix A includes an example illustrating such a strategy.

398. The requirements in this Statement for hedge accounting for strategies that use written options are based on symmetry of the gain and loss potential of the combined hedged position. To qualify for hedge accounting, either the upside and downside potential of the net position must be symmetrical or the upside potential must be greater than the downside potential. That is, the combination of the hedged item and the written option must result in a position that provides at least as much potential for gains (or favorable cash flows) as exposure to losses (or unfavorable cash flows). Evaluation of the combined position's relative potential for gains and losses is based on the effect of a favorable or unfavorable change in price of a given percentage. For example, a 25 percent favorable change in the fair value of the hedged item must provide a gain on the combined position that is at least as large as the loss on that combined position that would result from a 25 percent unfavorable change in the fair value of the hedged item.

399. This Statement 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 that strategy, any loss on the written option will be covered by the gain on the owned asset. However, 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).

400. The symmetry requirement for hedges with written options described in paragraph 398 is intended to preclude 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. For example, assume that an entity has an investment in equity securities that have a current fair value of \$150 per share. To sell some, but

not all, of the upside potential of those securities, the entity writes a call option contract to sell the securities for \$150 per share and purchases a call option contract to buy the same securities at \$160 per share. On a net basis, the entity still has *unlimited* upside potential because there are infinite possible outcomes above \$160 per share, but its downside risk is limited to \$150 per share. Without the requirement to compare increases and decreases of comparable percentages, an entity could assert that its written option strategy warrants hedge accounting because, after entering into the written and purchased option contracts, there is still more potential for gains than for losses from its combined position in the equity securities and option contracts. The Board decided that hedge accounting should not be available for a transaction that merely "sells" part of the potential for gain from an existing asset.

401. This Statement does not require that a written option be entered into at the same time the hedged item is issued or acquired because the combined position is the same regardless of when the position originated (assuming, of course, that the price of the hedged item is the same as the underlying for the option at the time the hedge is entered into). In addition, the Board decided not to limit the items that may be hedged with written options to financial instruments. The Board decided that this Statement's provisions for hedging with written options should accommodate similar risk management strategies regardless of the nature of the asset or liability that is the hedged item.

#### **Exposures to Changes in Fair Value or Cash Flows That Could Affect Reported Earnings**

402. This Statement requires that a hedged item or hedged forecasted transaction embody an exposure to changes in fair value or variations in cash flow, for the risk being hedged, that could affect reported earnings. That is, a change in the fair value of a hedged item or variation in the cash flow of a hedged forecasted transaction attributable to the risk being hedged must have the potential to change the amount that could be recognized in earnings. For example, the future sale of an asset or settlement of a liability that exposes an entity 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.

403. Some respondents to the Exposure Draft asked the Board to permit some transactions that create an exposure to variability in cash flows to qualify as hedgeable transactions even though they could not affect reported earnings. They asserted that hedges of those transactions successfully reduce an entity's cash flow exposure. The Board decided to retain the criterion of an earnings exposure because the objective of hedge accounting is to allow the gain or loss on a hedging instrument and the loss or gain on a designated hedged item or transaction to be

recognized in earnings at the same time. Moreover, without an earnings exposure, there would be no way to determine the period in which the derivative gain or loss should be included in earnings to comply with this Statement.

404. The earnings exposure criterion specifically precludes hedge accounting for derivatives used to hedge (a) transactions with stockholders as stockholders, such as projected purchases of treasury stock or payments of dividends, (b) intercompany transactions (except for foreign-currency-denominated forecasted intercompany transactions, which are discussed in paragraphs 482–487) between entities included in consolidated financial statements, and (c) 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. However, intercompany transactions may present an earnings exposure for a subsidiary in its freestanding financial statements; a hedge of an intercompany transaction would be eligible for hedge accounting for purposes of those statements.

#### **The Hedged Item or Transaction Is Not Remeasured through Earnings for the Hedged Risk**

405. Special hedge accounting is not necessary if both the hedged item and the hedging instrument are measured at fair value with changes in fair value reported in earnings as they occur because offsetting gains and losses will be recognized in earnings together. The Board therefore decided to specifically prohibit hedge accounting if the related asset or liability is, or will be, measured at fair value, with changes in fair value reported in earnings when they occur. That prohibition results from the Board's belief that a standard on hedge accounting should not provide the opportunity to change the accounting for an asset or liability that would otherwise be reported at fair value with changes in fair value reported in earnings. Thus, for a fair value hedge, the prohibition is intended to prevent an entity from recognizing only the change in fair value of the hedged item attributable to the risk being hedged rather than its entire change in fair value. For a cash flow hedge, the prohibition is intended to prevent an entity from reflecting a derivative's gain or loss in accumulated other comprehensive income when the related asset or liability will be measured at fair value upon acquisition or incurrence.

406. The Exposure Draft would have excluded from its scope all of the assets and liabilities of an entity that follows specialized industry practice under which it measures substantially all of its assets at fair value and recognizes changes in those fair values in earnings. That exclusion was aimed at preventing those entities from avoiding fair value accounting. Respondents to the Exposure Draft noted that exclusion also would have prohibited those entities from applying hedge accounting to hedged assets or liabilities that are not measured at fair value, such as long-term debt. The Board decided to remove the exclusion and instead focus on assets and liabilities that are reported at fair value because that approach would (a) be consistent with the notion that eligibility for hedge accounting should be based on the criteria in this Statement, (b) provide consistent fair value accounting for all derivatives, and (c) be responsive to the concerns of constituents.

407. The criteria in this Statement also preclude hedge accounting for an asset or a liability that is remeasured for changes in price attributable to the risk being hedged, with those changes in value reported currently in earnings. The criteria therefore preclude fair value or cash flow hedge accounting for foreign currency risk associated with any asset or liability that is denominated in a foreign currency and remeasured into the functional currency under Statement 52. The Board believes that special accounting is neither appropriate nor necessary in that situation because the transaction gain or loss on the foreign-currency-denominated asset or liability will be reported in earnings along with the gain or loss on the undesignated derivative. The criteria also preclude a cash flow hedge of the forecasted acquisition or incurrence of an item that will be denominated in a foreign currency and remeasured into the functional currency each period after acquisition or incurrence. However, the criteria do not preclude a cash flow hedge of the foreign currency exposure associated with the forecasted purchase of a nonmonetary item for a foreign currency, even if the purchase will be on credit, because nonmonetary items are not subsequently remeasured into an entity's functional currency. Nor do the criteria preclude hedging the forecasted sale of a nonmonetary asset for a foreign currency, even if the sale will be on credit.

#### **Risks That May Be Designated as Being Hedged**

408. The Board recognizes that entities are commonly exposed to a variety of risks in the course of their activities, including interest rate, foreign exchange, market price, credit, liquidity, theft, weather, health, catastrophe, competitive, and business cycle risks. The Exposure Draft did not propose detailed guidance on what risks could be designated as being hedged, other than to note in the basis for conclusions that special hedge accounting for certain risk management transactions, such as hedges of strategic risk, would be precluded. In redeliberating the issue of risk, the Board reaffirmed that hedge accounting cannot be provided for all possible risks and decided to be more specific about the risks for which hedge accounting is available.

409. Because this Statement, unlike the Exposure Draft, bases the accounting for a hedged item in a fair value hedge on changes in fair value attributable to the risk being hedged, the Board decided that it needed to limit the types of risks that could be designated as being hedged. The absence of limits could make meaningless the notion of hedge effectiveness by ignoring the consequence of basis or other differences between the hedged item or transaction and the hedging instrument in assessing the initial and continuing qualification for hedge accounting.

410. For example, an entity using a LIBOR-based interest rate futures contract as a hedge of a prime-based asset might assert that the risk being hedged is the fair value exposure of the prime-based asset to changes in LIBOR. Because that designation would ignore the basis difference between the prime-based hedged asset and the LIBOR-based derivative hedging instrument, it could result in asserted "automatic" compliance with the effectiveness criterion. That type of designation might also lead an entity to assert that the amount of the change in the hedged item's fair value attributable to the hedged risk corresponds to the change in the fair value of the hedging derivative and, therefore, to erroneously conclude that the derivative's

change in fair value could be used as a surrogate for changes in the fair value of the hedged item attributable to the hedged risk. Such a designation also would remove any possibility that actual ineffectiveness of a hedge would be measured and reflected in earnings in the period in which it occurs.

### ***Financial Assets and Liabilities***

411. For financial instruments, this Statement specifies that hedge accounting is permitted for hedges of changes in fair value or variability of future cash flows that result from changes in four types of risk. As indicated in paragraph 21(f), those four risks also apply to fair value hedges of firm commitments with financial components.

- a. *Market price risk.* A fair value hedge focuses on the exposure to changes in the fair value of the entire hedged item. The definition of *fair value* requires that the fair value of a hedged item be based on a quoted market price in an active market, if available. Similarly, a cash flow hedge focuses on variations in cash flows, for example, the cash flows stemming from the purchase or sale of an asset, which obviously are affected by changes in the market price of the item. The Board therefore concluded that the market price risk of the entire hedged item (that is, the risk of changes in the fair value of the entire hedged item) should be eligible for designation as the hedged risk in a fair value hedge. Likewise, variable cash flows stemming from changes in the market price of the entire item are eligible for designation as the hedged risk in a cash flow hedge.
- b. *Market interest rate risk.* For financial assets and liabilities, changes in market interest rates may affect the right to receive (or obligation to pay or transfer) cash or other financial instruments in the future or the fair value of that right (or obligation). The time value of money is a broadly accepted concept that is incorporated in generally accepted accounting principles (for example, in APB Opinion No. 21, *Interest on Receivables and Payables*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*). Because the marketplace has developed techniques to delineate and extract interest rate risk from financial instruments, the Board decided that the risk that changes in market interest rates will affect the fair value or cash flows of the hedged item warrants being identified as a risk that may be designated as being hedged.
- c. *Foreign exchange risk.* The fair value (expressed in the entity's functional currency) of an asset such as a foreign debt or equity security that is classified as available for sale, as well as the fair value of the financial component of a firm commitment that is denominated in a currency other than the entity's functional currency, generally is exposed to changes in foreign exchange rates. Similarly, the cash flows of a forecasted transaction generally are exposed to changes in foreign exchange rates if the transaction will be denominated in a foreign currency. Statement 52 specifies special accounting for reflecting the effects of changes in foreign exchange rates, and this Statement continues much of that accounting. The Board therefore decided that the risk of changes in foreign exchange rates on the fair value of certain hedged items and on the cash flows of hedged transactions warrants being

identified as a risk that may be designated as being hedged.

- d. *Default (credit) risk.* A financial asset embodies a right to receive cash or another financial instrument from a counterparty. A financial asset thus embodies a risk that the counterparty will fail to perform according to the terms of the contract; that risk generally is referred to as credit risk. Because that risk affects the fair value of a financial asset, as well as the related cash flows, the Board decided that the risk of the counterparty's default on its obligation is a risk that may be designated as being hedged.

Focusing on those four risks is consistent with the belief that the largest amount of present hedging activity is aimed at protecting against market price, credit, foreign exchange, or interest rate risk. Those also were the risks generally accommodated by special hedge accounting before this Statement. Focusing on those four risks also is consistent with responses to the Exposure Draft. Although the notice for recipients did not ask respondents to comment on the type of risks that should be eligible for hedge accounting, respondents generally discussed hedging transactions in terms of those four risks.

412. This Statement also focuses on those four specified risks because a change in the price associated with one of those risks ordinarily will directly affect the fair value of an asset or liability or the cash flows of a future transaction in a determinable or predictable manner. Price changes associated with other risks may not be as direct. For example, price changes associated with "strategic risk" exposures do not have a direct impact on the fair value of a hedged item or cash flow of a forecasted transaction and thus may not be designated as the risk being hedged. Strategic hedges are described in paragraph 231.

413. This Statement does not permit designating a subcomponent of market price, market interest rate, foreign exchange, or credit risk as the risk being hedged. However, some of those subcomponents may be embodied in a separable portion of a financial instrument. For example, prepayment risk is a subcomponent of market interest rate risk, but the prepayment risk in a financial asset stems from the embedded written call option. An entity may hedge prepayment risk by separately designating a hedge of the embedded call option. Even though this Statement does not require an embedded prepayment option to be accounted for separately because it is deemed to be clearly and closely related to the host contract, that embedded call option still is a derivative. Because this Statement does not permit a compound derivative to be separated into risk components for hedge accounting purposes, only the market price risk of the entire option qualifies as the hedged risk. Hedge effectiveness therefore must be measured based on changes in the fair value of the option.

414. Measuring the effectiveness of a fair value hedge requires determining whether a gain or loss on a hedging derivative offsets the loss or gain in the value of the hedged item that is attributable to the risk being hedged. Once the change in the value of a hedged item attributable to a particular risk has been offset by the change in value of a hedging derivative, a second, identical derivative cannot also be an effective hedge of that same risk. Similarly, an embedded derivative in a hedged item will modify the nature of the risk to which that item is exposed.

Thus, all embedded derivatives relating to the same risk class (that is, market prices, market interest rates, foreign exchange rates, or credit) in a hedged item must be considered together in assessing the effectiveness of an additional (freestanding) derivative as the hedging instrument.

415. For example, an entity might enter into a firm commitment to purchase an asset for 1,000,000 Deutsche marks (DM), with a provision that caps the U.S. dollar equivalent price at \$600,000. A hedge of the foreign currency risk in that commitment cannot be effective unless it takes into account the effect of the cap. Similarly, a hedge of the effect on the holder of changes in market interest rates on the unconditional receivable component of a prepayable bond cannot ignore the effect of the embedded prepayment option. To disregard the effects of embedded derivatives related to the same risk class could result in a designated hedge that is not effective at achieving offsetting changes in fair value attributable to the risk being hedged.

#### ***Nonfinancial Assets and Liabilities***

416. The Board decided to limit fair value and cash flow hedge accounting for hedges of nonfinancial assets and liabilities (other than recognized loan servicing rights and nonfinancial firm commitments with financial components) to hedges of the risk of changes in the market price of the *entire* hedged item in a fair value hedge or the *entire* asset to be acquired or sold in a hedged forecasted transaction, with one exception. The risk of changes in the functional-currency-equivalent cash flows attributable to changes in foreign exchange rates may be separately hedged in a cash flow hedge of the forecasted purchase or sale of a nonfinancial item. The Board decided not to permit the market price risk of only a principal ingredient or other component of a nonfinancial hedged item to be designated as the risk being hedged because changes in the price of an ingredient or component of a nonfinancial item generally do not have a predictable, separately measurable effect on the price of the item that is comparable to the effect of, say, a change in market interest rates on the price of a bond.

417. For example, if an entity wishes to enter into a cash flow hedge of the variability in cash inflows from selling tires, the market price risk of rubber alone could not be designated as the risk being hedged. There is no mechanism in the market for tires to directly relate the amount or quality of rubber in a tire to the price of the tire. Similarly, if a derivative is used in a fair value hedge to hedge the exposure to changes in the fair value of tires held in inventory, the entity could not designate the market price of rubber as the hedged risk even though rubber is a component of the tires. The fair value of the tire inventory is based on the market price of tires, not rubber, even though the price of rubber may have an effect on the fair value of the tires. Permitting an entity to designate the market price of rubber as the risk being hedged would ignore other components of the price of the tires, such as steel and labor. It also could result in automatic compliance with the effectiveness test even though the price of rubber may not be highly correlated with the market price of tires. As discussed in the effectiveness examples in Section 2 of Appendix A, the use of a rubber-based derivative as a fair value hedge of the tire inventory or a cash flow hedge of its sale or purchase may qualify for hedge accounting. To do so, however, the entire change in the fair value of the derivative and the entire change in the fair value of the hedged item must be expected to be highly effective at offsetting each other, and all

of the remaining hedge criteria must be met. Any ineffectiveness must be included currently in earnings.

418. Some respondents to the Task Force Draft objected to this Statement's different provisions about risks that may be hedged in financial versus nonfinancial items. They asserted that an entity also should be permitted to separate a nonfinancial item into its principal components for hedge accounting purposes. The Board considers those differing requirements to be an appropriate consequence of the nature of the items being hedged.

419. For example, the effect of changes in market interest rates qualifies for designation as the hedged risk in a financial item but not in a nonfinancial item. An increase in market interest rates will result in a decrease in the fair value of a fixed-rate financial asset because the market rate of interest directly affects the present value computation of the item's future cash flows. Similarly, an increase in market interest rates will result in an increase in the cash flows of a variable-rate financial asset. For both fixed- and variable-rate financial assets, the effect of a change in market interest rates is not only direct but also predictable and separately determinable. For instance, holding factors like credit risk constant, it is relatively easy to calculate the effect of a 100-basis-point increase in market interest rates on the market price of a fixed-rate bond with a specified interest rate and specified time to maturity. It is even easier to determine the effect of a 100-basis-point increase in interest rates on the cash flows stemming from a variable-rate bond. In contrast, although an increase of 100 basis points in market interest rates may affect the market price of a residential building, techniques do not currently exist to isolate and predict that effect.

420. The effect of changes in interest rates on the market price of residential real estate is much less direct than the effect of interest rate changes on financial items. Interest rates may indirectly affect the market price of a single-family house because of the effect of a change in market interest rates on consumer buying behavior or rental rates. For example, an increase in market interest rates may lead to decreased consumer demand for real estate mortgage loans and, in turn, for real estate purchases. Enticing consumers to purchase real estate in a higher interest-rate environment may necessitate lower prices. However, a myriad of other factors may affect the price of residential real estate, and any effect of interest rates is not predictable, immediate, or subject to isolation.

421. Unlike a change in market interest rates, it may be possible to isolate the effect of a change in foreign exchange rates on the functional currency cash flows stemming from a nonfinancial item. For example, an entity with a U.S. dollar functional currency owns residential real estate located in France with a market price of FF5,000,000. If the price of residential real estate in France and the U.S. dollar–French franc exchange rate are not correlated, an increase of \$0.01 in the value of the franc will increase the U.S. dollar equivalent of the sales price of the real estate by \$50,000 ( $FF5,000,000 \times 0.01$ ). This Statement thus permits the effect of changes in foreign exchange rates to be designated as the hedged risk in a cash flow hedge of a forecasted transaction involving a nonfinancial item.

## **Simultaneous Hedges of Fair Value and Cash Flow Exposures**

422. The Exposure Draft would have prohibited the simultaneous designation of an asset or liability as a fair value hedged item and that asset's or liability's cash flows as a hedged forecasted transaction. The Board had previously concluded that, in certain circumstances, if an entity were permitted to apply hedge accounting at the same time for hedges of both the fair value and the cash flow variability of a single item, the results would be questionable because the entity may be hedging some (if not all) of the same cash flows twice. For example, simultaneous hedging of both the fair value of 1,000 barrels of existing crude oil inventory in a fair value hedge and the forecasted sale of refined oil from those 1,000 barrels of oil in a cash flow hedge would change the nature of the entity's exposure to oil price movements. The two hedges would take the entity from a net long position to a net short position; together they would not necessarily neutralize risk.

423. The Board decided to remove the restriction on simultaneous fair value and cash flow hedges. That change was made, in part, because of the change to base both the assessment of hedge effectiveness and hedge accounting on the change in fair value or cash flows attributable to the risk being hedged. The Board believes this Statement can accommodate simultaneous fair value and cash flow hedging in certain situations if different risk exposures are being hedged because hedge accounting in this Statement accounts for each risk exposure separately. For example, an entity might designate both a cash flow hedge of the interest rate risk associated with a variable-rate financial asset and a fair value hedge of the credit risk on that asset.

424. Removing the restriction on simultaneous fair value and cash flow hedges is not, however, intended to permit simultaneous hedges of the same risk, such as credit risk or market price risk, with both a fair value hedge and a cash flow hedge. For example, the Board does not consider the simultaneous hedge of the fair value of crude oil and the cash flows from selling a product made from that oil described in paragraph 422 to be consistent with the requirements of this Statement because the crude oil and the refined product do not present separate earnings exposures. The entity cannot sell both the crude oil and a refined product made from the same oil—it can only do one or the other. Regardless of how it intends to use the crude oil, the entity can choose to hedge its exposure to changes in the price of a specific amount of crude oil as either a fair value exposure or a cash flow exposure, but not as both.

425. Some respondents to the Exposure Draft opposed the prohibition on simultaneous hedges because it would preclude swapping foreign-currency-denominated variable-rate debt to U.S. dollar fixed-rate debt. That strategy was not eligible for hedge accounting under the Exposure Draft because the variable interest rate exposure is a cash flow exposure and the foreign currency exposure was deemed to be a fair value exposure. Even though this Statement no longer includes a restriction on simultaneous hedges, the foreign currency aspect of that strategy is not hedgeable under this Statement because the debt will be remeasured into the entity's functional currency under Statement 52, with the related transaction gain or loss reported in earnings. An

entity might, however, be able to achieve income statement results similar to hedge accounting using separate interest rate and foreign currency derivatives and designating only the interest rate derivative as a hedging instrument. Income statement offset would be achieved for the foreign currency aspect because the change in fair value of the undesignated foreign currency derivatives will flow through earnings along with the remeasurement of the debt into the functional currency.

#### **Prohibition against Hedge Accounting for Hedges of Interest Rate Risk of Debt Securities Classified as Held-to-Maturity**

426. This Statement prohibits hedge accounting for a fair value or cash flow hedge of the interest rate risk associated with a debt security classified as held-to-maturity pursuant to Statement 115. During the deliberations that preceded issuance of Statement 115, the Board considered whether such a debt security could be designated as being hedged for hedge accounting purposes. Although the Board's view at that time was that hedging debt securities classified as held-to-maturity is inconsistent with the basis for that classification, Statement 115 did not restrict hedge accounting of those securities because constituents argued that the appropriateness of such restrictions should be considered in the Board's project on hedging.

427. The Exposure Draft proposed prohibiting a held-to-maturity debt security from being designated as a hedged item, regardless of the risk being hedged. The Exposure Draft explained the Board's belief that designating a derivative as a hedge of the changes in fair value, or variations in cash flow, of a debt security that is classified as held-to-maturity contradicts the notion of that classification. Respondents to the Exposure Draft objected to the proposed exclusion, asserting the following: (a) hedging a held-to-maturity security does not conflict with an asserted intent to hold that security to maturity, (b) a held-to-maturity security contributes to interest rate risk if it is funded with shorter term liabilities, and (c) prohibiting hedge accounting for a hedge of a held-to-maturity security is inconsistent with permitting hedge accounting for other fixed-rate assets and liabilities that are being held to maturity.

428. The Board continues to believe that providing hedge accounting for a held-to-maturity security conflicts with the notion underlying the held-to-maturity classification in Statement 115 if the risk being hedged is the risk of changes in the fair value of the entire hedged item or is otherwise related to interest rate risk. The Board believes an entity's decision to classify a security as held-to-maturity implies that future decisions about continuing to hold that security will not be affected by changes in market interest rates. The decision to classify a security as held-to-maturity is consistent with the view that a change in fair value or cash flow stemming from a change in market interest rates is not relevant for that security. In addition, fair value hedge accounting effectively alters the traditional income recognition pattern for that debt security by accelerating gains and losses on the security during the term of the hedge into earnings, with subsequent amortization of the related premium or discount over the period until maturity. That accounting changes the measurement attribute of the security away from amortized historical cost. The Board also notes that the rollover of a shorter term liability that funds a held-to-maturity security may be eligible for hedge accounting. The Board therefore

decided to prohibit both a fixed-rate held-to-maturity debt security from being designated as a hedged item in a fair value hedge and the variable interest receipts on a variable-rate held-to-maturity security from being designated as hedged forecasted transactions in a cash flow hedge if the risk being hedged includes changes in market interest rates.

429. The Board does not consider it inconsistent to prohibit hedge accounting for a hedge of market interest rate risk in a held-to-maturity debt security while permitting it for hedges of other items that an entity may be holding to maturity. Only held-to-maturity debt securities receive special accounting (that is, being measured at amortized cost when they otherwise would be required to be measured at fair value) as a result of an asserted intent to hold them to maturity.

430. The Board modified the Exposure Draft to permit hedge accounting for hedges of credit risk on held-to-maturity debt securities. It decided that hedging the credit risk of a held-to-maturity debt security is not inconsistent with Statement 115 because that Statement allows a sale or transfer of a held-to-maturity debt security in response to a significant deterioration in credit quality.

431. Some respondents to the Task Force Draft said that a hedge of the prepayment risk in a held-to-maturity debt security should be permitted because it does not contradict the entity's stated intention to hold the instrument to maturity. The Board agreed that in designating a security as held-to-maturity, an entity declares its intention not to voluntarily sell the security as a result of changes in market interest rates, and "selling" a security in response to the exercise of a call option is not a voluntary sale. Accordingly, the Board decided to permit designating the embedded written prepayment option in a held-to-maturity security as the hedged item. Although prepayment risk is a subcomponent of market interest rate risk, the Board notes that prepayments, especially of mortgages, occur for reasons other than changes in interest rates. The Board therefore does not consider it inconsistent to permit hedging of prepayment risk but not interest rate risk in a held-to-maturity security.

## **Additional Qualifying Criteria for Fair Value Hedges**

### **Specific Identification**

432. This Statement requires specific identification of the hedged item. The hedged item must be (a) an entire recognized asset or liability, or an unrecognized firm commitment, (b) a portfolio of similar assets or similar liabilities, or (c) a specific portion of a recognized asset or liability, unrecognized firm commitment, or portfolio of similar items. If an entity hedges a specified portion of a portfolio of similar assets or similar liabilities, that portion should relate to every item in the portfolio. If an entity wishes to hedge only certain similar items in a portfolio, it should first identify a smaller portfolio of only the items to be hedged.

433. The Exposure Draft would not have permitted designation of a portion of an asset or a

liability as a hedged item. Under the Exposure Draft, those items could only have been hedged in their entirety or on a percentage basis. Some respondents to the Exposure Draft objected to that limitation because it precluded identification of only selected contractual cash flows as the item being hedged (referred to as partial-term hedging for a debt security). For example, it would have prohibited identification of the interest payments for the first two years of a four-year fixed-rate debt instrument as the hedged item and, therefore, would have precluded hedge accounting for a hedge of that debt with a two-year interest rate swap.

434. The Board was reluctant to permit identification of a selected portion (rather than proportion) of an asset or liability as the hedged item because it believes that, in many cases, partial-term hedge transactions would fail to meet the offset requirement. For example, the changes in the fair value of a two-year interest rate swap cannot be expected to offset the changes in fair value attributable to changes in market interest rates of a four-year fixed-rate debt instrument. For offset to be expected, a principal repayment on the debt (equal to the notional amount on the swap) would need to be expected at the end of year two. The Board decided to remove the prohibition against partial-term hedging and other designations of a portion of an asset or liability to be consistent with the modification to the Exposure Draft to require an entity to define how the expectation of offsetting changes in fair value or cash flows would be assessed. However, removal of that criterion does not necessarily result in qualification for hedge accounting for partial-term or other hedges of part of an asset or a liability.

435. The criterion in paragraph 21(a) that permits a hedged item in a fair value hedge to be a designated portion of an asset or liability (or a portfolio of similar assets or similar liabilities) makes the following eligible for designation as a hedged item:

- a. A percentage of the entire asset or liability (or of the entire portfolio)
- b. One or more selected contractual cash flows (such as the asset or liability representing the interest payments in the first two years of a four-year debt instrument) <sup>32</sup>
- c. A put option, a call option, an interest rate cap, or an interest rate floor embedded in an existing asset or liability that is not an embedded derivative accounted for separately under this Statement
- d. The residual value in a lessor's net investment in a direct-financing or sales-type lease.

If the entire asset or liability is a variable-rate instrument, the hedged item cannot be a fixed-to-variable interest rate swap (or similar instrument) perceived to be embedded in a fixed-rate host contract. The Board does not intend for an entity to be able to use the provision that a hedged item may be a portion of an asset or liability to justify hedging a contractual provision that creates variability in future cash flows as a fair value hedge rather than as a cash flow hedge. In addition, all other criteria, including the criterion that requires a hedge to be expected to be highly effective at achieving offset, must still be met for items such as the above to be designated and to qualify for hedge accounting.

436. As discussed in paragraphs 414 and 415, in designating a hedge of a component of an asset

or liability, an entity must consider the effect of any derivatives embedded in that asset or liability related to the same risk class. To disregard the effects of an embedded derivative related to the same risk class could result in a designated hedge that is not effective at achieving offsetting changes in fair value or cash flows. The same unacceptable result would occur if a freestanding derivative that was accounted for as hedging a particular item was ignored in considering whether another derivative would qualify as a hedge of the same risk in that item.

### **Recognized Asset or Liability or Unrecognized Firm Commitment**

437. This Statement requires that the item designated as hedged in a fair value hedge be a recognized asset or liability or an unrecognized firm commitment. The Board decided that an unrecognized asset or liability that does not embody a firm commitment should not be eligible for designation as a hedged item because applying fair value hedge accounting to such an unrecognized asset or liability would result in recognizing a portion of it. For example, fair value hedge accounting for an unrecognized intangible asset, such as an internally generated core deposit intangible, would have the effect of recognizing the change in the present value of the intangible asset. The Board believes a change to require or permit recognition of certain intangible assets or potential liabilities that are not now recognized should be made only after careful consideration of the related conceptual and practical issues rather than being a by-product of hedge accounting.

438. This Statement permits an unrecognized firm commitment, including one that is embodied in an unrecognized asset or liability such as an operating lease with substantial cancellation penalties, to be designated as the hedged item in a fair value hedge. The Board recognizes that permitting certain such firm commitments to be designated as hedged items may be viewed as inconsistent with not permitting other unrecognized assets and liabilities to be hedged items. The Board considered limiting the firm commitments that can be hedged items, for example, to those for which there is no explicit authoritative accounting requirement that precludes recognition of the related asset or liability. However, the Board was unable to identify a specific limitation that would be both workable and equitable. Moreover, the Board notes that a firm commitment as defined in this Statement must have a fixed price and a disincentive for nonperformance sufficiently large to make performance probable (discussed further in paragraphs 440 and 441), which makes hedging a firm commitment less problematic than hedging an unrecognized item such as an internally generated intangible asset. Accordingly, with the limited exceptions discussed in paragraphs 455 and 456, the Board decided to permit all firm commitments as defined in this Statement to qualify as hedged items in fair value hedges.

439. This Statement requires that hedge accounting adjustments to the carrying amount of hedged assets and liabilities be subsequently reported in earnings in the same manner as other adjustments of the carrying amount of the hedged item. For example, gains and losses on an interest-bearing debt instrument that are attributable to interest rate risk generally would be amortized over the life of the instrument as a yield adjustment. For some unrecognized firm commitments, such as a firm commitment to purchase inventory, the nature of the hedged item

will clearly specify a basis for recognizing hedge accounting adjustments in income. For others, such as the operating lease discussed in paragraph 438, there will be no obvious pattern of income recognition for hedge accounting adjustments. This Statement requires that an entity specify as part of its initial hedge designation how hedge accounting adjustments will be subsequently recognized in income. The Board believes that such designation at inception of a hedge is consistent with other provisions in this Statement that prohibit retroactive decisions after the results of a hedge are known.

***Definition of a Firm Commitment***

440. Because this Statement provides fair value hedge accounting for hedges of unrecognized firm commitments, a definition of *firm commitment* is necessary. For purposes of this Statement, a firm commitment is defined as:

An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

- a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It also may be expressed as a specified interest rate or specified effective yield.
- b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable.

That definition is based on the definition of a firm commitment in Statements 52 and 80.

441. Some respondents to the Exposure Draft focused more on the "probability" aspect of the definition than on the requirements that the agreement be binding on both parties and that it specify the significant terms of the transaction, including the price. For example, some respondents wanted to treat as a firm commitment for hedge accounting purposes a group of contracts that are binding on one party but not on the other. They said that if the entity is a party to a sufficient number of those contracts, sufficient evidence would be available to permit a reasonable estimate of the number of transactions that would be consummated under the agreements. The Board notes that an agreement that is binding on one party but not on the other is an option rather than a firm commitment. In developing hedge accounting requirements, the Board believes that the fundamental nature of a financial instrument should not be ignored.

442. The definition of a firm commitment in this Statement 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, such as ounces of gold. 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. To avoid such a situation, the Board decided that it was necessary

to require that the fixed price in a firm commitment be specified in terms of a currency or a rate. A similar situation can exist for a firm commitment that is denominated in a foreign currency if the price of the item to be purchased or sold varies with changes in exchange rates. The Board accepted that possibility because it had been accepted under Statement 52, and it did not want to undertake a complete reconsideration of the hedging provisions of that Statement at this time. Therefore, the price may be specified in any currency—it need not be in the entity's functional currency.

#### **Single Asset or Liability or a Portfolio of Similar Assets or Similar Liabilities**

443. This Statement retains the provision from the Exposure Draft that prohibits a portfolio of dissimilar items from being designated as a hedged item. Many respondents said that hedge accounting should be extended to hedges of portfolios of dissimilar items (often called *macro hedges*) because macro hedging is an effective and efficient way to manage risk. To qualify for designation as a hedged item on an aggregate rather than individual basis, the Exposure Draft would have required that individual items in a portfolio of similar assets or liabilities be expected to respond to changes in a market variable in an equivalent way. The Exposure Draft also included a list of specific characteristics to be considered in determining whether items were sufficiently similar to qualify for hedging as a portfolio. Respondents said that, taken together, the list of characteristics and the "equivalent way" requirement would have meant that individual items could qualify as "similar" only if they were virtually identical.

444. To deal with the concerns of respondents, the Board modified the Exposure Draft in two ways. First, the Board deleted the requirement that the value of all items in a portfolio respond in an equivalent way to changes in a market variable. Instead, this Statement requires that the items in a portfolio share the risk exposure for which they are designated as being hedged and that the fair values of individual items attributable to the hedged risk be expected to respond proportionately to the total change in fair value of the hedged portfolio. The Board intends *proportionately* to be interpreted strictly, but the term does not mean *identically*. For example, a group of assets would not be considered to respond proportionately to a change in interest rates if a 100-basis-point increase in interest rates is expected to result in percentage decreases in the fair values of the individual items ranging from 7 percent to 13 percent. However, percentage decreases within a range of 9 percent to 11 percent could be considered proportionate if that change in interest rates reduced the fair value of the portfolio by 10 percent.

445. The second way in which the Board modified the Exposure Draft was to delete the requirement to consider all specified risk characteristics of the items in a portfolio. The Board considered completely deleting the list of risk characteristics included in the Exposure Draft, and the Task Force Draft did not include that list. However, respondents to that draft asked for additional guidance on how to determine whether individual assets or liabilities qualify as "similar." In response to those requests, the Board decided to reinstate the list of characteristics from the Exposure Draft. The Board intends the list to be only an indication of factors that an entity may find helpful.

446. Those two changes are consistent with other changes to the Exposure Draft to focus on the risk being hedged and to rely on management to define how effectiveness will be assessed. It is the responsibility of management to appropriately assess the similarity of hedged items and to determine whether the derivative and a group of hedged items will be highly effective at achieving offset. Those changes to the Exposure Draft do not, however, permit aggregation of dissimilar items. Although the Board recognizes that certain entities are increasingly disposed toward managing specific risks within portfolios of assets and liabilities, it decided to retain the prohibition of hedge accounting for a hedge of a portfolio of dissimilar items for the reasons discussed in the following paragraphs.

447. Hedge accounting adjustments that result from application of this Statement must be allocated to individual items in a hedged portfolio to determine the carrying amount of an individual item in various circumstances, including (a) upon sale or settlement of the item (to compute the gain or loss), (b) upon discontinuance of a hedging relationship (to determine the new carrying amount that will be the basis for subsequent accounting), and (c) when other generally accepted accounting principles require assessing that item for impairment. The Board decided that a hedge accounting approach that adjusts the basis of the hedged item could not accommodate a portfolio of dissimilar items (macro hedging) because of the difficulties of allocating hedge accounting adjustments to dissimilar hedged items. It would be difficult, if not impossible, to allocate derivative gains and losses to a group of items if their values respond differently (both in direction and in amount) to a change in the risk being hedged, such as market interest rate risk. For example, some components of a portfolio of dissimilar items may increase in value while other components decrease in value as a result of a given price change. Those allocation difficulties are exacerbated if the items to be hedged represent different exposures, that is, a fair value risk and a cash flow risk, because a single exposure to risk must be chosen to provide a basis on which to allocate a net amount to multiple hedged items.

448. The Board considered alternative approaches that would require amortizing the hedge accounting adjustments to earnings based on the average holding period, average maturity or duration of the items in the hedged portfolio, or in some other manner that would not allocate adjustments to the individual items in the hedged portfolio. The Board rejected those approaches because determining the carrying amount for an individual item when it is (a) impaired or (b) sold, settled, or otherwise removed from the hedged portfolio would ignore its related hedge accounting adjustment, if any. Additionally, it was not clear how those approaches would work for certain portfolios, such as a portfolio of equity securities.

449. Advocates of macro hedging generally believe that it is a more effective and efficient way of managing an entity's risk than hedging on an individual-item basis. Macro hedging seems to imply a notion of entity-wide risk reduction. The Board also believes that permitting hedge accounting for a portfolio of dissimilar items would be appropriate only if risk were required to be assessed on an entity-wide basis. As discussed in paragraph 357, the Board decided not to include entity-wide risk reduction as a criterion for hedge accounting.

450. Although this Statement does not accommodate designating a portfolio of dissimilar items as a hedged item, the Board believes that its requirements are consistent with (a) the hedge accounting guidance that was in Statements 52 and 80, (b) what the Board generally understands to have been current practice in accounting for hedges not addressed by those Statements, and (c) what has been required by the SEC staff. The Board's ultimate goal of requiring that all financial instruments be measured at fair value when the conceptual and measurement issues are resolved would better accommodate risk management for those items on a portfolio basis. Measuring all financial instruments at fair value with all gains or losses recognized in earnings would, without accounting complexity, faithfully represent the results of operations of entities using sophisticated risk management techniques for hedging on a portfolio basis.

#### **Items the Exposure Draft Prohibited from Designation as Hedged Items in Fair Value Hedges**

451. The Exposure Draft proposed to prohibit the following from being designated as a hedged item in a fair value hedge:

- a. Oil or gas that has not yet been produced, unmined mineral ore, an agricultural product in process of growing, and similar items
- b. An intangible asset
- c. An investment accounted for by the equity method
- d. Mortgage servicing rights not recognized as assets in accordance with FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*
- e. A lease, as defined in FASB Statement No. 13, *Accounting for Leases*
- f. A liability for insurance contracts written, as defined and discussed in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, except for a financial guarantee.

The Board proposed those exclusions, in part, because of concerns about the reliability of available measures of fair values for those items. However, this Statement focuses on changes in the fair value of a hedged item attributable to the risk being hedged, rather than the entire change in the fair value of a hedged item. That shift in focus somewhat mitigated the Board's concerns about determining changes in fair value for those hedged items. The Board agrees with respondents to the Exposure Draft that eligibility for designation as a hedged item should rely on the fair value hedge criteria. Consequently, the Board decided to remove the prohibitions proposed in the Exposure Draft, some of which are discussed further in the following paragraphs. The Board notes, however, that some intangible assets would fail to qualify for hedge accounting because they are neither recognized assets nor firm commitments and would not meet the criterion that requires that the hedged item embody an exposure that could affect reported earnings.

### **Oil or Gas That Has Not Been Produced and Similar Items**

452. The Board decided to permit designating as a hedged item in a fair value hedge oil or gas that has not been produced, unmined mineral ore, agricultural products in process of growing, and similar items. In reconsidering whether to specifically prohibit such items from hedge accounting, the Board addressed issues such as (a) whether the costs capitalized to extract, harvest, or mine those items would qualify as a "recognized" asset (one of the criteria for a fair value hedge), (b) whether the amounts recognized for those items bear a close relationship to their fair values, and (c) whether the offset test could ever be met because, for example, extracting and otherwise turning unproduced oil or gas into a salable product would require significant costs. The unproduced oil or gas thus is a different asset from the product upon which a forward sales contract would be based. The Board also considered limiting qualification as a "recognized asset or liability" to those assets and liabilities whose initial recorded amounts represent their fair value at acquisition or incurrence.

453. The Board ultimately decided that hedge accounting qualification for oil or gas that has not been produced, unmined mineral ore, agricultural products in process of growing, and similar items should be consistent—that is, all of them should be either eligible or ineligible for designation as a hedged item. It decided that such items should be eligible for designation, subject to the other criteria for hedge accounting. However, the Board has significant reservations about how the fair value of such items would be determined and how the effectiveness of a fair value hedge of such items would be assessed. It notes that oil or gas that has not yet been produced, unmined mineral ore, agricultural products in the process of growing, and similar items are not final, salable products. Consequently, a derivative based on a final, salable product has a different basis than the hedged item and may not be highly effective at providing offsetting changes in fair value. It would be more likely that such a derivative would be highly effective at providing offsetting cash flows for the forecasted sale of a product made from oil in the ground, for example. Section 2 of Appendix A provides additional discussion and examples on assessing offset for agricultural products in the process of growing and similar items.

### ***Leases***

454. In developing the Exposure Draft, the Board had concerns about the consistency of permitting fair value hedge accounting of a specific risk inherent in a lessor's net investment in a direct financing, sales-type, or leveraged lease (for example, the interest rate risk associated with the minimum lease payments but not the unguaranteed residual value). Under Statement 13, the unguaranteed residual value is viewed simply as a final payment on which income is earned during the lease term. The Board ultimately decided to make all recognized assets and liabilities and unrecognized firm commitments related to leases eligible for designation as hedged items in fair value hedges because it believes that the modification to the Exposure Draft to permit designation of a portion of an item as being hedged would enable a lessor to split out the residual value from its net investment in identifying the hedged item. However, an entity may not designate an operating lease that does not qualify under this Statement's definition of a firm

commitment as a hedged item in a fair value hedge because a hedged item must be either a recognized asset or liability or a firm commitment as defined in this Statement.

***Investment Accounted for by the Equity Method***

455. The Board decided to retain the prohibition in the Exposure Draft from designating an investment accounted for by the equity method as a hedged item to avoid conflicts with the existing accounting requirements for that item. Providing fair value hedge accounting for an equity method investment conflicts with the notion underlying APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. Opinion 18 requires an investor in common stock and corporate joint ventures to apply the equity method of accounting when the investor has the ability to exercise significant influence over the operating and financial policies of the investee. Under the equity method of accounting, the investor generally records its share of the investee's earnings or losses from its investment. It does not account for changes in the price of the common stock, which would become part of the basis of an equity method investment under fair value hedge accounting. Changes in the earnings of an equity method investee presumably would affect the fair value of its common stock. Applying fair value hedge accounting to an equity method investment thus could result in some amount of double counting of the investor's share of the investee's earnings. The Board believes that result would be inappropriate. In addition to those conceptual issues, the Board was concerned that it would be difficult to develop a method of implementing fair value hedge accounting, including measuring hedge ineffectiveness, for equity method investments and that the results of any method would be difficult to understand. For similar reasons, this Statement also prohibits fair value hedge accounting for an unrecognized firm commitment to acquire or dispose of an investment accounted for by the equity method.

***Other Exclusions***

456. For reasons similar to those discussed above, the Board also decided to specifically prohibit designation of (a) a minority interest in one or more consolidated subsidiaries and (b) an equity investment in a consolidated subsidiary as the hedged item in a fair value hedge. Those assets do not qualify for designation as a hedged item in a fair value hedge, and a forecasted transaction to acquire or sell them does not qualify as a hedged transaction in a cash flow hedge. Thus, a firm commitment to acquire or sell one of them also does not qualify as a hedged item in a fair value hedge. For the same reason, a firm commitment to enter into a business combination does not qualify as a hedged item in a fair value hedge.

457. This Statement also specifically prohibits an equity instrument classified by an entity in its stockholders' equity in the statement of financial position from being designated as a hedged item. That prohibition is consistent with the requirements that (a) a hedged item be a recognized asset or liability and (b) the hedged item present an exposure to changes in fair value that could affect reported earnings. That prohibition does not, of course, apply to the holder of an equity instrument. Paragraph 286 discusses the application of this Statement to obligations (or rights) that may be settled in an entity's own stock but that are indexed to something other than that

stock.

## **Additional Qualifying Criteria for Cash Flow Hedges**

### **Specific Identification**

458. To qualify for cash flow hedge accounting, this Statement requires that an entity specifically identify the forecasted transaction that gives rise to the cash flow exposure. That information is necessary to (a) assess the likelihood that the transaction will occur, (b) determine if the cumulative cash flows of the designated derivative are expected to be highly effective at offsetting the change in expected cash flow of the forecasted transaction attributable to the risk being hedged, and (c) assess the hedge's effectiveness on an ongoing basis. The expected market price of the transaction, both at inception of the hedge and subsequently, is necessary information to determine the change in expected cash flows. Because the circumstances of each entity and transaction are different, the information needed to assess the expected offset may vary.

### **Single Transaction or Group of Individual Transactions**

459. The Exposure Draft would have required that an entity be able to predict the date on which a forecasted transaction will occur for it to qualify for cash flow hedge accounting. The Exposure Draft also would have required the gain or loss on a derivative that hedges a forecasted transaction to be reclassified into earnings on the date that the forecasted transaction was expected to occur. This Statement instead requires the gain or loss on a hedge of a forecasted transaction to be reclassified into earnings in the same period(s) that the hedged transaction affects earnings. That change makes it less important for an entity to be able to predict the exact date on which a hedged forecasted transaction will occur. The Board decided to require 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. 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, the Board does not consider it necessary to 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 to prevent such after-the-fact designation.

460. The following example illustrates the requirement for specific identification of the hedged transaction. Company 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 Company A is already committed but the precise timing of which has not yet been determined. To qualify for cash flow hedge accounting, Company 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.

461. The Board understands that 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. The Board decided that an entity should be permitted to aggregate individual forecasted transactions for hedging purposes in some circumstances. As for a hedge of a single forecasted transaction, an entity must identify the hedged transactions with sufficient specificity that it is possible to determine which transactions are hedged transactions when they occur. 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.

462. To qualify for hedging as a group rather than individually, the aggregated transactions must share the risk exposure for which they are being hedged. If a forecasted transaction does not share the risk exposure for which the group of items is being hedged, it should not be part of the group being hedged. The Board considers that requirement to be necessary to ensure that a single derivative will be effective as a hedge of the aggregated transactions. To illustrate, under the guidance in this Statement, a single derivative of appropriate size could be designated as hedging a given amount of aggregated forecasted transactions such as 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.

However, the transactions in each group must share the risk exposure for which they are being hedged. For example, the interest payments in group (c) above must vary with the same index to qualify for hedging with a single derivative. In addition, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions. Although they may be based on the same underlying, they have opposite exposures.

### **Probability of a Forecasted Transaction**

463. The Board concluded that, similar to Statement 80, changes in the fair value of a derivative should be excluded from current earnings only if the related forecasted transaction is probable. An assessment of the likelihood that a forecasted transaction will take place 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).

464. The term *probable* is used in this Statement consistent with its use in paragraph 3 of FASB Statement No. 5, *Accounting for Contingencies*, which defines *probable* as an area within a range of the likelihood that a future event or events will occur confirming the fact of the loss. That range is from probable to remote, as follows:

*Probable.* The future event or events are likely to occur.

*Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.

*Remote.* The chance of the future event or events occurring is slight.

The term *probable* requires a significantly greater likelihood of occurrence than the phrase *more likely than not*.

465. In addition, the Board believes that 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, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be needed to support an assertion that it is probable. For example, a transaction forecasted to occur in five years may be less likely than a transaction forecasted to occur in one year. However, forecasted interest payments for the next 20 years on variable-rate debt typically would be probable if supported by an existing contract. Additionally, other factors being equal, 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. For example, less evidence generally would be needed to support forecasted sales of 100,000 units in a particular month than would be needed to support forecasted sales of 950,000 units in that month by an entity, even if its sales have averaged 950,000 units per month for the past 3 months.

## **Contractual Maturity**

466. When an entity enters into a hedge that uses a derivative with a maturity that extends approximately to the date the forecasted transaction is expected to occur, the derivative "locks in" a price or rate for the entire term of the hedge, provided that the hedging instrument is held to its maturity. Consistent with that view, the Exposure Draft proposed that, to qualify for hedge accounting, the contractual maturity or repricing date of the derivative must be on or about the same date as the projected date of the hedged forecasted transaction.

467. Respondents to the Exposure Draft objected to that requirement because it would have precluded rollover strategies and hedges of a portion of the term of a forecasted transaction from qualifying for hedge accounting. A rollover strategy involves establishing over time a series of short-term futures, options, or both in consecutive contract months to hedge a forecasted transaction. In a rollover strategy, the complete series of derivatives is not acquired at the inception of the hedge; rather, short-term derivatives are initially acquired as part of a plan to replace maturing derivatives with successive new short-term hedging derivatives. The Exposure Draft explained the Board's belief that, even though an entity may ultimately achieve the same or similar result with a series of short-term contracts, a single short-term derivative by itself does not lock in a price or rate for the period until the forecasted transaction is expected to occur.

468. The Board decided to remove the maturity criterion and thus to permit hedge accounting for rollover strategies. Respondents asserted that those strategies are a common, cost-effective, risk management practice that may achieve results similar to the results of using a single long-term derivative as the hedging instrument. Although the Board notes that a rollover strategy or other hedge using a derivative that does not extend to the transaction date does not necessarily "fix" the price of a forecasted transaction, it decided to accede to respondents' requests to permit hedge accounting for rollover strategies. The Board also decided that removing the maturity criterion was acceptable because it makes the qualifying requirements for fair value and cash flow hedge accounting more consistent. Prohibiting hedges of a portion of a forecasted transaction term from qualifying for cash flow hedge accounting would have been inconsistent with permitting fair value hedge accounting for hedges of a portion of the life of a hedged asset or liability.

## **Transaction with External Third Party**

469. The Exposure Draft proposed that, to qualify for hedge accounting, a hedged forecasted exposure must be a *transaction*, which Concepts Statement 6 defines as an external event involving transfer of something of value (future economic benefit) between two (or more) entities. That definition was intended to clearly distinguish a transaction from an internal cost allocation or an event that happens within an entity. The Exposure Draft explained that the Board considers hedge accounting to be appropriate only when there is a hedgeable risk arising from a transaction with an external party. Accounting allocations and intercompany transactions, in and of themselves, do not give rise to economic exposure.

470. A number of respondents to the Exposure Draft objected to the requirement that a hedgeable transaction be with an external party because it prohibited an intercompany transaction, including one denominated in a foreign currency, from being designated as a forecasted transaction and afforded hedge accounting.

471. Although the requirements of this Statement are not described in terms of the Concepts Statement 6 definition of a *transaction*, the requirements for hedges of other than foreign currency risk are the same as in the Exposure Draft. As discussed in paragraphs 482–487, the Board decided to accommodate cash flow hedges of the foreign currency risk in forecasted intercompany foreign currency transactions. However, for other than foreign currency hedges, this Statement requires that a forecasted transaction be with a party external to the reporting entity to qualify as a hedged transaction, which is consistent with the Exposure Draft. Therefore, depreciation expense, cost of sales, and similar internal accounting allocations do not qualify as hedgeable forecasted transactions. Forecasted transactions between members of a consolidated entity, except for intercompany transactions denominated in a foreign currency, are not hedgeable transactions except for purposes of separate stand-alone subsidiary financial statements. Thus, a consolidated entity cannot apply hedge accounting to forecasted intercompany transactions, unless the risk being hedged is a foreign currency exposure. A subsidiary could, however, apply hedge accounting to a hedge of a forecasted intercompany transaction in its separate, stand-alone financial statements because those transactions are with a party "external to" the reporting entity in those stand-alone statements.

#### **Forecasted Transactions Prohibited from Designation as the Hedged Item in a Cash Flow Hedge**

72. This Statement prohibits cash flow hedge accounting for forecasted transactions involving (a) an entity's interests in consolidated subsidiaries, (b) minority interests in consolidated subsidiaries, (c) investments accounted for by the equity method, or (d) an entity's own equity instruments classified in stockholders' equity. The reasons for those prohibitions are similar to those for prohibiting the same items from being hedged items in fair value hedges, as discussed in paragraphs 455–457. In addition, the Board noted that implementing cash flow hedge accounting for those items could present significant practical and conceptual problems, such as determining when to transfer to earnings amounts accumulated in other comprehensive income. Finally, certain of those items, such as issuances and repurchases of an entity's own equity instruments, would not qualify for hedge accounting because they do not present a cash flow risk that could affect earnings.

473. Prohibiting the forecasted purchase of a consolidated subsidiary from being the hedged item in a cash flow hedge effectively prohibits cash flow hedge accounting for a forecasted business combination to be accounted for as a purchase, and paragraph 29(f) of this Statement makes that prohibition explicit. The Board noted that the current accounting for a business combination is based on considering the combination as a discrete event at the consummation date. Applying cash flow hedge accounting to a forecasted business combination would be

inconsistent with that current accounting. It also would be, at best, difficult to determine when to reclassify the gain or loss on the hedging derivative to earnings.

### **Foreign Currency Hedges**

474. The Board's objectives in providing hedge accounting for hedges of foreign currency exposures are the following:

- a. To continue to permit hedge accounting for the types of hedged items and hedging instruments that were permitted hedge accounting under Statement 52
- b. To increase the consistency of hedge accounting guidance for foreign currency hedges and other types of hedges by broadening the scope of foreign currency hedges that are eligible for hedge accounting, as necessary.

### **Carried Forward from Statement 52**

475. Because the scope of this project did not include a comprehensive reconsideration of accounting for foreign currency translation, this Statement makes two exceptions to retain certain provisions of Statement 52. The Board decided to make those exceptions to the hedge accounting requirements in this Statement because of the accounting anomalies that otherwise would be created by this Statement and the existing guidance in Statement 52.

476. Although the Board decided not to extend hedge accounting to nonderivative instruments used as hedging instruments, as discussed in paragraphs 246 and 247, it decided to permit an entity to designate a nonderivative financial instrument denominated in a foreign currency as a hedge of a firm commitment. It did so for practical reasons. The Board understands that such hedges are extensively used in practice, and it does not think constituents would understand why that practice should be prohibited now, given the acceptance of it in Statement 52.

477. This Statement also makes an exception to permit an entity to designate a financial instrument denominated in a foreign currency (derivative or nonderivative) as a hedge of the foreign currency exposure of a net investment in a foreign operation. Net investment hedges are subject only to the criteria in paragraph 20 of Statement 52. The net investment in a foreign operation can be viewed as a portfolio of dissimilar assets and liabilities that would not meet the criterion in this Statement that the hedged item be a single item or a group of similar items. Alternatively, it can be viewed as part of the fair value of the parent's investment account. Under either view, without a specific exception, the net investment in a foreign operation would not qualify for hedging under this Statement. The Board decided, however, that it was acceptable to retain the current provisions of Statement 52 in that area. The Board also notes that, unlike other hedges of portfolios of dissimilar items, hedge accounting for the net investment in a foreign operation has been explicitly permitted by the authoritative literature.

478. The Exposure Draft would have retained the approach required by paragraph 20 of

Statement 52 for measuring the effective portion of a foreign currency forward contract that is designated as a hedge of the net investment in a foreign operation. The resulting difference between the effective portion and the change in fair value of the hedging derivative would have been reported currently in earnings. The approach in Statement 52 was appropriate given how forward contracts were measured under that Statement. Unlike Statement 52, this Statement requires that forward contracts be measured at fair value, which incorporates discounting future cash flows. Accordingly, the Exposure Draft's requirements would have always produced an amount to be recognized in earnings that would have been of opposite sign to the effective portion recognized in the cumulative translation adjustment component of other comprehensive income. That amount could have been explained only in terms of the arithmetic process that produced it. The Board therefore decided that the effective portion of a forward contract that is a hedge of a net investment should be determined not by looking only to changes in spot rates but should include the effects of discounting in the same way as for forward contracts used in other foreign currency hedges.

***Fair Value Hedges of Foreign Currency Risk in Available-for-Sale Securities***

479. This Statement permits the portion of the change in value of foreign-currency-denominated debt securities and certain foreign marketable equity securities classified as available-for-sale that is attributable to foreign exchange risk to qualify for fair value hedge accounting. The requirements of this Statement in that area are generally consistent with the provisions of EITF Issues No. 96-15, "Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities," and No. 97-7, "Accounting for Hedges of the Foreign Currency Risk Inherent in an Available-for-Sale Marketable Equity Security." However, unlike those EITF Issues, this Statement does not permit a nonderivative instrument to be used as the hedging instrument in a hedge of an available-for-sale security.

480. Foreign available-for-sale debt securities give rise to hedgeable foreign exchange risk because they embody cash flows denominated in a foreign currency. The cash flows embodied in an investment in a marketable equity security, on the other hand, are not inherently "denominated" in a particular currency. Therefore, both the EITF and the Board concluded that a marketable equity security has hedgeable foreign exchange risk only if both of the following criteria are met:

- a. The marketable equity security (or an instrument that represents an interest in it, such as an American Depository Receipt) is not traded on an exchange (or other established marketplace) on which trades are denominated in the investor's functional currency.
- b. The dividends or other cash flows to be received by the investor are all denominated in the same foreign currency as the currency expected to be received upon sale of the security.

Regardless of the country in which the issuer of an equity security is domiciled, that security presents no discernible foreign exchange risk to a holder who may trade the security for a price denominated in its functional currency. For example, for an investor with a U.S. dollar

functional currency, its foreign exchange risk related to the equity securities of a multinational company domiciled in Italy that trade on a U.S. exchange is essentially the same as its foreign exchange risk in the equity securities of a U.S. company with significant foreign operations in Italy. In both situations, the investor's foreign exchange risk is indirect and not reliably measurable. The operations of the issuer rather than the prices in which trades in its equity securities are denominated are the source of the investor's foreign exchange risk.

### **Broadening of Statement 52**

481. Unlike Statement 52, this Statement permits hedge accounting for hedges of forecasted foreign currency transactions, including intercompany transactions. Because this Statement permits hedge accounting for hedges of forecasted interest rate, credit, and market price exposures, the Board considered it appropriate to include foreign currency exposures as well. Forecasted intercompany foreign currency transactions are discussed in the following paragraphs.

#### ***Forecasted Intercompany Foreign Currency Transactions***

482. This Statement permits an entity to designate the foreign currency exposure of a forecasted foreign-currency-denominated intercompany transaction as a hedged transaction in a cash flow hedge. The Exposure Draft proposed that, in general, forecasted transactions between members of a consolidated group would not qualify as hedgeable exposures in the consolidated financial statements. However, if costs are incurred in one currency and the third-party revenues for recovering those costs are generated in another currency, the Exposure Draft would have permitted the entity that incurred the costs to designate the forecasted third-party revenues as a hedged transaction. The Exposure Draft would have required a direct, substantive relationship between the costs incurred and the recovery of those costs from the outside third party. For example, the Exposure Draft would have permitted an English subsidiary that incurs manufacturing costs in pounds sterling to hedge the ultimate sale of that product for French francs by its affiliated French subsidiary to an unrelated third party. The Board proposed that exception because it considered those transactions to be, in substance, direct foreign export sales.

483. A number of respondents said that the guidance provided in the Exposure Draft was unduly restrictive because forecasted intercompany royalties and licensing fees, which are based on third-party sales and remitted from foreign subsidiaries to a parent company, would not be afforded cash flow hedge accounting. Respondents also took exception to the requirement that there be a "direct, substantive relationship" between costs incurred and recovery of those costs.

484. The Board decided to remove the restrictions on hedge accounting for hedges of forecasted intercompany foreign currency transactions because, pursuant to Statement 52 as amended by this Statement, an intercompany transaction that is denominated in a currency other than the entity's functional currency gives rise to a transaction gain or loss if exchange rates change. A forecasted intercompany transaction that is expected to be denominated in a foreign currency can be viewed as giving rise to the same kind of foreign currency risk. Therefore, pursuant to this

Statement, a forecasted intercompany transaction that presents an exposure to foreign currency risk and that otherwise satisfies the criteria for a foreign currency cash flow hedge is eligible for designation as a hedged transaction.

485. As with other hedges of forecasted transactions, amounts accumulated in other comprehensive income for a forecasted foreign currency transaction are to be recognized in earnings in the same period or periods that the hedged transaction affects earnings. Because an intercompany dividend does not affect earnings, a forecasted intercompany dividend cannot qualify as a hedgeable forecasted transaction. In essence, a hedge of a forecasted intercompany dividend expected to be paid from future earnings is a hedge of those future earnings. This Statement prohibits hedge accounting for hedges of future earnings.

486. The Board also made an exception for forecasted intercompany foreign currency transactions because hedging foreign currency intercompany cash flows with foreign currency options is a common practice among multinational companies—a practice that was permitted in specified circumstances under EITF Issue No. 91-1, "Hedging Intercompany Foreign Currency Risks." This Statement modifies Issue 91-1 to permit hedge accounting for intercompany transactions using other derivatives, such as forward contracts, as the hedging instrument and expands the situations in which hedge accounting may be applied because the Board believes the accounting for all derivative instruments should be the same.

487. For a hedge of a forecasted foreign currency transaction to qualify for hedge accounting, this Statement requires that the component of the entity that has the foreign currency exposure be a party to the hedging transaction. That requirement is necessary because, under the functional currency approach in Statement 52, all foreign currency exposures exist only in relation to an entity's functional currency. Thus, for example, a U.S. parent company cannot directly hedge the foreign currency risk in its French franc subsidiary's U.S.-dollar-denominated export sales because the U.S. parent has no exposure to exchange risk for dollar-denominated sales. However, one component of a consolidated entity, such as a central treasury operation, can effectively take on another component's exchange risk by means of an intercompany transaction. For example, the U.S. parent (or a centralized treasury operation with a U.S. dollar functional currency) might enter into a forward contract to buy dollars from its French subsidiary in exchange for francs. The French subsidiary could designate that intercompany forward contract (in which the French subsidiary sells dollars for francs) as a hedge of its forecasted U.S.-dollar-denominated sales. The U.S. parent then would enter into a sell dollars–buy francs forward contract with an unaffiliated third party to offset its foreign exchange risk on the intercompany forward contract. That third-party transaction is required for the previous intercompany arrangement to qualify in the consolidated financial statements as a hedge of the French subsidiary's forecasted dollar sales. (As noted in paragraph 471, a parent company is a "third party" in a subsidiary's separate financial statements. Thus, the French subsidiary could designate the intercompany derivative as a hedge of its U.S. dollar sales in its stand-alone financial statements regardless of whether the parent has entered into an offsetting contract with an outside party.)

## **Discontinuing Hedge Accounting**

488. This Statement requires that an entity discontinue hedge accounting prospectively if the qualifying criteria are no longer met; if a derivative expires or is sold, terminated, or exercised; or if the entity removes the designation of the hedge. The Board believes hedge accounting is no longer appropriate in those circumstances. This Statement also requires certain modifications to hedge accounting for the interim reporting period in which a discontinuance occurs in circumstances discussed below.

## **Discontinuing Fair Value Hedge Accounting**

489. The Board is concerned that a fair value hedge that no longer qualifies as being highly effective at achieving offsetting changes in fair value for the risk being hedged may continue to receive hedge accounting simply because an entity fails to assess compliance with that effectiveness criterion on a sufficiently frequent basis. If an entity determines at the end of a period that a hedge is no longer effective, it is likely that it was also ineffective during a portion of that period. To minimize the possibility of providing hedge accounting for hedges that do not qualify as highly effective, the Board decided that fair value hedge accounting should not be provided from the point at which the hedge ceased to qualify. It believes that an entity will be able to determine the point at which a hedge became ineffective if it assesses compliance with the effectiveness criterion at the inception of the hedge, on a recurring basis, and whenever something happens that could affect the hedging relationship. The Board believes that immediate evaluation of the effect of relevant changes in circumstances on a hedge's qualification for hedge accounting should be an integral aspect of an ongoing assessment of compliance.

490. The Board expects that entities entering into hedging transactions that do not qualify for an assumption of automatic effectiveness and zero ineffectiveness under the criteria discussed in Appendix A will monitor hedge effectiveness frequently—often daily. However, the Board recognizes that it may not be cost-effective for some entities to assess compliance with the effectiveness criterion on a daily or weekly basis. It therefore decided that compliance should be assessed no less frequently than quarterly. However, if the event or change in circumstances that caused the hedging relationship to cease to qualify cannot be identified, the entity is prohibited from applying hedge accounting from the date at which compliance was last assessed and satisfied. Otherwise, a hedging relationship that does not satisfy the conditions for fair value hedge accounting might nevertheless receive such accounting.

491. For hedges of firm commitments, the Board decided that if hedge accounting is discontinued because the hedged item no longer meets the definition of a firm commitment, an entity should derecognize any previously recognized asset or liability and recognize a corresponding loss or gain in earnings. That accounting is appropriate because the asset or liability that represented the value of the firm commitment no longer exists if the hedged

transaction no longer qualifies as a firm commitment, for example, because performance is no longer probable. The Board believes those circumstances should be rare. 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.

### **Discontinuing Cash Flow Hedge Accounting**

492. The Exposure Draft proposed that if cash flow hedge accounting is discontinued, the derivative gain or loss accumulated in other comprehensive income to the date of discontinuance would be recognized in earnings on the originally projected date of the hedged forecasted transaction. That proposed requirement was intended to instill discipline in the accounting for cash flow hedges and reduce the possibility for managing of earnings. Respondents to the Exposure Draft disagreed with that provision as it related to discontinuances that resulted from a change in probability. They said that gains and losses previously recognized in other comprehensive income should be reclassified into earnings on the date it is decided that the forecasted transaction is no longer considered probable.

493. The Board considers it inappropriate to defer a gain or loss on a derivative that arises after a hedged forecasted transaction is deemed no longer probable. However, if the occurrence of the forecasted transaction is still reasonably possible, the Board considers it appropriate to continue to include in accumulated other comprehensive income the gain or loss that arose before the date the forecasted transaction is deemed no longer probable. The Board also was concerned that requiring a gain or loss in accumulated other comprehensive income to be reported in earnings when a forecasted transaction is no longer probable but still is reasonably possible (paragraph 464 describes the range of probability) would provide an entity with the opportunity to manage earnings by changing its estimate of probability. For those reasons, the Board decided to require earnings recognition of a related gain or loss in accumulated other comprehensive income only when an entity determines it is probable that the transaction will *not* occur.

494. A pattern of determining that hedged forecasted transactions probably will not occur 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.

### **Interaction with Standards on Impairment**

495. A hedged item may be reported at fair value as a consequence of applying the provisions of this Statement. That would occur if the carrying amount of the hedged item equaled its fair value at the inception of a hedge and all changes in the fair value of a hedged item were recognized as a result of hedge accounting. However, that is not the same as continuous measurement at fair value. Therefore, accounting for changes in the fair value of a hedged item attributable to the risk being hedged does not exempt the hedged item from accounting provisions of other Statements that apply to assets or liabilities that are not measured at fair

value. For example, a loan that is designated as a hedged item but is not otherwise measured at fair value or lower of cost or market value is subject to the impairment provisions of Statement 114.

496. Respondents to the Exposure Draft questioned whether the carrying amount of a derivative should be considered in assessing impairment of a related asset or liability, if any. (In this Statement, the term *impairment* includes the recognition of an increase in a liability as well as a decrease in an asset.) The related asset or liability would be either an existing asset or liability or an asset or liability that was acquired or incurred as a result of a hedged forecasted transaction.

497. The Board decided that it would be inappropriate to consider the carrying amount of a derivative hedging instrument in an assessment of impairment of a related asset or liability in either a fair value hedge or a cash flow hedge. To do so would be inconsistent with the fact that the derivative is a separate asset or liability.

498. This Statement provides that a derivative gain or loss recognized in accumulated other comprehensive income as a hedge of a variable cash flow on a forecasted transaction is to be reclassified into earnings in the same period or periods as the offsetting loss or gain on the hedged item. For example, a derivative gain that arose from a cash flow hedge of a purchase of equipment used in operations is to be included in earnings in the same periods that depreciation on the equipment is recognized. The net effect on earnings should be the same as if the derivative gain or loss had been included in the basis of the asset or liability to which the hedged forecasted transaction relates. To be consistent with that provision, the Board decided that a derivative gain that offsets part or all of an impairment loss on a related asset or liability should be reclassified into earnings in the period that an impairment loss is recognized. Similarly, a related derivative loss, if any, in accumulated other comprehensive income should be reclassified into earnings in the same period that a recovery of a previous impairment loss is recognized. The Board decided that the reason that a loss or gain on a hedged asset or liability is recognized in income—for example, whether through an ordinary depreciation charge or an impairment write-down—should not affect the reclassification into earnings of a related offsetting gain or loss in accumulated other comprehensive income.

### **Current Earnings Recognition of Certain Derivative Losses**

499. The Board sees no justification for delaying recognition in earnings of a derivative loss that the entity does not expect to recover through revenues related to the hedged transaction. Accordingly, this Statement prohibits continuing to report a loss in accumulated other comprehensive income if the entity expects that doing so would lead to recognizing a net loss on the combined hedging instrument and the hedged transaction in a future period(s). For example, a loss on a derivative designated as a hedge of the forecasted purchase of inventory should be recognized in earnings immediately to the extent that the loss is not expected to be recovered through future sales of the inventory. Statements 52 and 80 included the same requirement.

## **Accounting by Not-for-Profit Organizations and Other Entities That Do Not Report Earnings**

500. This Statement applies to all entities, including not-for-profit organizations, defined benefit pension plans, and other entities that do not report earnings as a separate caption in a statement of financial performance. For example, a not-for-profit entity reports the total change in net assets during a period, which is analogous to total comprehensive income for a business enterprise. The Exposure Draft indicated that cash flow hedge accounting would not be available to an entity that does not report earnings. A few respondents objected to what they interpreted as the Exposure Draft's unequal treatment of not-for-profit and other entities that do not report earnings. They did not consider it fair to deny those entities access to hedge accounting for hedges of forecasted transactions.

501. The effect of cash flow hedge accounting is to report a derivative gain or loss in other comprehensive income—that is, outside earnings—in the period in which it occurs and then to reclassify that gain or loss into earnings in a later period. It thus would be mechanically impossible for an entity that only reports an amount comparable to total comprehensive income to apply cash flow hedge accounting. For this Statement to permit a not-for-profit entity, for example, to apply cash flow hedge accounting, the Board would first have to define a subcomponent of the total change in net assets during a period that would be analogous to earnings for a business enterprise. Neither Concepts Statement 6 nor Statement 117 defines such a measure of operating performance for a not-for-profit entity, and an attempt to define that measure was beyond the scope of the project that led to this Statement. Accordingly, the Board decided to retain the provision that cash flow hedge accounting is not available to a not-for-profit or other entity that does not report earnings as a separate caption in a statement of financial performance.

## **Disclosures**

502. This Statement supersedes Statements 105 and 119, both of which provided disclosure guidance for derivatives and financial instruments. Consistent with its objective of making the guidance on financial reporting related to derivatives easier to use, the Board decided that this Statement should provide comprehensive disclosure guidance, as well as recognition and measurement guidance, for derivatives. This Statement therefore carries forward from Statement 119 the requirement for disclosure of a description of the objectives, context, and strategies for holding or issuing derivatives. The purpose of that disclosure is to "help investors and creditors understand what an entity is trying to accomplish with its derivatives" (Statement 119, paragraph 58). The Board also decided to require additional qualitative disclosures describing an entity's risk management policy and the items or transactions and the risks being hedged for each type of hedge. The Board believes the qualitative disclosures are necessary to assist investors, creditors, and other users of financial statements in understanding the nature of an entity's derivative activities and in evaluating the success of those activities, their importance to the entity, and their

effect on the entity's financial statements. Many respondents to the Exposure Draft supported the qualitative disclosures.

503. This Statement modifies some of the disclosure requirements from the Exposure Draft, mostly as a result of changes to the accounting requirements proposed in the Exposure Draft. Notwithstanding the modifications, the Board decided to retain many of the disclosure requirements in the Exposure Draft given the extent of use and complexity of derivatives and hedging activities and because many users of financial statements have asked for improved disclosures.

504. A few respondents to the Task Force Draft suggested that both the qualitative and the quantitative disclosures should distinguish between derivatives used for risk management based on the type of risk (for example, interest rate risk, foreign currency risk, or credit risk) being hedged rather than based on accounting designations (for example, fair value hedges versus cash flow hedges). Those respondents said that disclosures organized in that manner, perhaps including even narrower distinctions such as the type of asset or liability that is hedged, would better aid the financial statement user in understanding an entity's success in managing the different types of risk that it encounters.

505. The Board agreed that disclosures presented in a manner that distinguishes between the nature of the risk being hedged would provide useful information that would help users understand management's risk management strategies. However, the Board decided not to require that disclosures about derivative instruments be organized in the manner suggested by those respondents. The Board made that decision somewhat reluctantly, based primarily on its concern that it could not require such disclosures without additional study and that such a requirement would necessitate a greater level of detail than the disclosures required by this Statement. Distinguishing between derivatives based on their accounting designation, as this Statement requires, helps users understand the information provided in the financial statements. Information about derivatives used in fair value hedges, cash flow hedges, hedges of the net investment in a foreign operation, and for other purposes likely would be needed even if the disclosures distinguished between derivatives based on the type of risk being hedged. The result could be a rather complicated multilevel set of disclosures. The Board also notes that this Statement requires disclosures about the risks that management hedges with derivatives as part of the description of the "context needed" to understand the entity's objectives for holding or issuing those instruments. The Board encourages companies to experiment with ways in which disclosures about derivative instruments, including how the gains and losses on them relate to other exposures of the entity, might be presented to make them more understandable and useful.

506. In response to comments about the volume of the proposed disclosure requirements in both the Exposure Draft and the Task Force Draft, the Board reconsidered the costs and benefits of the proposed disclosures. In reconsidering the proposed disclosures, the Board concluded that by eliminating certain of the requirements, it could reduce the cost of applying the Statement without a significant reduction in the benefits to users. Consequently, the following proposed

disclosures were eliminated:

- a. Amount of gains and losses on hedged items and on related derivatives recognized in earnings for fair value hedges
- b. Description of where in the financial statements hedged items and the gains and losses on those hedged items are reported
- c. Cumulative net unamortized amount of gains and losses included in the carrying amount of hedged items
- d. Separate amounts for the reporting period of hedging gains and hedging losses on derivatives not recognized in earnings for cash flow hedges
- e. Description of where derivatives related to cash flow hedges are reported in the statement of financial position
- f. Separate amounts for the reporting period of gains and losses on the cash flow hedging instrument
- g. Amount of gains and losses recognized during the period on derivatives not designated as hedges
- h. Beginning and ending balances in accumulated other comprehensive income for accumulated derivative gains and losses, and the related current period changes, separately for the following two categories: (1) gains and losses related to forecasted transactions for which the variability of hedged future cash flows has ceased and (2) gains and losses related to forecasted transactions for which that variability has not ceased
- i. Description of where gains and losses on derivatives not designated as hedges are reported in the statement of income or other statement of financial performance.

In addition, the Board replaced some of the remaining proposed disclosures requiring separate amounts of *gains and losses* with disclosures requiring the amount of *net gain or loss*.

507. The Board also modified the disclosure requirements as a result of changes to the accounting for fair value and cash flow hedges. Those modifications include:

**Modification to Hedge Accounting**

**Resulting Modification to Disclosure**

- |  |   |
|--|---|
| <ol style="list-style-type: none"><li>a. Require an entity to determine how to assess hedge effectiveness and to report all hedge ineffectiveness in earnings.</li><li>b. Require gains and losses included in accumulated other comprehensive income to be reclassified into earnings when the forecasted transaction affects</li></ol> | <p>Add a requirement to disclose the net amount of hedge ineffectiveness recognized in earnings and the component of the derivative's gain or loss excluded from the assessment of hedge effectiveness and included directly in earnings.</p> <p>Replace proposed disclosure of designated reporting periods in which forecasted transactions are expected to occur and the amounts to be reclassified into earnings in</p> |
|--|---|

earnings.

those periods with a description of the transactions or other events that will result in reclassification into earnings of gains and losses that are reported in accumulated other comprehensive income and the estimated net amount of existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months.

- c. Require gain or loss included in accumulated other comprehensive income to be reclassified into earnings when it is probable that a hedged forecasted transaction will not occur.

Require disclosure of gross gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the forecasted transactions will not occur.

508. Certain respondents were concerned that some of the cash flow hedge disclosures would reveal proprietary information that could be used by competitors and market participants, putting the disclosing entity at a competitive disadvantage. The Board carefully considered those concerns and decided that the ability of traders and competitors to use the cash flow hedge disclosures to determine an entity's competitively sensitive positions would be significantly limited by an entity's ability to designate and dedesignate derivative instruments as cash flow hedges during the reporting period, the aggregate nature of the cash flow hedging disclosures, and the timing and frequency of those disclosures. Notwithstanding that conclusion, the Board notes that the following modifications to the disclosures proposed in the Exposure Draft and the Task Force Draft are directly responsive to the competitive harm concerns raised by some respondents:

- a. Elimination of the proposed disclosure of the separate amounts for the reporting period of hedging gains and hedging losses on the derivatives not recognized in earnings
- b. Replacement of the proposed disclosure of the designated reporting periods in which the forecasted transactions are expected to occur and the amounts of gains and losses to be reclassified to earnings in those periods with a description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in accumulated other comprehensive income, and the estimated net amount of the existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months
- c. Elimination of the proposed disclosure of the separate amounts for the reporting period of gains and losses on the cash flow hedging instruments
- d. Elimination of the proposed disclosure of the beginning and ending balances in accumulated other comprehensive income for accumulated derivative gains and losses, and the related current period changes, separately for the following two categories: gains and losses related

to forecasted transactions for which the variability of hedged future cash flows has ceased and gains and losses related to forecasted transactions for which the variability of hedged future cash flows has not ceased

- e. Replacement of some of the remaining proposed disclosures of separate amounts of *gains and losses* with disclosure of the amount of *net gain or loss*.

The Board believes the required cash flow hedge disclosures, as modified, provide necessary information in helping financial statement users assess the effect on the financial statements of an entity's cash flow hedge strategies.

509. This Statement also amends Statement 107 to carry forward the provision in Statement 119 that encourages disclosure of quantitative information about market risk. That provision has been revised to clarify that it applies to all financial instruments—not just to derivatives. The Board believes that disclosure will provide useful information to users of financial statements about the overall market risk of an entity's financial instruments. The Board is encouraging, rather than requiring, that information because it continues to believe that ". . . the continuing evolution of approaches to risk management limits the ability to clearly define the most useful approach to disclosing quantitative information about market risks" (Statement 119, paragraph 72). The Board observes that the SEC issued final rules <sup>33</sup> in January 1997 that require certain registrants to make quantitative disclosures of market risk similar to those encouraged by Statement 119.

510. The Board decided that disclosures about concentrations of credit risk previously included in Statement 105 should continue to be required because a number of constituents, including some regulators, have commented on their usefulness. The purpose of those disclosures is to allow "investors, creditors, and other users to make their own assessments of the credit risk associated with the area of concentration" (Statement 105, paragraph 100). The Board decided to modify the disclosure about concentrations of credit risk to require that the amount disclosed be based on the gross fair value of the financial instruments rather than the "amount of the accounting loss" (described in Statement 105, paragraph 20(b)). Preparers found "the amount of the accounting loss" to be confusing, and users of financial statements have stated that fair value information provides a better indication of the credit exposure arising from financial instruments. The disclosure was also modified to require information about an entity's master netting arrangements and their effect on the maximum amount of loss due to credit risk. The Board believes that information provides users with important insight into the potential impact of those arrangements on concentrations of credit risk of an entity.

511. The Board considered either leaving the disclosures about concentrations of credit risk in Statement 105 or including them in this Statement. The Board decided not to retain them in Statement 105 because this Statement supersedes all other guidance in that Statement. The Board decided not to include those disclosures in this Statement because they refer to all financial instruments and this Statement addresses derivative instruments. The Board decided instead to amend Statement 107 to include those disclosures so that all disclosure requirements

that apply to all financial instruments will be available in one place.

512. Certain other requirements from Statements 105 and 119 have been deleted, including disclosure of the "face or contract amount" for all derivative financial instruments held at the balance sheet date (Statement 105, paragraph 17, and Statement 119, paragraph 8). The Board originally required that disclosure, in part, to provide users with "information [that] conveys some of the same information provided by amounts recognized for on-balance-sheet instruments" (Statement 105, paragraph 89). That disclosure also provided an indication "of the volume of derivative activity" (Statement 119, paragraph 79). This Statement's requirement that all derivatives be recognized in the statement of financial position at fair value lessens the usefulness of the disclosure of the face or contract amount. For example, reporting all derivatives as assets or liabilities in the statement of financial position will provide an indication of the use of derivatives. More important, although the face or contract amount of derivative instruments held provides some indication of derivatives activity, their usefulness for that purpose may be suspect given that some derivatives are commonly neutralized either by canceling the original derivative—which lowers the reported amount—or by acquiring or issuing an offsetting derivative—which increases the reported amount. The Exposure Draft would have required the disclosure only when necessary to enable investors and creditors to understand what an entity is trying to accomplish with its derivatives. Some respondents were concerned that provision would not have been operational. The Board agreed and decided that disclosure of the face or contract amount should no longer be required.

513. Also deleted is the requirement to disclose the average fair value of derivative financial instruments held for trading purposes (Statement 119, paragraph 10(a)). The Board originally required that disclosure to provide users "with a better indication of the level of risk assumed by an entity when holding or issuing derivative financial instruments for *trading purposes*" (Statement 119, paragraph 50). The Board had noted that "trading positions typically fluctuate, and the ending balance may not always be representative of the range of balances and related risks that an entity has assumed during a period" (Statement 119, paragraph 50). The Board had also indicated that it did not extend the disclosure to derivatives used for other than trading purposes because "the necessary data may be less likely to be available for derivative financial instruments held or issued for purposes other than trading" (Statement 119, paragraph 54). Because this Statement eliminates the distinction between derivatives held for *trading purposes* and those held for *purposes other than trading* and because of the Board's continuing concerns about the availability of that information, particularly for nonfinancial entities, the Board decided to eliminate that disclosure.

### **Effective Date and Transition**

514. This Statement is effective for fiscal years beginning after June 15, 1999. Recognizing derivatives as assets and liabilities and measuring them at fair value is a primary objective of this Statement, and the Board considers it important to achieve the objective as early as is reasonably possible following the issuance of this Statement. However, many respondents indicated that

they would need more than a year following the issuance of this Statement to make the systems changes necessary to implement it. The Board notes that an effective date of years beginning after June 15, 1999 will provide an implementation period of at least a year for all entities. That should be adequate time for entities to assimilate and develop the information required by this Statement. The Board also decided to permit an entity to adopt the provisions of this Statement as of the beginning of any fiscal quarter that begins after issuance of this Statement. The Board recognizes that the financial statements of an entity that adopts this Statement during a fiscal year will be based on differing measurement principles and hedge accounting requirements for derivative instruments. The Board decided that the urgency of providing improved information about derivatives outweighed concerns about the resulting potential lack of consistency within that year's financial statements.

515. Because hedge accounting is based on an entity's intent at the time a hedging relationship is established, the Board decided that retroactive application of the provisions of this Statement was not appropriate. Accordingly, changes in the fair value of derivatives that arose before initial application of this Statement and were previously recognized in net income, added to the carrying amount of hedged assets or liabilities, or included in other comprehensive income as part of a hedge of a net investment in a foreign entity are not to be included in transition adjustments. However, the Board decided that hedging relationships that existed before the date of initial application are relevant in determining other transition adjustments. Basing the transition adjustments on past hedging relationships also should prevent an entity from selectively affecting the transition adjustments by changing previously designated hedging relationships.

516. The Board considered whether past changes in the fair values of derivatives that were deferred as separate assets or liabilities in the statement of financial position rather than being added to the carrying amount of hedged assets or liabilities, such as those related to hedged forecasted transactions, should continue to be deferred at the date of initial application. Continued deferral of those gains and losses would be consistent with the continued deferral of amounts that were previously added to the carrying amount of hedged assets or liabilities. However, separately deferred losses and gains do not represent assets or liabilities and thus are different from amounts that adjusted the basis of an asset or liability or otherwise represent assets or liabilities. Continuing to report them in the statement of financial position would be inconsistent with the Board's fundamental decision to recognize in the statement of financial position only items that are assets or liabilities (paragraph 229). The Board concluded that gains and losses separately characterized as liabilities and assets in the statement of financial position should be removed and reported in a manner consistent with the requirements of this Statement.

517. The adjustments to recognize all derivatives as assets or liabilities at fair value and to reverse certain deferred gains and losses will affect net income or other comprehensive income at the date of initial application. Consequently, the Board decided also to require that an entity recognize concurrently the effect of any preexisting offsetting differences between the carrying amount and the fair value of hedged items; that is, differences that arose before the date of initial

application. The Board noted that reporting offsetting unrealized gains and losses on hedged items is consistent with the notion in this Statement of accelerating gains and losses on hedged items to provide income statement offset.

### **Transition Provisions for Embedded Derivatives**

518. Paragraphs 12–16 of this Statement require that certain embedded derivatives be separated from their host contracts and accounted for as derivative instruments under this Statement. The Board considered how that requirement for separate accounting should apply to hybrid instruments outstanding at the date of initial application of this Statement. In considering that issue, the Board first considered two alternative ways in which an embedded derivative could be separated from the host contract after the date of acquisition or issuance:

- a. Based on the fair values of the embedded derivative and the host contract at the date of initial application
- b. Based on the fair values of the embedded derivative and the host contract at the date of initial acquisition or issuance.

The choice between those two methods determines the carrying amount of the host contract after separation of the embedded derivative. It also significantly affects the difficulty of obtaining the necessary information needed to separate an embedded derivative from the host contract after the date of initial acquisition or incurrence.

519. Separating a hybrid instrument into its host contract and its embedded derivative based on fair values at the date of initial adoption would be the simpler method. Under that method, the fair value of all of an entity's host contracts and embedded derivatives would be determined as of the same date, based on information current as of that date. In contrast, basing the separation of an embedded derivative on fair values at the date a hybrid instrument was acquired or incurred would necessitate calculations as of multiple past dates. For an entity with many hybrid instruments, some of which may have been initiated a decade or more in the past, separation based on fair values at dates of acquisition or incurrence could be a significant effort.

520. Although separation based on fair values at the date of initial application of this Statement would be the easier method, its results could be questionable. Many host contracts will be interest-bearing financial instruments, and separating the value of their embedded derivatives will affect both the carrying amounts of the host contracts and their effective interest rates. Determining the carrying amount of such a host contract based on the value of an embedded derivative at a date significantly later than acquisition or issuance of the instrument could result in a substantial discount or premium to be amortized as an adjustment of interest income or expense. For example, several years before it adopts this Statement, an entity might have purchased an equity-indexed note in which the principal is linked to the S&P 500 index. If the S&P 500 index is, say, 60 percent higher on July 1, 1999 when the entity adopts this Statement than it was at the date the note was acquired and the embedded derivative is separated on that basis, the carrying amount of the host contract would be artificially low, resulting in an

artificially high reported interest yield. In contrast, separation based on fair values at the date the equity-indexed note was acquired would result in carrying amounts for both components that are determined on the same basis, and the carrying amount for the host contract need not compensate for subsequent changes in the value of the embedded derivative.

521. For the reasons just discussed, the Board decided that separation of a hybrid instrument into its host contract and embedded derivative instrument should be based on fair values at the date the instrument was acquired or issued. Having made that decision, the Board decided it was not feasible to require entities to apply the requirements of paragraphs 12–16 of this Statement to all hybrid instruments held or owed at the date of initial adoption. However, the Board also did not want to provide an entity with the opportunity to embed numerous derivatives in hybrid instruments during the year or two before the effective date of this Statement for the purpose of avoiding its requirements. Therefore, this Statement requires that a hybrid instrument acquired or issued after December 31, 1997 be separated into its host contract and embedded derivative. For instruments acquired or issued after that date, separation on the basis of fair values at the date of acquisition or issuance should not be unduly burdensome.

522. The Board also considered whether an entity should be permitted to separate hybrid instruments acquired or issued before January 1, 1998 into their host contracts and derivative components if it wishes to do so. That alternative might be provided on either an individual instrument or an entity-wide basis. The Board recognizes that an entity might wish to separate the embedded derivative from a hybrid instrument and designate it as a hedging instrument. However, the Board was concerned that providing a choice on an instrument-by-instrument basis might have unintended consequences, such as separate accounting only for those embedded derivatives that are in a loss position at the date of initial adoption. The Board therefore decided to provide an entity the choice of separating out the embedded derivatives of existing hybrid instruments, but only on an all-or-none basis. The Board also believes that providing the choice only on an entity-wide basis will make it easier for users of financial statements to understand the effects of an entity's choices in transition and the resulting financial information.

### **Transition Provisions for Compound Derivatives**

523. This Statement prohibits separation of a compound derivative instrument into its components for hedge accounting purposes (paragraph 18). The Board does not consider that prohibition to be unduly burdensome on an ongoing basis. To qualify for hedge accounting, an entity will simply need to obtain separate derivative instruments in some situations in which compound derivatives may have been used in the past. However, the Board recognizes that an entity may have entered into long-term derivative instruments combining, for example, foreign exchange and interest rate components before it knew that only separate derivatives would qualify for hedge accounting. The Board therefore considered whether this Statement should include special transition provisions for compound derivatives entered into before the date of initial adoption.

524. The Board understands that many hedging relationships in which compound derivatives were used involved hybrid instruments. For example, an entity may have entered into an interest rate swap with an embedded equity option to hedge outstanding debt with an embedded equity feature, such as a bond whose principal amount increases with specified percentage increases in the S&P 500 index. The Board believes that its decision not to require separate accounting for the derivative features of hybrid instruments acquired or issued before January 1, 1998 significantly reduces the need to permit compound derivatives outstanding at the date of initial adoption to be separated into dissimilar components. However, this Statement prohibits hedge accounting for the foreign exchange risk in instruments that are remeasured with changes in carrying amounts attributable to changes in foreign exchange rates included currently in earnings. A similar prohibition applies to cash flow hedges of the future acquisition or incurrence of instruments that will be remeasured with changes in carrying value attributable to changes in foreign exchange rates included in current earnings. Thus, a compound derivative that includes a foreign exchange component rarely will qualify for use as a hedging instrument under this Statement. The Board therefore decided to permit only the foreign exchange component of a compound derivative entered into before this Statement is adopted to be separated for accounting purposes. Thus, for example, a derivative that combines a foreign currency forward contract with an interest rate swap may be separated into its components at the date of initial adoption based on the fair values of the components at that date. In contrast, a combined interest rate swap and equity option may not be separated into its components.

## **Appendix D: AMENDMENTS TO EXISTING PRONOUNCEMENTS**

525. This Statement supersedes the following pronouncements:

- a. FASB Statement No. 80, *Accounting for Futures Contracts*
- b. FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*
- c. FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.*

526. In paragraph 8 of Chapter 4, “Inventory Pricing,” of ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, the following is inserted after the fourth sentence:

(If inventory has been the hedged item in a fair value hedge, the inventory’s “cost” basis used in the cost-or-market-whichever-is-lower accounting shall reflect the effect of the adjustments of its carrying amount made pursuant to paragraph 22(b) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*)

527. FASB Statement No. 52, *Foreign Currency Translation*, is amended as follows:

- a. The following paragraph is inserted after the heading *Foreign Currency Transactions* and before paragraph 15:

14A. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, addresses the accounting for freestanding foreign currency derivatives and certain foreign currency derivatives embedded in other instruments. This Statement does not address the accounting for derivative instruments.

- b. In the last sentence of paragraph 15, *paragraphs 20 and 21* is replaced by *paragraph 20* and *and foreign currency commitments* is deleted.
- c. In the first sentence of paragraph 16, ***forward exchange contracts*** (*paragraphs 17–19*) is replaced by *derivative instruments* (*Statement 133*).
- d. Paragraphs 17–19 and the heading preceding paragraph 17 are deleted.
- e. Paragraph 21 is replaced by the following:

#### **Hedges of Firm Commitments**

The accounting for a gain or loss on a foreign currency transaction that is intended to hedge an identifiable foreign currency commitment (for example, an agreement to purchase or sell equipment) is addressed by paragraph 37 of Statement 133.

- f. In the second sentence of paragraph 30, *forward contracts determined in conformity with the requirements of paragraphs 18 and 19 shall be considered transaction gains or losses* is replaced by *derivative instruments shall comply with paragraph 45 of Statement 133*.
- g. The following sentence is added at the end of paragraph 31(b):

(Paragraph 45(c) of Statement 133 specifies additional disclosures for instruments designated as hedges of the foreign currency exposure of a net investment in a foreign operation.)

- h. The definitions of *currency swaps*, *discount or premium on a forward contract*, *forward exchange contract*, and *forward rate* in paragraph 162, the glossary, are deleted.

528. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, is amended as follows:

- a. Paragraph 46, as amended by FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, is amended as follows:

(1) The phrase *except as indicated in the following sentence* is added to the end of the second sentence.

(2) The following sentence is added after the second sentence:

All or a portion of the unrealized gain or loss of a security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge, pursuant to paragraph 22 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

b. In the first sentence of paragraph 50, as amended by FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and Statement 115, *as hedges as described in FASB Statements No. 52, Foreign Currency Translation, and No. 80, Accounting for Futures Contracts* is replaced by *as either hedges of net investments in foreign operations or cash flow hedges as described in Statement 133*.

529. FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, is amended as follows:

a. The following sentence is added after the first sentence of paragraph 4, as amended by Statements 115 and 124:

If a mortgage loan has been the hedged item in a fair value hedge, the loan's "cost" basis used in lower-of-cost-or-market accounting shall reflect the effect of the adjustments of its carrying amount made pursuant to paragraph 22(b) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

b. In the first sentence of paragraph 9(a), as amended by Statement 115 and FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, the phrase *commitment prices* is replaced by *fair values*.

c. The last sentence of paragraph 9(a), which was added by Statement 115, is deleted.

d. Paragraph 9(b)(1) is deleted.

530. In the third sentence of footnote 4 of FASB Statement No. 95, *Statement of Cash Flows*, as amended by FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions*, the phrase *futures contracts, forward contracts, option contracts, or swap contracts that are accounted for as hedges of identifiable transactions or events (for example, a cash payment from a futures contract that hedges a purchase or sale of inventory), including anticipatory hedges*, is

replaced by *derivative instruments that are accounted for as fair value hedges or cash flow hedges under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities*. In the last sentence of footnote 4, *identifiable transaction or event* is replaced by *asset, liability, firm commitment, or forecasted transaction*.

531. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, is amended as follows:

- a. Paragraph 4 is deleted.
- b. The last sentence of paragraph 10, which was added by Statement 119, is deleted.
- c. The paragraph added by Statement 119 after paragraph 13 is replaced by the following; the related footnote is deleted:

In disclosing the fair value of a financial instrument, an entity shall not net that fair value with the fair value of other financial instruments—even if those financial instruments are of the same class or are otherwise considered to be related, for example, by a risk management strategy—except to the extent that the offsetting of carrying amounts in the statement of financial position is permitted under the general principle in paragraphs 5 and 6 of FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, or the exceptions for master netting arrangements in paragraph 10 of Interpretation 39 and for amounts related to certain repurchase and reverse repurchase agreements in paragraphs 3 and 4 of FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*.

- d. The following paragraphs, with related headings and footnotes, are added after paragraph 15:

**Disclosure about Concentrations of Credit Risk of All Financial Instruments**

15A. Except as indicated in paragraph 15B, an entity shall disclose all significant concentrations of credit risk arising from *all* financial instruments, whether from an individual counterparty or groups of counterparties. *Group concentrations* of credit risk exist if a number of counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. The following shall be disclosed about each significant concentration:

- a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- b. The maximum amount of loss due to credit risk that, based on the gross fair value of the financial instrument, the entity would incur if parties to the financial instruments

- that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- c. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments
  - d. The entity's policy of entering into master netting arrangements to mitigate the credit risk of financial instruments, information about the arrangements for which the entity is a party, and a brief description of the terms of those arrangements, including the extent to which they would reduce the entity's maximum amount of loss due to credit risk.

15B. The requirements of the preceding paragraph do not apply to the following financial instruments, whether written or held:

- a. Financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of Statement 87\*
- b. The financial instruments described in paragraphs 8(a), 8(c), 8(e), and 8(f) of this Statement, as amended by FASB Statements No. 112, *Employers' Accounting for Postemployment Benefits*, No. 123, *Accounting for Stock-Based Compensation*, and 125, except for reinsurance receivables and prepaid reinsurance premiums.

### **Encouraged Disclosure about Market Risk of All Financial Instruments**

15C. An entity is encouraged, but not required, to disclose quantitative information about the market risks of financial instruments that is consistent with the way it manages or adjusts those risks.

15D. Appropriate ways of reporting the quantitative information encouraged in paragraph 15C will differ for different entities and will likely evolve over time as management approaches and measurement techniques evolve. Possibilities include disclosing (a) more details about current positions and perhaps activity during the period, (b) the hypothetical effects on comprehensive income (or net assets), or annual income, of several possible changes in market prices, (c) a gap analysis of interest rate repricing or maturity dates, (d) the duration of the financial instruments, or (e) the entity's value at risk from derivatives and from other positions at the end of the reporting period and the average value at risk during the year. This list is not exhaustive, and an entity is encouraged to develop other ways of reporting quantitative information.

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\*Financial instruments of a pension plan, other than the obligations for pension benefits, when subject to the accounting and reporting requirements of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, are subject to the requirements of paragraph 15A.

e. Example 1 in paragraph 31 is amended as follows:

(1) The following heading and sentence are deleted from illustrative Note V:

*Interest rate swap agreements*

The fair value of interest rate swaps (used for hedging purposes) is the estimated amount that the Bank would receive or pay to terminate the swap agreements at the reporting date, taking into account current interest rates and the current creditworthiness of the swap counterparties.

(2) In the table, the subheading *Interest rate swaps* and the two following related lines (*In a net receivable position* and *In a net payable position*) are deleted. In the second sentence of the related footnote \*, *Interest rate swaps and* is deleted.

532. This Statement carries forward the following amendments that Statement 119 made to Statement 107:

a. In paragraph 10, the following footnote is added after *either in the body of the financial statements or in the accompanying notes*:

\*If disclosed in more than a single note, one of the notes shall include a summary table. The summary table shall contain the fair value and related carrying amounts and cross-references to the location(s) of the remaining disclosures required by this Statement, as amended.

b. In paragraph 10, the following is added after the first sentence:

Fair value disclosed in the notes shall be presented together with the related carrying amount in a form that makes it clear whether the fair value and carrying amount represent assets or liabilities and how the carrying amounts relate to what is reported in the statement of financial position.

533. In paragraph 28 of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, the phrase *FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* is replaced by *paragraph 15A of FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, as amended by FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities*.

534. FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, is amended as follows:

- a. The following sentence is added at the end of paragraph 4, as amended by Statement 124:

This Statement does not apply to investments in derivative instruments that are subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. If an investment would otherwise be in the scope of this Statement and it has within it an embedded derivative that is subject to Statement 133, the host instrument (as described in Statement 133) remains within the scope of this Statement. A transaction gain or loss on a held-to-maturity foreign-currency-denominated debt security shall be accounted for pursuant to FASB Statement No. 52, *Foreign Currency Translation*.

- b. Paragraph 13, as amended by FASB Statement No. 130, *Reporting Comprehensive Income*, is amended as follows:

- (1) The phrase *until realized except as indicated in the following sentence* is added to the end of the second sentence.
- (2) The following sentence is added after the second sentence:

All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge, pursuant to paragraph 22 of Statement 133.

- c. In paragraph 15(b), *portion of the* is inserted before *unrealized*, and *that has not been previously recognized in earnings* is added after *transfer*.

- d. In paragraph 16, the following is inserted after the first sentence:

(If a security has been the hedged item in a fair value hedge, the security's "amortized cost basis" shall reflect the effect of the adjustments of its carrying amount made pursuant to paragraph 22(b) of Statement 133.)

- e. The first sentence of paragraph 19 is replaced by the following two sentences:

For securities classified as available-for-sale, all reporting enterprises shall disclose the aggregate fair value, the total gains for securities with net gains in accumulated other comprehensive income, and the total losses for securities with net losses in accumulated other comprehensive income, by major security type as of each date for which a statement of financial position is presented. For securities classified as held-to-maturity, all reporting enterprises shall disclose the aggregate fair value, gross unrecognized holding gains, gross unrecognized holding losses, the net carrying amount, and the gross gains and losses in accumulated other comprehensive income for any derivatives that hedged the forecasted acquisition of the held-to-maturity securities, by major security

type as of each date for which a statement of financial position is presented.

- f. In the third sentence in paragraph 20, *amortized cost* is replaced by *net carrying amount (if different from fair value)*.
- g. Paragraph 21 is amended as follows:
  - (1) In paragraph 21(a), *on those sales* is replaced by *that have been included in earnings as a result of those sales*
  - (2) In paragraph 21(b), *cost was determined in computing realized gain or loss* is replaced by *the cost of a security sold or the amount reclassified out of accumulated other comprehensive income into earnings was determined*
  - (3) Paragraph 21(d) is replaced by the following:

The amount of the net unrealized holding gain or loss on available-for-sale securities for the period that has been included in accumulated other comprehensive income and the amount of gains and losses reclassified out of accumulated other comprehensive income into earnings for the period
  - (4) Paragraph 21(e) is replaced by *The portion of trading gains and losses for the period that relates to trading securities still held at the reporting date.*
- h. In the first sentence of paragraph 22, *amortized cost* is replaced by *net carrying* and *the net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the held-to-maturity security*, is added immediately preceding *the related realized*.
- i. The last four sentences of paragraph 115 are deleted.
- j. The definition of *fair value* in paragraph 137, the glossary, is replaced by the following:

The amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved,

option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring assets should be consistent with the objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, including assumptions about interest rates, default, prepayment, and volatility.

535. FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, is amended as follows:

- a. In paragraph 3, *except as noted in paragraph 5* is added to the end of the first sentence.
- b. The following is added to the end of paragraph 5:

This Statement also does not apply to investments in derivative instruments that are subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. If an investment would otherwise be in the scope of this Statement and it has within it an embedded derivative that is subject to Statement 133, the host instrument (as described in Statement 133) remains within the scope of this Statement.

- c. In the second sentence of paragraph 6, *No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and *No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* are deleted and *No. 133, Accounting for Derivative Instruments and Hedging Activities*, is added to the end of the sentence.
- d. In footnote 6 of paragraph 16, *Paragraph 20 of Statement 105* is replaced by *Paragraph 15A of Statement 107, as amended by Statement 133*.
- e. The definition of *fair value* in paragraph 112, the glossary, is replaced by the following:

The amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring assets should be consistent with the

objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, including assumptions about interest rates, default, prepayment, and volatility.

536. FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, is amended as follows:

- a. In paragraph 4, *and that are not within the scope of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities* is added to the end of the second sentence.
- b. In paragraph 14, *Except for instruments that are within the scope of Statement 133* is added to the beginning of the first sentence.
- c. In the fourth sentence of paragraph 31, ***derivative financial instrument*** is replaced by ***derivative instrument***.
- d. In paragraph 243, the glossary, the definition of *derivative financial instrument* is replaced by:

**Derivative instrument**

Refer to paragraphs 6–9 in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

537. Paragraph 2(c) of FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, is replaced by the following:

The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.

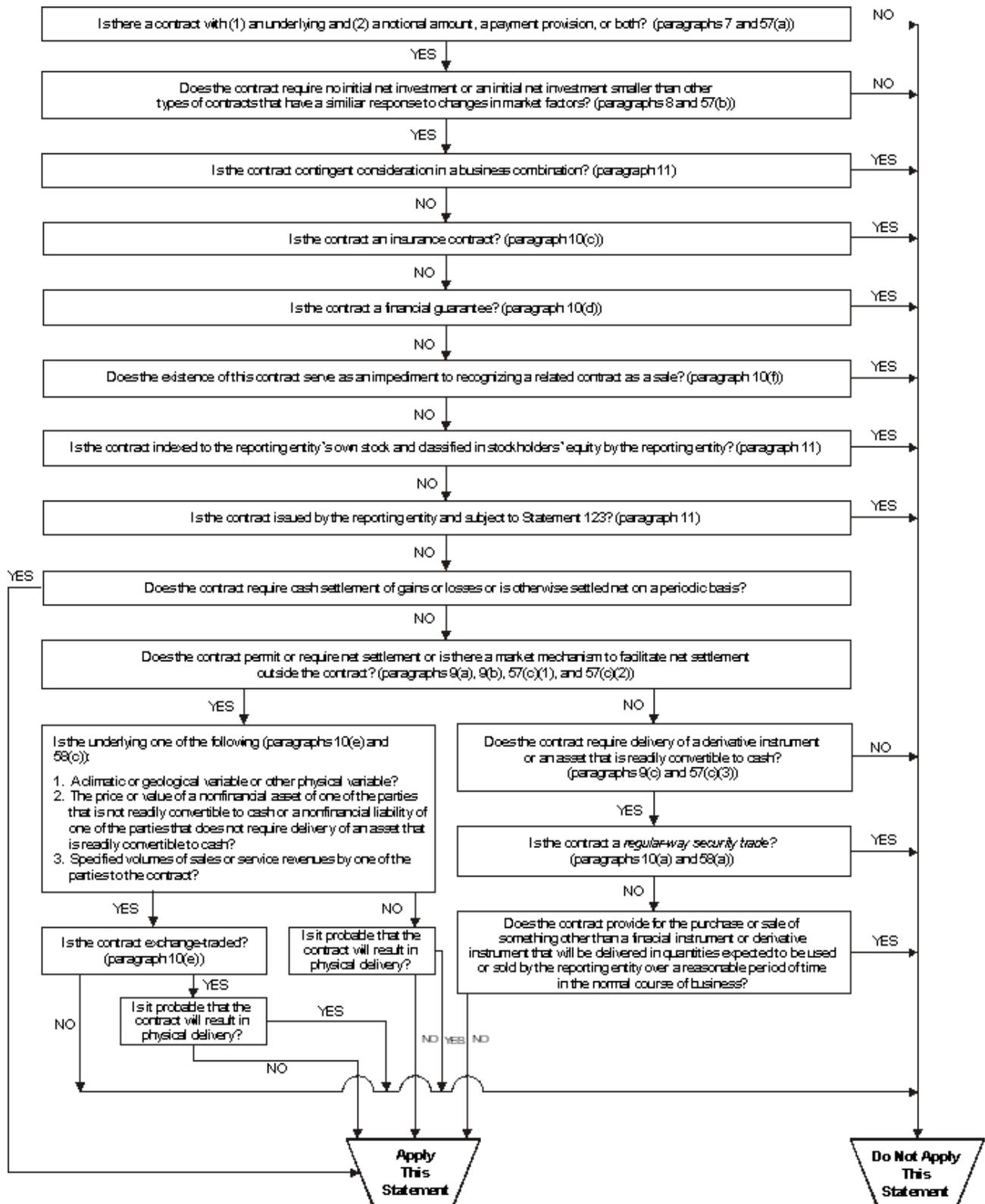
538. Paragraph 6 of FASB Technical Bulletin No. 79-19, *Investor's Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee*, as amended by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, is replaced by the following:

If an investee that is accounted for by the equity method is required to include unrealized holding gains and losses on investments in debt and equity securities in other comprehensive income pursuant to the provisions of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the investor shall adjust its investment in that investee by its proportionate share of the unrealized gains and losses and a like amount shall be included in its other

comprehensive income.

## **Appendix E: DIAGRAM FOR DETERMINING WHETHER A CONTRACT IS A FREESTANDING DERIVATIVE SUBJECT TO THE SCOPE OF THIS STATEMENT**

539. The following diagram depicts the process for determining whether a freestanding contract is within the scope of this Statement. The diagram is a visual supplement to the written standards section. It should not be interpreted to alter any requirements of this Statement nor should it be considered a substitute for the requirements. The relevant paragraphs in the standards section and Appendix A are identified in the parenthetical note after the question.



## **Appendix F: GLOSSARY**

540. This appendix contains definitions of terms or phrases as used in this Statement.

### **Comprehensive income**

The change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners (FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 70).

### **Derivative instrument**

Refer to paragraphs 6–9.

### **Fair value**

The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using discount rates commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring assets and liabilities should be consistent with the objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring forward contracts, such as foreign currency forward contracts, at fair value by discounting estimated future cash flows, an entity should base the estimate of future cash flows on the changes in the forward rate (rather than the spot rate). In measuring financial liabilities and nonfinancial derivatives that are liabilities at fair value by discounting estimated future cash flows (or equivalent outflows of other assets), an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

### **Financial instrument**

Cash, evidence of an ownership interest in an entity, or a contract that both:

- a. Imposes on one entity a contractual obligation\* (1) to deliver cash or another financial instrument† to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity
- b. Conveys to that second entity a contractual right‡ (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

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\*Contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of liability set forth in Concepts Statement 6, although some may not be recognized as liabilities in financial statements—may be "off-balance-sheet"—because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

†The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

‡Contractual rights encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of asset set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements—may be “off-balance-sheet”—because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity.

### **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.
- b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable.

### **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.

**Notional amount**

A number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument.

**Underlying**

A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

## Footnotes

FAS133, Footnote 1--Words defined in Appendix F, the glossary are set in **boldface** type the first time they appear.

FAS133, Footnote 2--An unrecognized firm commitment can be viewed as an executory contract that represents both a right and an obligation. When a previously unrecognized firm commitment that is designated as a hedged item is accounted for in accordance with this Statement, an asset or a liability is recognized and reported in the statement of financial position related to the recognition of the gain or loss on the firm commitment. Consequently, subsequent references to an asset or a liability in this Statement include a firm commitment.

FAS133, Footnote 3--Sometimes other names are used. For example, the notional amount is called a face amount in some contracts.

FAS133, Footnote 4--The terms *underlying*, *notional amount*, *payment provision*, and *settlement* are intended to include the plural forms in the remainder of this Statement. Including both the singular and plural forms used in this paragraph is more accurate but much more awkward and impairs the readability.

FAS133, Footnote 5--FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, states that assets that are readily convertible to cash "have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price" (paragraph 83(a)). For contracts that involve multiple deliveries of the asset, the phrase *in an active market that can rapidly absorb the quantity held by the entity* should be applied separately to the expected quantity in each delivery.

FAS133, Footnote 6--Examples are an interest rate cap or an interest rate collar. An embedded derivative instrument that alters net interest payments based on changes in a stock price index (or another non-interest-rate index) is not addressed in paragraph 13.

FAS133, Footnote 7--The reference to *combined instruments* refers to the written option and the hedged item, such as an embedded purchased option.

FAS133, Footnote 8--A firm commitment that represents an asset or liability that a specific accounting standard prohibits recognizing (such as a noncancelable operating lease or an unrecognized mortgage servicing right) may nevertheless be designated as the hedged item in a fair value hedge. A mortgage banker's unrecognized "interest rate lock commitment" (IRLC) does not qualify as a firm commitment (because as an option it does not obligate both parties)

and thus is not eligible for fair value hedge accounting as the hedged item. (However, a mortgage banker's "forward sale commitments," which are derivatives that lock in the prices at which the mortgage loans will be sold to investors, may qualify as hedging instruments in cash flow hedges of the forecasted sales of mortgage loans.)

FAS133, Footnote 9--Mortgage bankers and other servicers of financial assets that designate a hedged portfolio by aggregating servicing rights within one or more risk strata used under paragraph 37(g) of Statement 125 would not necessarily comply with the requirement in this paragraph for portfolios of similar assets. The risk stratum under paragraph 37(g) of Statement 125 can be based on any predominant risk characteristic, including date of origination or geographic location.

FAS133, Footnote 10--For purposes of paragraphs 28–35, the individual cash flows related to a recognized asset or liability and the cash flows related to a forecasted transaction are both referred to as a *forecasted transaction* or *hedged transaction*.

FAS133, Footnote 11--The carrying basis for a nonderivative financial instrument that gives rise to a foreign currency transaction gain or loss under Statement 52 is not addressed by this Statement.

FAS133, Footnote 12--The foreign currency transaction gain or loss on a hedging instrument is determined, consistent with paragraph 15 of Statement 52, as the increase or decrease in functional currency cash flows attributable to the change in spot exchange rates between the functional currency and the currency in which the hedging instrument is denominated.

FAS133, Footnote 13--For a compound derivative that has a foreign currency exchange risk component (such as a foreign currency interest rate swap), an entity is permitted at the date of initial application to separate the compound derivative into two parts: the foreign currency derivative and the remaining derivative. Each of them would thereafter be accounted for at fair value, with an overall limit that the sum of their fair values could not exceed the fair value of the compound derivative. An entity may not separate a compound derivative into components representing different risks after the date of initial application.

FAS133, Footnote 14--EITF Topic No. D-51, "The Applicability of FASB Statement No. 115 to Desecuritizations of Financial Assets," indicates that certain financial assets received or retained in a desecuritization must be held to maturity to avoid calling into question the entity's intent to hold other debt securities to maturity in the future. In conjunction with the initial adoption of this Statement, the held-to-maturity restriction on those financial assets held on the date of initial application is removed, and those financial assets that had been received or retained in a previous desecuritization are available in the future to be designated as the hedged item, or their variable interest payments as the hedged transaction, in a hedge of the exposure to changes in market interest rates. Consequently, the sale of those financial assets before maturity would not call into

question the entity's intent to hold other debt securities to maturity in the future.

FAS133, Appendix A, Footnote 15--Even though a contract may be a derivative as described in paragraphs 6–10 for both parties, the exceptions in paragraph 11 apply only to the issuer of the contract and will result in different reporting by the two parties. The exception in paragraph 10(b) also may apply to one of the parties but not the other.

FAS133, Appendix A, Footnote 16--Contracts that require delivery of securities that are not readily convertible to cash are not subject to the requirements of this Statement unless there is a market mechanism outside the contract to facilitate net settlement.

FAS133, Footnote 17--Contracts that require delivery of assets that are not readily convertible to cash are not subject to the requirements of this Statement unless there is a market mechanism outside the contract to facilitate net settlement.

FAS133, Appendix A, Footnote 18--This discussion applies only to short sales with the characteristics described here. Some groups of transactions that are referred to as short sales may have different characteristics. If so, a different analysis would be appropriate, and other derivative instruments may be involved.

FAS133, Footnote 19--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 market 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.

FAS133, Footnote 20--The period of time over which correlation of prices should be assessed would be based on management's judgment in the particular circumstance.

FAS133, Appendix B, Footnote 21--A slightly different shortcut method for interest rate swaps used as cash flow hedges is illustrated in Example 5.

FAS133, Appendix B, Footnote 22--If the hedged item were a foreign-currency-denominated available-for-sale security instead of a firm commitment, Statement 52 would have required its carrying value to be measured using the spot exchange rate. Therefore, the spot-forward difference would have been recognized immediately in earnings either because it represented ineffectiveness or because it was excluded from the assessment of effectiveness.

FAS133, Appendix B, Footnote 23--Paragraph 112 discusses the zero-coupon method.

FAS133, Appendix B, Footnote 24--A slightly different shortcut method for interest rate swaps used as fair value hedges is illustrated in Example 2.

FAS133, Appendix B, Footnote 25--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.

FAS133, Appendix B, Footnote 26--Statement 52 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.

FAS133, Appendix C, Footnote 27--The terms *derivative instrument* and *derivative* are used interchangeably in this appendix.

FAS133, Appendix C, Footnote 28--Harold Bierman, Jr., L. Todd Johnson, and D. Scott Peterson, FASB Research Report, Hedge Accounting: An Exploratory Study of the Underlying Issues.

FAS133, Appendix C, Footnote 29--Jane B. Adams and Corliss J. Montesi, FASB Special Report, *Major Issues Related to Hedge Accounting*.

FAS133, Appendix C, Footnote 30--United States General Accounting Office, Report to Congressional Requesters, *Financial Derivatives: Actions Needed to Protect the Financial System*, May 1994, 16.

FAS133, Appendix C, Footnote 31--The term *underlying* as used in the Exposure Draft encompassed the asset or liability, the price of which was the underlying for the contract.

FAS133, Appendix C, Footnote 32--However, as noted in paragraph 434, it likely will be difficult to find a derivative that will be effective as a fair value hedge of selected cash flows.

FAS133, Appendix C, Footnote 33--SEC Final Rules, *Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Quantitative and Qualitative Information about Market Risk Inherent in Derivative Financial*

*Instruments, Other Financial Instruments, and Derivative Commodity Instruments.*