



Derivatives and hedging

As amended by ASU 2017-12

Handbook

US GAAP

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Perspectives on a complex area

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

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

Our objective with this publication is to help you navigate this complex area. We provide you with insights, examples and perspectives based on our years of experience – so you can understand the requirements and, when options are provided, decide which alternatives are right for you.

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Department of Professional Practice, KPMG LLP

About this publication

The purpose of this Handbook is to assist you in understanding the standard on derivatives and hedging, Topic 815.

Accounting literature and scope

This Handbook focuses on derivatives and hedge accounting under ASC 815, Derivatives and Hedging. The Handbook assumes an entity has adopted Accounting Standards Update No. 2017-12, Targeted Improvements to Accounting for Hedging Activities, which was issued in August 2017 and first became effective in 2019.

Embedded derivatives and disclosures will be addressed in future updates to this Handbook. In the meantime, guidance on this topic is included in KPMG's publication, [Derivatives and hedging \(pre-ASU 2017-02\)](#), which provides guidance for entities that have not yet adopted ASU 2017-12.

Organization of the text

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

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

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

October 2020 edition

The October 2020 edition of our Handbook includes updates for the following:

- guidance on the scope of Topic 815, the definition of a derivative, accounting for derivatives and presentation;
- significant updates and new guidance addressing the amendments to Topic 815 (see below, 'Pending content').

- new and updated interpretations based on our experiences with companies implementing Topic 815; and
- a summary of the guidance in ASU 2020-04, Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting, which affects derivatives and hedging.

Compared to the September 2018 edition, new Questions and Examples added are identified throughout the Handbook with ** and items that have been significantly updated or revised are identified with #.

Certain chapters have been relocated to accommodate the guidance added in this edition. The following table summarizes the changes.

Chapter in previous edition	Chapter in this edition
2. General hedging requirements	6. General hedging requirements
3. Qualifying criteria for fair value hedges	7. Qualifying criteria for fair value hedges
4. Accounting for fair value hedges	8. Accounting for fair value hedges
5. Qualifying criteria for cash flow hedges	9. Qualifying criteria for cash flow hedges
6. Accounting for cash flow hedges	10. Accounting for cash flow hedges
7. Hedging foreign currency exposures	11. Hedging foreign currency exposures
8. Net investment hedges	12. Net investment hedges
9. Hedge effectiveness	13. Hedge effectiveness
10. Private companies	16. Private companies and entities that do not report earnings
11. Effective dates and transition	17. Effective dates and transition

Pending content

This Handbook incorporates a number of amendments in Accounting Standards Updates that are not yet effective for all entities in all periods. When amendments were effective on January 1, 2020 for a calendar year-end public business entity that was not eligible to be a smaller reporting company, the Codification excerpts are reproduced as if the pending content were currently effective for all entities.

The amendments in the following Accounting Standards Updates are reflected as pending content in this Handbook:

- ASU 2020-01, Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815) —Clarifying the Interactions between Topic 321, Topic 323, and Topic 815
- ASU 2018-12, Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts

When an excerpt from the Codification is affected by pending content:

- the specific sentences that have been superseded are struck out and the added text is underlined; and
- the amended sentences are marked as pending content.

Future developments

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

In addition, the FASB is currently working on three different projects to address implementation issues associated with hedging. Summaries of the potential Codification improvements are included in chapters 6, 7, 9 and 10 (in 'Future Developments').

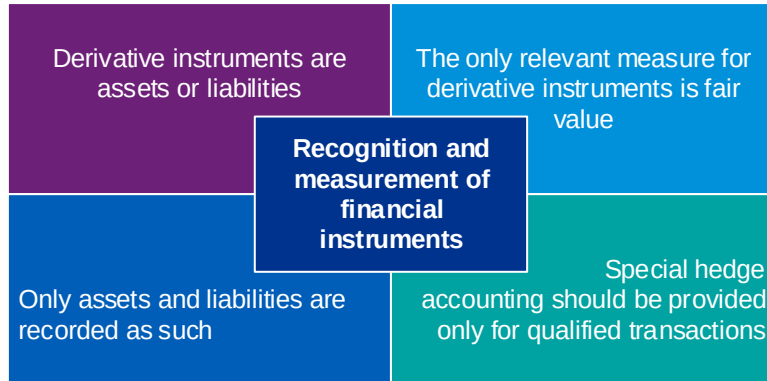
Abbreviations

We use the following abbreviations in this Handbook.

AFS	Available-for-sale
AOCI	Accumulated other comprehensive income
BPS	Basis points
CTA	Cumulative translation adjustment
DIG	Derivatives Implementation Group
FCD	Foreign currency denominated
HTM	Held-to-maturity
LIBOR	London Interbank Offered Rate
NFP	Not-for-profit entity
NPNS	Normal purchases and normal sales
NYMEX	New York Mercantile Exchange
OCI	Other comprehensive income
PEH	Perfectly effective hypothetical (derivative)
SIFMA	Securities Industry and Financial Markets Association

1. Executive summary

Topic 815 provides comprehensive guidance for all derivative instruments and hedging activities. In developing the accounting model for derivative instruments and hedging activities, the FASB made four fundamental decisions that serve as Topic 815's cornerstones.



Scope of Topic 815

Topic 815's scope primarily includes instruments and contracts that meet the definition of a derivative. However, its scope:

- **excludes** certain items even if they meet the definition of a derivative; and
- **includes** certain items even if they do not meet the definition of a derivative.

The following table summarizes the instruments that are specifically excluded from or included in the scope of Topic 815.

Instrument / contract	Applies to:
Scope exceptions	
Regular-way security trades	Certain forward contracts created when security trades are not settled on the trade date.
Normal purchases and normal sales	Certain purchases or sales of nonfinancial items that the entity will use or sell over a reasonable period in the normal course of business.
Insurance contracts	Certain insurance contracts when payments are triggered by the occurrence of an identified insurable event.
Financial guarantee contracts	Certain contracts in which a guarantor agrees to reimburse a creditor if a debtor fails to make its payment obligations under a nonderivative contract.
Contracts that are not traded on an exchange	Certain contracts that are not traded on an exchange when the underlying is based on a physical variable, the value of a nonfinancial asset or liability, or specified volumes of revenue.

Instrument / contract	Applies to:
Derivatives that impede sale accounting	Derivative instruments whose existence serves as an impediment to recognizing a related contract as a sale or purchase.
Investments in life insurance	A policyholder's investment in life insurance contracts in the scope of Subtopic 325-30.
Investment contracts	Certain investment contracts that are accounted for by defined benefit plans under either paragraph 960-325-35-1 or 960-325-35-3.
Loan commitments	— Holders (borrowers) of loan commitments; and — Issuers (lenders) of certain commitments to originate mortgage loans that will be held for investment purposes and all other types of loans.
Interest-only and principal-only strips	Certain interests in securitized financial assets that represent rights to receive only a specified proportion of the contractual interest or principal cash flows of a specific debt instrument.
Contracts involving an entity's own equity	The following contracts that involve an entity's own equity: — contracts indexed to an entity's own shares and classified in equity; — certain share-based payments; — certain contracts related to a business combination; and — certain forwards that require physical delivery.
Leases	Leases in the scope of Topic 842.
Residual value guarantees	Residual value guarantees that are in the scope of Topic 842.
Registration payment arrangements	Registration payment arrangements in the scope of Subtopic 825-20.
Fixed-odds wagering contracts	Certain fixed-odds wagering contracts that are accounted for as revenue transactions by an entity with casino operations.
Scope inclusions	
Forward-commitment dollar rolls	Forward commitment dollar rolls for which the underlying security does not yet exist. They are measured initially and subsequently at fair value.
Forward and option contracts for the purchase of debt and equity securities	Certain forward or option contracts for the purchase of debt or equity securities that will (when purchased) be subject to Topic 320 or Topic 321. Such a contract is accounted for as if the contract itself was in the scope of Topic 320 or Topic 321, as applicable.
Loan commitments related to originations of mortgage loans held-for-sale	Issuers of loan commitments related to the origination of mortgage loans that will be held-for-sale. Topic 815 requires these to be accounted for as derivatives, even if they do not meet the definition of a derivative.
Written options (SEC staff guidance)	All written options. They are measured initially and subsequently at fair value.

Read more: [Chapter 2](#)

Derivative definition

A derivative instrument is a financial instrument or other contract that has all of the following basic characteristics.

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

Read more: [Chapter 3](#)

Accounting for derivative instruments

Derivative instruments are assets or liabilities that are recorded on the balance sheet at fair value. The following table summarizes how changes in fair value of derivatives are reported.

Type of derivative	How changes in fair value are reported
Freestanding derivatives	
Nonhedging	Changes in fair value are reported in earnings.
Hedging instrument	Depends on the type of hedge and risk(s) being hedged. However, under all types of hedges, the timing of recognizing changes in fair value is generally matched with the offsetting losses and gains from the hedged item or forecasted transaction.
Embedded derivatives	
Hybrid instrument is measured at fair value in its entirety	Changes in fair value of the hybrid instrument (in its entirety) are reported in earnings. However, if the hybrid instrument is a liability measured at fair value due to an election made by the entity, the portion of the total change in the fair value that results from a change in the instrument-specific credit risk is reported in OCI. These instruments are not eligible as hedging instruments.

Type of derivative	How changes in fair value are reported
Embedded derivative is separated and is not designated as a hedging instrument	Changes in fair value of the embedded derivative are reported in earnings.
Embedded derivative is separated and is designated as a hedging instrument	Similar to freestanding derivatives (above) that are designated as hedging instruments.

Read more: [Chapter 5](#)

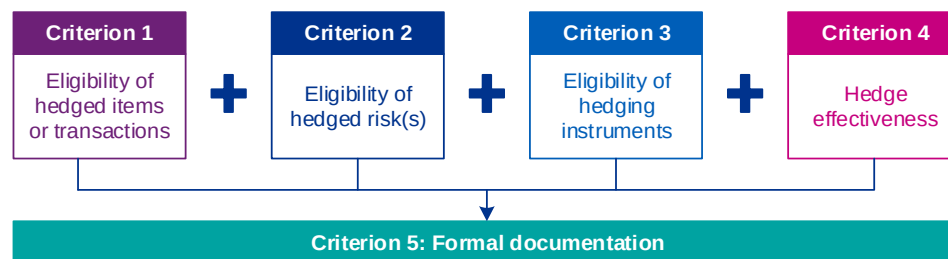
General qualifying criteria for hedge accounting

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

Topic 815 provides for three different types of hedges.

- **Fair value hedge.** A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that is attributable to a particular risk.
- **Cash flow hedge.** A hedge of the exposure to variability in the future cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk.
- **Net investment hedge.** A hedge of the exposure to foreign currency risk of a net investment in a foreign operation.

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



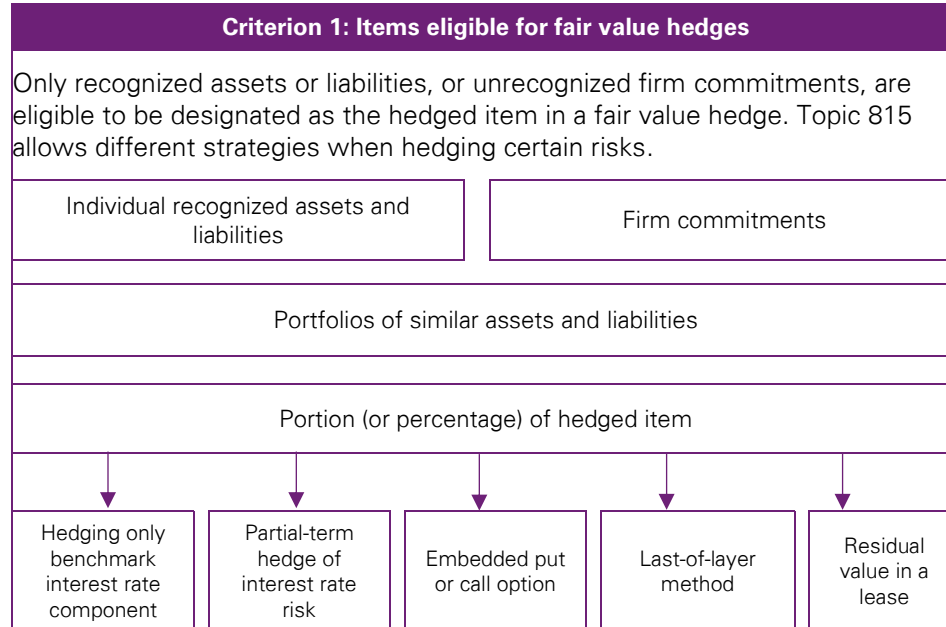
There are also specific qualifying criteria based on the type of hedge and the type of risk(s) being hedged. Topic 815 also specifically prohibits certain items and transactions from hedge accounting.

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

Read more: [Chapter 6](#)

Qualifying criteria for fair value hedges

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



Criterion 2: Risks eligible for fair value hedges

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

	Financial items	Nonfinancial items
 Interest rate risk	Changes in the benchmark interest rate for recognized fixed-rate financial instruments.	Not applicable.
 Credit risk	Includes: - changes in the obligor's creditworthiness; and - changes in the credit spread over the benchmark interest rate.	Not applicable.
 Foreign currency risk	Changes in the related foreign currency exchange rates.	Changes in the related foreign currency exchange rates if the firm commitment is denominated in a foreign currency.

	Financial items	Nonfinancial items
 Price risk	— Total change in the fair value.	— Total change in the fair value.

Criterion 3: Hedging instruments eligible for fair value hedges

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

Read more: [Chapter 7](#)

Accounting for fair value hedges

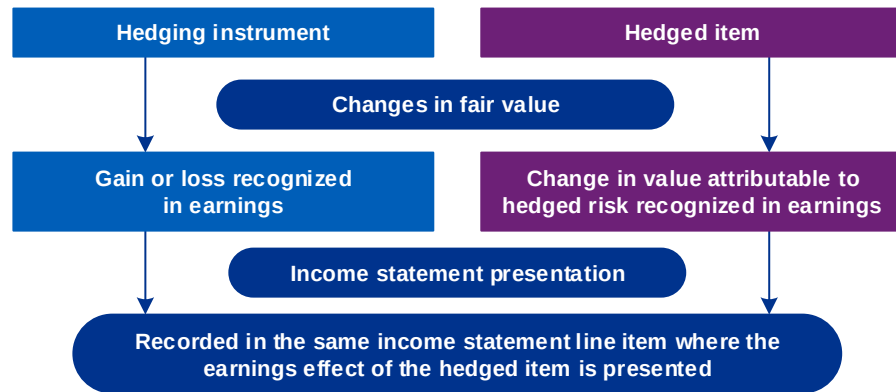
The fair value hedge accounting model can change how the hedged item is measured on the balance sheet.

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

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

Hedging instrument	Hedged item
A derivative hedging instrument is recognized at fair value on the balance sheet with changes in fair value recognized in earnings, other than amounts related to excluded components that are recognized through an amortization approach.	Changes in the fair value of the hedged item that are attributable to the hedged risk are recognized as an adjustment to the amortized cost basis of the hedged item. The offsetting entry is a gain or loss that is recognized in earnings.

The following diagram shows the general accounting and presentation for a highly effective fair value hedge (assuming there are no excluded components).



The effect is to offset gains or losses on the hedging instrument with gains or losses on the hedged item that are attributable to the hedged risk within one line item in the income statement.

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

Read more: [Chapter 8](#)

Qualifying criteria for cash flow hedges

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

Criterion 1: Transactions eligible for cash flow hedges

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

Cash flows from existing recognized assets and liabilities	Forecasted transactions – e.g. forecasted purchases or sales
Group of similar forecasted transactions	All-in-one hedge

Criterion 2: Risks eligible for cash flow hedges

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

	Financial assets and liabilities	Nonfinancial assets and liabilities
 Interest rate risk	Either: — changes in a contractually specified interest rate for variable-rate financial instruments or forecasted issuances or purchases of variable-rate financial instruments; or — changes in the benchmark interest rate for forecasted issuances or purchases of fixed-rate financial instruments.	Not applicable.
 Credit risk	Includes: — risk of default; — changes in the obligor's creditworthiness; and — changes in the credit spread over the contractually specified interest rate or the benchmark interest rate.	Not applicable.
 Foreign currency risk	— Changes in the related foreign currency exchange rates.	— Changes in the related foreign currency exchange rates of foreign currency denominated forecasted transactions or firm commitments.
 Price risk	— Total change in the cash flows related to the asset or liability – e.g. all changes in the purchase price or sales price.	Either: — all changes in the purchase price or sales price of the asset – i.e. price risk; or — changes in a contractually specified component – i.e. a component of price risk.

Criterion 3: Hedging instruments eligible for cash flow hedges

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

Read more: [Chapter 9](#)

Cash flow hedge accounting

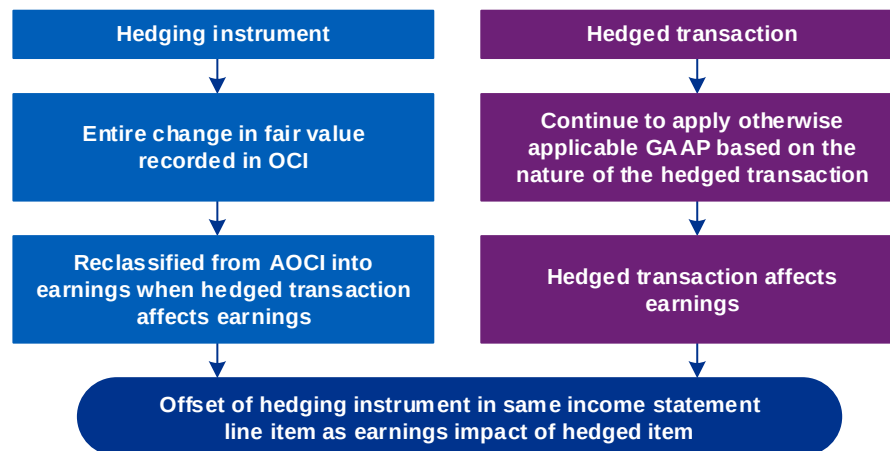
The cash flow hedge accounting model allows changes in the fair value of the derivative instrument to be recorded in OCI instead of earnings.

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

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

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

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



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

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

Read more: [Chapter 10](#)

Hedging foreign currency exposures



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

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

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

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

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

	Criterion 1: Eligibility of hedged items or transactions	Criterion 3: Eligibility of hedging instruments
Foreign currency fair value hedge	FCD asset or liability	Derivative
	Unrecognized FCD firm commitment	Derivative or Nonderivative financial instrument
Foreign currency cash flow hedge	FCD asset or liability	Derivative
	Unrecognized FCD firm commitment	Derivative
	FCD forecasted transaction	Derivative

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

Read more: [Chapter 11](#)

Net investment hedges

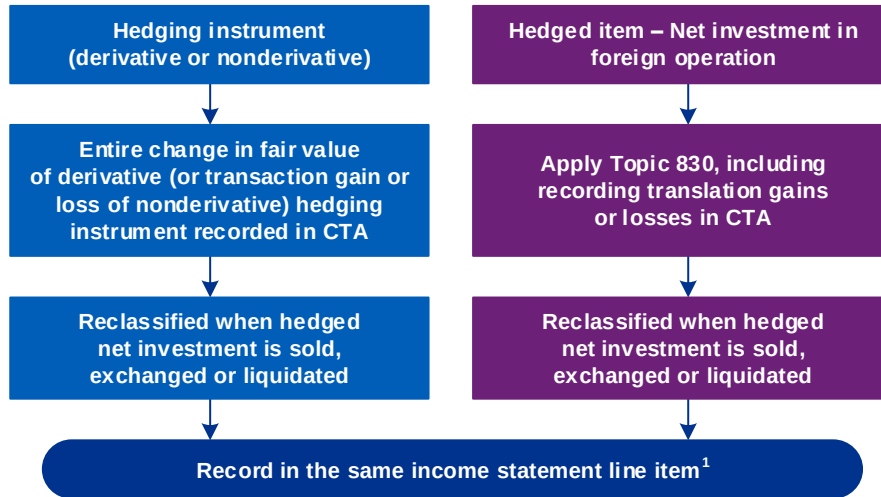
Net investment hedges are subject only to the following hedging criteria.

General qualifying criteria for all foreign currency hedges	— Hedging instrument. The entity with the foreign currency exposure needs to be a party to the hedging instrument. — Hedged item or transaction. The hedged net investment needs to be denominated in a currency other than the entity's functional currency.
Hedge effectiveness	The hedging instrument must be both designated and effective as an economic hedge of the net investment. The entity assesses effectiveness at least quarterly and whenever financial statements are issued or earnings are reported.
Formal documentation	The entity formally documents the hedging relationship.

In general, the net investment hedge accounting model works as follows.

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

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



Note:

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

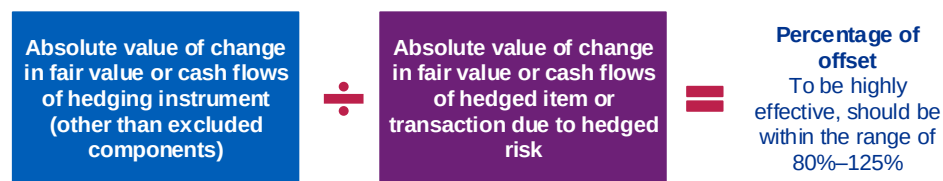
Read more: [Chapter 12](#)

Hedge effectiveness

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

- For a **prospective** assessment, the entity evaluates whether the hedging relationship is expected to be highly effective.
- For a **retrospective** assessment, the entity evaluates whether the hedging relationship has actually been highly effective.

The following diagram summarizes how effectiveness is assessed.



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

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

- shortcut method; and
- critical terms match method.

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

Read more: [Chapter 13](#)

Presentation

The following table summarizes Topic 815's presentation guidance and KPMG interpretations.

Topic	Summary
Balance sheet	
Balance sheet offsetting	Derivative instruments may be offset as a policy election when certain conditions are met.
Classification as current or noncurrent	Determining the current or noncurrent classification of a derivative contract may often be complex. Entities should develop an accounting policy, apply that policy consistently, and disclose their policy accordingly.
Income statement	
Changes in fair value of derivative instrument	— Nonhedging derivatives: Topic 815 does not provide specific presentation guidance. — Fair value or cash flow derivative hedging instruments: When they are recognized in the income statement, changes in fair value – including amounts related to excluded components – are recognized in the same line item as the earnings effect of the hedged item or transaction. However, Topic 815 does not provide specific guidance for amounts reclassified from AOCI to earnings related to missed forecasts of cash flow hedging relationships. — Net investment derivative hedging instruments: Changes in fair value that are included in the effectiveness assessment are included in the same line item as the earnings effect of the hedged net investment. Topic 815 does not provide specific presentation guidance related to amounts excluded from the effectiveness assessment.
Gross vs net presentation of gains or losses	— Derivative is held for trading purposes <i>or</i> will be settled net: Net presentation is appropriate. — Derivative is not held for trading purposes and will be settled gross: Judgment is applied based on relevant facts and circumstances.

Topic	Summary
OCI and AOCI	
Required presentation (or disclosure) of changes in AOCI	An entity is required to present certain changes in AOCI on the face of the financial statements (or disclose them in the notes).
Cash flow statement	
Classification of cash receipts and payments	— Cash receipts and payments from/for a derivative are generally classified as operating, financing or investing based on the instrument's nature. — Additional guidance applies to derivatives with 'other-than-insignificant' financing elements.

Read more: [Chapter 14](#)

Private companies and entities that do not report earnings

Relief provisions for private companies and NFPs

Many private companies historically have found the hedging requirements under the general hedge accounting guidance to be onerous. To provide relief to these companies, the FASB developed a simplified hedge accounting approach for private companies' qualifying **cash flow hedging** relationships, as well as relief in the timing of **documentation** and **hedge effectiveness** requirements for private companies not adopting the simplified hedge accounting approach and certain not-for-profit entities.

		Private companies	NFP entities
Simplified hedge accounting:	Available for certain interest rate swaps in cash flow hedges	✓	✗
Relaxed time requirements for documentation:	Available if simplified hedge accounting not elected	✓	✓

Entities that do not report earnings

Topic 815 applies to all entities, including those that do not report earnings as a separate caption. For these entities:

- amounts that would normally be reported in earnings are instead reported in the change in net assets; and
- hedge accounting may be used, except that these entities cannot use cash flow hedge accounting and they cannot elect an amortization approach for excluded components when applying fair value hedge accounting.

Read more: [Chapter 16](#)

2. Scope of Topic 815**

Detailed contents

This is a new chapter added in this edition **

2.1 How the standard works

2.2 General scope considerations

2.2.10 Overview

2.3 Regular-way security trades

Future developments

2.3.10 Overview

2.3.20 Interaction with trade-date accounting

2.3.30 Contracts for existing securities that are readily convertible to cash

2.3.40 Contracts for the purchase or sale of net-yet-existing securities

2.3.50 Forward and option contracts for the purchase of certain debt securities and equity instruments

Questions

2.3.10 Why does Topic 815 include a scope exception for entities that apply trade-date accounting?

2.3.20 Does an entity determine whether the time period for delivery is customary based on its individual practices?

2.3.30 Does a contract to purchase a security that permits settlement in a different security meet the regular-way security trades scope exception?

2.3.40 Is the regular-way security trades exception for contracts for securities that do not exist elective?

2.3.50 Why are contracts to purchase and sell when-issued and similar securities in the regular-way security trades scope exception?

2.3.60 How does an entity account for a forward commitment dollar roll?

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Examples

2.3.10 Two-day forward contract to acquire stock that is readily convertible to cash

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2.4.10 Overview

2.4.20 Types of contracts eligible for NPNS election

2.4.30 Probable physical settlement

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2.4.50 Contract pricing (price adjustment clauses)

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2.4.70 Documentation

Questions

2.4.10 Can a contract that qualifies under the NPNS scope exception be the hedged item in a hedging relationship?

2.4.20 When does the NPNS scope exception apply to a forward contract with optionality?

2.4.30 Can a forward contract with optionality be bifurcated into a forward contract and an option?

2.4.40 Is a requirements contract eligible for the NPNS scope exception if it includes optionality as to quantity?

2.4.50 How is the concept of netting applied in the electric utility industry?

2.4.60 What are the documentation requirements regarding net settlement?

2.4.70 What does 'probable' mean when evaluating whether a contract is of a type that is eligible for the NPNS scope exception?

2.4.80 Does a contract that calls for 'flash title' qualify for the NPNS scope exception?

2.4.90 Does a service contract qualify for the NPNS scope exception?

2.4.100 Is a contract that requires periodic cash settlements eligible for the NPNS scope exception?

2.4.110 Does a 'take-or-pay' contract qualify for the NPNS scope exception?

2.4.120 Can each party to a contract reach a different conclusion about whether the contract is eligible for the NPNS scope exception?

2.4.130 Is a contract for an asset being purchased for resale by the entity eligible for the NPNS scope exception?

- 2.4.140 On what concept is a clearly and closely related analysis for a price adjustment clause based?
- 2.4.150 When is a price adjustment or foreign currency in a contract *not* clearly and closely related to the asset being purchased or sold?
- 2.4.160 Does the phrase 'clearly and closely related' mean the same thing under the NPNS scope exception and the embedded derivatives evaluation?
- 2.4.170 Is a contract's pricing extraneous if it is irrelevant to changes in the cost *or* changes in the fair value of the asset being sold or purchased (but not both)?
- 2.4.180 Does an entity analyze the ingredients or other factors related to the production of the asset to which the contract's pricing is extraneous?
- 2.4.190 Can a price adjustment that includes indexing to the ingredients in an asset qualify for the NPNS scope exception?
- 2.4.200 Is a contract that qualifies for the NPNS scope exception evaluated to determine whether it contains an embedded feature requiring separate accounting?
- 2.4.210 Why does the NPNS scope exception have special provisions for power purchase or sale agreements?
- 2.4.220 What does 'capacity' mean for an electric utility?
- 2.4.230 Are the NPNS criteria for power purchase or sale agreements that are capacity contracts relevant to retail buyers?
- 2.4.240 Does the use of locational marginal pricing to determine a transmission charge (or credit) within nodal energy markets constitute net settlement?
- 2.4.250 Is an entity required to document its basis for designating a contract as a NPNS scope exception?
- 2.4.260 Is the NPNS scope exception essentially an election?
- 2.4.270 Is an entity required to document the NPNS scope exception for each individual contract?
- 2.4.280 Is an entity required to apply the NPNS scope exception to all similar contracts?
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- 2.4.300 If a contract that was designated under the NPNS scope exception is net settled, does it taint all similar contracts?
- 2.4.310 How does an entity account for a contract that ceases to be eligible for the NPNS scope exception?

- 2.4.320 How does an entity account for a contract that was not designated as NPNS until after the contract's inception?
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Examples

- 2.4.10 Eligibility of requirements and nonrequirements contracts for the NPNS scope exception
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- 2.4.30 Physically settled forward contract for rubber inventory
- 2.4.40 Price adjustments
- 2.4.50 Currency in which the price is routinely denominated in international commerce
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- 2.5.20 Dual-trigger property and casualty insurance contracts
- 2.5.30 Contracts with actuarially determined minimum amounts of expected claim payments

Questions

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Example

- 2.5.10 Dual-trigger property and casualty insurance contract – fixed payment

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- 2.6.20 Failure of the debtor to satisfy its required payment obligations
- 2.6.30 Debtor's obligation is past due
- 2.6.40 Guaranteed party is exposed to the risk of nonpayment
- 2.6.50 Application issues

Questions

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- 2.6.20 Is a guarantee that compensates a creditor upon the occurrence of a nonpayment-based default eligible for the financial guarantee scope exception?
- 2.6.30 Does a contract that compensates a creditor if a debtor files for bankruptcy meet the financial guarantee scope exception?
- 2.6.40 Do credit derivatives that provide protection against a decline in creditworthiness qualify for the financial guarantee scope exception?
- 2.6.50 Does the financial guarantee scope exception apply if the guaranteed party can sell the referenced asset?
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- 2.6.70 Does a back-to-back guarantee arrangement qualify for the financial guarantee scope exception if the guaranteed amount is less than that under the related written guarantee?
- 2.6.80 Do dual-trigger financial guarantees qualify for the financial guarantee scope exception?

Examples

- 2.6.10 Financial guarantee – Hedging credit exposure
- 2.6.20 Credit derivatives
- 2.6.30 Financial guarantee contract – scheduled payment is past due
- 2.6.40 Financial guarantee contract – scope exception

2.7 Certain contracts that are not traded on an exchange

Questions

- 2.7.10 How often does an entity assess the listed status of instruments or contracts in the context of this scope exception?
- 2.7.20 Does a contract with both physical and financial variables as underlyings qualify for this scope exception?
- 2.7.30 Does it matter which party to the contract owns the nonfinancial asset?
- 2.7.40 How is 'unique' defined in the context of this scope exception?
- 2.7.50 Does this scope exception apply to an agreement whose payments are based on revenue?

- 2.7.60 Does this scope exception apply to contracts with settlements based on performance measures other than the volume of items sold or services rendered?
- 2.7.70 Does this scope exception apply to contracts with settlements based on expenses?
- 2.7.80 Does an underlying that is a volume of sales of a specific product (rather than aggregate sales) qualify for the scope exception?
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- 2.7.120 How is the intrinsic value method applied to weather derivatives?

Examples

- 2.7.10 Geological variable
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2.8 Derivatives that impede sale accounting

Question

- 2.8.10 Why are derivatives that impede sale accounting subject to a scope exception?

2.9 Investments in life insurance

Question

- 2.9.10 Is a policyholder required to evaluate an investment in a life insurance contract for embedded derivatives requiring bifurcation?

2.10 Certain investment contracts

Questions

- 2.10.10 How does a synthetic GIC differ from a traditional GIC?
- 2.10.20 How does an entity account for a synthetic GIC that does not qualify for the scope exception?

2.11 Certain loan commitments

Questions

- 2.11.10 What contracts qualify as loan commitments?
- 2.11.20 What types of commitments qualify for the loan commitment scope exception?

- 2.11.30 Does a commitment to make a working capital loan in the future qualify for the loan commitment scope exception?
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- 2.11.50 Why are an issuer's loan commitments related to the origination of mortgage loans that will be held-for-sale automatically required to be accounted for as derivatives?
- 2.11.60 If the issuer can terminate the loan commitment agreement, does it account for the loan commitment as a derivative?
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- 2.11.80 How does a lender account for the origination of a mortgage loan held-for-sale that previously was the subject of a loan commitment accounted for as a derivative?
- 2.11.90 How is the fair value of servicing rights included in a loan commitment's fair value measured?
- 2.11.100 How does an entity reflect late charges that the servicer is entitled to receive?

Examples

- 2.11.10 Examples of loan origination commitments
- 2.11.20 Fair value measurement – components of loan commitments

2.12 Certain interest-only and principal-only strips

Questions

- 2.12.10 Does allocating a portion of an instrument's cash flows to compensate for stripping or servicing the instrument disqualify an IO or PO strip from the scope exception?
- 2.12.20 Do beneficial interests in securitized financial instruments with multiple tranches qualify for the IO/PO strip scope exception?

Examples

- 2.12.10 IO and PO strips
- 2.12.20 IO and PO strips with terms not present in the original bond

2.13 Certain contracts involving an entity's own equity

Questions

- 2.13.10 Are there circumstances in which the scope exceptions cannot be applied?

- 2.13.20 How does an entity account for the change in fair value of an instrument that was equity-classified under Topic 718 and requires derivative accounting when Topic 718 ceases to apply?

Example

- 2.13.10 Share-based payment to a nonemployee

2.14 Leases

2.15 Residual value guarantees

Question

- 2.15.10 Do all residual value guarantees meet the residual value guarantee scope exception?

Example

- 2.15.10 Third-party residual value guarantee

2.16 Registration payment arrangements

Questions

- 2.16.10 What are some examples of registration payment arrangements that do not qualify for the scope exception?
- 2.16.20 Can this scope exception be applied by analogy to registration payment arrangements not in the scope of Subtopic 825-20?

2.17 Certain fixed-odds wagering contracts

2.18 SEC staff's longstanding position on written options

2.1 How the standard works

Topic 815's scope primarily includes instruments and contracts that meet the definition of a derivative (see chapter 3). However, its scope:

- **excludes** certain items even if they meet the definition of a derivative; and
- **includes** certain items even if they do *not* meet the definition of a derivative.

The following table summarizes the instruments that are specifically excluded from or included in the scope of Topic 815 and where they are discussed in this chapter.

Instrument / contract	Applies to:
Scope exceptions	
Regular-way security trades (section 2.3)	Certain forward contracts created when security trades are not settled on the trade date.
Normal purchases and normal sales (section 2.4)	Certain purchases or sales of nonfinancial items that the entity will use or sell over a reasonable period in the normal course of business.
Insurance contracts (section 2.5)	Certain insurance contracts when payments are triggered by the occurrence of an identified insurable event.
Financial guarantee contracts (section 2.6)	Certain contracts in which a guarantor agrees to reimburse a creditor if a debtor fails to make its payment obligations under a nonderivative contract.
Contracts that are not traded on an exchange (section 2.7)	Certain contracts that are not traded on an exchange when the underlying is based on a physical variable, the value of a nonfinancial asset or liability, or specified volumes of revenue.
Derivatives that impede sale accounting (section 2.8)	Derivative instruments whose existence serves as an impediment to recognizing a related contract as a sale or purchase.
Investments in life insurance (section 2.9)	A policyholder's investment in life insurance contracts in the scope of Subtopic 325-30.
Investment contracts (section 2.10)	Certain investment contracts that are accounted for by defined benefit plans under either paragraph 960-325-35-1 or 960-325-35-3.
Loan commitments (section 2.11)	— Holders (borrowers) of loan commitments; and — Issuers (lenders) of certain commitments to originate mortgage loans that will be held for investment purposes and all other types of loans.
Interest-only and principal-only strips (section 2.12)	Certain interests in securitized financial assets that represent rights to receive only a specified proportion of the contractual interest or principal cash flows of a specific debt instrument.

Instrument / contract	Applies to:
Scope exceptions	
Contracts involving an entity's own equity (section 2.13)	The following contracts that involve an entity's own equity: — contracts indexed to an entity's own shares and classified in equity; — certain share-based payments; — certain contracts related to a business combination; and — certain forwards that require physical delivery.
Leases (section 2.14)	Leases in the scope of Topic 842.
Residual value guarantees (section 2.15)	Residual value guarantees that are in the scope of Topic 842.
Registration payment arrangements (section 2.16)	Registration payment arrangements in the scope of Subtopic 825-20.
Fixed-odds wagering contracts (section 2.17)	Certain fixed-odds wagering contracts that are accounted for as revenue transactions by an entity with casino operations.
Scope inclusions	
Forward-commitment dollar rolls (Question 2.3.50)	Forward commitment dollar rolls for which the underlying security does not yet exist. They are measured initially and subsequently at fair value.
Forward and option contracts for the purchase of debt and equity securities (section 2.3.50)	Certain forward or option contracts for the purchase of debt or equity securities that will (when purchased) be subject to Topic 320 or Topic 321. Such a contract is accounted for as if the contract itself was in the scope of Topic 320 or Topic 321, as applicable.
Loan commitments related to originations of mortgage loans held-for-sale (section 2.11.30)	Issuers of loan commitments related to the origination of mortgage loans that will be held-for-sale. Topic 815 requires these to be accounted for as derivatives, even if they do not meet the definition of a derivative.
Written options (SEC staff guidance) (section 2.18)	Written options. They are measured initially and subsequently at fair value.

2.2 General scope considerations

2.2.10 Overview



Excerpt from ASC 815-10

> Instruments

15-2 The scope of this Subtopic relates primarily to whether a contract meets the definition of a **derivative instrument** (see paragraph 815-10-15-83). However, as discussed in this Subsection, some contracts that meet the definition of derivative instrument are not within the scope of this Subtopic, while other contracts that do not meet the definition of derivative instrument are within the scope of this Subtopic. Some of the disclosure requirements in Section 815-10-50 apply to nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 815-20-25-58 and 815-20-25-66.

15-4 If a contract meets the definition of both a derivative instrument and a **firm commitment** under this Subtopic, then an entity shall account for the contract as a derivative instrument unless one of the scope exceptions in this Subsection applies.

>> Instruments Within Scope

15-10 The guidance in the General Subsections of this Subtopic applies to all derivative instruments, as that term is defined in paragraph 815-10-15-83, unless explicitly excluded by this Subsection (see paragraphs 815-10-15-13 through 15-82). The General Subsections of this Subtopic also identify incremental guidance that applies specifically to **forward commitment dollar rolls**.

Certain instruments and contracts that meet the definition of a derivative are nevertheless excluded from the scope of Topic 815 through a series of scope exceptions. In contrast, a few types of instruments and contracts that do not meet the definition of a derivative are included in the scope of Topic 815, which provides specific accounting guidance. [\[815-10-15-2\]](#)

The FASB developed a comprehensive definition of a derivative instrument in Topic 815. However, several contracts for which explicit accounting literature already existed met that comprehensive definition of a derivative, creating potential conflicts in how to account for those contracts. Because the FASB did not want to rewrite the other accounting literature, instead it provided several scope exceptions to Topic 815.

Some of the scope exceptions (or scope inclusions) apply to both parties to the contract while others apply to only one party to the contract.

2.3 Regular-way security trades

2.3.10 Overview



Excerpt from ASC 815-10

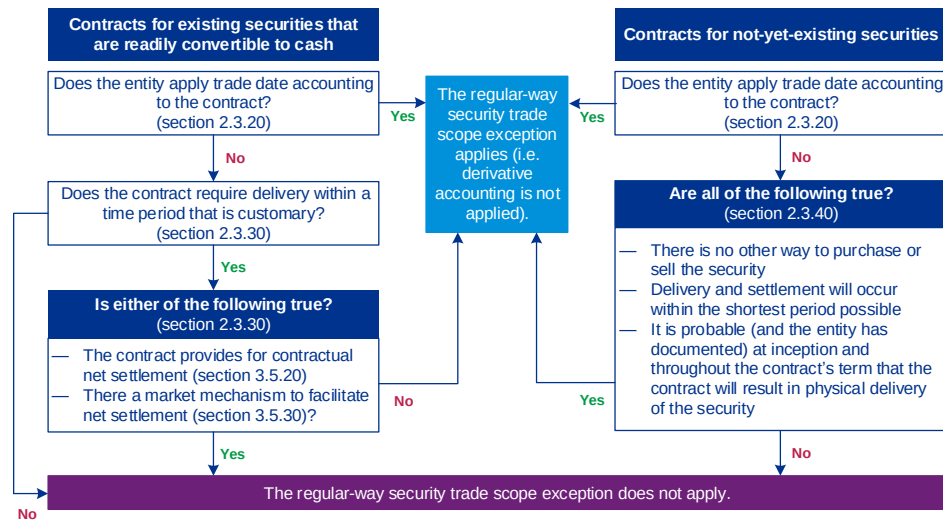
>>> Regular-Way Security Trades

15-15 Regular-way security trades are defined as contracts that provide for delivery of a security within the period of time (after the trade date) generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. 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 security trades scope exception applies, but if the contract requires settlement in five days, the regular-way security trades scope exception does not apply unless the reporting entity is required to account for the contract on a trade-date basis.

15-18 Note that contracts that require delivery of securities that are not readily convertible to cash (and thus do not permit net settlement) are not subject to the requirements of this Subtopic unless there is a market mechanism outside the contract to facilitate net settlement (as described in paragraph 815-10-15-110).

A regular-way security trade arises from the trade of a specified security that is settled on a gross basis (i.e. physically settled with the specified security) – e.g. when an investor purchases securities from a brokerage firm. It is fairly common for the normal trading of securities to have a time delay between the date the trade is initiated and the date it is settled. This delay results in a forward contract. That forward contract frequently meets the definition of a derivative, particularly when it is for a security that is readily convertible to cash (see section 3.5.40). [\[815-10-15-15\]](#)

The regular-way security trades scope exception can apply to this forward contract. When the forward contract is for an existing security, it only applies when that security is readily convertible to cash. The conditions for meeting this scope exception are summarized in the following decision tree. This exception applies to either party to the contract as long as each meets the applicable requirements. [\[815-10-15-15 – 15-21\]](#)



Further, Topic 815 provides accounting guidance for certain forward and option contracts when the underlying security is not recognized on the trade date, even if they do not meet the definition of a derivative (see section 2.3.50).

2.3.20 Interaction with trade-date accounting



Excerpt from ASC 815-10

>>> Regular-Way Security Trades

15-17 The scope exception for regular-way security trades applies only to a contract that requires delivery of securities that are **readily convertible to cash** except that the scope exception also shall or may apply in any of the following circumstances:

- If an entity is required, or has a continuing policy, to account for a contract to purchase or sell an existing security on a trade-date basis, rather than a settlement-date basis, and thus recognizes the acquisition (or disposition) of the security at the inception of the contract, then the entity shall apply the regular-way security trades scope exception to that contract.
- If an entity is required, or has a continuing policy, to account for a contract for the purchase or sale of when-issued securities or other securities that do not yet exist on a trade-date basis, rather than a settlement-date basis, and thus recognizes the acquisition or disposition of the securities at the inception of the contract, that entity shall apply the regular-way security trades scope exception to those contracts.

15-21 This Subtopic does not change whether an entity recognizes regular-way security trades on the trade date or the settlement date.

Regular-way security trades of securities were explicitly excluded from derivative accounting under Topic 815 to avoid resolving the debate over whether trade-date versus settlement-date accounting is preferable. That

debate exists because US GAAP is inconsistent about the date on which transfers of financial instruments should be recognized. [FAS 133.BC274]

- **Trade-date accounting.** Transfers are recognized at the date of trade – e.g. the purchaser recognizes the security as an asset with a corresponding liability to pay for the security on the date of trade.
- **Settlement-date accounting.** Transfers are recognized on the date the financial instrument is transferred and the transaction is settled – e.g. the purchaser does not recognize the security until the trade is settled.

If an entity is required (or has a continuing policy) to apply trade-date accounting, the regular-way security trades exception applies regardless of whether or not the securities used to settle the trade exist. [815-10-15-17, 15-20]



Question 2.3.10

Why does Topic 815 include a scope exception for entities that apply trade-date accounting?

Interpretive response: If Topic 815 required derivative accounting for a regular-way security trade of an existing security that is readily convertible to cash, Topic 815 would have effectively required settlement-date accounting for the ultimate purchases and sales of the securities of those transactions. The FASB felt the resolution of settlement-date versus trade-date accounting was not an objective of FAS 133 (now Topic 815). [FAS 133.BC274]

As a result, the FASB provided a scope exception for an entity that applies trade-date accounting, thereby leaving intact existing US GAAP about the date on which a trade should be recognized. [815-10-15-20 – 15-21]

2.3.30 Contracts for existing securities that are readily convertible to cash



Excerpt from ASC 815-10

>>> Regular-Way Security Trades

15-16 Except as provided in (a) in the following paragraph, a contract for an existing security does not qualify for the regular-way security trades scope exception if either of the following is true:

- a. It requires or permits net settlement (as discussed in paragraphs 815-10-15-100 through 15-109).
- b. A market mechanism exists to facilitate net settlement of that contract (as discussed in paragraphs 815-10-15-110 through 15-118).

When settlement-date accounting (rather than trade-date accounting) is applied, the regular-way security trades scope exception applies to contracts to purchase or sell existing securities that are readily convertible to cash if:

- the contract requires delivery of the security within a time period that is customary;
- the contract does not provide for contractual net settlement (see section 3.5.20); and
- there is not a market mechanism to facilitate net settlement (see section 3.5.30).



Question 2.3.20

Does an entity determine whether the time period for delivery is customary based on its individual practices?

Interpretive response: No. The notion of a regular-way security trade is based on marketplace regulations or conventions and not the normal practices of an individual entity. [815-10-15-15]

For example, if it is required or customary for certain securities on a specified exchange to settle within two days, a contract requiring settlement in more than two days is not a regular-way security trade. This is true even if the entity customarily enters into contracts to purchase those same securities more than two days forward.

As a result, a forward purchase or sale contract arising in connection with the sale of that same security that is expected to be settled in five days is not subject to the regular-way trade scope exception; this because five days is not the normal settlement convention for that specified exchange.

Regulations or conventions may be more difficult to determine for some foreign or less active exchanges. However, the regular-way trade scope exception applies only when the underlying security is readily convertible to cash. As a result, the regulations or conventions of the marketplace should be reasonably apparent because the related market must be sufficiently active to rapidly absorb the quantities involved without significantly affecting the price. [FAS 133.BC275]



Example 2.3.10

Two-day forward contract to acquire stock that is readily convertible to cash

ABC Corp. enters into a two-day forward contract to acquire 30,000 existing shares of DEF Corp. common stock. DEF's common stock is publicly traded in an active market, and there is not a market mechanism that facilitates net settlement of the forward contract (see section 3.5.30). Assume such a contract customarily requires settlement within two business days. ABC pays a small commission to enter into this contract.

This forward contract meets the regular-way security trades exception because:

- it does not provide for net settlement;

- a market mechanism does not exist to facilitate net settlement of the forward contract; and
- the contract requires delivery within a time period that is customary.

Therefore, the forward contract is not accounted for as a derivative.



Question 2.3.30

Does a contract to purchase a security that permits settlement in a different security meet the regular-way security trades scope exception?

Interpretive response: No. A regular-way security trade arises from the trade of a specified security and is settled through physical delivery of that specified security. We believe the related scope exception for existing securities pertains only to delivery of the specified security, even if the contract settles in the customary period for settlement and both securities that may be used for settlement are readily convertible to cash.



Example 2.3.20

Contract approval and customary business practice

ABC Corp. enters into a two-day forward to acquire 30,000 existing shares of DEF Corp. common stock. DEF's common stock is publicly traded in an active market, and there is not a market mechanism that facilitates net settlement of the forward contract (see section 3.5.30). ABC pays a small commission to enter into this contract.

The contract continues to be valued based on DEF common stock, but permits settlement in an equivalent value of XYZ Corp. common stock. XYZ is an equity investee of DEF, and its common stock is publicly traded in an active market.

This forward contract does not meet the regular-way security trades exception. Although it may be settled in two days, it does not require settlement for the security specified in the contract (i.e. DEF common stock), but instead permits settlement in XYZ Corp. common stock.

The contract has an underlying (DEF common stock), a notional amount (30,000 shares), requires no (or a small) initial investment, and may be settled in DEF or XYZ common stock, both of which are readily convertible to cash (see section 3.5.40).

Therefore, ABC accounts for the contract as a derivative instrument because it meets the definition of a derivative instrument and does not meet a scope exception.

2.3.40 Contracts for the purchase or sale of net-yet-existing securities



Excerpt from ASC 815-10

>>> Regular-Way Security Trades

15-17 The scope exception for regular-way security trades applies only to a contract that requires delivery of securities that are readily convertible to cash except that the scope exception also shall or may apply in any of the following circumstances:

- c. Contracts for the purchase or sale of when-issued securities or other securities that do not yet exist, except for those contracts accounted for on a trade-date basis, are excluded from the requirements of this Subtopic as a regular-way security trade only if all of the following are true:
 - 1. There is no other way to purchase or sell that security.
 - 2. Delivery of that security and settlement will occur within the shortest period possible for that type of security.
 - 3. It is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery of a security when it is issued. (The entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery.)

Example 9 (see paragraph 815-10-55-118) illustrates the application of item (c) in this paragraph.

15-19 A contract for the purchase or sale of when-issued securities or other securities that do not yet exist is eligible to qualify for the regular-way security trades scope exception (as discussed in paragraph 815-10-15-17) even though either of the following is true:

- a. That contract permits net settlement (as discussed in paragraphs 815-10-15-100 through 15-109).
- b. A market mechanism exists to facilitate net settlement of that contract (as discussed in paragraphs 815-10-15-110 through 15-118).

See Example 9 (paragraph 815-10-55-118).

15-20 Net settlement (as described in paragraphs 815-10-15-100 and 815-10-15-110) of contracts in a group of contracts similarly designated as regular-way security trades would call into question the continued application of the scope exception to such contracts.

When settlement-date accounting (rather than trade date accounting) is applied, the regular-way security trades scope exception applies to a contract for the purchase or sale of when-issued securities or other securities that do not yet exist (collectively referred to as 'not-yet-existing' securities) if: [\[815-10-15-17\]](#)

- there is no other way to purchase or sell the security;
- delivery and settlement will occur within the shortest period possible (see FASB Example 9, reproduced below); and

- it is probable – and the entity has documented – that the contract will result in physical delivery of the security (rather than net settlement).

This scope exception applies to contracts for not-yet-existing securities even if the contract provides for contractual net settlement or a market mechanism exists to facilitate net settlement. However, net settlement of contracts in a group of contracts similarly designated as regular-way security trades would call into question the continued exemption of such contracts. [815-10-15-19 – 15-20]



Excerpt from ASC 815-10

>> Example 9: Regular-Way Security Trades—Shortest-Period Criterion

55-118 This Example illustrates the application of paragraph 815-10-15-17(c). Assume a variety of forward contracts exists for a when-issued security, such as a to-be-announced security, that provides a choice of settlement dates for each of the next three months (such as November, December, or January). An entity enters into a forward contract to purchase the to-be-announced security, which will otherwise meet the qualifications of paragraphs 815-10-15-13 through 15-20, that requires delivery in the second-nearest month (such as December), not the nearest month (such as November). The entity may not apply the **regular-way security trade** exception to the forward purchase contract that requires delivery of the to-be-announced security in the second-nearest month (such as December).

55-119 In this Example, the to-be-announced security (identified by issuer, contractual maturity of the underlying loans, and the net coupon, such as 30-year Government National Mortgage Association [GNMA] securities bearing interest of 7 percent) is available under multiple settlement periods (that is, the standardized settlement date in November, December, or January). The regular-way security trade exception may be applied only to forward contracts for that to-be-announced security that require delivery in November, the shortest period permitted for that type of to-be-announced security. The December and January settlement to-be-announced forward contracts must be accounted for as derivative instruments under this Subtopic.

55-120 If the forward contracts in this Example meet the hedge accounting criteria, they may be designated in cash flow hedges of the anticipated purchase of the securities, as discussed in paragraph 815-20-25-22.



Question 2.3.40

Is the regular-way security trades exception for contracts for securities that do not exist elective?

Interpretive response: Yes. We believe that, by analogy to paragraph 815-10-15-39 related to the NPNS scope exception (see Question 2.4.260), the regular-way security trades exception for when-issued or similar securities is effectively an election.

This means an entity may choose to not document whether it is probable that the contract will settle gross (rather than net). This ability to choose whether to meet the documentation requirement effectively constitutes an election to apply (or not apply) the regular-way security trades scope exception.

However, once an entity complies with the documentation requirements, which can be done at the inception of the contract or a later date, the entity cannot subsequently change its election and account for the contract as a derivative.

[815-10-15-39]



Question 2.3.50

Why are contracts to purchase and sell when-issued and similar securities in the regular-way security trades scope exception?

Interpretive response: The FASB considered limiting the exception for regular-way security trades to purchases or sales of existing securities, which entitle the purchaser to receive – and requires the seller to deliver – a specific security. The delay is a matter of market regulations and conventions for delivery. In contrast, a forward contract for when-issued or other forms of a nonexistent security does not entitle or obligate parties to exchange a specific security. Instead, it entitles the issuer and holder to participate in price changes without being required to own or deliver an asset that is associated with the underlying. For that reason, the FASB would have preferred that a forward contract on a nonexistent security be subject to the requirements of derivative accounting. [FAS 133.BC276]

However, the FASB was concerned that including certain forward contracts for when-issued securities in the scope of derivative accounting would subject entities to potentially burdensome regulatory disclosure requirements for transactions in derivative instruments. One type of forward contract the FASB specifically mentioned in this regard is to-be-announced (TBA) Government National Mortgage Association (GNMA) forward contracts. On balance, the FASB decided to extend the regular-way security trades scope exception to contracts for the purchase or sale of when-issued securities or other securities that do not yet exist provided they meet certain characteristics. [FAS 133.BC276]

Forward commitment dollar rolls



Excerpt from ASC 815-10

20 Glossary

Forward Commitment Dollar Roll – See Government National Mortgage Association Rolls.

Government National Mortgage Association Rolls

The term Government National Mortgage Association (GNMA) rolls has been used broadly to refer to a variety of transactions involving mortgage-backed

securities, frequently those issued by the GNMA. There are four basic types of transactions:

- a. Type 1. Reverse repurchase agreements for which the exact same security is received at the end of the repurchase period (vanilla repo)
- b. Type 2. Fixed coupon dollar reverse repurchase agreements (dollar repo)
- c. Type 3. Fixed coupon dollar reverse repurchase agreements that are rolled at their maturities, that is, renewed in lieu of taking delivery of an underlying security (GNMA roll)
- d. Type 4. Forward commitment dollar rolls (also referred to as to-be-announced GNMA forward contracts or to-be-announced GNMA rolls), for which the underlying security does not yet exist.

>>> Forward Commitment Dollar Rolls

15-12 A forward commitment dollar roll that does not meet the definition of a derivative instrument is within the scope of the guidance specified for such contracts in this Subtopic (see paragraphs 815-10-25-15, 815-10-30-4, and 815-10-35-4).

> Forward Commitment Dollar Rolls

25-15 Forward commitment dollar rolls that are not otherwise subject to this Subtopic's provisions shall be recognized as either assets or liabilities depending on the rights or obligations under the contracts.

> Forward Commitment Dollar Rolls

30-4 A **forward commitment dollar** roll that is not subject otherwise to this Subtopic's provisions shall be measured initially at fair value.

> Forward Commitment Dollar Rolls

35-4 A **forward commitment dollar roll** that is not subject otherwise to this Subtopic's provisions shall be measured subsequently at fair value.



Question 2.3.60

How does an entity account for a forward commitment dollar roll?

Interpretive response: Topic 815 requires an entity to account for forward commitment dollar rolls as assets or liabilities that are measured both initially and subsequently at fair value. This is the case even if they do not meet the definition of a derivative. [815-10-15-12, 25-15, 30-4, 35-4]

2.3.50 Forward and option contracts for the purchase of certain debt securities and equity instruments



Excerpt from ASC 815-10

Certain Contracts on Debt and Equity Securities

> Overall Guidance

15-140 The guidance in the Certain Contracts on Debt and Equity Securities Subsections applies to all entities, with specific instrument qualifications noted below.

> Instruments

15-141 The guidance in the Certain Contracts on Debt and Equity Securities Subsections applies only to those forward contracts and purchased options having all of the following characteristics:

- a. The contract is entered into to purchase securities that will be accounted for under either Topic 320 or Topic 321.
- b. The contract's terms require physical settlement of the contract by delivery of the securities.
- c. The contract is not a **derivative instrument** otherwise subject to this Subtopic.
- d. The contract, if a purchased option, has no intrinsic value at acquisition.

Pending Content:

Transition Date: (P) December 16, 2020; (N) December 16, 2021 | Transition Guidance: 825-10-65-6

15-141A For the purposes of applying paragraph 815-10-15-141(a) for forward contracts and purchased options, an entity shall not consider whether, upon the settlement of the forward contract or the exercise of the purchased option, individually or with existing investments, the underlying securities would be accounted for under either of the following:

- a. The equity method in accordance with Topic 323
- b. The fair value option in accordance with Topic 825 if those securities otherwise would have been accounted for under Topic 323.

15-142 The guidance in the Certain Contracts on Debt and Equity Securities Subsections does not apply to contracts involving securities not within the scope of either Topic 320 or Topic 321.

Pending Content:

Transition Date: (P) December 16, 2020; (N) December 16, 2021 | Transition Guidance: 825-10-65-6

15-142 The guidance in the Certain Contracts on Debt and Equity Securities Subsections does not apply to contracts involving securities not within the scope of either Topic 320 or Topic 321, after considering the guidance in paragraph 815-10-15-141A.

Certain Contracts on Debt and Equity Securities

25-17 Forward contracts and purchased options on debt securities within the scope of this Subsection (see the Certain Contracts on Debt and Equity Securities Subsection of Section 815-10-15) shall, at inception, be designated as held to maturity, available for sale, or **trading** in a manner consistent with the accounting prescribed by Topic 320 for debt securities. Such forward and option contracts are not eligible to be hedging instruments.

25-18 Forward contracts and purchased options on equity securities within the scope of this Subsection (see the Certain Contracts on Debt and Equity Securities Subsection of Section 815-10-15) shall, at inception, be recognized in a manner consistent with the accounting prescribed by Topic 321 for equity securities. Such forward and option contracts are not eligible to be hedging instruments.

Certain Contracts on Debt and Equity Securities

30-5 Forward contracts and purchased options on debt securities within the scope of this Subsection designated as held to maturity, available for sale, or trading shall be measured initially in a manner consistent with the accounting prescribed by Topic 320 for that category of securities.

30-6 Forward contracts and purchased options on equity securities within the scope of this Subsection shall be measured initially in a manner consistent with the accounting prescribed by Topic 321.

Certain Contracts on Debt and Equity Securities

35-5 Forward contracts and purchased options on debt securities within the scope of this Subsection shall be measured subsequently according to their initial classification as follows:

- a. Held to maturity:
 1. Changes in the **fair value** of the forward contract or purchased option shall not be recognized. Credit losses on the underlying securities in a forward contract shall be recorded through an allowance for credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. Credit losses on the underlying securities in a purchased option shall be recorded through an allowance for credit losses in accordance with Subtopic 326-20 and shall be limited by the amount of the option premium.
 2. Debt securities purchased under a forward contract shall be recorded at the forward contract price at the settlement date.
 3. Debt securities purchased by exercising an option shall be recorded at the option strike price plus any remaining carrying amount for the option premium at the exercise date.
 4. If an option expires worthless and the same debt security is purchased in the market, the security shall be recorded at its market price plus any remaining carrying amount for the option premium.
 5. If an entity does not take delivery under the forward contract or purchase the same security in the market if the option expires worthless, the entity's intent to hold other debt securities to maturity will be called into question.
- b. Available for sale:

1. Changes in the fair value of the forward contract or purchased option shall be recognized as part of the separate component of shareholders' equity under Topic 320 as they occur. Credit losses on the underlying securities in a forward contract shall be recorded through an allowance for credit losses in accordance with Subtopic 326-30 on measuring credit losses on available-for-sale debt securities. Credit losses on the underlying securities in a purchased option shall be recorded through an allowance for credit losses in accordance with Subtopic 326-30 and shall be limited by the amount of the option premium.
 2. Debt securities purchased under a forward contract shall be recorded at their fair values at the settlement date.
 3. Debt securities purchased by exercising an option shall be recorded at the option strike price plus the fair value of the option at the exercise date.
 4. If the option expires worthless and the same debt security is purchased in the market, the security shall be recorded at its market price plus any remaining carrying amount for the option premium.
- c. **Trading:**
1. Changes in the fair value of the forward contract or purchased option shall be recognized in earnings as they occur.
 2. Debt securities purchased under a forward contract or by exercising an option shall be recorded at their fair values at the settlement date.

35-6 Changes in the fair value of forward contracts and purchased options on equity securities within the scope of this Subsection shall be recognized in earnings as they occur. Changes in observable price or impairment of forward contracts and purchased options on equity securities without readily determinable fair value within the scope of this Subsection measured in accordance with paragraph 321-10-35-2 shall be recognized in earnings as they occur. A change in observable price or impairment of the underlying securities of forward contracts and purchased options on equity securities shall result in a remeasurement of the entire fair value of the forward contracts and purchased options as of the date that the observable transaction took place. Equity securities within the scope of this Subsection purchased under a forward contract or by exercising an option shall be recorded at their fair values at the settlement date.

In some cases, a forward or option contract to purchase debt or equity securities is not accounted for as a derivative. This may be the case when, for example:

- a forward or option to purchase an equity security does not meet the definition of a derivative because the underlying equity security is not readily convertible to cash; or
- a forward or option qualifies for a scope exception, such as the regular-way security trades scope exception.

Topic 815 provides accounting guidance for such a contract, provided that: [815-10-15-141]

- the underlying securities will (when purchased) be subject to Topic 320 (investments in debt securities) or Topic 321 (investments in equity securities);

- the contract's terms require physical settlement; and
- if the contract is a purchased option, it has no intrinsic value at acquisition.

Under the guidance in Topic 815, such a forward or option contract is accounted for as if the contract itself was in the scope of Topic 320 or Topic 321, as applicable. [815-10-25-17 – 25-18, 30-5 – 30-6, 35-5 – 35-6]



Question 2.3.70

How does an entity account for a forward or option contract to purchase debt or equity investments?

Interpretive response: The following table summarizes the applicable accounting guidance under Topic 815 for forward and option contracts for the purchase of debt or equity securities that will be subject to Topic 320 or Topic 321 when purchased.

Nature of contract	Applicable accounting
Contract meets the definition of a derivative and no scope exception applies	
Purchase of debt or equity securities [815-10-15-141(c)]	Contract is accounted for as a derivative and measured at fair value with changes in fair value recognized in earnings – unless it is designated as a hedging instrument in a hedging relationship
Contract that either does not meet the definition of a derivative or for which a scope exception applies	
Purchase of debt securities [815-10-25-17, 35-5]	Contract is accounted for as if it were subject to Topic 320. It is designated as HTM, AFS or trading and is accounted for in a manner consistent with the accounting prescribed by Topic 320 for that category of securities. In summary: — HTM. Changes in fair value are not recognized. Credit losses on securities underlying the contracts are recorded through an allowance for credit losses under Subtopic 326-20. For securities underlying purchased option contracts, credit losses are limited to the amount of the option premium. See KPMG Handbook, Credit impairment, for in-depth guidance. — AFS. Changes in fair value are recognized in OCI. Credit losses on securities underlying the contracts are recorded through an allowance for credit losses under Subtopic 326-30. For securities underlying purchased option contracts, credit losses are limited to the amount of the option premium. See KPMG Handbook, Credit impairment, for in-depth guidance. — Trading. Changes in fair value are recognized in earnings. These instruments are not eligible to be hedging instruments.

Nature of contract	Applicable accounting
Purchase of equity securities [815-10-25-18, 35-6]	Contract is accounted for as if it were subject to Topic 321. In summary, changes in fair value – or changes in observable price or impairment if the measurement alternative applies – are recognized in earnings. These instruments are not eligible to be hedging instruments. See also KPMG Handbook, Recognition and measurement of financial assets and financial liabilities .



Future developments

Topic 815 addresses the accounting for contracts to purchase equity securities that will be accounted for under Topic 321 once they are purchased. However, US GAAP does not currently address how to account for contracts to purchase equity securities that will be accounted for under the equity method of accounting (Topic 323).

In January 2020, the FASB issued guidance clarifying that when accounting for forward contracts and purchased call options to acquire equity securities, an entity should not consider whether the underlying securities will, upon purchase, be accounted for under: [\[ASU 2020-01\]](#)

- the equity method in Topic 323; or
- the fair value option under Topic 825.

An entity should account for such a contract as if it was subject to Topic 321, provided it otherwise meets the conditions of the scope inclusion for forward and option contracts for the purchase of debt and equity securities. [\[ASU 2020-01\]](#)

This guidance is effective as indicated in the following table. It should be applied on a prospective basis at the beginning of the interim period that includes the adoption date. [\[ASU 2020-01\]](#)

	Public business entities	All other entities
Annual and interim periods – Fiscal years beginning after	December 15, 2020	December 15, 2021
Early adoption allowed?	Yes.	

2.4 Normal purchases and normal sales

2.4.10 Overview



Excerpt from ASC 815-10

>>> Normal Purchases and Normal Sales

15-22 Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a **financial instrument** or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business.

15-23 The assessment of whether a contract qualifies for the normal purchases and normal sales scope exception (including whether the **underlying** of a price adjustment within the contract is not clearly and closely related to the asset being sold or purchased) shall be performed only at the inception of the contract.

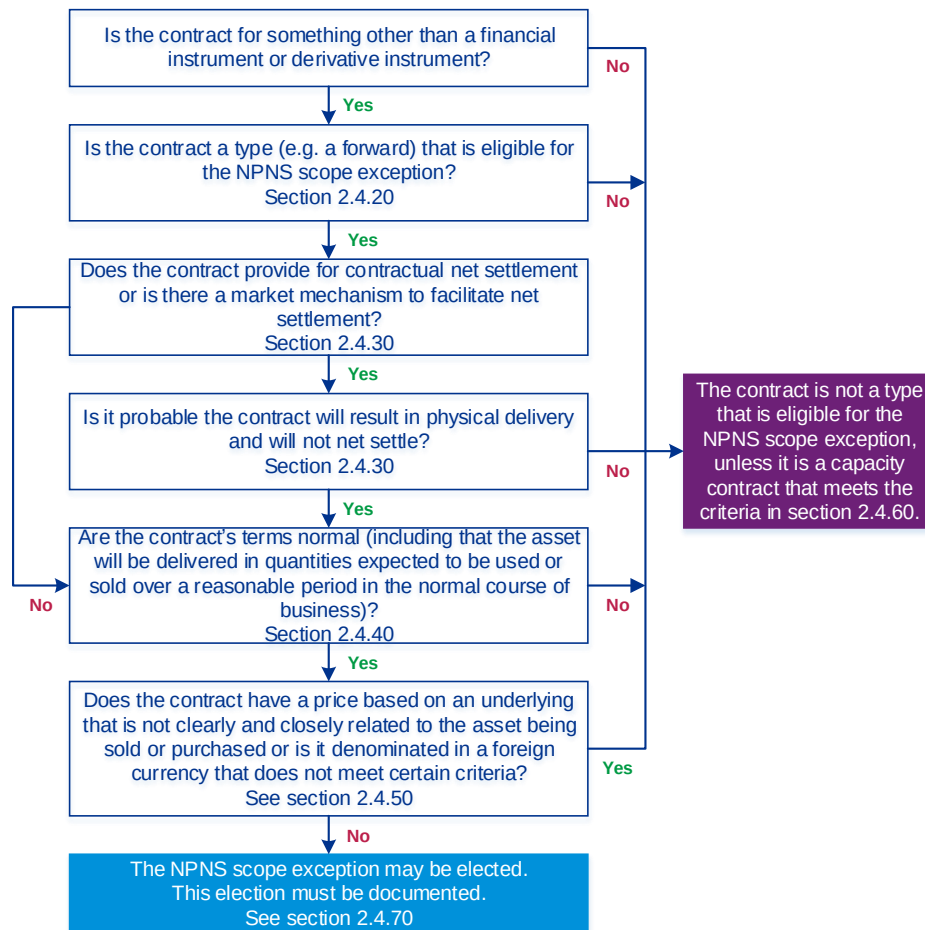
15-25 Following are discussions of four important elements needed to qualify for the normal purchases and normal sales scope exception:

- Normal terms (including normal quantity)
- Clearly and closely related underlying
- Probable physical settlement
- Documentation.

The NPNS scope exception applies to either party to the contract as long as the party meets the requirements for the scope exception. Although the requirements vary depending on the type of contract, all of the following requirements must be met for any contract to qualify for the exception: [\[815-10-15-22 – 15-23, 15-25\]](#)

- the asset under the contract is delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business;
- the contract does not have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased;
- it is probable that the contract will physically settle on a gross basis; and
- the entity documents the designation of the contract as a normal purchase or a normal sale at the contract's inception.

The following decision tree summarizes considerations for determining whether the NPNS scope exception may be elected for a contract.



An entity is required to document its election of the NPNS scope exception and is not permitted to change that election. However, an entity is required to assess whether it is probable that the contract will result in physical delivery and will not net settle on an ongoing basis. See Question 2.4.290 for further discussion. [815-10-15-23, 15-35, 15-39]



Question 2.4.10

Can a contract that qualifies under the NPNS scope exception be the hedged item in a hedging relationship?

Interpretive response: Yes. A contract that is not accounted for as a derivative because it qualifies for the NPNS scope exception may be designated as the hedged item in a fair value or cash flow hedge, provided certain criteria are met. See sections 7.3.30 (fair value hedges) and 9.3.20 (cash flow hedges) for further discussion.

Further, as discussed in Question 2.4.100, a derivative that does not meet the scope exception (e.g. because it provides for periodic cash settlements) may be designated as the hedging instrument in an all-in-one hedge, provided the

contract is ultimately expected to be settled gross and it meets the other cash flow hedge criteria.

2.4.20 Types of contracts eligible for NPNS election



Excerpt from ASC 815-10

>>>> Application to Freestanding Option Contracts

15-40 Option contracts that would require delivery of the related asset at an established price under the contract only if exercised are not eligible to qualify for the normal purchases and normal sales scope exception, except as indicated in paragraphs 815-10-15-45 through 15-51.

>>>> Application to Forward (Non-Option-Based) Contracts

15-41 Forward contracts are eligible to qualify for the normal purchases and normal sales scope exception. However, forward contracts that contain net settlement provisions as described in either paragraphs 815-10-15-100 through 15-109 or 815-10-15-110 through 15-118 are not eligible for the normal purchases and normal sales scope exception unless it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery. Contracts that are subject to unplanned netting (referred to as a book-out in the electric utility industry) do not qualify for this scope exception except as specified in paragraph 815-10-15-46. Net settlement (as described in paragraphs 815-10-15-100 through 15-109 and 815-10-15-110 through 15-118) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses or are otherwise settled net on a periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for the normal purchases and normal sales scope exception.

>>>> Application to Forward Contracts that Contain Optionality Features

15-42 Forward contracts that contain optionality features that do not modify the quantity of the asset to be delivered under the contract are eligible to qualify for the normal purchases and normal sales scope exception. Except for power purchase or sales agreements addressed in paragraphs 815-10-15-45 through 15-51, if an option component permits modification of the quantity of the assets to be delivered, the contract is not eligible for the normal purchases and normal sales scope exception, unless the option component permits the holder only to purchase or sell additional quantities at the market price at the date of delivery. For forward contracts that contain optionality features to qualify for the normal purchases and normal sales scope exception, the criteria discussed in the preceding paragraph must be met.

15-44 The inclusion of a purchased option that would, if exercised, require delivery of the related asset at an established price under the contract within a

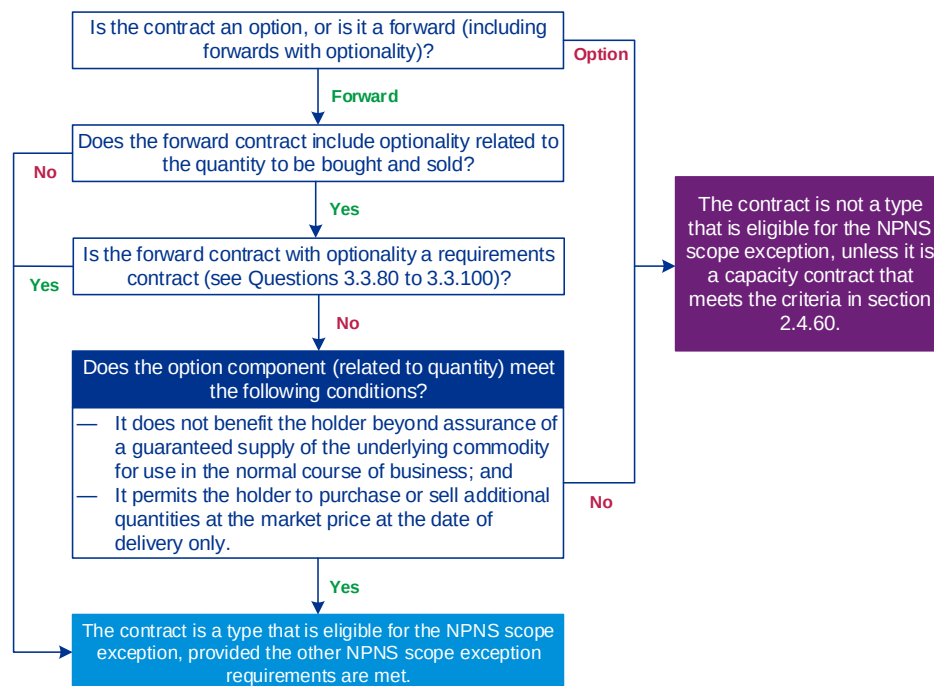
single contract that meets the definition of a derivative instrument disqualifies the entire contract from being eligible to qualify for the normal purchases and normal sales scope exception in this Subsection except as provided in the following paragraph through paragraph 815-10-15-51 with respect to certain power purchase or sales agreements.

Topic 815 distinguishes between option contracts, forward contracts and forward contracts with optionality when determining whether a contract is eligible for the NPNS scope exception.

Option contracts are not eligible for the scope exception unless they are capacity contracts that meet additional criteria (see section 2.4.60). This is because option contracts only contingently provide for the purchase or sale of the asset since exercise of the option is not assured. As a result, an entity cannot determine at inception of the contract that it will be probable throughout the contract's term that physical delivery under that specific contract will occur. This prohibition applies to both parties to the contract. [815-10-15-40]

In contrast, forward contracts are generally eligible for the scope exception and forward contracts with optionality are eligible provided they meet certain criteria. [815-10-15-41 – 15-42]

The following decision tree summarizes considerations for whether a type of contract is eligible for the NPNS scope exception. [815-10-15-40 – 15-42, 55-39]



Forward contracts with optionality



Excerpt from ASC 815-10

>>>> Application to Forward Contracts that Contain Optionality Features

15-43 If the optionality feature in the forward contract can modify the quantity of the asset to be delivered under the contract and that option feature has expired or has been completely exercised (even if delivery has not yet occurred), there is no longer any uncertainty as to the quantity to be delivered under the forward contract. Accordingly, following such expiration or exercise, the forward contract would be eligible for designation as a normal purchase or normal sale, provided that the other applicable conditions in this Subsection are met. Example 10 (see paragraph 815-10-55-121) illustrates this guidance.

>>>> Contracts that Combine a Forward Contract and a Purchased Option Contract

55-24 Paragraph 815-10-15-44 states that the inclusion of a purchased option that would, if exercised, require delivery of the related asset at an established price under the contract within a single contract that meets the definition of a derivative instrument disqualifies the entire contract from being eligible to qualify for the normal purchases and normal sales scope exception in this Subsection except as provided in paragraphs 815-10-15-45 through 15-51 with respect to certain power purchase or sales agreements. Although the guidance that follows discusses such circumstances in the context of utilities and independent power producers, it applies to all entities that enter into contracts that combine a forward contract and a purchased option contract, not just to utilities and independent power producers. Some utilities and independent power producers have fuel supply contracts that require delivery of a contractual minimum quantity of fuel at a fixed price and have an option that permits the holder to take specified additional amounts of fuel at the same fixed price at various times. Essentially, that option to take more fuel is a purchased option that is combined with the forward contract in a single supply contract. Typically, the option to take additional fuel is built into the contract to ensure that the buyer has a supply of fuel to produce the electricity during peak demands; however, the buyer may have the ability to sell to third parties the additional fuel purchased through exercise of the purchased option. Due to the difficulty in estimating peak electricity load and thus the amount of fuel needed to generate the required electricity, those fuel supply contracts are common in the electric utility industry (though similar supply contracts may exist in other industries).

55-25 Those fuel supply contracts are not requirements contracts that are addressed in paragraphs 815-10-55-5 through 55-7. Many of those contracts meet the definition of a derivative instrument because they have a notional amount and an underlying, require no or a smaller initial net investment, and provide for net settlement (for example, through their default provisions or by requiring delivery of an asset that is **readily convertible to cash**). The fuel supply contract cannot qualify for the normal purchases and normal sales exception because of the optionality regarding the quantity of fuel to be delivered under the contract.

55-26 An entity shall not bifurcate the forward contract component and the option component of a fuel supply contract that in its entirety meets the definition of a derivative instrument and then assert that the forward contract component is eligible to qualify for the normal purchases and normal sales exception.

55-27 An entity may wish to enter into two separate contracts—a forward contract and an option—that economically achieve the same results as the single derivative instrument and determine whether the normal purchases and normal sales scope exception (as discussed beginning in paragraph 815-10-15-22) applies to the separate forward contract.

55-28 Similar to the contractual options discussed in Example 10 (see paragraph 815-10-55-121), this guidance addresses option components that would require delivery of the related asset at an established price under the contract.

55-29 If the option component does not provide any benefit to the holder beyond the assurance of a guaranteed supply of the underlying commodity for use in the normal course of business and that option component only permits the holder to purchase additional quantities at the market price at the date of delivery (that is, that option component will always have a fair value of zero), that option component would not require delivery of the related asset at an established price under the contract.

55-30 If an entity's single supply contract included at its inception both a forward contract and an option and, in subsequent renegotiations, that contract is negated and replaced by two separate contracts (a forward contract for a specific quantity that will be purchased and an option for additional quantities whose purchase is conditional upon exercise of the option), the new forward contract would be eligible to qualify for the normal purchases and normal sales exception (as discussed beginning in paragraph 815-10-15-22), whereas the new option would not be eligible for that exception. From its inception the new separate option would be accounted for under this Subtopic.



Question 2.4.20

When does the NPNS scope exception apply to a forward contract with optionality?

Interpretive response: Certain forward purchase and sale contracts may contain optionality, including optionality related to pricing or to the quantity to be bought or sold under the contract.

The following table summarizes guidance that applies to both parties to the contract when determining whether a forward contract with optionality is eligible for the NPNS scope exception.

Example	Eligible for NPNS election?	Comment
Optionality related to pricing (and not to quantity)		
A purchase contract to buy a specified quantity of a commodity at the current market price on the date of purchase, not to exceed a specified maximum price (a cap) or not less than a specified minimum price (a floor).	Yes. [815-10-15-42, 55-126 – 55-129]	Although pricing optionality does not result in the contract being a type that is not eligible for the NPNS scope exception, that optionality may result in the contract not meeting other conditions necessary for the NPNS scope exception. For example, if the pricing optionality is attributable to a price adjustment clause that is based on an underlying that is different from the asset to be delivered under the contract (i.e. not clearly and closely related to the asset to be delivered), the contract is not eligible for the NPNS scope exception (see section 2.4.50). See also FASB Example 10, Cases A and B, reproduced below.
Optionality related to quantity – price is established in the contract		
A forward contract that requires the purchase of a specified quantity at an established price(s) plus an option to purchase specified additional quantities. The option to buy specified additional quantities within the forward contract is at an established price(s).	No. [815-10-15-42, 15-44, 55-130 – 55-131]	This optionality only contingently provides for sales or purchases, because the exercise of the option is not assured and typically depends on future changes in the price of the underlying. Because of the contingent nature, an entity cannot determine at the contract's inception that it will be probable throughout the contract's term that physical delivery will occur. As a result, such a contract is not a type that is eligible for the NPNS scope exception unless it is a capacity contract that meets certain conditions (see section 2.4.60). However, if the optionality related to the quantity expires and there is no further uncertainty over the quantity to be delivered, the contract would be eligible prospectively for the NPNS scope exception. [815-10-15-43, 55-30] See also FASB Example 10, Case C, reproduced below.

Example	Eligible for NPNS election?	Comment
Optionality related to quantity – market price at the date of delivery		
A forward contract that requires the purchase of a specified quantity at an established price(s) plus an option to purchase specified additional quantities. The option to buy specified additional quantities within the forward contract is at the market price at the date of delivery.	Yes, if the option component does not provide benefit to the holder beyond the assurance of a guaranteed supply of the underlying commodity for use in the normal course of business. [815-10-55-29]	Many contracts have this type of optionality, particularly in manufacturing where a purchaser contracts to purchase a minimum quantity of the subject commodity at an established price with an option to purchase additional specified quantities at the market price to assure an additional supply of the commodity if needed. Because the option component permits the holder to purchase additional quantities at the market price at the date of delivery only, it will always have a fair value at, or near, zero.



Question 2.4.30

Can a forward contract with optionality be bifurcated into a forward contract and an option?

Interpretive response: No. If a contract in its entirety meets the definition of a derivative, an entity cannot bifurcate the forward contract component and the option contract component and then assert that the forward component is eligible for the NPNS scope exception. [815-10-15-26]

As discussed in section 6.7.40, an entity is prohibited from separating a compound derivative into components that represent different risks. While Topic 815 requires certain derivatives that are embedded in nonderivative hybrid instruments to be split out from the host contract and accounted for separately as a derivative, the requirement to bifurcate a contract does not apply to a contract that meets the definition of a derivative in its entirety.

Alternatively, rather than entering into a forward contract that contains optionality as it relates to quantity, an entity may enter into two separate contracts (i.e. a forward contract and an option contract) that economically achieve the same results as the single contract. The separate forward contract can qualify for the NPNS scope exception even though the separate option contract cannot. [815-10-55-27, 55-30]



Question 2.4.40

Is a requirements contract eligible for the NPNS scope exception if it includes optionality as to quantity?

Interpretive response: Yes. As discussed in Question 3.3.80, a requirements contract represents an agreement to purchase or sell as many units as needed (with or without defined limits) to the end-user of the commodity that is being sold. A requirements contract is always considered a forward contract and optionality in excess of the deemed notional is disregarded (see Questions 3.3.80 to 3.3.100). [815-10-15-92, 55-5 – 55-7]

As a result, a requirements contract may include optionality related to the quantity and still be eligible for the NPNS scope exception as a nonoption-based forward contract. This is the case even if the contract includes specified quantity optionality.

However, a similar contract that is not a requirements contract and that has the same specified quantity optionality does not qualify for the NPNS scope exception. Therefore, for purposes of ascertaining whether a contract is eligible for the NPNS scope exception, it is important to first determine:

- whether the contract is a requirements or nonrequirements contract;
- whether it is a forward, an option or a combination of both; and,
- the notional amount of the contract.

See section 3.3.30 for further discussion of these topics.

Examples – Forward contracts with optionality

The following examples illustrate how to determine whether various forward contracts with optionality are of a type eligible for the NPNS scope exception.

- Example 2.4.10 illustrates how to determine whether various requirements and nonrequirements contracts are of a type that is eligible.
- FASB Example 10 illustrates how to determine whether various optionality features involve optionality related to quantity (versus optionality related to pricing).



Example 2.4.10

Eligibility of requirements and nonrequirements contracts for the NPNS scope exception

This example illustrates identifying whether a contract is eligible for the NPNS scope exception, depending on whether it is a requirements or nonrequirements contract.

In each scenario, ABC Corp. has a contract to purchase units of a commodity from DEF Corp. at a fixed price. See also section 3.3.30 for guidance regarding notional amounts.

Scenario 1 assumptions

ABC is required to purchase a minimum of 60 units and a maximum of 100 units. The contract includes explicit provisions that support a determinable quantity of 80 units.

The contract is a requirements contract that limits the use of the commodity to consumption by ABC (i.e. it does not allow ABC to resell it).

The contract is considered a forward contract with a notional of 80 units.

Because this is a requirements contract, the ability of ABC to purchase more units than the minimum, if needed, represents optionality that is disregarded for a requirements contract (see Question 3.3.90).

This contract is eligible for the NPNS scope exception.

Scenario 2 assumptions

The same as Scenario 1, except that the contract is not a requirements contract (it does not limit ABC's use of the commodity).

This contract comprises two features:

- a forward component to purchase 80 units – i.e. the determinable quantity, which is in excess of the contractually specified minimum; and
- an option component to purchase 20 units – i.e. the difference between the maximum requirement and determinable quantity.
- This contract is *not* eligible for the NPNS scope exception.

Scenario 3 assumptions

ABC is required to purchase a minimum of 60 units and is permitted to purchase as many additional units as it wants. The contract does not include explicit provisions that allow another notional amount to be readily and objectively quantified.

The contract is not a requirements contract because it does not limit ABC's use of the commodity.

The contract is considered to be a forward contract with a notional of 60 units – i.e. the contractually specified minimum.

- This contract is eligible for the NPNS scope exception.



Excerpt from ASC 815-10

>> Example 10: Normal Purchases and Normal Sales—Application to Forward Contracts that Contain Optionality Features

55-121 In some circumstances, an option may be combined with a forward contract. In some instances, the optionality feature in the forward contract can modify the quantity of the asset to be delivered under the contract. In other cases, the optionality feature in the forward contract can modify only the price to be paid or the timing of the delivery.

55-122 This Example presents three Cases of forward contracts with optionality features:

- a. Optionality feature involving price floor (cash-settled put option) written by purchaser and price cap (cash-settled call option) written by seller (Case A)
- b. Optionality feature involving cash-settled put option written by purchaser (Case B)
- c. Optionality feature involving physically settled put option written by purchaser (Case C).

55-123 In Cases A, B, and C, the optionality feature must be analyzed to determine whether it could modify the quantity of the asset to be delivered under the contract. In doing so, the conclusion as to whether the contract is eligible for the normal purchases and normal sales scope exception applies in the same way to both counterparties—the purchaser and the writer of the option (within the forward contract).

55-124 The contracts addressed in this Example do not have a price based on an underlying that is not clearly and closely related to the asset being purchased, nor do they require cash settlement of gains or losses as stipulated in paragraph 815-10-15-22.

55-125 Paragraph 815-10-15-43 explains that, if the optionality feature in the forward contract can modify the quantity of the asset to be delivered under the contract, but that option feature has expired or has been completely exercised (even if delivery has not yet occurred), there is no longer any uncertainty as to the quantity to be delivered under the forward contract. That paragraph explains that, following such expiration or exercise, the forward contract would be eligible for designation as a normal purchase or normal sale, provided that the other conditions in paragraph 815-10-15-22 are met.

>>> Case A: Optionality Feature Involving Price Floor (Cash-Settled Put Option) Written by Purchaser and Price Cap (Cash-Settled Call Option) Written by Seller

55-126 Entity A enters into a forward contract to purchase on a specified date a specified quantity of a raw material that is readily convertible to cash. The purchase price is the current market price on the date of purchase, not to exceed a specified maximum price (a cap) nor to be less than a specified minimum price (a floor).

55-127 In this Case, the optionality feature cannot modify the quantity to be delivered; thus, the contract is eligible to qualify for the normal purchases and normal sales scope exception.

>>> Case B: Optionality Feature Involving Cash-Settled Put Option Written by Purchaser

55-128 Entity B enters into a forward contract to purchase on a specified date a specified quantity of a raw material that is readily convertible to cash. The contract's purchase price is a fixed amount per unit that is below the current forward price; however, if the market price on the date of purchase has fallen below a specified level, Entity B's purchase price would be adjusted to a higher fixed amount significantly in excess of the current forward price at the inception of the contract. (The contract entered into by Entity B is a compound derivative consisting of a forward contract to purchase raw material at the original fixed price and a written option that obligates Entity B to purchase the raw material for the higher adjusted price if the market price of the raw material falls below the specified level. In exchange for the written option,

Entity B received a premium representing the difference between the purchase price in the contract and the forward market price of the raw material at the inception of the contract.)

55-129 The forward purchase contract in this Case is eligible to qualify for the normal purchases and normal sales scope exception because the optionality feature in the contract cannot modify the quantity to be delivered.

>>> Case C: Optionality Feature Involving Physically Settled Put Option Written by Purchaser

55-130 Entity C enters into a forward contract to purchase on a specified date a specified quantity of a raw material that is readily convertible to cash. The contract's purchase price is a fixed amount per unit that is below the current forward price. However, if the market price on the date of purchase has fallen below a specified level that is below the contract's fixed purchase price, Entity C would be required to purchase a specified additional quantity of the raw material at the contract's fixed purchase price (which is above the current market price on the date of purchase). (The contract entered into by Entity C is a compound derivative consisting of a forward contract to purchase raw material at the original fixed price and a written option that obligates Entity C to purchase additional quantities of the raw material at an above-market price if the market price of the raw material falls below the specified level.)

55-131 The contract in this Case is not eligible to qualify for the normal purchases and normal sales scope exception because the optionality feature in the contract can modify the quantity of the asset to be delivered under the contract.

2.4.30 Probable physical settlement



Excerpt from ASC 815-10

>>>> Probable Physical Settlement

15-35 For a contract that meets the net settlement provisions of paragraphs 815-10-15-100 through 15-109 and the market mechanism provisions of paragraphs 815-10-15-110 through 15-118 to qualify for the normal purchases and normal sales scope exception, it must be probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery.

To qualify for the NPNS scope exception, both of the following must be probable at inception and throughout the term of the individual contract: [\[815-10-15-35\]](#)

- the contract will not net settle; and
- the contract will result in physical delivery.

If a contract does not permit contractual net settlement and there is no market mechanism that facilitates net settlement, it is generally presumed that the above conditions are probable.

However, if a contract permits contractual net settlement (see section 3.5.20) or there is a market mechanism that facilitates net settlement of the contract (see section 3.5.30), an entity must conclude that both of the above conditions are probable to qualify for the NPNS scope exception. If the entity is unable to conclude on either, the contract is not eligible for the NPNS scope exception. [815-10-15-35]

Contracts that are subject to unplanned netting do not qualify for the NPNS scope exception even if an entity can conclude that physical delivery is probable. An exception is capacity contracts that meet certain conditions, as discussed in section 2.4.60; see Question 2.4.50 related to the electric utility industry.

Further, any net settlement of contracts in a group of contracts similarly designated as normal purchases and normal sales calls into question the classification of all similar contracts as normal purchases or normal sales. [815-10-15-41]



Question 2.4.50

How is the concept of netting applied in the electric utility industry?

Interpretive response: Contracts that are subject to unplanned netting (a bookout in the electric utility industry) do not qualify for the NPNS scope exception, except for capacity contracts that meet certain conditions (see section 2.4.60).

In certain forward contracts to purchase or sell electricity that necessitate transmission through (or delivery to a location within) an electricity grid operated by an independent system operator, one of the contracting parties incurs charges (or credits) for the transmission of that electricity based in part on locational marginal pricing differences payable to (or receivable from) the independent system operator. These charges do not constitute net settlement when evaluating eligibility for the NPNS scope exception (see Question 2.4.240). [815-10-15-45-(a)(1)]



Question 2.4.60

What are the documentation requirements regarding net settlement?

Interpretive response: An entity is required to document the designation of the contract as a NPNS scope exception. When performing that documentation for a forward contract that permits contractual net settlement or for which there is a market mechanism to facilitate net settlement, the entity must also document the basis for concluding it is probable that the contract will not settle

net and will result in physical delivery. See further discussion about documentation requirements in section 2.4.70.

Further, an entity is required to assess on an ongoing basis whether it is probable that the contract will result in physical delivery and will not net settle. A net settlement of one contract may cause similar contracts to not be eligible for the exception. See Questions 2.4.290 and 2.4.300 for further discussion.



Example 2.4.20

Contract to purchase fuel oil

ABC Corp. enters into a one-year contract to purchase 34,000 gallons of fuel oil at a fixed price from an oil entity to satisfy ABC's normal requirements for fuel oil.

As an alternative to taking physical delivery of fuel oil, during any given month the contract allows ABC to net settle the contract in cash for the difference between the fixed price in the contract and the market price of the fuel oil. However, ABC concludes at the contract's inception that it is probable at inception and throughout the contract's term that the contract will not be settled net and that ABC will take physical delivery of the 34,000 gallons of fuel oil. In addition, ABC has documented its basis for this conclusion.

Although the contract permits net settlement, it still meets the NPNS scope exception for ABC for the following reasons:

- 34,000 gallons of fuel oil is a quantity that will meet ABC's requirements over a reasonable period of time in the normal course of business;
- ABC has concluded that it is probable at the contract's inception and throughout the contract's term that ABC will not settle the contract net and will take physical delivery of the fuel oil; and
- ABC has documented its election, including the basis for its conclusion (see section 2.4.70).



Question 2.4.70

What does 'probable' mean when evaluating whether a contract is of a type that is eligible for the NPNS scope exception?

Interpretive response: We believe the use of the term 'probable' is consistent with its use in paragraph 450-20-25-1, which describes probable as 'likely to occur'. The term probable requires a significantly greater likelihood of occurrence than the term 'more likely than not'.



Question 2.4.80

Does a contract that calls for 'flash title' qualify for the NPNS scope exception?

Interpretive response: No. Flash title is an instantaneous flow-through of title caused by purchases and sales of certain commodities for delivery at the same time and location. We believe flash title generally does not constitute physical settlement of a contract. As a result, contracts that call for flash title do not qualify for the NPNS scope exception.



Question 2.4.90

Does a service contract qualify for the NPNS scope exception?

Interpretive response: No. We believe a service contract cannot qualify for the NPNS scope exception because performing a service does not comply with the requirement of physical delivery. Further, the NPNS scope exception only applies to a contract that involves the purchase or sale of assets.

Contracts that require periodic cash settlements



Excerpt from ASC 815-10

15-36 The normal purchases and normal sales scope exception only relates to a contract that results in gross delivery of the commodity under that contract. The normal purchases and normal sales scope exception shall not be applied to a contract that requires cash settlements of gains or losses or otherwise settle gains or losses periodically because those settlements are net settlements. Paragraph 815-20-25-22 explains how an entity may designate such a contract as a hedged item in an **all-in-one hedge** if all related criteria are met.



Question 2.4.100

Is a contract that requires periodic cash settlements eligible for the NPNS scope exception?

Interpretive response: No. The NPNS scope exception is not available for contracts that require cash settlements of gains or losses or otherwise settle gains or losses on a periodic basis. This prohibition includes individual contracts that are a part of a series of sequential contracts intended to accomplish the ultimate acquisition or sale of a commodity (e.g. crude oil) because those settlements are considered net settlements.

An example of such a contract is an exchange-traded futures contract. Futures contracts require daily cash settlements of gains or losses and therefore are not eligible for the NPNS scope exception even if the entity intends to settle the contract gross at maturity.

However, an entity may designate a contract that requires cash settlements of gains or losses or otherwise settles gains or losses on a periodic basis as the hedging instrument in an all-in-one hedge, provided the contract is ultimately expected to be settled gross and meets the other cash flow hedge criteria. See section 5.3.90 for discussion of all-in-one hedges.

Take-or-pay contracts



Excerpt from ASC 815-10

>>> Take-or-Pay Contracts

55-60 Whether a **take-or-pay contract** is subject to this Subtopic 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 net settlement criterion in paragraph 815-10-15-83(c) and is not subject to the requirements of this Subtopic. In certain circumstances, a take-or-pay contract may represent or contain a lease that should be accounted for in accordance with Topic 842. (Paragraph 815-10-15-79 explains that leases subject to that Topic are not subject to this Subtopic.)

A 'take-or-pay' contract is a contract under which an entity agrees to pay a specified price for a specified quantity of a product, regardless of whether that entity takes delivery. If a 'take-or-pay' contract is not a lease in the scope of Topic 842 (leases) and meets the definition of a derivative, it is subject to the requirements of Topic 815.



Question 2.4.110

Does a 'take-or-pay' contract qualify for the NPNS scope exception?

Interpretive response: Yes, if it meets all of the requirements for the scope exception, including that it is probable at inception and throughout the term of the contract that the contract will not settle net and will result in physical delivery. [815-10-55-60]

2.4.40 Normal terms (quantities expected to be used or sold over a reasonable period)



Excerpt from ASC 815-10

>>> Normal Purchases and Normal Sales

15-24 The normal purchases and normal sales scope exception 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 but not for ordinary purchases by the counterparty.

>>>> Normal Terms (Including Normal Quantity)

15-27 To qualify for the scope exception, a contract's terms 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 requires judgment.

15-28 In making those judgments, an entity should consider all relevant factors, including all of the following:

- a. The quantities provided under the contract and the entity's need for the related assets
- b. The locations to which delivery of the items will be made
- c. The period of time between entering into the contract and delivery
- d. The entity's prior practices with regard to such contracts.

15-29 Further, each of the following types of evidence should help in identifying contracts that qualify as normal purchases or normal sales:

- a. Past trends
- b. Expected future demand
- c. Other contracts for delivery of similar items
- d. An entity's and industry's customs for acquiring and storing the related commodities
- e. An entity's operating locations.

For guidance on normal purchases and normal sales as hedged items, see paragraph 815-20-25-7.

For a contract to qualify for the NPNS scope exception, its terms must be consistent with the terms of an entity's normal purchases or normal sales. Specifically, the assets under the contract must be delivered in quantities expected to be used or sold by the entity over a reasonable period in the normal course of business. [\[815-10-15-27\]](#)

To determine whether the contract terms are consistent with its normal purchases or normal sales, an entity uses its judgment and considers all relevant factors, such as the following. [\[815-10-15-27 – 15-28\]](#)



¹ The entity's needs are evaluated based on prior experience and projected usage over a reasonable period

Evidence to help evaluate these and other factors include past trends, expected future demand, other contracts for delivery of similar items, the entity's and industry's customs or practices for acquiring and storing the related goods, and the entity's operating location. [815-10-15-29]



Example 2.4.30

Physically settled forward contract for rubber inventory

Manufacturer enters into a physically settled forward contract for the purchase of a three-month supply of rubber inventory. Manufacturer normally maintains more than a three-month supply of rubber inventory. Therefore, the forward contract is for a quantity expected to be used or sold over a reasonable period in the normal course of ABC's business.



Question 2.4.120

Can each party to a contract reach a different conclusion about whether the contract is eligible for the NPNS scope exception?

Interpretive response: Yes. Application of the factors discussed in this section to specific transactions may result in accounting that is not symmetrical between the two parties to the transaction.

A sale may be considered normal by the seller (i.e. quantity sold to the buyer is normal in the course of its business) and therefore not accounted for as a derivative instrument. However, the buyer may deem the purchase not to be ordinary (i.e. quantity purchased was greater than could be used in a reasonable period in the normal course of its business) and therefore would account for the contract as a derivative instrument. [815-10-15-24, FAS 133.BC272]



Question 2.4.130

Is a contract for an asset being purchased for resale by the entity eligible for the NPNS scope exception?

Interpretive response: It depends. There is no overall limitation that the asset be consumed by the entity (e.g. retailers or wholesalers) for the contract to qualify for the NPNS scope exception.

However, an entity that actively trades commodities may not be able to establish an expected quantity to be used or sold in the normal course of business. A trader enters into contracts with the objective of generating profits from the movements in price and market price movements influence its trades. This is inconsistent with the concept of expected quantities to be delivered and used in the normal course of business. Therefore, we believe purchase and sale contracts related to trading activities do not generally qualify for the NPNS scope exception.

2.4.50 Contract pricing (price adjustment clauses)



Excerpt from ASC 815-10

>>>> Clearly and Closely Related Underlying

15-30 Contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the Standard and Poor's index) or that are denominated in a foreign currency that meets none of the criteria in paragraph 815-15-10(b) shall not be considered normal purchases and normal sales.

15-31 The phrase not clearly and closely related in the preceding paragraph with respect to the normal purchases and normal sales scope exception is used to convey a different meaning than in paragraphs 815-15-25-1(a) and 815-15-25-16 through 25-51 with respect to the relationship between an embedded derivative and the host contract in which it is embedded. The guidance in this discussion of normal purchases and normal sales does not affect the use of the phrase not clearly and closely related in paragraphs other than the preceding paragraph. For purposes of determining whether a contract qualifies for the normal purchases and normal sales scope exception, the application of the phrase not clearly and closely related to the asset being sold or purchased shall involve an analysis of both qualitative and quantitative considerations. The analysis is specific to the contract being considered for the normal purchases and normal sales scope exception and may include identification of the components of the asset being sold or purchased.

15-32 The underlying in a price adjustment incorporated into a contract that otherwise satisfies the requirements for the normal purchases and normal sales scope exception shall be considered to be not clearly and closely related to the asset being sold or purchased in any of the following circumstances:

- a. The underlying is extraneous (that is, irrelevant and not pertinent) to both the changes in the cost and the changes in the **fair value** of the asset being sold or purchased, including being extraneous to an ingredient or direct factor in the customary or specific production of that asset.
- b. If the underlying is not extraneous as discussed in (a), the magnitude and direction of the impact of the price adjustment are not consistent with the relevancy of the underlying. That is, the magnitude of the price adjustment based on the underlying is significantly disproportionate to the impact of

the underlying on the fair value or cost of the asset being purchased or sold (or of an ingredient or direct factor, as appropriate).

- c. The underlying is a currency exchange rate involving a foreign currency that meets none of the criteria in paragraph 815-15-15-10(b) for that reporting entity.

15-33 For example, in the case in which the price adjustment focuses on the changes in the fair value of the asset being purchased or sold, if the terms of the price adjustment are expected, at the inception of the contract, to affect the purchase or sales price in a manner comparable to the outcome that would be obtained if, at each delivery date, the parties were to reprice the contract amount under the then-existing conditions for the asset being delivered on that date, the price adjustment's underlying is considered to be clearly and closely related to the asset being sold or purchased and the price adjustment would not be an impediment to the contract qualifying for the normal purchases and normal sales scope exception.

15-34 If the underlying in a price adjustment incorporated into a purchase or sales contract is not an impediment to qualifying for the normal purchases and normal sales scope exception because it is considered to be clearly and closely related to the asset being sold or purchased, the contract must meet the other requirements in this Subsection to qualify for the normal purchases and normal sales scope exception.

Certain contracts have a price adjustment clause based on an underlying that is different from the asset to be delivered under the contract. For such a contract to be considered a normal purchase or normal sale, the underlying must be clearly and closely related to the asset being delivered. [\[815-10-15-30\]](#)



Question 2.4.140

On what concept is a clearly and closely related analysis for a price adjustment clause based?

Interpretive response: The broad concept is that if the underlying in a price adjustment clause is reasonably related to either the costs of the asset subject to the contract or the fair value of that asset, then the price adjustment is not an impediment for the contract to qualify for the NPNS scope exception.

The analysis of whether an underlying is clearly and closely related includes both qualitative and quantitative considerations (see Question 2.4.150). Further, we believe the underlying is deemed clearly and closely related to the contract unless evidence suggests otherwise. [\[815-10-15-31\]](#)

Similarly, for a contract denominated in a foreign currency to be considered a normal purchase or normal sale, the foreign currency must meet specified criteria (see Question 2.4.150). [\[815-10-15-30\]](#)



Question 2.4.150

When is a price adjustment or foreign currency in a contract *not* clearly and closely related to the asset being purchased or sold?

Interpretive response: A price adjustment or foreign currency incorporated into a contract is not clearly and closely related to the asset being sold or purchased in any of the following circumstances. [815-10-15-30, 15-32]

The underlying is extraneous to the asset being sold or purchased

[815-10-15-32(a)]

- An underlying is extraneous to the asset being sold or purchased if it is extraneous (i.e. irrelevant and not pertinent) to:
- changes in the cost of the asset being sold or purchased; and
- changes in the fair value of the asset being sold or purchased.
- This includes being extraneous to an ingredient or direct factor in the customary or specific production of the asset being sold or purchased.

See also Question 2.4.170.

The magnitude and direction of the effect of the price adjustment is not consistent with the relevance of the underlying

[815-10-15-32(b)]

The magnitude and direction of the effect is not consistent with the relevance of the underlying when the magnitude of the price adjustment based on the underlying is significantly disproportionate to the effect of the underlying on the fair value or cost of the asset being purchased or sold (or of an ingredient or direct factor, as appropriate).

See Question 2.4.190.

The contract is denominated in a foreign currency that does not meet certain criteria

[815-10-15-32(c)]

If the contract is denominated in a foreign currency, that foreign currency must be one of the following for the contract to be eligible for the NPNS scope exception: [815-15-15-10(b)]

- the functional currency of any substantial party to that contract
- the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce
- the local currency of any substantial party to the contract
- the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary.
- The above concepts are the same as those used with respect to embedded derivatives.

See Examples 2.4.40 – 2.4.50.



Question 2.4.160

Does the phrase 'clearly and closely related' mean the same thing under the NPNS scope exception and the embedded derivatives evaluation?

Interpretive response: No. The meaning of the phrase 'clearly and closely related' under the NPNS scope exception is different from the meaning of the same phrase used to evaluate the relationship between an embedded derivative and its host contract. [815-10-15-31]

The following is a brief comparison of the meaning of the phrase 'clearly and closely related' for these purposes.

- Evaluating embedded features for separate accounting: In this situation, applying the phrase involves determining whether the economic characteristics and risks of the embedded derivative component are clearly and closely related to the host contract.
- Evaluating whether a contract is eligible for the NPNS scope exception: In this situation, applying the phrase involves determining whether the underlying in a price adjustment incorporated into a purchase or sale contract is reasonably related to either the cost of the asset subject to the contract or the fair value of that asset.

If a contract that would otherwise be eligible for the NPNS scope exception contains a pricing feature that is considered clearly and closely related to the asset being sold or purchased within the context of the NPNS scope exception, further analysis for embedded features is not necessary once the contract has been reviewed relative to those provisions (see Question 2.4.200).

See also Example 2.4.50.



Question 2.4.170

Is a contract's pricing extraneous if it is irrelevant to changes in the cost *or* changes in the fair value of the asset being sold or purchased (but not both)?

Interpretive response: No. We believe that for an underlying in a price adjustment to be considered not clearly and closely related, the underlying must be extraneous to both the changes in the costs incurred as a result of the asset being sold or purchased *and* the changes in the fair value of the asset. This means that an index or price adjustment that is extraneous to the costs incurred to produce or purchase the asset meets the clearly and closely related requirement for the NPNS scope exception if it is not be extraneous to the fair value of the asset (or vice versa). [810-15-15-33]

Further, the analysis of whether the underlying is extraneous should generally be made by comparing it with an ingredient or direct factor in the specific production of the asset or to one that is customary to the production (see Question 2.4.180).



Question 2.4.180

Does an entity analyze the ingredients or other factors related to the production of the asset to which the contract's pricing is extraneous?

Interpretive response: Generally, yes. In determining whether a pricing adjustment is extraneous, we believe that in many cases it will be useful for an entity to analyze the ingredients or direct factors involved in the production of the specific asset (e.g. electricity consumed in the production process), or to one that is customary to producing that asset.

However, because the analysis is of whether the pricing is extraneous to both the cost and changes in fair value of the asset, other approaches may be acceptable depending on the circumstances.



Example 2.4.40 Price adjustments

Examples of whether price adjustments are clearly and closely related when applying the NPNS scope exception include the following.

Not clearly and closely related

A forward contract to purchase corn that is indexed to an equity index would not have an underlying that is clearly and closely related to the corn. As a result, the contract would not meet the NPNS scope exception.

May be clearly and closely related

A forward contract to sell chocolate that is indexed to sugar would have an underlying that is clearly and closely related to the chocolate if sugar is an ingredient to chocolate. As a result, it would qualify for the NPNS scope exception if the other requirements of the scope exception are met.



Question 2.4.190

Can a price adjustment that includes indexing to the ingredients in an asset qualify for the NPNS scope exception?

Interpretive response: Yes. We believe a price adjustment that includes indexing to ingredients in the asset may qualify as clearly and closely related, as long as it does not contain leverage.

Specifically, a contract with a price adjustment that is proportionately equal to the value of the ingredients or direct factors in the asset being purchased or sold qualifies for the NPNS scope exception because it contains indexing without leverage.

For example, if the costs to produce Widget X comprise 50% steel, 25% labor and 25% overhead, the price adjustment to the contract could possibly contain

an adjustment equal to 50% of the percentage change in the market price of steel and 25% of the percentage change in CPI (or both) and still qualify as clearly and closely related.



Example 2.4.50

Currency in which the price is routinely denominated in international commerce

ABC Corp. (located in Saudi Arabia) enters into a forward contract to sell 100,000 barrels of crude oil to DEF Corp. (located in Canada). Neither entity is a US dollar functional currency entity and the price of a barrel of oil in the contract is denominated in US dollars.

Because crude oil transactions are routinely denominated in US dollars in international commerce, ABC and/or DEF could designate the contract as a NPNS, as long as the other criteria for NPNS are met.



Question 2.4.200

Is a contract that qualifies for the NPNS scope exception evaluated to determine whether it contains an embedded feature requiring separate accounting?

Interpretive response: No. A contract that is a derivative in its entirety and that qualifies for the NPNS scope exception is not evaluated to determine whether it contains embedded features requiring separate accounting.

By including the term 'clearly and closely related' in the guidance related to the NPNS scope exception, the FASB did not intend for an entity to review a contract that is eligible for the NPNS scope exception to determine whether it has an embedded feature requiring separate accounting. The NPNS scope exception is written narrowly to permit only a subset of contracts with specific characteristics to qualify. If a contract that is a derivative in its entirety does not qualify for the NPNS scope exception, the application of the NPNS scope exception is not permitted and the contract (in its entirety) must be accounted for as a derivative.



Example 2.4.60

Purchase contract denominated in a foreign currency

ABC Corp. enters into a forward purchase contract to buy rice at 1,000 yen per bushel.

Scenario 1: Contract meets the definition of a derivative (in its entirety)

ABC evaluates whether the contract is eligible for the NPNS scope exception. To be eligible, the yen must be one of the following:

- the functional currency of any substantial party to that contract;
- the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce;
- the local currency of any substantial party to the contract;
- the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary.

If it is one of the above and the remaining criteria for the NPNS scope exception are met, further analysis of the embedded foreign currency pricing feature is not necessary and the entire contract is eligible for the NPNS scope exception.

Scenario 2: Contract does not meet the definition of a derivative (in its entirety)

ABC does not evaluate whether the contract is eligible for the NPNS scope exception because that exception relates only to contracts that are in their entirety derivative instruments.

Instead, ABC reviews the contract to determine whether an embedded feature exists (i.e. a foreign currency embedded feature) that requires separate accounting. An embedded foreign currency feature is not separated from the forward purchase contract if the yen is one of the following:

- the functional currency of any substantial party to that contract;
- the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce;
- the local currency of any substantial party to the contract; or
- the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary.

2.4.60 Power purchase or sale agreements



Excerpt from ASC 815-10

>>> > Application to Power Purchase or Sale Agreements

15-45 Notwithstanding the criteria in paragraphs 815-10-15-41 through 15-44, a power purchase or sales agreement (whether a forward contract, option contract, or a combination of both) that is a capacity contract for the purchase or sale of electricity also qualifies for the normal purchases and normal sales scope exception if all of the following applicable criteria are met:

- a. For both parties to the contract, both of the following criteria are met:
 1. The terms of the contract require physical delivery of electricity. That is, the contract does not permit net settlement, as described in paragraphs 815-10-15-100 through 15-109. For an option contract, physical delivery is required if the option contract is exercised. Certain contracts for the purchase or sale of electricity on a forward basis that necessitate transmission through, or delivery to a location within, an electricity grid operated by an independent system operator result in

one of the contracting parties incurring charges (or credits) for the transmission of that electricity based in part on locational marginal pricing differences payable to (or receivable from) the independent system operator. For example, this is the case when the delivery location under the contract (for example, a hub location) is not the same location as the point of ultimate consumption of the electricity or the point from which the electricity exits the electricity grid for transmission to a customer load zone. Delivery to the point of ultimate consumption or the exit point is facilitated by the independent system operator of the grid. The use of locational marginal pricing to determine the transmission charge (or credit) does not constitute net settlement, even in situations in which legal title to the associated electricity is conveyed to the independent system operator during transmission.

2. The power purchase or sales agreement is a capacity contract. Differentiating between a capacity contract and a traditional option contract (that is, a financial option on electricity) is a matter of judgment that depends on the facts and circumstances. For power purchase or sale agreements that contain option features, the characteristics of an option contract that is a capacity contract and a traditional option contract, which are set forth in paragraph 815-10-55-31 shall be considered in that evaluation; however, other characteristics not listed in that paragraph may also be relevant to that evaluation.
- b. For the seller of electricity: The electricity that would be deliverable under the contract involves quantities that are expected to be sold by the reporting entity in the normal course of business.
- c. For the buyer of electricity, all of the following criteria are met:
 1. The electricity that would be deliverable under the contract involves quantities that are expected to be used or sold by the reporting entity in the normal course of business.
 2. The buyer of the electricity under the power purchase or sales agreement is an entity that meets both of the following criteria:
 - i. The entity is engaged in selling electricity to retail or wholesale customers.
 - ii. The entity is statutorily or otherwise contractually obligated to maintain sufficient capacity to meet electricity needs of its customer base.
 3. The contracts are entered into to meet the buyer's obligation to maintain a sufficient capacity, including a reasonable reserve margin established by or based on a regulatory commission, local standards, regional reliability councils, or regional transmission organizations.

15-46 Power purchase or sales agreements that meet only the applicable criteria in paragraph 815-10-15-45 qualify for the normal purchases and normal sales scope exception even if they are subject to being booked out or are scheduled to be booked out.

15-47 Forward contracts for the purchase or sale of electricity that do not meet those applicable criteria as well as other forward contracts are nevertheless eligible to qualify for the normal purchases and normal sales scope exception by meeting the criteria in this Subsection (other than paragraph 815-10-15-45),

unless those contracts are subject to unplanned netting (that is, subject to possibly being booked out).

15-48 Because electricity cannot be readily stored in significant quantities and the entity engaged in selling electricity is obligated to maintain sufficient capacity to meet the electricity needs of its customer base, an option contract for the purchase of electricity that meets the criteria in paragraph 815-10-15-45 qualifies for the normal purchases and normal sales scope exception in that paragraph.

15-49 This guidance does not affect the accounting for requirements contracts that would not be required to be accounted for under the guidance in this Subtopic pursuant to paragraphs 815-10-55-5 through 55-7.

15-50 Contracts that qualify for the normal purchases and normal sales scope exception based on this guidance do not require compliance with any additional guidance in paragraphs 815-10-15-22 through 15-44. However, contracts that have a price based on an underlying that is not clearly and closely related to the electricity being sold or purchased or that are denominated in a foreign currency that meets none of the criteria in paragraph 815-15-15-10(b) shall not be considered normal purchases and normal sales.

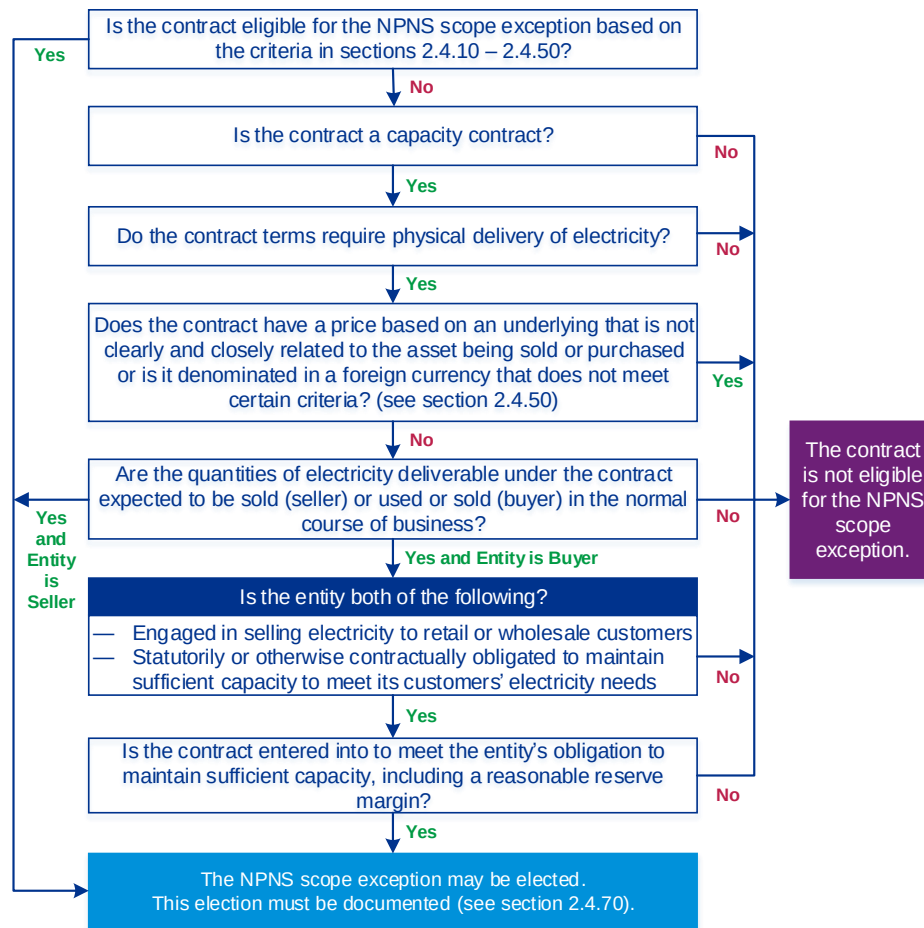
15-51 This guidance shall not be applied by analogy to the accounting for other types of contracts not meeting the stated criteria.

In the electricity industry, contracts that permit one party to purchase electricity (power) from another party are very common. Such contracts can vary substantially in terms, with some requiring delivery of a specific quantity of power and others providing optionality regarding the quantity to be delivered.

A power purchase or sales agreement (including a forward contract, option contract or a combination thereof) can qualify for the NPNS scope exception in one of two ways:

- it meets the general criteria for the scope exception (see sections 2.4.10 – 2.4.50); or
- it is a capacity contract (see below) and meets specific criteria.

The following decision tree summarizes whether a power purchase or sale agreement qualifies for the NPNS scope exception. [\[815-10-15-45 – 15-48\]](#)



Question 2.4.210

Why does the NPNS scope exception have special provisions for power purchase or sale agreements?

Interpretive response: Topic 815 provides special provisions for the applicability of the NPNS scope exception to power contracts that meet the definition of a derivative due to the unique characteristics of the electricity industry. These unique characteristics include the following.

- **Electricity cannot be readily stored in significant quantities.** Contracts to buy and sell electricity are driven by the characteristics of the industry and often contain quantity optionality. The optionality provides the purchaser with a guaranteed supply source because electricity cannot be readily stored. For some electricity producers, the optionality allows the purchaser to meet local, state or national public utility commission regulatory requirements. The flexibility in power contracts typically allows the buyer to meet fluctuating demand. [815-10-15-48]
- **A high level of fixed costs to produce electricity.** Electricity contracts typically include a specified charge (a capacity or demand charge) to provide

for recovery of plant costs. Some contracts also include a variable charge related to the variable cost (the energy charge) of producing electricity.

Under these special provisions, a capacity contract is eligible for the NPNS scope exception if it meets the requirements in the above decision tree even if the capacity contract would not be eligible under the regular requirements for the scope exception. [815-10-15-50]

Other than the guidance in sections 2.4.50 (related to contract pricing) and 2.4.70 (related to documentation), the regular requirements for the NPNS scope exception do not generally apply to capacity contracts that meet the special provisions for the NPNS scope exception (i.e. sections 2.4.20 – 2.4.40 are not generally applicable). When an entity documents the designation of a capacity contract that would not otherwise be eligible for the NPNS scope exception, the entity must also document the basis for concluding that the agreement meets all of the applicable criteria; see further discussion about documentation requirements in section 2.4.70. [815-10-15-50]

Agreement is a capacity contract (seller and buyer)



Excerpt from ASC 815-10

20 Glossary

Capacity Contract – An agreement by an owner of capacity to sell the right to that capacity to another party so that it can satisfy its obligations. For example, in the electric industry, capacity (sometimes referred to as installed capacity) is the capability to deliver electric power to the electric transmission system of an operating control area.

>>>> Distinguishing Between Options that Are Capacity Contracts and Financial Options on Electricity

55-31 The following table lists characteristics of an option that is a **capacity contract** and a traditional option. The characteristics listed may be relevant to the application of paragraph 815-10-15-45(a)(2). Other characteristics not listed may also be relevant.

Option Contract That is a Capacity Contract	Financial Option Contract on Electricity
1 The contract usually specifies the power plant or group of power plants providing the electricity.	No reference is made to the generation origination or the electricity.
2 The strike price (paid upon exercise) includes pricing terms to compensate the plant operator for variable operations and maintenance costs expected during the specified production periods.	The strike price is structured based on the expected forward prices of power.
3 The specified quantity is based on individual needs of parties to the agreement.	The specified quantity reflects standard amounts of electric energy, which facilitate market liquidity (for example, exercise in increments of 10,000 kilowatt-hours)
4 The title transfer point is usually at one or a group of specified physical delivery point(s), as opposed to a major market hub.	The specified index transfer point is a major market hub (liquid trading hub), not seller- or buyer-site specific.
5 The contract usually specifies certain operational performance by the facility (for example, the achievement of a certain heat rate)	No operational performance is specified (not plant specific).

6 The contract sometimes incorporates requirements for interconnection facilities, physical transmission facilities, or reservations for transmission services.	None specified.
7 The contract may specify jointly agreed-to plant outages (for example, for maintenance) and provide for penalties in the event of unexpected outages.	Penalties for outages are not specified (not plant specific).
8 Damage provisions upon default are usually based on a reduction of the capacity payment (which is not market based). If default provisions specify market liquidating damages, they usually contain some form of floor, ceiling, or both. The characteristics of the default provision are usually tied to the expected generation facility.	Damage provisions upon default are based on market liquidating damages.
9 The contract's term is usually long (one year or more).	The contract's term is not longer than 18 to 24 months because financial options on electricity are currently illiquid beyond that period.

The special provisions of the NPNS scope exception apply to a power purchase or sale agreement only if it is a capacity contract. A capacity contract is an agreement by an owner of capacity to sell the right to that capacity to another party so that it can satisfy its obligations. [815-10 Glossary]

Determining whether an option contract is a capacity contract or a traditional option contract is a matter of judgment. Paragraph 815-10-55-31 (reproduced above) lists characteristics of an option capacity contract and a traditional option contract that should be considered in that evaluation for contracts that contain option features; however, other characteristics may also be relevant. Those characteristics are not relevant to a forward contract. [815-10-15-45(a)(2), 55-31]



Question 2.4.220

What does 'capacity' mean for an electric utility?

Interpretive response: For purposes of determining whether a contract qualifies for the NPNS scope exception, an electric utility determines whether the contract is a capacity contract. When making this determination, capacity (or installed capacity) is generally understood to be the capability to deliver electric power to the electric transmission system of an operating control area. A control area is a portion of the electric grid that schedules, dispatches and controls generating resources to serve area load (ultimate users of electricity) and coordinates scheduling of the flow of electric power over the transmission system to neighboring control areas.

A control area requires entities that serve load within the control area to:

- demonstrate ownership or contractual rights to capacity sufficient to serve that load at times of peak demand; and
- provide a reserve margin to protect the integrity of the system against potential generating unit outages in the control area.



Question 2.4.230

Are the NPNS criteria for power purchase or sale agreements that are capacity contracts relevant to retail buyers?

Interpretive response: No. Large retail buyers (e.g. a large retail store or a large manufacturer) sometimes enter into power purchase agreements with electricity providers to ensure they have a guaranteed supply of power. However, the NPNS criteria for power purchase or sale agreements that are capacity contracts are only relevant to buyers of power that are engaged in selling electricity to retail or wholesale buyers. [815-10-15-45(c)(2)(i)]

The NPNS criteria that are relevant to retail buyers are those described in sections 2.4.10 – 2.4.50.

Physical delivery of electricity (seller and buyer)



Excerpt from ASC 815-10

15-36A Certain contracts for the purchase or sale of electricity on a forward basis that necessitate transmission through, or delivery to a location within, an electricity grid operated by an independent system operator result in one of the contracting parties incurring charges (or credits) for the transmission of that electricity based in part on locational marginal pricing differences payable to (or receivable from) the independent system operator. For example, this is the case when the delivery location under the contract (for example, a hub location) is not the same location as the point of ultimate consumption of the electricity or the point from which the electricity exits the electricity grid for transmission to a customer load zone. Delivery to the point of ultimate consumption or the exit point is facilitated by the independent system operator of the grid. The purchase or sale contract and the transmission services do not constitute a series of sequential contracts intended to accomplish the ultimate acquisition or sale of a commodity as discussed in paragraph 815-10-15-41, and the use of locational marginal pricing to determine the transmission charge (or credit) does not constitute net settlement, even in situations in which legal title to the associated electricity is conveyed to the independent system operator during transmission.

To qualify for the NPNS scope exception, a capacity contract must require physical delivery of electricity, including that an option or option component must require physical delivery if it is exercised. It cannot permit contractual net settlement (see section 3.5.20).

For example, a capacity contract that contains a market-based liquidating damage provision does not qualify for the NPNS scope exception. This requirement is stricter than the NPNS requirements for other types of contracts described in section 2.4.40. This is because the requirements for other types of

contracts permit contractual net settlement as long as it is probable that the contract will result in physical delivery and will not net settle. [815-10-15-45(a)(1)]

A capacity contract that requires physical delivery qualifies for the NPNS scope exception even if the contract is subject to being booked out or is scheduled to be booked out. A bookout is an unplanned netting of physical transactions with the same counterparty or group of counterparties in the electric utility industry and is a common scheduling convenience when two or more utilities have offsetting transactions. [815-10-15-46]



Question 2.4.240

Does the use of locational marginal pricing to determine a transmission charge (or credit) within nodal energy markets constitute net settlement?

Background: Entities in the wholesale electricity industry often join regional transmission organizations within which grid operations are managed by an Independent System Operator (ISO). ISOs do not generate, market or trade electricity for their own account. Rather, their activities are profit neutral and quantity balanced.

Uniquely for contracts in this market, transmission of the electricity often involves contractual delivery locations that are not the same as where the electricity will ultimately be consumed or the point from which the electricity exits the grid for transmission to a customer. ISOs also generally take title to electricity as it is transmitted through the grid. The ISO assigns prices for electricity at locations (referred to as nodes) on the grid where electricity can be delivered and withdrawn. The price an ISO charges market participants includes the recovery of various costs, but also the difference in locational pricing at the delivery and withdrawal locations.

Interpretive response: No. Due to the unique characteristic of contracts in nodal energy markets, there is a special exemption to the physical delivery criterion of the NPNS scope exception for a contract that necessitates transmission through (or delivery to a location within) a nodal energy market. [815-10-15-36, 15-45(a)(1), ASU 2015-13.BC10]

These contracts are not considered to be net settled even if the contracts: [815-10-15-36A]

- require delivery locations that are different from where the electricity will ultimately be consumed or the point from which the electricity exits the grid for transmission to a customer;
- involve the transfer of legal title to the ISO; or
- involve locational pricing differences.

Before the evolution of the nodal energy market structure, entities used other means of transmission and applied the NPNS scope exception (assuming all other criteria were met). However, with the industry moving to nodal energy markets, excluding these contracts from the NPNS scope exception would have resulted in a significant number of routine physical transactions being accounted for as derivatives. The EITF did not believe that derivative accounting at fair value would provide decision-useful information. [ASU 2015-13.BC15, BC17]

Quantities are expected to be sold (seller) or used or sold (buyer) in the normal course of business

From the perspective of the seller, to qualify for the NPNS scope exception, the electricity that would be deliverable under the contract must involve quantities that are expected to be sold by the reporting entity in the normal course of its business. There is no requirement that the seller of the electricity must generate the electricity. That is, as long as the quantities that are deliverable under the contract are quantities that are expected to be generated or purchased by the seller (or both) and sold to the buyer in the normal course of its business, the contract is eligible for the scope exception. [815-10-15-45(b)]

Similarly, from the perspective of the buyer, to qualify for the NPNS scope exception, the electricity that would be deliverable under the contract must involve quantities that are expected to be used or sold by the reporting entity in the normal course of its business. As long as the quantities that are deliverable under the contract are quantities that are expected to be sold or consumed by the buyer (or both) in the normal course of its business, the contract is eligible for the scope exception. [815-10-15-45(c)(1)]

Additional criteria relevant to the buyer only

From the perspective of the buyer of the electricity, to qualify for the NPNS scope exception, the buyer must be an entity that: [815-10-15-45(c)(2)]

- engages in the sale of electricity to retail or wholesale customers; and
- is statutorily or otherwise contractually obligated to maintain sufficient capacity to meet electricity needs of its customer base (i.e. the retail or wholesale customers).

Further, the contract must be entered into to meet the buyer's obligation to maintain sufficient capacity. That obligation must be established or based on a regulatory commission, local standards, regional reliability councils or regional transmission organizations. [815-10-15-45(c)(3)]

2.4.70 Documentation



Excerpt from ASC 815-10

>>>> Documentation

15-37 For contracts that qualify for the normal purchases and normal sales exception under any provision of paragraphs 815-10-15-22 through 15-51, the entity shall document the designation of the contract as a normal purchase or normal sale, including either of the following:

- a. For contracts that qualify for the normal purchases and normal sales exception under paragraph 815-10-15-41 or 815-10-15-42 through 15-44, the entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery.

- b. For contracts that qualify for the normal purchases and normal sales exception under paragraphs 815-10-15-45 through 15-51, the entity shall document the basis for concluding that the agreement meets the criteria in that paragraph, including the basis for concluding that the agreement is a **capacity contract**.

15-38 The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract. Failure to comply with the documentation requirements precludes application of the normal purchases and normal sales scope exception to contracts that would otherwise qualify for that scope exception.

15-39 The normal purchases and normal sales scope exception could effectively be interpreted as an election in all cases. However, once an entity documents compliance with the requirements of paragraphs 815-10-15-22 through 15-51, which could be done at the inception of the contract or at a later date, the entity is not permitted at a later date to change its election and treat the contract as a derivative instrument.

For an entity to apply the NPNS scope exception, Topic 815 has certain documentation requirements. [\[815-10-15-37\]](#)

Designation of the contract as a NPNS

Documentation of the NPNS scope exception may be for individual contracts or groups of similar contracts. [\[815-10-15-38\]](#)
See Questions 2.4.270 and 2.4.280.

Contracts with contractual or market mechanism for net settlement

As discussed in section 2.4.30, a forward contract (including a forward contract with optionality) that permits contractual net settlement or for which there is a market mechanism for net settlement is eligible for the NPNS scope exception only if it is probable that the contract will result in physical delivery and will not net settle. For these types of contracts, the entity is required to document its basis for concluding that these conditions are met.

Capacity contracts

Certain capacity contracts are eligible for the NPNS scope exception based on the criteria in section 2.4.60 (i.e. they are eligible even though they do not meet the criteria in sections 2.4.10 to 2.4.40). In these situations, the entity is required to document its basis for concluding that the criteria in section 2.4.60 are met.



Question 2.4.250

Is an entity required to document its basis for designating a contract as a NPNS scope exception?

Interpretive response: Yes. We believe an entity must document both the designation of the contract as a NPNS scope exception and the basis for the designation (i.e. how it qualifies for the scope exception).



Question 2.4.260

Is the NPNS scope exception essentially an election?

Interpretive response: Yes. Failure to comply with the documentation requirements precludes application of the NPNS scope exception to contracts that would otherwise qualify for it. In essence, an entity can choose either of the following for a contract that is eligible for this exception: [\[815-10-15-38 – 15-39\]](#)

- elect to apply the NPNS scope exception by documenting the exception; or
- elect to account for the contract as a derivative by not documenting the exception.

An entity may elect to apply the NPNS scope exception to a derivative contract either at inception of the contract or at a later date. However, once an entity elects to apply the exception, it cannot subsequently change the election and account for the contract as a derivative. [\[815-10-15-39\]](#)



Question 2.4.270

Is an entity required to document the NPNS scope exception for each individual contract?

Interpretive response: No. Documentation of the NPNS scope exception may be for individual contracts or groups of similar contracts. The group approach may be useful to an entity that applies the NPNS scope exception to all of its similar contracts for future purchases or sales of nonfinancial assets. [\[815-10-15-38\]](#)

We believe that when an entity uses the group approach, its designation documentation should define the group with sufficient specificity that it would be clear to a third party whether an individual contract is included in (or excluded from) the group. The identification of contracts included in the group is important because (as discussed in Questions 2.4.280 – 2.4.300) a contract that ceases to be eligible for the NPNS scope exception (e.g. due to not settling through gross physical delivery) may cause other similar contracts to also not be eligible for it.



Question 2.4.280

Is an entity required to apply the NPNS scope exception to all similar contracts?

Interpretive response: No. In general, we believe an entity can apply the NPNS scope exception to one contract and not apply it to another contract with similar terms and usage.

However, inconsistent application of the NPNS scope exception to contracts with similar terms and usage may make it difficult to apply the exception to any contract. For example, it may be difficult for an entity to apply the NPNS scope

exception if it historically did not apply the NPNS scope exception and net settled some (or all) of the contracts.

For a purchase contract to be eligible for the NPNS scope exception, it must be for delivery of assets in quantities expected to be used or sold by the entity over a reasonable period in the normal course of business. Determining whether this condition is met requires judgment, including consideration of the entity's past practices with similar contracts (see section 2.4.40). Therefore, an entity that historically did not consider some contracts normal (e.g. because they were net settled) would need to prepare sufficient documentation to overcome that experience when supporting a similar contract as normal.



Question 2.4.290

After an entity has documented the NPNS scope exception, is it required to reassess whether physical settlement remains probable?

Interpretive response: Yes. An entity needs to reassess whether the contract continues to qualify for the NPNS scope exception when conditions change in a way that changes the likelihood that the contract will physically settle (and will not net settle). [\[815-10-15-23, 15-35, 15-39\]](#)

Changes in conditions such as the following may result in an entity concluding that a contract no longer qualifies for the NPNS scope exception:

- changes in the entity's business, such as its expected production levels and whether it has net settled similar contracts;
- changes in the entity's or the counterparty's creditworthiness; and
- changes in market conditions (e.g. supply and demand).

When an entity concludes that a contract no longer qualifies for the NPNS scope exception, its documentation should include an analysis of how the assessment affects other similar contracts. This is because net settlement of an individual contract that was previously designated as a normal purchase or normal sale could call into question the classification of all similar contracts designated as normal purchases or normal sales.

In other words, the entity must consider whether the unplanned net settlement of a contract designated as a normal purchase or normal sale affects its intent for all existing similar contracts that are not expected to be net settled and any future similar contracts (see also Question 2.4.300).



Question 2.4.300

If a contract that was designated under the NPNS scope exception is net settled, does it taint all similar contracts?

Interpretive response: Not necessarily. As discussed in Question 2.4.290, we believe that when a contract designated under the NPNS scope exception is net

settled, an entity needs to consider whether its intent has changed for similar contracts. Although this concept of tainting is similar to the one in Topic 320, we do not believe it is as restrictive.

Under Topic 320, sales or transfers of HTM debt securities may call into question an entity's intent to hold other debt securities to maturity. For such transactions not to taint other HTM debt securities, Topic 320 requires the transactions to be 'isolated, non-recurring, and unusual'. In addition, Topic 320 states that such transactions 'should be rare'. [320-10-25-9, 35-8 – 35-9, 35-11]

In contrast, Topic 815 does not include definitive guidelines about the tainting of other contracts. We believe an entity should evaluate the circumstances that led to a contract for which the NPNS scope exception was being applied being net settled. If an entity has a valid business reason for the net settlement of a specific contract(s) that would not apply to other contracts, the net settlement would not prevent the entity from applying the NPNS scope exception to similar contracts currently or in the future as long as a clear differentiation can be made between the net settled contract and the other contracts.

The following are examples.

Circumstance	Are similar contracts tainted?
An entity decides to net settle a contract to take advantage of price movements	If an entity has a history of choosing to net settle a specific type of contract, the entity would usually be precluded from applying the NPNS scope exception to that type of contract currently and in the future.
A contract is net settled because of events that were reasonably unexpected and outside the entity's control	Other contracts affected by such events are generally tainted, while contracts that are not affected are generally not.
A contract is net settled because of significant deterioration in counterparty's creditworthiness	Contracts that are similarly affected by the change in the counterparty's creditworthiness are generally tainted, while contracts with other counterparties are generally not tainted. See also Question 2.4.290, which indicates that an entity should consider counterparty (and own) credit risk after a contract has been designated under the NPNS scope exception in evaluating whether that designation continues to be appropriate.
A contract within one business unit is net settled	We believe a contract that is net settled by one business unit within a consolidated group should not call into question the use of the NPNS scope exception for similar contracts for all other units within the consolidated group if each unit is autonomous and independently manages its operations, including its risk management activities.



Question 2.4.310

How does an entity account for a contract that ceases to be eligible for the NPNS scope exception?

Interpretive response: When a derivative contract that was accounted for as a normal purchase or normal sale ceases to be eligible for the NPNS scope exception, the entity recognizes a derivative asset or liability for its then-current fair value with an offsetting entry to earnings. That derivative is then eligible to be designated as the hedging instrument in a hedging relationship (see Question 2.4.10).

This is the same accounting as for a financial instrument or other contract that does not initially meet the definition of a derivative but does later on (see Question 3.6.10).

See also Question 2.4.320 regarding whether an entity may elect the NPNS scope exception for a contract that does not initially meet the definition of a derivative.



Question 2.4.320

How does an entity account for a contract that was not designated as NPNS until after the contract's inception?

Interpretive response: As indicated in Question 2.4.260, an entity may elect the NPNS scope exception for an eligible contract at its inception or at a later date. An entity accounts for a contract as a derivative until the contract is designated under the NPNS scope exception.

While a financial instrument or other contract is accounted for as a derivative, an asset or liability is recorded representing its fair value with changes in fair value recorded in earnings. When the NPNS scope exception is elected, the entity prospectively applies other generally accepted accounting principles that apply to that asset or liability.

In some cases, the other principles that should be applied may be clearly identifiable. In other cases, there may not be accounting principles that deal specifically with the instrument concerned – including that they may not have required recognizing any asset or liability for such an instrument until physical settlement.

When the accounting principles are not clearly identifiable, the entity should not eliminate the contract's carrying amount (i.e. the contract's cost basis). Instead, we believe the entity should adopt an accounting approach consistent with the fundamental recognition and measurement criteria contained in FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises (CON 5), and No. 6, Elements of Financial Statements (CON 6).

The entity should consider whether the amount recognized continues to meet the definition of an asset or liability. If the amount recognized meets the

definition of an asset or liability, it should remain as an asset or liability until it is recognized in income (at the same time as the items underlying the contract). If the amount recognized is an asset, the entity should also consider whether the cost basis is recoverable and the requirement to provide for any probable and estimable loss contingency in accordance with Topic 450 (contingencies).

If a contract was designated as a hedging instrument in a cash flow hedge before its designation under the NPNS scope exception, the accumulated gain or loss included in AOCI is accounted for under the guidance in section 10.3 for dedesignated hedging relationships. [815-10-25-3]

This is the same accounting as for a financial instrument or other contract that initially meets the definition of a derivative and later ceases to meet it (see Question 3.6.10).



Question 2.4.330

Can an entity document election of the NPNS scope exception for a contract that is not a derivative but could become one in the future?

Background: The NPNS scope election only applies to a contract that is a derivative. As discussed in section 3.6, an entity is required to evaluate whether a contract is a derivative at inception and on an ongoing basis. As a result, whether a financial instrument or other contract is a derivative may change over time.

An entity may not always be aware of the exact point at which a contract becomes a derivative. If a contract became a derivative after its inception and the entity did not document its election of the NPNS scope exception until after the contract became a derivative, the entity would have to apply derivative accounting to the contract from the point it became a derivative through the election date (see Question 2.4.320).

Interpretive response: Yes. We believe an entity is permitted to document its election of the NPNS scope exception for a contract that is not a derivative but otherwise is eligible for that scope exception.

Documenting such an election prevents an entity from having to apply derivative accounting to a nonderivative contract that otherwise meets the requirements for the NPNS scope exception and that has the potential to become a derivative. This is because if an entity documents such an election, the nonderivative contract continues to be excluded from the scope of Topic 815 even if it later meets the definition of a derivative (see Question 2.4.260).

Further, we believe the guidance for derivative contracts for which the NPNS scope exception is elected also applies to nonderivative contracts for which it is elected. For example, all other NPNS scope exception requirements must be met, including that:

it must be probable at inception and on an ongoing basis that the entity will physically settle and not net settle the contract; and

net settlements may affect whether other similar contracts, including derivative contracts, qualify for the NPNS scope exception.

2.5 Certain insurance contracts

2.5.10 Overview



Excerpt from ASC 815-10

>>> Certain Insurance Contracts

15-52 A contract is not subject to the requirements of this Subtopic 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. Only those contracts for which payment of a claim is triggered only by a bona fide insurable exposure (that is, contracts comprising either solely insurance or both an insurance component and a derivative instrument) may qualify for this scope exception. To qualify, the contract must provide for a legitimate transfer of risk, not simply constitute a deposit or form of self-insurance.

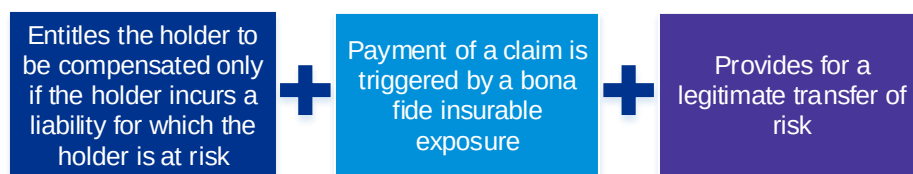
15-53 The following types of contracts written by insurance entities or held by the insureds are not subject to the requirements of this Subtopic for the reasons given:

- a. 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.
- B. 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.

15-54 In addition, some contracts with insurance or other entities combine derivative instruments 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 815-15-25-1. However, insurance entities enter into other types of contracts that may be subject to the provisions of this Subtopic.

Topic 815 includes a scope exception for certain insurance contracts when benefits (payments) under the contract may be affected by the change in a variable, but the payment is triggered by the occurrence of an identified insurable event (not the change in the variable). This exception applies to both parties to the contract. [\[815-10-15-52\]](#)

An insurance contract that possesses the following characteristics is eligible for the scope exception. [\[815-10-15-52\]](#)



Traditional insurance contracts (e.g. life insurance, property and casualty insurance) are the most common type of contracts that meet this scope exception. This is because the settlement of the contract is tied to a loss triggered by the occurrence of a specified insurable event (e.g. death of the insured, property loss). Those contracts are accounted for under Topic 944 (insurance). [815-10-15-53]



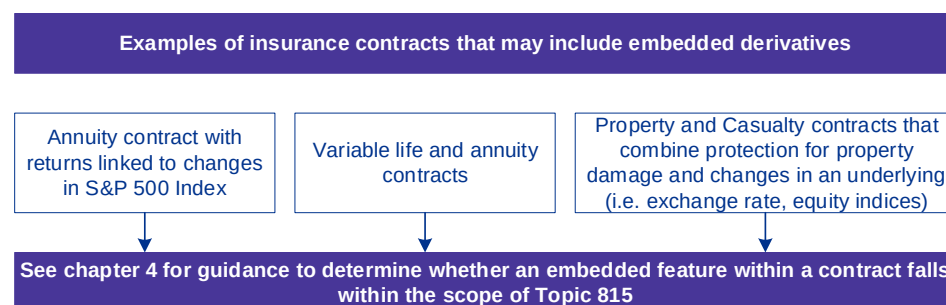
Question 2.5.10

Is a contract that qualifies for the insurance scope exception evaluated to determine whether it contains an embedded feature requiring separate accounting?

Interpretive response: Potentially. In most circumstances, when a contract is a derivative in its entirety and a scope exception applies, Topic 815 does not require an entity to determine if the contract contains an embedded derivative.

However, in certain circumstances, an entity is required to consider whether an insurance contract is a hybrid contract containing an embedded derivative even when the contract includes features that meet the definition of a derivative and features that qualify for the insurance scope exception. See section 2.5.30 related to contracts with actuarially determined minimum amounts, and paragraphs 815-15-05-1, 25-1 and 25-14 regarding period-certain guaranteed minimum periodic payments in a period-certain-plus-life-contingent annuity.

The following table illustrates examples of contracts that may include embedded derivatives; see related FASB Example in paragraphs 815-15-55-73 – 55-76.





Question 2.5.20

Do all 'insurance contracts' qualify for the insurance scope exception?

Interpretive response: No. A contract is included in, or excluded from, the scope of Topic 815 based on its characteristics rather than on whether it is referred to as an 'insurance contract'.

As a result, insurance contracts that meet the definition of a derivative instrument but that do not meet a scope exception (such as the insurance scope exception) are subject to derivative accounting, whether issued by an insurance entity or another type of entity.



Future developments

In August 2018, the FASB issued ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts, which changes how insurance entities recognize, measure, present and disclose long-duration contracts.

ASU 2018-12 introduces a new term – 'market risk benefits' – for certain contracts or contract features that provide potential benefits in addition to the contract holder's account balance. When those contracts or features protect the contract holder and also expose the insurance entity to other-than-nominal capital market risks, they are market risk benefits – e.g. guaranteed minimum benefit features. The ASU requires market risk benefits to be measured at fair value with changes recorded in income, except for changes in instrument-specific credit risk which are recorded in OCI.

Under the ASU, when a contract includes benefits in addition to the account balance, an assessment of the appropriate accounting treatment for each individual contract or contract feature is made at inception. The entity should determine the accounting for the contract or contract feature, in the following order:

- market risk benefit;
- embedded derivative; and then
- annuitization, death or other insurance benefit.

The insurance scope exception may apply to contracts or contract features that are not market risk benefits. The scope exclusion extends to contract features that would otherwise be embedded derivatives if they are not market risk benefits.

As a result of the FASB's issuance of ASC 2019-09, *Financial Services – Insurance: Effective Dates*, ASU 2018-12's effective dates are as follows.

	SEC filers that are <i>not</i> eligible to be smaller reporting companies ¹	All other entities
Annual periods – Fiscal years beginning after	December 15, 2021	December 15, 2023
Interim periods – In fiscal years beginning after	December 15, 2021	December 15, 2024
Early adoption allowed?	Yes.	
Note: 1. An entity determines whether it is eligible to be a smaller reporting company (SRC) based on its most recent SRC determination as of November 15, 2019. [944-40-65-2(a)]		

The accounting for market risk benefits is applied on a retrospective basis at the beginning of the earliest period presented.

In July 2020, the FASB proposed to defer the effective date of the ASU on long-duration insurance contracts by one year for all insurance entities and to change the early adoption transition date to the beginning of the prior period (to align it with the regular adoption transition date).

See KPMG Handbook, [Long-duration contracts: Targeted improvements](#), for further information, including chapter 3 (market risk benefits) and chapter 7 (effective dates and transition).

2.5.20 Dual-trigger property and casualty insurance contracts



Excerpt from ASC 815-10

15-55 A property and casualty contract that provides for the payment of benefits or claims as a result of both an identifiable insurable event and changes in a variable would in its entirety not be subject to the requirements of this Subtopic (and thus not contain an embedded derivative that is required to be separately accounted for as a derivative instrument) provided all of the following conditions are met:

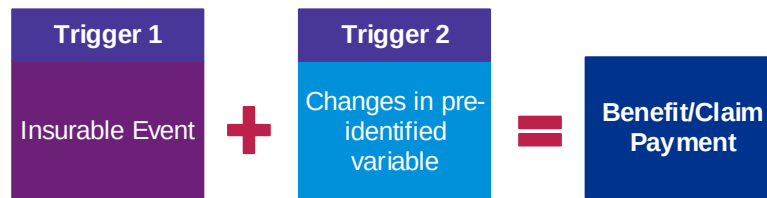
- Benefits or claims are paid only if an identifiable insurable event occurs (for example, theft or fire).
- The amount of the payment is limited to the amount of the policyholder's incurred insured loss.
- The contract does not involve essentially assured amounts of cash flows (regardless of the timing of those cash flows) based on insurable events highly probable of occurrence because the insured would nearly always receive the benefits (or suffer the detriment) of changes in the variable

>>> Certain Insurance Contracts—Dual-Trigger Property and Casualty Insurance Contracts

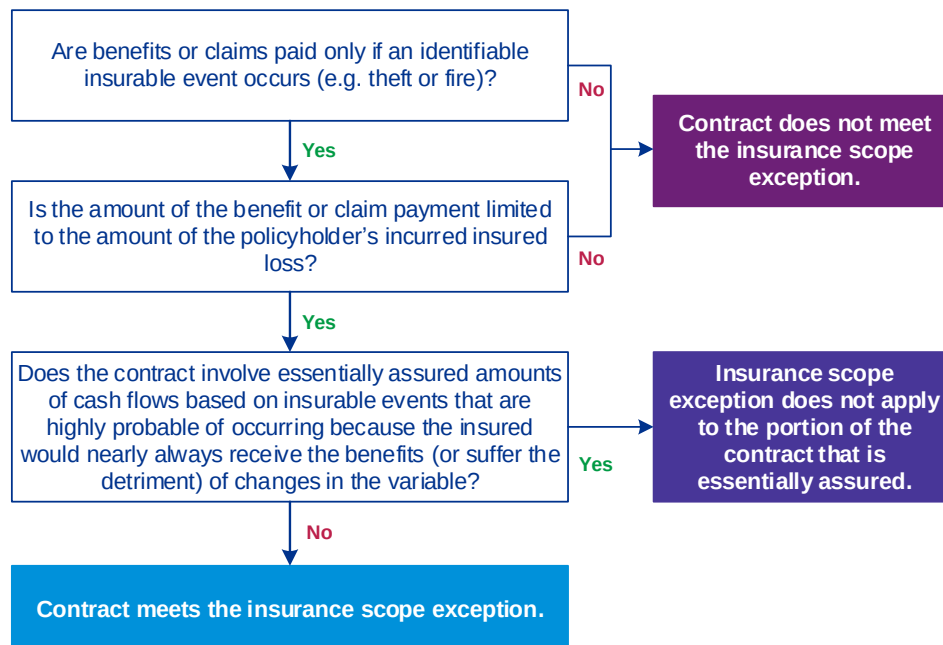
55-37 A common characteristic of dual-trigger policies is that the payment of a claim is triggered by the occurrence of two events (that is, the occurrence of both an insurable event and changes in a separate pre-identified variable). Because the likelihood of both events occurring is less than the likelihood of only one of the events occurring, the dual-trigger policy premiums are lower than traditional policies that insure only one of the risks. The policyholder is often purchasing the policy to provide for coverage against a catastrophe because if both events occur, the combined impact may be disastrous to its business.

Dual-trigger property and casualty insurance contracts are contracts that pay a benefit/claim only when two events occur. They are used to provide tailored commercial risk coverage at lower premiums than those for traditional policies that insure only one risk. The policyholder is usually purchasing the policy to provide for coverage against a catastrophe because the combined effect of both effects occurring may be disastrous to its business. [815-10-15-55, 55-37]

The following diagram illustrates the characteristics of a dual-trigger property and casualty insurance contract.



The insurance scope exception applies to dual-trigger property and casualty policies provided certain conditions are met. The following decision tree summarizes these conditions. [815-10-15-55, 55-39]



FASB Examples

The following examples illustrate seven dual-trigger insurance policies. Each of the policies described is eligible for either the insurance scope exception or the scope exception for certain contracts that are not traded on an exchange (see section 2.7).

For example, Contract E qualifies for the insurance scope exception because claims: [815-10-15-55, 55-40]

- are paid only on the occurrence of an insurable event;
- are limited (capped) at the amount of the policyholder's incurred insured loss; and
- do not involve assured cash flows based on a highly probable event.



Excerpt from ASC 815-10

>>> Certain Insurance Contracts—Dual-Trigger Property and Casualty Insurance Contracts

55-38 Paragraph 815-10-55-40 addresses seven contracts that illustrate the characteristics of dual-trigger policies offered to different types of policyholders that have different risk management needs. All seven contracts qualify for either the exception in paragraph 815-10-15-53(b) for traditional property and casualty contracts or the exception in paragraph 815-10-15-59(b) for non-exchange-traded contracts involving nonfinancial assets. Therefore, the dual-trigger variable in those contracts is not separated and accounted for separately as a derivative instrument.

55-39 In contrast, paragraph 815-15-55-12 states that, if a contract issued by an insurance entity involves essentially assured amounts of cash flows based on insurable events that are highly probable of occurrence (as discussed in paragraph 815-10-15-55(c)), an embedded derivative related to changes in the separate pre-identified variable for that portion of the contract would be required to be separately accounted for as a derivative instrument.

55-40 Following are descriptions of seven contracts:

- a. Contract A—electric utility. A dual-trigger policy pays for a level of actual losses caused by the following two events occurring simultaneously:
 1. A power outage resulting from equipment failure or storm-related damage causes more than 500 megawatts of lost power.
 2. The spot market price for power exceeds \$65 per megawatt hour during the storm or equipment-failure period.

The contract pays the difference between the strike price and the actual market price for the lost power (that is, the cost of replacement power).

- b. Contract B—trucking delivery entity. A dual-trigger policy pays extra expenses associated with rerouting trucks over a certain time period if snowfall exceeds a specified level during that time period. The snowfall causes delays and creates the need to reroute trucks to meet delivery demands.

- c. Contract C—hospital. A dual-trigger policy pays actual medical malpractice claims above a specified level only if the value of the hospital's equity portfolio falls below a specified level during the same period.
- d. Contract D—iron ore mining entity. A dual-trigger policy pays a specified level of workers' compensation claims (not to exceed actual claims) if the claims exceed a specified level at the same time iron ore prices decrease below a specified level.
- e. Contract E—golf resort in Florida. A dual-trigger policy pays property damage from hurricanes incurred by a specific golf resort in Florida; however, the losses are covered only if other golf courses in the region incur hurricane-related losses and the claims cannot exceed the average property damages incurred by the other golf resorts in the county.
- f. Contract F—cherry orchard in Michigan. A dual-trigger policy pays crop losses incurred due to bad weather during growing season, and the claims are at risk of being reduced based on changes in the inflation rate in Brazil. The cherry producer has no operations in Brazil or any transactions in Brazilian currency. However, a Brazilian cherry producer exports cherries to the United States and is a competitor of the Michigan cherry producer.
- g. Contract G—property-casualty reinsurance contract. Reinsurance contracts, which indemnify the holder of the contract (the reinsured) against loss or liability relating to insurance risk, are accounted for under the provisions of Topic 944. Reinsurance contract provisions often adjust the amount at risk or the price of the amount at risk for a number of events or circumstances, such as loss experience or premium volume, while continuing to provide indemnification related to insurance risk. One type of reinsurance contract, an excess contract, provides the reinsured with indemnification against a finite amount of insured losses in excess of a defined level of insured losses retained by the reinsured. Example 11 (see paragraph 815-10-55-132) illustrates a reinsurance contract with a provision that adjusts the retention amount downward based on the performance of a specified equity index.

>> Example 11: Certain Insurance Contracts—Dual-Trigger Property-Casualty Reinsurance Contract

55-132 This Example illustrates a reinsurance contract with a provision that adjusts the retention amount downward based on the performance of a specified equity index as discussed in paragraph 815-10-55-40(g). Reinsurer enters into a reinsurance contract with Reinsured to indemnify Reinsured for certain insured losses in excess of a defined retention. The intent of the coverage is to protect Reinsured from significant or catastrophic property-casualty losses. The coverage would include a retention amount that would be adjusted downward according to a scale tied to the Dow Jones Industrial Average. If a catastrophic loss occurs, Reinsured would likely have to liquidate some of its investment holdings (bonds or equities) to pay its losses, which exposes Reinsured to significant investment risk in a down market. The adjustment feature provides protection against investment risk by allowing Reinsured to recover more losses in a declining investment market. Reinsured has no ability to receive appreciation in the Dow Jones Industrial Average.

- a. Parties: Reinsurer and Reinsured
- b. Coverage: Property losses
- c. Period: January 1, X1, through December 31, X1

- d. Retention: \$20 million per occurrence, adjusted downward in the same percentage as period-to-date (from January 1, X1, to measurement date) decreases in the Dow Jones Industrial Average, not to exceed 50%
- e. Limit: \$15 million per occurrence, \$15 million per annum
- f. Premium: \$1.4 million per annum.

55-133 Both of the following scenarios assume that the Dow Jones Industrial Average on January 1, X1, was 10,000.

	Scenario 1		Scenario 2	
	7/1/X1	9/1/X1	7/1/X1	9/1/X1
Property-casualty losses	\$25,000,000	\$25,000,000	\$15,000,000	\$15,000,000
Dow Jones Industrial Average	10,000	8,000	10,000	7,000
Retention	20,000,000	16,000,000	20,000,000	14,000,000
Recovery under contract	5,000,000	9,000,000	-	1,000,000

55-133A As discussed in paragraph 815-10-55-38, the contract qualifies for the exception in paragraph 815-10-15-53(b) for traditional property and casualty contracts and, so, the dual-trigger variable in the contract is not separated and accounted for separately as a derivative instrument.



Example 2.5.10

Dual-trigger property and casualty insurance contract – fixed payment

ABC Corp. enters into a contract that specifies that if there is a windstorm or earthquake event in the county in which ABC is located that results in property damage exceeding \$200 million, then ABC will receive a payment of \$80 million.

This contract is a dual-trigger property and casualty insurance contract because the claim is triggered by the occurrence of both:

- an insurable event: a windstorm or earthquake; and
- changes in a separate variable: property damage in the county of operation exceeding \$200 million.

An earthquake occurs that results in \$300 million of property damage in the county, with ABC's properties sustaining \$45 million in damages. As a result, ABC receives the fixed payment of \$80 million even though its incurred insured loss was only \$45 million.

This contract does not qualify for the insurance scope exception because the amount of the payment under the contract is not limited to the amount of ABC's incurred insured loss.

Further, because the contract contains two underlyings and one of the underlyings is a financial variable (damage exceeds \$200 million), the contract does not qualify for the scope exception for certain contracts that are not traded on an exchange (see section 2.7).

2.5.30 Contracts with actuarially determined minimum amounts of expected claim payments



Excerpt from ASC 815-10

15-56 If there is an actuarially determined minimum amount of expected claim payments that are the result of insurable events that are highly probable of occurring under the contract, that portion of the contract does not qualify for the insurance scope exception if both of the following conditions are met:

- a. Those minimum payment cash flows are indexed to or altered by changes in a variable.
- b. Those minimum payment amounts are expected to be paid each policy year (or on another predictable basis).

15-57 If an insurance contract has an actuarially determined minimum amount of expected claim payments that are highly probable of occurring, then effectively the amount of those claims is the contract's minimum **notional amount** in determining the embedded derivative under Section 815-15-25.

Typically, when a contract meets the definition of a derivative but also qualifies for a scope exception, it is not evaluated to determine whether any embedded derivatives require bifurcation.

However, an insurance contract may have an actuarially determined minimum amount of expected claim payments that are the result of insurable events that are highly probable of occurring. In that situation, that portion of the contract does not qualify for the insurance scope exception if: [\[815-10-15-55, 55-40\]](#)

those minimum payment cash flows are indexed to or altered by changes in a variable; and

those minimum payment amounts are expected to be paid each policy year (or on another predictable basis).

FASB Example

Topic 815's Example 12 (reproduced below) illustrates that the insurance scope exception would not apply to the portion of a contract that involves essentially assured amounts.



Excerpt from ASC 815-10

>> Example 12: Certain Insurance Contracts—Essentially Assured Amounts

55-134 This Example illustrates the guidance in paragraph 815-10-15-55(c) for a contract involving essentially assured amounts. Insured Entity has received at least \$2 million in claim payments from its insurance entity (or at least \$2 million in claim payments were made by the insurance entity on the insured

entity's behalf) for each of the previous 5 years related to specific types of insured events that occur each year. That minimum level of coverage would not qualify for the insurance contract scope exclusion.

2.6 Certain financial guarantee contracts

2.6.10 Overview



Excerpt from ASC 815-10

>>> Certain Financial Guarantee Contracts

15-58 Financial guarantee contracts are not subject to this Subtopic only if they meet all of the following conditions:

- a. They provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations under a nonderivative contract, either:
 1. At prespecified payment dates
 2. At accelerated payment dates as a result of either the occurrence of an event of default (as defined in the financial obligation covered by the guarantee contract) or notice of acceleration being made to the debtor by the creditor.
- b. Payment under the financial guarantee contract is made only if the debtor's obligation to make payments as a result of conditions as described in (a) is past due.
- c. The guaranteed party is, as a precondition in the contract (or in the back-to-back arrangement, if applicable) for receiving payment of any claim under the guarantee, exposed to the risk of nonpayment both at inception of the financial guarantee contract and throughout its term either through direct legal ownership of the guaranteed obligation or through a back-to-back arrangement with another party that is required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation.

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

Topic 815 provides a scope exception for certain financial guarantee contracts.

In a financial guarantee contract, a guarantor agrees to pay the creditor if an event of default occurs with a specified lending agreement between the creditor and its debtor. The following diagram provides an example of such an arrangement.



For a contract to qualify for the scope exception, it must: [\[815-10-15-58\]](#)

- provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations under a nonderivative contract (see section 2.6.20);
- provide payment only if the debtor's obligation is past due (see section 2.6.30); and
- provide payment only if the guaranteed party is exposed to the risk of nonpayment at inception of the guarantee arrangement and throughout its life (see section 2.6.40).

Further, when it is determined that a required payment obligation has not been satisfied by the debtor, the creditor must relinquish to the guarantor its rights to receive payment from the debtor before it receives payment from the guarantor. This enhances alignment of the financial guarantee scope exception with the insurance scope exception. [\[FAS 149.A21–A22\]](#)

2.6.20 Failure of the debtor to satisfy its required payment obligations

The first condition of the financial guarantee contract scope exception is that a guarantee provide for payment to the creditor (i.e. the guaranteed party) only in response to the debtor failing to satisfy a required payment obligation under a nonderivative contract. [\[815-10-15-58\(a\)\]](#)

In most lending agreements, the creditor has the right to require payment in full if any event of default occurs. This is a right and not an automatic contractual acceleration of payment under the lending agreement. Events of default are either payment based (e.g. payment of principal or interest when due) or nonpayment based (e.g. violation of a covenant or a change in control). Consequently, if a payment or nonpayment based default occurs, the debtor does not fail to satisfy its required payment obligation (if not already due) unless and until the creditor exercises its right to accelerate payment under the lending agreement. [\[815-10-15-58\(a\)\]](#)



Question 2.6.10

Is a guarantee that protects an entity from a counterparty's nonpayment of an interest rate swap eligible for the financial guarantee scope exception?

Interpretive response: No. The financial guarantee scope exception only applies to contracts that provide for payments to be made solely to reimburse

the guaranteed party for failure of the debtor to satisfy its required payment obligations under a nonderivative contract (e.g. a loan). Because an interest rate swap is a derivative contract, the scope exception does not apply.



Question 2.6.20

Is a guarantee that compensates a creditor upon the occurrence of a nonpayment-based default eligible for the financial guarantee scope exception?

Background: Under some guarantee agreements, the guarantor compensates the creditor (i.e. the guaranteed party) when the debtor violates a covenant or experiences a change in control even if the creditor does not exercise its right to accelerate payment.

Interpretive response: No. Creditors in these types of guarantee agreements are typically attempting to mitigate operational risk in addition to credit risk. Specifically, the creditor is attempting to reduce its risk related to nonpayment by a debtor as well as reduce its risk related to operational and other changes that may occur with the debtor during the life of the lending agreement.

The FASB intended the financial guarantee scope exception to align with the scope exception for certain insurance contracts (see section 2.5). As a result, for a financial guarantee contract to qualify for the scope exception, the creditor may be entitled to payment only if the debtor has failed to satisfy a payment obligation. [FAS 149.A22]

When a debtor violates a covenant or experiences another operational change, it may still meet its payment obligation – e.g. because the creditor chooses to not accelerate the contractual payments. The financial guarantee scope exception does not apply when a guarantor makes payment in such circumstances.



Question 2.6.30

Does a contract that compensates a creditor if a debtor files for bankruptcy meet the financial guarantee scope exception?

Interpretive response: No, because a debtor declaring bankruptcy does not necessarily mean the debtor has failed to make a payment.



Example 2.6.10

Financial guarantee – Hedging credit exposure

ABC Bank has a two-year, \$50 million, 15% fixed-rate loan with XYZ Corp.

To hedge the credit exposure associated with this loan, ABC enters into an arrangement with Bank. The following facts about the arrangement are relevant:

- ABC will pay Bank all principal and interest collected from XYZ on the loan;
- in return, Bank will pay ABC interest at an annual rate of 9% (on a notional amount of \$50 million) plus a \$50 million payment in two years;
- this contract will settle on a net basis annually;
- at the end of Year 2, ABC will transfer any remaining legal title on the loan to Bank; and
- the arrangement meets the definition of a derivative.

This arrangement does not qualify for the financial guarantee scope exception. The contract is similar to a financial guarantee contract because no matter how XYZ performs on the loan, ABC will receive the principal plus a 9% return. However, the contract does not explicitly require nonpayment by XYZ before Bank will reimburse ABC. As a result, the first condition of the financial guarantee scope exception is not met.



Question 2.6.40

Do credit derivatives that provide protection against a decline in creditworthiness qualify for the financial guarantee scope exception?



Excerpt from ASC 815-10

>>> Credit Derivatives

55-45 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 815-10-15-58 are guarantees and are not subject to the requirements of this Subtopic. Credit-indexed contracts (often referred to as credit derivatives) that do not have the characteristics necessary to qualify for the exception in that paragraph are subject to the requirements of this Subtopic. 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).

Background: A credit derivative represents a financial instrument (typically a swap) that provides protection to the holder of the derivative in case of a

decline in the creditworthiness of a specific entity or group of entities. Many credit derivatives define the underlying as either: [\[FAS 149.A21–A22\]](#)

- the credit spread (sector and/or obligor’s creditworthiness) of a particular entity’s outstanding debt securities (i.e. credit spread options); or
- the value of the security when such security has defaulted (i.e. credit default swaps).

Interpretive response: No, those types of credit derivatives do not meet the conditions of the financial guarantee scope exception. This is because these contracts do not require the borrower to fail to satisfy its contractual payment obligations before the subject credit derivative provides payment. [\[815-10-15-58\]](#)



Example 2.6.20 Credit derivatives

Insurer executes a credit spread option with Investment Bank that has a notional amount of \$100 million.

Under the option, Investment Bank will make payments to Insurer when the yield on ABC Corp.’s Series A Debt Securities is more than 600 points greater than the yield of US Treasuries. The current credit spread on the Series A Debt Securities was 600 bps over US Treasuries when the option was executed.

Investment Bank is required to own the Series A Debt Securities to receive payment under the option’s terms.

The payment under the option is calculated as follows.

- If the yield (i.e. credit spread) on the Series A Debt Securities is between 600 and 700 bps, Investment Bank will pay Insurer the product of \$100 million (the notional amount) multiplied by the incremental increase in that yield over 600 bps above the yield on US Treasuries. For example, if the yield on the Series A Debt Securities is 650 bps, Investment Bank will pay Insurer \$500,000: \$100 million × (0.065 – 0.06).
- If the yield (i.e. credit spread) on the Series A Debt Securities increases to 700 bps or more above US Treasuries, Investment Bank will pay Insurer \$1 million. This represents the product of \$100 million (the notional amount) multiplied by the incremental increase above 600 bps: \$100 million × (0.07 – 0.06).

This credit derivative does not qualify for the financial guarantee scope exception because the option does not require that ABC fail to satisfy its contractual payment obligations related to its Series A Debt Securities before the guaranteed party (Insurer) is reimbursed. [\[815-10-15-58\]](#)

2.6.30 Debtor’s obligation is past due

The second condition of the financial guarantee contract scope exception is that payment under the contract can be made to the guaranteed party by the guarantor only if:

The guaranteed party was contractually due an amount by the debtor



That amount is now past due



Further, the amount of payment the guaranteed party can receive from the guarantor must be limited to the amount that is currently past due by the debtor. Any contractual amount that is not paid by the debtor under the lending agreement is considered past due. [\[815-10-15-58\(b\)\]](#)



Example 2.6.30

Financial guarantee contract – scheduled payment is past due

Debtor owes a total principal amount of \$10,000 to Creditor in principal installments of \$100. A contractually scheduled payment of \$100 is due to Creditor by 1:00 pm EST on December 15, Year 1 and is not received.

Scenario 1: Creditor has no right to demand repayment of the full outstanding principal when payment is not received

To meet the second condition of the financial guarantee scope exception, the amount Creditor can receive from the guarantor must be limited to \$100 (i.e. the amount that is past due and that the debtor has failed to satisfy), not the full outstanding principal of \$10,000.

Scenario 2: Creditor has the right to demand (and does demand) repayment of the full outstanding principal when payment is not received

Creditor notifies Debtor that it demands payment in the amount of \$10,000 in satisfaction of the lending agreement as a result of the missed payment and Debtor does not make that payment. As a result, the guarantee meets the second condition of the financial guarantee scope exception if the amount Creditor can receive from the guarantor is limited to \$10,000.

Note: If the guarantee arrangement paid the full outstanding amount of \$10,000 (or purchased the entire outstanding note for \$10,000) regardless of whether Creditor required full and immediate payment, it would not meet the financial guarantee scope exception.

2.6.40 Guaranteed party is exposed to the risk of nonpayment

The third condition of the financial guarantee contract scope exception is that a financial guarantee contract must require (as a precondition for payment of a claim) that the guaranteed party (the creditor) be exposed to the risk of nonpayment on the referenced asset – both at inception of the financial guarantee contract and over its life. [815-10-15-58(c)]



Question 2.6.50

Does the financial guarantee scope exception apply if the guaranteed party can sell the referenced asset?

Interpretive response: No, unless the guarantee contract explicitly terminates on the sale of the referenced asset. If the guaranteed party is able to eliminate its risk of nonpayment on the referenced asset by selling the asset and would still be entitled to receive payment under the guarantee, the contract will not qualify for the exception.



Example 2.6.40

Financial guarantee contract – scope exception

Lender Bank has a loan to Borrower and wants to reduce its credit exposure on this loan. Lender enters into an agreement with Guarantor Bank, with terms as follows.

- Lender will pay Guarantor a periodic payment of 20 bps a year.
- In return, Guarantor agrees to pay Lender any missed scheduled payments that Borrower fails to make, provided Lender is exposed to the risk of nonpayment on the loan over the life of the agreement. If Guarantor makes such a payment, Guarantor will receive the rights to that payment in exchange.

This contract qualifies for the financial guarantee scope exception because it meets all applicable conditions:

- Guarantor is not required to pay Lender until Borrower misses a payment on the loan;
- the payment amount equals the scheduled payment due; and
- Lender is exposed to the risk of nonpayment throughout the life of the agreement with Guarantor.

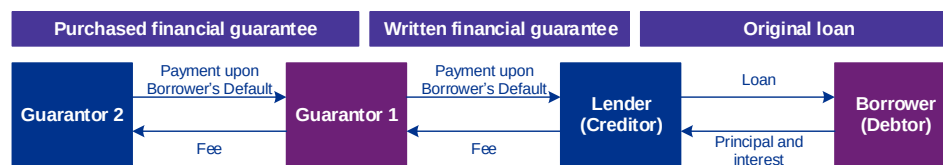
Therefore, the contract is excluded from the scope of Topic 815 by both Lender and Guarantor. The annual payments made by Lender to Guarantor are analogous to paying premiums for purchased insurance to cover a future loss.

2.6.50 Application issues

Back-to-back arrangements

If a guarantor writes a financial guarantee contract that references a specific asset, it may concurrently or subsequently purchase a financial guarantee contract that references the same asset and become the guaranteed party under that purchased contract. If payment is required under the written financial guarantee contract, a mirror payment and transfer of rights will occur under the purchased financial guarantee contract. These arrangements are typically referred to as 'back-to-back arrangements'. [815-10-15-58]

The following diagram illustrates an example of a back-to-back arrangement.



Question 2.6.60

What conditions must be met for a back-to-back contract to meet the financial guarantee scope exception?

Interpretive response: We believe all of the following conditions must be met for a back-to-back contract to meet this scope exception:

- the original written financial guarantee contract meets the financial guarantee scope exception;
- all receipts contractually required under the purchased financial guarantee contract mirror the required payments under the written financial guarantee contract;
- all terms of the purchased financial guarantee contract mirror the terms under the written financial guarantee contract; and
- the purchased financial guarantee contract requires the guaranteed party to continue to be exposed to the obligations under the written financial guarantee contract.



Question 2.6.70

Does a back-to-back guarantee arrangement qualify for the financial guarantee scope exception if the guaranteed amount is less than that under the related written guarantee?

Background: ABC Corp. writes a guarantee on a \$100 loan made by Lender. That written guarantee qualifies for the financial guarantee scope exception.

One year later, ABC purchases a guarantee from Finance Corp. to receive up to \$80 in the event that ABC is required to pay Lender under the original written guarantee – i.e. a back-to-back guarantee arrangement. The terms of the purchased guarantee mirror those of the written guarantee, and the purchased guarantee requires Lender to remain exposed to the obligations under the original written guarantee.

Interpretive response: Yes. The purchased back-to-back guarantee arrangement qualifies for the financial guarantee scope exception.

We believe the receipts under the purchased contract mirror a portion of the payments required under the written contract. Based on the background example, if ABC is required to pay \$80 to Lender under the original written guarantee, ABC will in turn receive \$80 from Finance Corp, which are mirrored receipts and payments. The fact that the purchased guarantee is for only a portion of the payments under the written guarantee does not negate the fact that a portion of the payments under the written guarantee are mirrored.

Dual-trigger financial guarantees

Dual-trigger financial guarantee contracts are similar to dual-trigger property and casualty insurance contracts (see section 2.5.20). Such contracts typically lower a guaranteed party's premium because claims are limited by external factors and the guarantor is not exposed solely to the guaranteed party's underwriting performance.



Question 2.6.80

Do dual-trigger financial guarantees qualify for the financial guarantee scope exception?

Interpretive response: Dual-trigger financial guarantee contracts typically qualify for the financial guarantee scope exception if all the conditions are met (see section 2.6.10). Those conditions are met even when the amount paid to the guaranteed party is the lesser of the missed payments on the referenced asset or, for example, the missed payments on a referenced pool of other assets. The lesser of payment provision in the dual-trigger financial guarantee contract in essence represents a type of deductible in the contract.

The FASB Example reproduced below provides an illustration of a dual-trigger financial guarantee.



Excerpt from ASC 815-10

>>> Dual-Trigger Financial Guarantee Contracts

55-32 Entity ABC extends credit to consumers through credit cards and personal loans of various sorts. Entity ABC is exposed to credit losses from its managed asset portfolio, including owned and securitized receivables. Entity

ABC would like to purchase an insurance policy to protect itself against high levels of consumer default.

55-33 The proposed insurance policy will entitle Entity ABC to collect claims to the extent that its credit losses exceed a specified minimum level but limited to the amount by which the credit losses on a customized pool or index of consumer loans exceed that same specified minimum level. Thus, Entity ABC will collect claims based on the lesser of the following:

- a. Entity ABC's actual credit losses
- b. The credit losses on a customized pool or index of consumer loans.

55-34 Although the insurer's payment to Entity ABC may be affected by credit losses on a customized pool, the payment nevertheless represents compensation for actual credit losses Entity ABC incurred. Entity ABC purchases this insurance to obtain a lower premium because claims are limited by external charge-off rates and the insurer is not exposed to Entity ABC's underwriting performance.

55-35 This type of control may also exist in property and casualty reinsurance policies. For example, an insurance entity may purchase reinsurance that covers actual hurricane losses in excess of a specified level in their block of business, but the coverage does not apply to losses in excess of a geographically diversified index of hurricane losses.

55-36 Financial guarantee insurance contracts are not subject to this Subtopic only if all of the conditions in paragraph 815-10-15-58 are met. The description of the financial guarantee insurance contract in paragraph 815-10-55-32 is insufficient for determining whether those conditions are met. The following provisions of that contract represent a type of deductible and do not affect the application of the conditions in paragraph 815-10-15-58:

- a. The provision that limits any claims to the extent that Entity ABC's actual credit losses exceed a specified minimum level
- b. The provision that limits any payments for those claims to the amount by which the credit losses on a customized pool or index of consumer loans exceed that same specified minimum level.

2.7 Certain contracts that are not traded on an exchange

2.7.10 Overview



Excerpt from ASC 815-10

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

15-59 Contracts that are not exchange-traded are not subject to the requirements of this Subtopic if the underlying on which the settlement is based is any one of the following:

- a. 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. (See Example 13 [paragraph 815-10-55-135].)
- b. 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. This scope exception applies only if both of the following are true:
 1. The nonfinancial assets are unique.
 2. The nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset. (If the contract is a call option, the scope exception applies only if that nonfinancial asset is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset above the option's strike price.)
- c. The fair value of a nonfinancial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash.
- d. Specified volumes of sales or service revenues of one of the parties to the contract. (This scope exception applies to contracts with settlements based on the volume of items sold or services rendered, for example, royalty agreements. This scope exception does not apply to contracts based on changes in sales or revenues due to changes in market prices.)

15-61 A contract based on any variable that is not specifically excluded by paragraph 815-10-15-59 is subject to the requirements of this Subtopic if it has the other two characteristics (initial net investment and net settlement) identified in this Subsection.

15-62 Example 14 (see paragraph 815-10-55-142) illustrates the application of paragraph 815-10-15-59(b).

Topic 815 provides a scope exception for certain contracts that are not traded on an exchange, called the nonexchange traded scope exception. This scope exception applies to both parties to the contract. Contracts that are not exchange traded fall within this scope exception if the underlying on which the settlement is based is any one of the following. [815-10-15-59]

- Climatic, geological or other physical variable.
- Price or value of a nonfinancial asset or liability.
- Specified volumes of revenue.

In contrast, any instrument or contract traded on an exchange does not meet this scope exception, even if its underlying is one of those specified above. This is because contracts that are exchange traded provide different benefits and pose different risks from nonexchange traded contracts. As such, accounting guidance for exchange traded and nonexchange traded contracts differs. [815-10-15-59, FAS 133.BC252]



Question 2.7.10

How often does an entity assess the listed status of instruments or contracts in the context of this scope exception?

Interpretive response: An entity must continuously monitor whether instruments or contracts are traded on an exchange. This is because the instrument or contract may change between exchange traded and nonexchange traded and as a result between inclusion and exclusion from the scope of Topic 815. [FAS 133.BC252]

2.7.20 Physical variables

As discussed in section 3.5.20, an underlying is any variable factor whose changes are observable or otherwise objectively verifiable. In concept, any observable variable may be an underlying for a derivative instrument. For example, a contract or instrument may be settled or valued based on the number of inches of rainfall or snow in a particular area, or the severity of an earthquake as measured by the Richter scale.

However, contracts that are not exchanged traded and are settled as a result of a climatic, geological or another physical variable are excluded from derivative accounting under the nonexchange traded scope exception. The FASB noted potential measurement difficulties associated with accounting for such contracts as derivatives. [815-10-15-59(a), FAS 133.BC252]

See section 2.7.60 for discussion about accounting for weather derivatives that are excluded from derivative accounting – e.g. because they are not exchange-traded and are settled as a result of a climatic variable.



Example 2.7.10

Geological variable

In exchange for \$1 million, Insurer 1 agrees to pay Insurer 2 a specified amount on the occurrence of an earthquake in a specified region of Japan during a specified time frame – i.e. a triggering event, which is an underlying.

The specified amount is \$100 million (a notional amount) multiplied by the magnitude of the earthquake as measured on the Richter scale by the Japan Meteorological Agency.

If an earthquake occurs, Insurer 2 neither has to suffer a loss nor be obligated to pay losses under insurance policies written to receive payment from Insurer 1. The contract is not traded on an exchange.

The contract meets the definition of a derivative instrument because it has an underlying and a notional amount. Further, the \$1 million payment made by Insurer 2 is considered to be a small investment relative to the minimum payment of \$100 million if an earthquake should occur, and the contract has a payment provision resulting in net settlement.

However, the contract is explicitly excluded from the scope of derivative accounting because:

- the underlying on which settlement is based is a geological (i.e. physical) variable; and
- the contract is not exchange traded.



Question 2.7.20

Does a contract with both physical and financial variables as underlyings qualify for this scope exception?



Excerpt from ASC 815-10

>>> Contract with Payment Provision

55-44 If the contract contains a **payment provision** that requires the issuer to pay to the holder a specified dollar amount based on a financial variable, the contract is subject to the requirements of this Subtopic.

Interpretive response: No. A contract that contains a payment provision that requires a payment based on both a physical variable and a financial variable is not eligible for this scope exception because of the presence of the financial variable. [815-10-55-44]

However, the contract is a traditional insurance contract that is excluded from the scope of Topic 815 under the insurance scope exception (see section 2.5) if: [815-10-55-141]

- the contract requires a payment only when the holder incurs a decline in revenue or an increase in expense as a result of an event (e.g. an earthquake); and
- the amount of the payoff is solely compensation for the amount of the holder's loss.

Subtopic 815-10's Example 13 (reproduced below) illustrates how to distinguish between physical and financial variables.



Excerpt from ASC 815-10

>> Example 13: Certain Contracts that Are Not Traded on an Exchange—Distinguishing Between Physical and Financial Variables

55-135 The following Cases illustrate the difference between physical and financial variables for purposes of applying the scope exception in paragraph 815-10-15-59(a):

- a. Contract containing both a physical variable and a financial variable (Case A)
- b. Contract containing only a physical variable (Case B)
- c. Contract containing only a financial variable (Case C).

>>> Case A: Contract Containing Both a Physical Variable and a Financial Variable

55-136 A contract's payment provision specifies that the issuer will pay to the holder \$10,000,000 if aggregate property damage from all hurricanes in the state of Florida exceeds \$50,000,000 during the year 2001.

55-137 In this Case, the payment under the contract occurs if aggregate property damage from all hurricanes in the state of Florida exceeds \$50,000,000 during the year 2001. The contract contains 2 underlyings—a physical variable (that is, the occurrence of at least 1 hurricane) and a financial variable (that is, aggregate property damage exceeding a specified or determinable dollar limit of \$50,000,000). Because of the presence of the financial variable as an underlying, the derivative instrument does not qualify for the scope exclusion in paragraph 815-10-15-59(a).

>>> Case B: Contract Containing Only a Physical Variable

55-138 A contract specifies that the issuer pays the holder \$10,000,000 in the event that a hurricane occurs in Florida in 2001.

55-139 If a contract contains a payment provision that requires the issuer to pay to the holder a specified dollar amount that is linked solely to a climatic or other physical variable (for example, wind velocity or flood-water level), paragraph 815-10-15-59(a) provides that the contract is not subject to the requirements of this Subtopic.

55-140 In this Case, the payment provision is triggered if a hurricane occurs in Florida in 2001. The underlying is a physical variable (that is, occurrence of a hurricane). Therefore, the contract qualifies for the scope exclusion in paragraph 815-10-15-59(a).

>>> Case C: Contract Containing Only a Financial Variable

55-141 A contract would be a traditional insurance contract that is excluded from the scope of this Subtopic under the exception discussed beginning in paragraph 815-10-15-52 if the contract requires a payment only if the holder incurs a decline in revenue or an increase in expense as a result of an event (for example, a hurricane) and the amount of the payoff is solely compensation for the amount of the holder's loss.

2.7.30 Nonfinancial underlyings

The nonexchange traded scope exception applies to contracts whose underlying (on which settlement is based) is a price or value of certain nonfinancial assets and liabilities.

For a contract to qualify for this scope exception:

- **Nonfinancial assets** on which settlement is based must be unique, owned by one of the parties to the contract, and not readily convertible to cash.

The nonfinancial asset related to the underlying must be owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset. [815-10-15-59(b)]

- **Nonfinancial liabilities** on which settlement is based must not require delivery of an asset that is readily convertible to cash. [815-10-15-59(c)]



Question 2.7.30

Does it matter which party to the contract owns the nonfinancial asset?

Interpretive response: Yes, this scope exception only applies when the party owning the nonfinancial asset is the party that would not benefit under the contract from increases in the asset's fair value. [815-10-15-59(b)]

We believe this exception was intended to apply to sales contracts of nonfinancial assets that meet the net settlement criterion due to inclusion of a cash-settled default provision. Therefore, the exception applies to either forward sales or written call options in which the selling party owns the unique nonfinancial asset (e.g. real estate) because the owner of the asset does not benefit under either type of contract if the asset's price or value increases.

For example, ABC Corp. owns a piece of artwork, which generally would be considered a unique nonfinancial asset – i.e. it is not an interchangeable unit (see Question 2.7.40).

- **Forward sale agreement.** ABC enters into a forward agreement to sell the artwork at a fixed price in six months. As the artwork's price or value increases, ABC does not benefit under the forward agreement because ABC is only entitled to receive the fixed price stated in the forward agreement.
- **Call option.** ABC writes a call option that provides the counterparty the right (but not the obligation) to purchase the artwork at a fixed price in six months. As the artwork's price or value increases, ABC does not benefit under the option contract because it is entitled to receive only the fixed price stated in the option contract if the counterparty exercises the option.

Requirement for the purchaser

To qualify for this exception, we believe the entity that does not own the asset (the purchaser) needs to verify that the counterparty (the seller) owns the asset associated with the underlying to the contract. In most instances, the counterparty will own the asset because it has obligated itself to deliver a unique asset.



Question 2.7.40

How is 'unique' defined in the context of this scope exception?

Interpretive response: Topic 815 does not provide guidance about the definition of 'unique'. We believe that for nonfinancial assets to be considered

unique, they should not have interchangeable (i.e. fungible) units. Further, we believe unique assets should have specific physical attributes or locations.

For example, we believe that parcels of real estate, buildings, collectibles, specially manufactured goods and machinery are unique. In contrast, commodities generally are fungible and therefore would not be considered unique.

Examples

The following examples illustrate this scope exception.

- Example 2.7.20 illustrates a contract to purchase a nonfinancial asset (building) that meets the scope exception.
- Subtopic 815-10's Example 14 illustrates a contract to purchase a nonfinancial asset that does not meet the scope exception.



Example 2.7.20 Contract to purchase a building

Purchaser pays \$100,000 to enter into a nonexchange traded option contract with Seller. Under the option, Purchaser has the right to purchase a building that Seller owns for \$5 million at any time during the next three years.

This contract meets the scope exception requirements because:

- the building is a nonfinancial asset that is unique – i.e. it is not interchangeable (fungible); and
- Seller will not benefit under the call option contract from an increase in the value of the building during the three-year option period. For example, if the building's value increases to \$8 million, Seller will not benefit because Seller can only sell the building to Purchaser for \$5 million.



Excerpt from ASC 815-10

>> Example 14: Certain Contracts that Are Not Traded on an Exchange—Nonfinancial Asset of One of the Parties to a Contract

55-142 This Example addresses the application of the scope exception in paragraph 815-10-15-59(b). Entity A enters into a non-exchange-traded forward contract to buy from Entity B 100 interchangeable (fungible) units of a nonfinancial asset that are not readily convertible to cash. The contract permits net settlement through its default provisions. Entity A already owns more than 100 units of that nonfinancial asset, but Entity B does not own any units of that nonfinancial asset.

55-143 The scope exception in paragraph 815-10-15-59(b) does not apply to the accounting for the contract for both of the following reasons:

- a. The contract's settlement is based on an underlying associated with a nonfinancial asset that is not unique (because it is based on the price or value of an interchangeable, nonfinancial unit).
- b. The entity that owns the nonfinancial asset related to the underlying (that is, Entity A) is the buyer of the units and thus would benefit from the forward contract if the price or value increases.

Consequently, neither Entity A nor Entity B qualifies for the scope exception in paragraph 815-10-15-59(b).

2.7.40 Specified volumes of revenues

The nonexchange traded scope exception applies to nonexchange traded contracts and instruments whose underlying is a specified volume of sales or service revenues by one of the parties to the contract. [815-10-15-59(d), FAS 133.BC253]

This exception applies to contracts with settlements based on the volume of items sold or services rendered – e.g. leases with payments contingent on the level of sales from the leased facility and royalty agreements. It does not apply to contracts based on changes in sales or revenues due to changes in market prices of the items sold. [815-10-15-59(d)]



Question 2.7.50

Does this scope exception apply to an agreement whose payments are based on revenue?

Interpretive response: Yes, we believe this scope exception applies provided the revenue on which the agreement is based is substantively affected by the volume of items sold or services rendered, rather than being based predominantly on changes in market prices.

Paragraph 815-10-15-59(d) indicates that this scope exception does not apply to contracts based on changes in sales or revenues due to changes in market prices of the items sold. However, we believe this was not intended to preclude the scope exception from applying to contracts that are substantively affected by the volume of items sold or services rendered.

For example, a royalty agreement may require one party to pay to the other a percentage of its sales revenue, which fluctuates based on both the volume of items sold and market prices of those items. Although the market price affects sales revenue, the sales revenue is substantively affected by the volume of items sold. As a result, this agreement qualifies for the scope exception.

In contrast, a royalty agreement whose payments are not substantively affected by the volume of items sold or services rendered, but rather are based predominantly on changes in market prices, would not qualify for the scope exception.



Question 2.7.60

Does this scope exception apply to contracts with settlements based on performance measures other than the volume of items sold or services rendered?

Interpretive response: It depends. We believe that there is more than one acceptable interpretation.

We believe an entity should adopt and consistently apply a policy regarding whether it will apply this scope exception:

- narrowly – i.e. only to contracts with the underlyings that are specifically referenced in the scope exception (that is, specific volumes of items sold or services rendered); or
- more broadly – i.e. including contracts with underlyings based on other entity-specific performance measures (e.g. net income, EBITDA or operating cash flows).

The broader interpretation is based on, for example, analogy to the guidance on equity kicker features, which indicates that a feature that is “based on a share in net earnings or operating cash flows” typically qualifies for this scope exception. [815-15-55-10 – 55-11]

As explained in section 2.7.50, if a contract has more than one underlying and some, but not all, underlyings qualify for the nonexchange traded scope exception, an entity evaluates the predominant characteristic of the combined underlyings. That guidance applies even if an entity selects the narrower view described above. For example, consider a contract that is based on both the volumes of items sold or services rendered and EBITDA.

- If an entity selects the broader view, both underlyings qualify for the nonexchange traded scope exception.
- If the entity selects the narrower view, the contract still qualifies for the nonexchange traded scope exception if all of its underlyings considered in combination – i.e. changes in the volumes of items sold or services rendered and EBITDA – meet the conditions in section 2.7.50 related to a contract’s predominant characteristics.



Example 2.7.30

Lease payments based on a percentage of sales

Retailer is the lessee of retail space that is used to house its retail outlet. The terms of the lease require Retailer to pay 5% of its gross sales each month as the lease payment.

Retailer’s policy is to broadly (rather than narrowly) apply the scope exception for certain contracts that are not exchange traded and that are based on specified volumes of revenues (see Question 2.7.50). When the broader policy is elected, the scope exception is applied to contracts based on entity-specific performance measures such as monthly net profit. This arrangement meets the nonexchange traded scope exception.



Question 2.7.70

Does this scope exception apply to contracts with settlements based on expenses?

Interpretive response: No. We do not believe that activity captured in an expense line item of the entity's income statement (or a component thereof) is considered an entity-specific performance measure.

For example, an entity enters into a contract for which settlement is based on a percentage or a multiple of the entity's R&D expense for a specific period or a specific project. This measure is not considered a specified volume of sales or service revenues.



Question 2.7.80

Does an underlying that is a volume of sales of a specific product (rather than aggregate sales) qualify for the scope exception?

Background: Assume that Pharma has several products under development and obtains financing for a new developmental pharmaceutical product from Lender. The arrangement provides Lender with an enhanced return in the event the product is successful and generates sales. This embedded feature meets the definition of a derivative.

Interpretive response: Yes. Based on the background example, while the embedded feature is based on the sales of a single product, the feature qualifies for the nonexchange traded scope exception.

We believe the scope exception applies to the sales of an individual product even though those sales are only one component of an entity's aggregate sales.

2.7.50 Contracts with more than one underlying



Excerpt from ASC 815-10

15-60 If a contract has more than one underlying and some, but not all, of them qualify for one of the scope exceptions in the preceding paragraph, the application of this Subtopic to that contract depends on its predominant characteristics. That is, the contract is subject to the requirements of this Subtopic 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 a scope exception.

Determining whether the nonexchange traded scope exception applies requires judgment when:

- an instrument or contract has an underlying that combines more than one variable (a combined underlying or multiple underlyings); and
- some, but not all, of the variables qualify for the scope exception.

In this case, an entity has to evaluate the predominant characteristic of the combined variables (underlyings). If the entity finds that changes in the combined underlying are highly correlated with changes in one of the component variables that would not qualify for the scope exception, the instrument or contract does not qualify for the scope exception. [815-10-15-60 – 15-61]



Question 2.7.90

Must an entity demonstrate that combined underlyings in a contract are correlated with a variable that qualifies for the scope exception?

Interpretive response: No. The evaluation of the predominant characteristics is based on whether the combined underlyings behave in a manner that is highly correlated with the behaviors of any of the component variables that does not qualify for an exception. [815-10-15-60]

There is no requirement that the combined underlyings behave in a manner that is highly correlated with the behavior of any of the component variables that do qualify for the nonexchange traded scope exception.

2.7.60 Weather derivatives



Excerpt from ASC 815-45

> Entities

15-1 The guidance in this Subtopic applies to all entities.

> Instruments

15-2 Except as noted in this paragraph, the guidance in this Subtopic applies to all **weather derivatives** that are not exchange-traded (and, therefore, not subject to the requirements of Subtopic 815-10). The guidance in this Subtopic does not apply to contracts written by insurance entities that entitle the holder to be compensated only if, as a result of an insurable event, 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.

815-45-25 Recognition

> Nontrading Activities

>> Non-Exchange-Traded Forward-Based Weather Derivative

25-1 An entity that enters into a non-exchange-traded forward-based **weather derivative** in connection with nontrading activities shall account for the contract by applying an intrinsic value method (as discussed in Section 815-45-30). See Example 1 (paragraph 815-45-55-7) for an illustration of the accounting for an example degree-day forward contract.

>> Non-Exchange-Traded Option-Based Weather Derivative

25-2 An entity that purchases a non-exchange-traded option-based weather derivative in connection with nontrading activities shall recognize an asset.

25-3 An entity that sells or writes a non-exchange-traded option-based weather derivative shall recognize a liability.

> Trading Activities

25-5 All weather derivative contracts entered into under **trading** or speculative activities shall be accounted for as assets or liabilities.

25-6 For purposes of this Subtopic, an entity shall be considered to be involved in trading or speculative activities if it enters into weather derivative contracts with the objective of generating profits on or from exposures to shifts or changes in climatic or geological conditions. See paragraphs 815-45-55-1 through 55-6 for specific guidance.

> Nontrading Activities

30-1 A purchased non-exchange-traded option-based **weather derivative** recognized as an asset under paragraph 815-45-25-2 shall be measured initially at the amount of the premium paid.

30-2 A sold or written non-exchange-traded option-based weather derivative recognized as a liability under paragraph 815-45-25-3 shall be measured initially at the amount of the premium received.

30-3 The intrinsic value method requires that the reporting entity allocate the cumulative strike amount to individual periods within the contract term. That allocation shall reflect reasonable expectations at the beginning of the contract term of normal or expected experience under the contract. That allocation shall be based on data from external statistical sources, such as the National Weather Service. See Example 1 (paragraph 815-45-55-7) for an illustration of the accounting for example contracts.

>> Embedded Premium or Discount

30-3A A purchased or written weather derivative may contain an embedded premium or discount if the contract terms are not consistent with current market terms (for example, the cumulative strike amount referenced in the contract is not consistent with historical weather data, adjusted for expected experience). In those circumstances, the premium or discount shall be quantified, removed from the calculated benchmark strike, and accounted for as discussed in the preceding paragraphs.

> Trading Activities

30-4 All weather derivative contracts entered into under **trading** or speculative activities shall be measured initially at their **fair value**.

815-45-35 Subsequent Measurement

> Nontrading Activities

>> Non-Exchange-Traded Forward-Based Weather Derivative

35-1 An entity that enters into a non-exchange-traded forward-based **weather derivative** in connection with nontrading activities shall account for the contract by applying the intrinsic value method.

35-2 The intrinsic value method computes an amount based on the difference between the expected results from an upfront allocation of the cumulative strike and the actual results during a period, multiplied by the contract price (for example, dollars per heating degree day). The intrinsic value (or intrinsic value measure) of the contract at interim dates shall be calculated based on cumulative differences between actual experience and the allocation through that date. The initial allocation of the cumulative strike amount shall not be adjusted over the term of the contract to reflect actual results.

35-3 See Example 1 (paragraph 815-45-55-7) for an illustration of the accounting for an example degree-day forward contract.

>> Non-Exchange-Traded Option-Based Weather Derivative

35-4 An entity that purchases a non-exchange-traded option-based weather derivative in connection with nontrading activities shall amortize to expense the premium paid (or due) and apply the intrinsic value method described in paragraph 815-45-35-2 to measure the contract at each interim balance sheet date. The premium asset shall be amortized in a rational and systematic manner.

35-5 All entities that sell or write a non-exchange-traded option-based weather derivative shall recognize any subsequent changes in **fair value** currently in earnings—the premium shall not be amortized.

35-6 See Example 1 (paragraph 815-45-55-7) for an illustration of the accounting for an example degree-day option contract.

> Trading Activities

35-7 All subsequent changes in fair value of weather derivative contracts entered into under trading or speculative activities shall be reported currently in earnings.

The term ‘weather derivative’ is used to describe a forward-based or option-based contract for which settlement is based on a climatic or geological variable. One such variable is the occurrence of nonoccurrence of a specified amount of snow at a specified location within a specified period of time. [\[815-45 Glossary\]](#)

Subtopic 815-45 provides guidance on accounting for weather derivatives that are excluded from Topic 815’s derivative accounting guidance. This section refers to instruments in the scope of Subtopic 815-45 as weather derivatives even though they are not derivative instruments as that term is otherwise used in Topic 815.

The following table summarizes the accounting guidance applicable to weather derivative contracts.

Exchange traded?	Accounting guidance
Exchange traded	Does not qualify for the nonexchange traded scope exception and is accounted for under the general derivative accounting guidance in Subtopic 815-10 (see chapter 5).
Nonexchange traded	Qualifies for the nonexchange traded scope exception (see section 2.7.20). This section (2.7.60) discusses the nonderivative accounting model in Subtopic 815-45 for these contracts. However, Subtopic 815-45 does not apply to a contract that is written by an insurance entity that entitles the holder to be compensated only if, as a result of an insurable event, 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. [815-45-15-2]



Question 2.7.100

How are weather derivatives accounted for under Subtopic 815-45?

Interpretive response: The accounting for weather derivatives depends on whether the contract is: [815-45-25-1, 30-1 – 30-2, 30-4, 35-1, 35-4, 35-7]

- entered into in connection with trading activities; and
- forward-based or option-based.

An entity that enters into weather derivative contracts with the objective of generating profits on or from exposure to shifts or changes in climatic or geological conditions is considered to be involved in trading activities. See also FASB implementation guidance reproduced further below related to identifying trading activities. [815-45-25-6]

The following table summarizes the accounting for weather derivatives:

Nontrading activities – forward-based contract	
Accounted for both initially and subsequently by applying the intrinsic value method. [815-45-25-1, 35-1]	
Nontrading activities – option-based contract	
Purchased	Sold or written
— Initially recognized as an asset at the amount of the premium paid. [815-45-30-1] — Subsequently: [815-45-35-4] — premium paid (or due) amortized to expense using a systematic and rational method; and — intrinsic value method applied to the contract.	— Initially recognized as a liability at the amount of premium received. [815-45-30-2] — Subsequently, premium not amortized; rather, weather derivative measured at fair value with changes therein reported in earnings.

Trading activities

Initially and subsequently measured at fair value, with changes in fair value reported in earnings. [815-45-30-4, 35-7]



Question 2.7.110

Are weather derivatives eligible to be designated as the hedging instrument in a hedging relationship?

Interpretive response: No. Although the accounting for weather derivatives is similar to the accounting required for derivative instruments (particularly for those in trading activities), weather derivatives are not derivative instruments. Therefore, such instruments are not eligible to be designated as the hedging instrument in a hedging relationship.



Question 2.7.120

How is the intrinsic value method applied to weather derivatives?

Interpretive response: The intrinsic value method is summarized as follows.

Contract inception

At contract inception, the entity allocates the cumulative strike amount to individual periods within the contract term. That allocation reflects reasonable expectations at that date of normal or expected experience under the contract. Further, the allocation should be based on data from external statistical sources, such as the National Weather Service. [815-45-30-3]

This initial allocation is not subsequently adjusted. [815-45-30-3, 35-2]

Subsequent (interim) periods

The intrinsic value measure of the contract is calculated based on cumulative differences between experience and the initial allocation of the cumulative strike amount through that date, multiplied by the contract price. [815-45-35-2]

FASB implementation guidance and example

The implementation guidance in Subtopic 815-45 includes the following:

- Paragraphs 815-45-55-1 to 55-6 provide additional guidance for determining whether an entity's activities represent trading or speculative activities, as compared to nontrading activities. This guidance includes fundamental and secondary indicators that an entity's activities are trading activities.
- Subtopic 815-45's Example 1 illustrates the intrinsic value method as applied to two types of degree-day contracts (a swap and an option).



Excerpt from ASC 815-45

>> Identifying Trading Activities

55-1 Determining whether or when an entity is involved in **trading** or speculative activities involving **weather derivative** contracts is a matter of judgment that depends on the relevant facts and circumstances. The framework in which such facts and circumstances are assessed shall be based on an evaluation of the various activities of an entity rather than solely on the terms of the contracts. Inherent in that framework is an evaluation of the entity's intent for entering into a weather derivative contract.

55-2 It is easier to evaluate the trading activities of an entity if such activities are segregated either organizationally or by legal entity. If an entity conducts both trading activities and nontrading activities and those activities are not segregated either organizationally or by legal entity, it is essential that the entity analyze contracts at inception according to the factors in paragraphs 815-45-55-5 through 55-6 and identify those contracts as either trading or nontrading. However, if an operation's trading activities are not segregated in either of those ways and an evaluation of the indicators identified in paragraphs 815-45-55-4 through 55-6 would conclude that a portion of the operation's activities are trading, then only that portion of the operation's activities that is considered trading shall be accounted for at **fair value**.

55-3 As used in this Subtopic, operation refers to any identifiable activity of an entity (for example, a subsidiary, a division, or a unit) that enters into the types of weather derivative contracts that are within the scope of this Subtopic.

55-4 For purposes of identifying trading activities, the following groups of indicators shall be considered for each identifiable operation (activity) of an entity that enters into weather derivative contracts that are within the scope of this Subtopic. Category A lists the fundamental indicators to be considered for purposes of determining whether the operation of an entity that enters into weather derivative contracts is involved in trading activities. Accordingly, the presence of indicators from Category A may be a strong indication that the operation's activities are trading. The presence of indicators from only Category B may indicate that such activities are trading. The absence of any or all of the indicators in either category, by itself, shall not preclude the operation's activities from being considered trading. Nevertheless, all available evidence shall be considered to determine whether, based on the weight of that evidence, an operation is involved in trading activities.

55-5 All of the following are fundamental indicators in Category A:

- a. The operation's primary business is not inherently exposed to the specific weather-related risk stated as a variable (for example, temperature, wind velocity, and humidity) in the weather derivative contracts it holds.
- b. The volume of weather derivative contracts exceeds a reasonable or supportable level of weather-related risk inherent in the operation's primary business.
- c. The change in value of the weather derivative contract (for example, based on a temperature variable) is expected to move in a direction that does not

mitigate or offset the risk of the underlying exposure (for example, fuel consumption).

- d. The operation develops and uses its own proprietary models to price the weather derivative contracts it offers or trades.

55-6 All of the following are secondary indicators (management and controls) in Category B:

- a. Compensation and/or performance measures are tied to the short-term results generated from weather derivative contracts (that is, the operation is measured based on trading profits or changes in the fair values of its positions as opposed to profitable management of income-producing assets).
- b. The operation communicates internally in terms of trading strategy (that is, management reports identify contractual positions, fair values, risk exposure, and so forth).
- c. The word trading is in the name of the operation for internal or external purposes.
- d. Employees of the operation are referred to as traders or have prior experience in derivative trading or risk-management activities.
- e. Assessment of net market positions of the operation is done on a regular basis.
- f. Infrastructure of the operation is similar to that of a trading operation of a bank or investment bank—front office, middle office, and back office (that is, there is a segregation of back-office processing and front-office trading functions).
- g. An infrastructure exists that enables the operation to capture price and other risks on a real-time basis.
- h. The activities are managed on a portfolio or book basis.



Excerpt from ASC 815-45

>> Example 1: Degree-Day Contracts

55-7 The following Cases illustrate two types of degree-day contracts:

- a. A degree-day swap (Case A)
- b. A degree-day option (Case B).

55-8 Cases A and B share all of the following assumptions:

- a. Entity A is a construction materials entity that has its sales decrease during cold winters or a chemical manufacturer that has its natural gas consumption costs increase during cold winters. Entity B is a natural gas distribution entity that experiences lower revenues during warm winters.
- b. Neither Entity A nor Entity B is a dealer in weather derivatives (that is, the operations of both entities that entered into this contract are nontrading).
- c. At inception of each contract, the reporting entity constructs the allocation (as presented in the table in paragraph 815-45-55-11) of the strike level of heating degree days across the contract period based on historical heating degree day averages (the weather-related index) for the respective

months. That allocation is not part of the contract terms. (Heating degree days is the winter measure of average daily temperature below 65 degrees Fahrenheit.)

- d. Actual heating degree days (as presented in the table in paragraph 815-45-55-11) reflect the measure of actual average daily temperatures below 65 degrees Fahrenheit based on weather service readings. If the average of the daily high and the daily low temperatures is 34 degrees Fahrenheit, then there are 31 heating degree days for that day. To determine the number of heating degree days for a period, add heating degree days for each day of the period.

>>> Case A: Degree-Day Swap Contract Terms

55-9 Entity A and Entity B enter into a degree-day swap (that is, a contract with two-directional risk). The contract requires no initial net investment and requires a payment by Entity A to Entity B if cumulative heating degree days are less than 4,500 heating degree days during the period from November 1, 1999, to March 31, 2000. If cumulative heating degree days exceed 4,500 heating degree days during that same period, Entity B will make a payment to Entity A. The contract has a floor of 2,500 heating degree days and a cap of 6,500 heating degree days. The payment under the contract is equal to \$10,000 multiplied by the cumulative number of heating degree days above or below 4,500 heating degree days and is made on April 5, 2000. Based on the foregoing terms, this contract carries a maximum payout limitation of \$20 million by Entity A and \$20 million by Entity B regardless of actual temperature levels experienced. The accounting for the degree-day swap by both parties is presented in the table in paragraph 815-45-55-11.

>>> Case B: Degree-Day Option Contract Terms

55-10 Entity A purchases on November 1, 1999, a degree-day option from Entity B for a premium payment of \$5.85 million. The option requires that Entity B pay Entity A \$10,000 for each heating degree day in excess of 4,500 heating degree days (the strike level) cumulative during the period from November 1, 1999, to March 31, 2000. This contract specifies a maximum payout limitation of \$20 million regardless of actual temperature levels experienced, thereby effectively stipulating a cap based on 6,500 heating degree days. The contract is settled on April 5, 2000. The accounting for the purchased degree-day option by both parties is presented in the table in the following paragraph. The accounting does not include amounts related to the option premium of \$5.85 million.

>>> Assumptions, Calculations, and Accounting

55-11 The following table presents the accounting by both parties for the weather derivatives in Cases A and B.

	November	December	January	February	March	Totals
Assumption—average historical temperature	48 degrees	33 degrees	26 degrees	26 degrees	42 degrees	
Allocation of heating degree days strike	500 ^(a)	1,000 ^(b)	1,200 ^(c)	1,100 ^(d)	700 ^(e)	4,500
Actual heating degree days	600	700	1,700	1,700	500	5,200
Warmer (colder) than average in heating degree days	(100)	300	(500)	(600)	200	(700)
Cumulative warmer (colder) in heating degree days	(100)	200	(300)	(900)	(700)	
Cumulative actual heating degree days	600	1,300	3,000	4,700	5,200	
Accounting for degree-day swap:						
Current period Entity A loss (gain)	\$(1,000,000)	\$ 3,000,000	\$(5,000,000)	\$(6,000,000)	\$ 2,000,000	\$(7,000,000)
Cumulative Entity A loss (gain)	\$(1,000,000)	\$ 2,000,000	\$(3,000,000)	\$(9,000,000)	\$(7,000,000)	
Current period Entity B loss (gain)	\$ 1,000,000	\$(3,000,000)	\$ 5,000,000	\$ 6,000,000	\$(2,000,000)	\$ 7,000,000
Cumulative Entity B loss (gain)	\$ 1,000,000	\$(2,000,000)	\$ 3,000,000	\$ 9,000,000	\$ 7,000,000	
Accounting for purchased degree-day option:						
Current period Entity A loss (gain)	\$(1,000,000)	\$1,000,000	\$(3,000,000)	\$(6,000,000)	\$ 2,000,000	\$(7,000,000)
Cumulative Entity A loss (gain)	\$(1,000,000)	-	\$(3,000,000)	\$(9,000,000)	\$(7,000,000)	

(a) $(65 - 48) \times 30 = 510$, rounded to 500 for presentation purposes.

(b) $(65 - 33) \times 31 = 992$, rounded to 1,000 for presentation purposes.

(c) $(65 - 26) \times 31 = 1,209$, rounded to 1,200 for presentation purposes.

(d) $(65 - 26) \times 28 = 1,092$, rounded to 1,100 for presentation purposes.

(e) $(65 - 42) \times 31 = 713$, rounded to 700 for presentation purposes.

2.8 Derivatives that impede sale accounting



Excerpt from ASC 815-10

>>> Derivative Instruments That Impede Sale Accounting

15-63 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 Subtopic. An example is the existence of a call option enabling a transferor to repurchase transferred assets that is an impediment to sales accounting under Topic 860. Such a call option on transferred financial assets that are not readily obtainable 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.

15-64 A derivative instrument held by a transferor that relates to assets transferred in a transaction accounted for as a financing under Topic 860, but which does not itself serve as an impediment to sale accounting, is not subject to the requirements of this Subtopic if recognizing both the derivative instrument and either the transferred asset or the liability arising from the transfer would result in counting the same thing twice in the transferor's balance sheet. However, if recognizing both the derivative instrument and either the transferred asset or the liability arising from the transfer would not result in counting the same thing twice in the transferor's balance sheet, the derivative instrument shall be accounted for in accordance with this Subtopic. For related implementation guidance, see paragraph 815-10-55-41.

Topic 815 includes a scope exception for 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. [815-10-15-63]



Question 2.8.10

Why are derivatives that impede sale accounting subject to a scope exception?

Interpretive response: Certain derivative instruments – when viewed alone or in connection with a related contract – prevent the transfer of control of an asset (or pool of assets) to the counterparty to the contract. The inability to transfer control of an asset (or pool of assets) prevents accounting for the transfer as a sale.

As a result, accounting for these contracts as derivative instruments under Topic 815 may result in accounting for essentially the same value twice. [815-10-15-63, FAS 133.BC284]

- first by retaining the assets subject to the derivative contract on the balance sheet; and
- second by accounting for the derivative contract as a freestanding derivative instrument (i.e. as an asset or liability).

In some cases, a contract may not be accounted for as a sale or purchase for reasons other than a derivative instrument's existence even though a related derivative instrument exists.

In those cases, the derivative instruments are not accounted for as derivatives under Topic 815 if such accounting would result in double counting the assets. If recognizing both the transferred asset or liability and the derivative would not result in double counting, the derivative instrument is accounted for as a derivative under Topic 815. [\[815-10-15-64\]](#)

FASB Examples

The FASB Examples below illustrate whether this scope exception applies to various derivatives related to a transfer of financial assets that is accounted for under Topic 860 (transfers and servicing).

These examples are summarized as follows.

- **Transfer of financial assets is not accounted for as a sale because of a call option on financial assets that is retained by the transferor**
 - The transferor continues to recognize the transferred financial assets. The scope exception applies because separate recognition of the call option would effectively result in the assets being recorded twice. [\[815-10-55-41\(a\)\]](#)
 - In such a transfer, the transferee might also receive a put option allowing it to require the transferor to repurchase the transferred financial assets. The scope exception also applies to the put option because separate recognition of the put option would effectively result in double counting the borrowing (financing). [\[815-10-55-41\(b\)\]](#)
- **Transfer of fixed-rate financial assets that involves issuing debt with a variable-rate return** [\[815-10-55-41\(c\) – 55-41\(d\)\]](#)
 - Transfer is accounted for as a sale and interest rate swap is entered into as part of the transfer: Sale accounting was not impeded and the scope exception does not apply – i.e. the interest rate swap is separately recognized.
 - Transfer is not accounted for as a sale: The transferor continues to recognize the transferred (fixed-rate) financial assets and also recognizes the issuance of variable-rate debt. No derivative instrument is recognized, unless the variable-rate debt includes embedded derivative features that require bifurcation and separate accounting.



Excerpt from ASC 815-10

>>> Derivative Instrument that Impedes Sales Accounting

55-41 The following guidance illustrates application of the scope exception (as discussed beginning in paragraph 815-10-15-63) for a derivative instrument that impedes sales accounting to situations in which the transferor accounts for the transfer as a financing:

- a. If a transferor transfers financial assets but retains a call option on those assets, the net settlement criterion (as discussed beginning in paragraph 815-10-15-119) may be satisfied because the assets transferred are readily obtainable; however, the transfer may fail the isolation criterion in paragraph 860-10-40-5(a) because of significant continued involvement by the transferor. In that example, because the transferor is required to continue to recognize the assets transferred, recognition of the call option on those assets would effectively result in recording the assets twice. Therefore, the derivative instrument is not subject to the scope of this Subtopic.
- b. In the situation described in (a), the transferor may have sold to the transferee a put option. Exercise of the put option by the transferee would result in the transferor repurchasing certain assets that it has transferred, but which it still records as assets in its balance sheet. Because the transferor is required to recognize the borrowing, recognition of the put option would result in recording the liability twice. Therefore, the derivative instrument is not subject to the scope of this Subtopic.
- c. A transferor may transfer fixed-rate financial assets to a transferee and guarantee a variable-rate return. If the transfer is accounted for as a sale and an interest-rate swap is entered into as part of the contractual provisions of the transfer, the transferor records the interest rate swap as one of the financial components. In that case, the interest rate swap should be accounted for separately in accordance with this Subtopic. However, if the transfer is accounted for as a financing, the transferor records on its balance sheet the issuance of variable-rate debt and continues to report the fixed-rate financial assets; no derivative instrument is recognized under this Subtopic.
- d. In a securitization **transaction**, a transferor transfers \$100 of fixed-rate financial assets and the contractual terms of the beneficial interests incorporate an interest rate swap with a notional principal of \$1 million. If the transfer is accounted for as a sale and the interest rate swap is entered into as part of the contractual provisions of the transfer, the transferor identifies and records the interest rate swap as one of the financial components. In that case, the interest rate swap would be accounted for separately in accordance with this Subtopic. However, if the transfer is accounted for as a financing, the transferor records in its balance sheet a \$100 variable-rate borrowing and continues to report the \$100 of fixed-rate financial assets. In this instance, because the liability is leveraged, requiring computation of interest flows based on a \$1 million notional amount, the liability (which does not meet the definition of a derivative instrument in its entirety) is a **hybrid instrument** that contains an embedded derivative—such as an interest rate swap with a notional amount of \$999,900. That

embedded derivative is not clearly and closely related to the host contract under Section 815-15-25 (see paragraph 815-15-25-1[c]) because it could result in a rate of return on the counterparty's asset that is at least double the initial rate and that is at least twice what otherwise would be the then-current market return for a contract that has the same terms as the host contract and that involves a debtor with credit quality similar to the issuer's credit quality at inception. Therefore, the derivative instrument must be recorded separately under paragraph 815-15-25-1.

2.9 Investments in life insurance



Excerpt from ASC 815-10

>>> Investments in Life Insurance

15-67 A policyholder's investment in a life insurance contract that is accounted for under Subtopic 325-30 is not subject to this Subtopic. This scope exclusion does not affect the accounting by the issuer of the life insurance contract.

Subtopic 815-10 includes a scope exception for a policyholder's investment in life insurance contracts that are in the scope of Subtopic 325-30 (investments in insurance contracts). The scope exception does not apply to issuers of the contracts and does not apply to a policyholder's investment in life insurance contracts that are not in the scope of Subtopic 325-30. [815-10-15-67]



Question 2.9.10

Is a policyholder required to evaluate an investment in a life insurance contract for embedded derivatives requiring bifurcation?

Background: Subtopic 325-30 addresses the accounting for purchases of life insurance contracts commonly referred to as COLI (corporate-owned life insurance), BOLI (business-owned life insurance), and key-man insurance. These provisions include the following: [325-30-25-2, 30-1 – 30-2, 35-1 – 35-12]

- a policyholder's investment in a life insurance contract is reported at net realizable value (cash surrender value), which does not equal fair value; and
- a third-party investor accounts for life settlement contracts using either the investment method or fair value method.

Certain of these contracts provide for a cash surrender value that is periodically adjusted to reflect the return on a portfolio of equity securities.

Interpretive response: No, provided the policyholder accounts for the investment under Subtopic 325-30. The scope exception for investments in life insurance indicates that the policyholder/investor accounts for its investment in a life insurance contract or life settlement contract in its entirety under the

provisions of Subtopic 325-30. This is the case even if the contract includes embedded derivatives that would otherwise require separate accounting. [815-10-15-67]

If the cash surrender value feature were to be separated from the host contract – i.e. the life insurance or life settlement contract, excluding the embedded feature – the host contract would not have a stated cash surrender value to which to apply the guidance in Subtopic 325-30. Therefore, the scope exception for investments in life insurance excludes from Topic 815 contracts that a policyholder accounts for under Subtopic 325-30. This includes that the policyholder is not required to evaluate the contracts for potential embedded derivatives requiring separation. [815-10-15-67]

However, this scope exception does not apply to issuers of these insurance contracts or to purchasers of contracts that are not subject to Subtopic 325-30. As a result, these entities need to analyze their contracts for potential embedded derivatives requiring separation.

2.10 Certain investment contracts

2.10.10 Overview



Excerpt from ASC 815-10

>>> Certain Investment Contracts

15-68 A contract that is accounted for under either paragraph 960-325-35-1 or 960-325-35-3 is not subject to this Subtopic. This scope exception applies only to the party that accounts for the contract under Topic 960.

Subtopic 815-10 provides a scope exception for investment contracts that are accounted for by defined benefit plans under either paragraph 960-325-35-1 or 960-325-35-3.

Defined benefit pension plans are required by Topic 960 (defined benefit pension plans) to report insurance contracts in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to the Employee Retirement Income Security Act of 1974 ('ERISA') – i.e. either at fair value or contract value. Absent a scope exception, Topic 815 would have required derivatives embedded in some insurance contracts – e.g. purchased put options on certain referenced securities – to be bifurcated and accounted for separately.

The investment contract scope exception resolves the potential conflict between Topic 960 and Topic 815 in this situation. The scope exception applies only to the party that accounts for the contract under Topic 960 – i.e. the scope exception does not apply to the contract's counterparty that does not account for it under Topic 960. [815-10-15-68]

2.10.20 Synthetic guaranteed investment contracts (GICs)



Excerpt from ASC 815-10

> Synthetic Guaranteed Investment Contracts

05-8 The following is a background discussion of synthetic guaranteed investment contracts, including a comparison with traditional and benefit-response guaranteed investment contracts. Paragraph 815-10-55-63 states that, from the perspective of the issuer of the contract, synthetic guaranteed investment contracts are derivative instruments within the scope of this Subtopic.

05-9 In a traditional guaranteed investment contract, the issuer of the contract takes deposits from a benefit plan or other institutional customer and purchases investments that are held in its general account. (Equity investments may also be acquired, although they are less common than fixed income investments.) The customer is a creditor of the issuing entity and therefore has **credit risk**, although generally the guaranteed investment contract issuers have a high credit-quality rating. The issuer is contractually obligated to repay the principal and specified interest guaranteed to the customer. The plan's provisions typically permit the participant to withdraw funds from the fund at book value (also referred to as account or contract value) for specified reasons, such as loans, hardship withdrawals, and transfers to other investment options offered by the plan.

05-10 A benefit-responsive guaranteed investment contract contains provisions that mirror the plan's participant-directed withdrawal or transfer provisions. Therefore, the issuer is at risk that interest rates could increase, reducing the price of the fixed-income investments backing the guaranteed investment contract liability, while those investments may have to be sold at a loss to cover withdrawals.

05-11 A synthetic guaranteed investment contract is a contract that simulates the performance of a traditional guaranteed investment contract through the use of **financial instruments**. As with other types of guaranteed investment contracts, the specific terms and conditions of synthetic guaranteed investment contracts are negotiated on a case-by-case basis. However, those contracts fall into several broad structural categories, as follows:

- a. Buy-and-hold. Typically, a buy-and-hold synthetic contract covers a limited class of assets, usually high-quality bonds expected to be held to maturity. There is no stated rate guarantee; instead, the interest rate is reset periodically as specified in the contract, subject to a specified floor—for example, 3 percent or 0 percent. The term of the contract generally is consistent with the maturity of the underlying assets. Although buy-and-hold contracts are structured to permit participant withdrawals and transfers at book value, generally no withdrawals are expected. The arrangements between the benefit plan or other institutional investor and the wrap provider typically contain provisions outlining operating and investing guidelines for the customer. These guidelines are designed to ensure the availability of other sources of liquidity sufficient to satisfy expected levels of net participant-directed withdrawals and transfers,

without the need to access the assets wrapped by the synthetic guaranteed investment contract. While participants can make withdrawals or transfers at book value, in most cases, the customer can terminate the contract at the value of the assets at any time, but it can withdraw at contract value only at maturity or earlier with a specified notification period.

- b. **Actively managed.** With an actively managed synthetic guaranteed investment contract, the assets often are managed by an outside investment manager, but may be managed by the insurer. Generally, the contract is evergreen—that is, there is no specified maturity date—and there is no stated rate guarantee; instead, the interest rate is reset periodically as specified in the contract, subject to a specified floor, frequently zero percent and typically not less than zero percent. Participant-directed withdrawals and transfers are made at book value, with future interest returns adjusted to recognize the difference between the fair value and book value of the remaining assets covered by the synthetic guaranteed investment contract, but typically not below a zero interest rate. Customer-initiated withdrawal provisions are similar to those for buy-and-hold guaranteed investment contracts.
- c. **Fixed-rate, fixed-maturity.** This contract is essentially the same as a traditional general account guaranteed investment contract. The synthetic guaranteed investment contract issuer guarantees a fixed rate for a fixed and certain term and assumes the investment risks and rewards of the assets. If the assets earn less than the guaranteed return, the insurance entity absorbs the loss. If the assets earn more than was assumed in pricing, the income recognized by the insurer will be greater than the wrap fee assumed in the pricing. Typically, the insurer also will be the investment manager because of the assumption of investment risk. Note that participant-initiated withdrawals and transfers of fixed-rate, fixed-maturity contracts are permitted at book value but are expected to occur infrequently. Withdrawals initiated by the customer generally are permitted only at the value of the assets and the guarantee is not activated.

05-12 A key difference between a synthetic guaranteed investment contract and a traditional guaranteed investment contract is that the policyholder (such as a benefit plan or other institutional customer) owns the assets underlying the synthetic guaranteed investment contract. (With a traditional guaranteed investment contract, the policyholder owns only the contract itself that provides the plan with a call on the contract issuer's assets in the event of default.) Those assets may be held in a trust owned by the policyholder and typically consist of government securities, private and public mortgage-backed securities, and other asset-backed securities, and investment grade corporate obligations. To enable the policyholder to realize a specific known value for the assets if it needs to liquidate them, synthetic guaranteed investment contract utilize a wrapper contract that provides market and cash flow risk protection to the policyholder. This wrapper or guarantee may be provided in a variety of structures. In one structure, the issuer provides cash advances to fund the policyholder's cash withdrawal requirements if the invested asset values have decreased.

5.13 Other structures include:

- a. A swap agreement whereby the synthetic guaranteed investment contract issuer exchanges a fixed return for the value of supporting assets, if needed for benefit payments
- b. An agreement by the issuer to buy assets at book value if a sale is needed to make benefit payments
- c. A payment upon termination of the contract equal to the difference between a hypothetical book value of plan assets and their value. (Provisions of benefit-responsive traditional guaranteed investment contracts and synthetic guaranteed investment contracts generally prohibit the benefit plan and its sponsor from taking any actions that would encourage participant withdrawals and transfers.)

05-14 Synthetic guaranteed investment contracts can be viewed as the issuer selling a put option to the policyholder. For many synthetic guaranteed investment contracts, the option premium is in the form of a fee charged on the outstanding contract book value. For some forms of synthetic guaranteed investment contracts, the option premium for the put option is not explicitly stated but, instead, is embedded in the determination of the investment return guaranteed to the policyholder.

05-15 In any of the structures, various methods can be used to limit the synthetic guaranteed investment contract issuer's exposure to net payments under the contract. In the current marketplace, most synthetic guaranteed investment contracts pass many of the asset- and cash-flow-related risks to the policyholder. Structures to limit such risk include the following:

- a. Reset of the crediting rate or maturity date. Cash flow volatility (for example, timing of benefit payments) as well as asset underperformance can be passed through to the policyholder through adjustments to future contract crediting rates and/or contract maturities. Formulas are typically provided in the contract that adjust renewal crediting rates to recognize the difference between the fair value and book value of remaining assets in the segregated portfolio.
- b. Exclusion of impaired securities. Impaired securities may also be excluded directly from book value guarantees.
- c. Investment guidelines. Carefully structured investment policy can limit significantly the cash volatility of assets in the segregated portfolio (for example, limit callable securities, mortgage backed securities, and so forth).
- d. Buffer funds. Cash and cash equivalents are maintained and are accessed first to fund benefit payments and thus limit the potential for synthetic guaranteed investment contract issuer's assets to be accessed to make benefit payments.
- e. Liquidation structure of pension plan. Pro rata or tiered structures dictate the order of accessing various plan assets, including synthetic guaranteed investment contract assets, for benefit payments

15-68A The wrapper of a synthetic guaranteed investment contract that meets the definition of a fully **benefit-responsive investment contract** that is held by an employee benefit plan is excluded from the scope of this Subtopic.

>> Synthetic Guaranteed Investment Contracts

55-63 From the perspective of the issuer of the contract, synthetic guaranteed investment contracts are derivative instruments as defined in this Subtopic. Synthetic guaranteed investment contracts contain an underlying, the formula by which interest is calculated, and a notional amount. The interplay between the fair value of a portfolio of segregated assets and a notional amount together determine the amount of the settlement(s), if any, due from the contract issuer, after considering all contract terms. Depending on the specifics of the contract, a synthetic guaranteed investment contract requires either no initial investment or the payment of a risk charge or fee (covering either the entire contract or, more typically, an initial period of the contract). The terms of a synthetic guaranteed investment contract require net settlement because the issuer of the contract makes a payment to the holder equal to the net amount due. For a background discussion of synthetic guaranteed investment contracts, including a comparison with traditional and benefit-responsive guaranteed investment contracts, see paragraph 815-10-05-8. Example 17 (see paragraph 815-10-55-169) illustrates contractual terms of a synthetic guaranteed investment contracts

Topic 815 provides a scope exception for the wrapper of a synthetic guaranteed investment contract (GIC) that meets the definition of a fully benefit-responsive investment contract. This scope exception is available only to the holder of a synthetic GIC wrapper contract that is an employee benefit plan; it is not available to the issuer or to holders that are not employee benefit plans. [815-10-15-68A]



Question 2.10.10

How does a synthetic GIC differ from a traditional GIC?

Interpretive response: In a traditional GIC, the issuer of the contract takes deposits from a benefit plan (or other institutional investor) and purchases investments (e.g. fixed income investments) that are held in its general account. The issuer is contractually obligated to repay the principal and specified interest guaranteed to the benefit plan. The GIC typically provides the policyholder with a call on the investments in the event the issuer defaults. [815-10-05-09, 05-12]

A benefit plan's provisions typically permit its participants to withdraw funds for specified reasons. A 'benefit-responsive' GIC contains provisions that mirror the plan's participant-directed withdrawal/transfer provisions. In these arrangements, the issuer is at risk that the value of the investments it holds may decrease and that it will have to sell those investments at a loss to cover withdrawals from the benefit plan. [815-10-05-09 – 05-10]

An issuer accounts for a traditional GIC under Topic 944 (insurance) in a manner similar to other financial instruments. Further, traditional GICs neither meet the characteristics of a derivative nor typically have embedded derivative components.

Synthetic GICs

A synthetic GIC is a contract that simulates the performance of a traditional GIC through the use of financial instruments. The policyholder of a synthetic GIC (e.g. benefit plan) – rather than the issuer – owns the asset underlying the wrapper contract, which is the key difference in a synthetic GIC. [815-10-05-12]

Synthetic GICs use a wrapper (or guarantee) contract that enables the policyholder to realize a specific known value for the assets in the event of liquidation, thereby providing market and cash flow protection to the policyholder. The option premium for synthetic GICs can be in the form of a fee charged on the outstanding contract book value or embedded in the determination of the investment return guaranteed to the policyholder. [815-10-05-11 – 05-12, 05-14 – 05-15]

While this wrapper (or guarantee) is provided in a variety of structures, the issuer of a synthetic GIC in effect sells a put option to the policyholder. As a result, a synthetic GIC wrapper contract typically meets the definition of a derivative and is considered freestanding because it was issued after the underlying assets were issued by a party other than the issuers of the assets. [815-10-55-63]

However, the wrapper does not qualify for the insurance scope exception (section 2.5) because payments under synthetic GICs are not limited to identifiable insurable events – i.e. the holder does not need to incur a loss to receive compensation under the contract. [815-10-15-68A, 55-63]



Question 2.10.20

How does an entity account for a synthetic GIC that does not qualify for the scope exception?

Interpretive response: The synthetic GIC wrapper scope exception is not available to the issuer of the synthetic GIC wrapper contract and is only available to a holder that is an employee benefit plan. As explained in Question 2.10.10, the synthetic GIC wrapper typically meets the definition of a derivative and is considered freestanding. Therefore, the wrapper is accounted for as a derivative when it does not qualify for the scope exception; see section 5.4.10. [815-10-15-68A, 815-10-55-63]

Further, the policyholder separately accounts for the underlying assets that it owns under the applicable accounting literature for those investments – e.g. Subtopic 320 (debt securities), Topic 231 (equity securities), Topic 323 (equity method and joint ventures), Subtopic 962-325 (defined contribution pension plans, investments – other) or Topic 944 (insurance).

FASB Example

Topic 815's Example 17 (reproduced below) illustrates the contractual terms of a synthetic GIC.



Excerpt from ASC 815-10

>> Example 17: Synthetic Guaranteed Investment Contract

55-169 Paragraph 815-10-55-63 explains that, from the perspective of the issuer of the contract, synthetic guaranteed investment contracts are derivative instruments as defined in this Subtopic. For a background discussion of synthetic guaranteed investment contracts, including a comparison with traditional and benefit-responsive guaranteed investment contracts, see paragraph 815-10-05-8. This Example illustrates the contractual terms of a synthetic guaranteed investment contract.

55-170 On January 1, 2000, ABC issues a synthetic guaranteed investment contract to the XYZ Pension Fund. XYZ has a fixed return plan option that provides participants with a guaranteed 6 percent return for a 3-year period. The plan's invested assets consist of one public, \$50 million par value, 6.50 percent, AA-rated, fixed-rate, noncallable, semiannual payment bond that matures at par on December 31, 2002. (A simplistic assumption that is unrealistic because the plan would diversify its exposure by owning various bonds.) XYZ acquired the bond at par on January 1, 2000. ABC is charging XYZ 12 basis points per year on the \$50 million plan balance, or \$60,000 per year. Assume that the market yield applicable to this bond immediately increased to 8 percent and caused the following events to occur:

- a. The bond price decreased to \$48,342,000.
- b. All plan participants requested that their funds be transferred to another plan fund.
- c. XYZ exercised its put option to transfer the bond to ABC in exchange for a \$50 million cash payment.
- d. ABC honored its synthetic guaranteed investment contract obligation and acquired the bond for \$50 million.
- e. XYZ used the \$50 million proceeds to make the transfer of participant funds to the newly selected fund.

2.11 Certain loan commitments

2.11.10 Overview



Excerpt from ASC 815-10

>>> Certain Loan Commitments

15-69 For the holder of a commitment to originate a loan (that is, the potential borrower), that commitment is not subject to the requirements of this Subtopic. For issuers of commitments to originate mortgage loans that will be held for investment purposes, as discussed in paragraphs 948-310-25-3 through 25-4, those commitments are not subject to this Subtopic. In addition, for issuers of **loan commitments** to originate other types of loans (that is,

other than mortgage loans), those commitments are not subject to the requirements of this Subtopic.

15-70 The preceding paragraph does not affect the accounting for commitments to purchase or sell mortgage loans or other types of loans at a future date. Those types of loan commitments must be evaluated under the definition of a derivative instrument to determine whether this Subtopic applies.

Topic 815 provides a scope exception for holders (borrowers) and issuers (lenders) of certain loan commitments.

The FASB created this scope exception to eliminate both diversity in practice and the significant operational burden of evaluating whether particular loan origination commitments meet the definition of a derivative under Topic 815. [FAS 149.BC29 – BC30]



Example 2.11.10

Examples of loan origination commitments

Examples of loan origination commitments include commitments to extend the following types of credit:

- One-to-four family residential mortgage loans
- Loans for multifamily properties
- Home equity lines (i.e. revolving, open-end lines of credit secured by one-to-four family residential property)
- Manufactured housing
- Commercial real estate, construction and land development
- Credit card lines (i.e. commitments to extend credit to individuals or commercial entities through credit cards)
- Automobile financing
- Subprime lending



Question 2.11.10

What contracts qualify as loan commitments?

Interpretive response: A loan origination commitment is a legally binding commitment to extend credit to a counterparty under certain pre-specified terms and conditions. [815-10 Glossary]

Although terms of a loan commitment can vary, loan commitments typically possess the following characteristics: [815-10 Glossary]

- fixed expiration dates;
- either fixed or variable rates;
- revolving or non-revolving;

- can be distributed through syndication arrangements, in which one entity acts as a lead and an agent on behalf of other entities that will each extend credit to a single borrower; and
- lender is generally permitted to terminate the arrangement under the terms of the covenants negotiated under the agreement.



Question 2.11.20

What types of commitments qualify for the loan commitment scope exception?

Interpretive response: The exception is applied differently for holders versus issuers. Further, it does not apply to commitments to purchase or sell (rather than to originate) loans. The following table summarizes whether various commitments meet the loan commitment scope exception. [815-10-15-69 –15-71]

Type of commitment	Meets the loan commitment scope exception?
Holders (borrowers) – see section 2.11.20	
Commitments to originate all types of loans	✓
Issuers (lenders) – see section 2.11.30	
Commitments to originate mortgage loans that will be held-for-investment	✓
Commitments to originate mortgage loans that will be held-for-sale	✗
Commitments to originate other types of loans (i.e. nonmortgage loans), whether they will be held-for-investment or held-for-sale	✓
Both holders and issuers	
Commitments to purchase or sell all types of loans	✗



Question 2.11.30

Does a commitment to make a working capital loan in the future qualify for the loan commitment scope exception?

Interpretive response: Yes. A working capital loan is an example of a nonmortgage loan. Commitments to originate nonmortgage loans meet the scope exception for both the holder and the issuer. As a result, neither the holder nor the issuer of the commitment accounts for the commitment as a derivative.

2.11.20 Holders (borrowers)

The loan commitment scope exception applies to the holder of any loan origination commitment (i.e. the potential borrower in the arrangement), even if that loan commitment meets the definition of a derivative. Further, it applies to commitments to originate all types of loans, both mortgage and nonmortgage loans. [815-10-15-69]



Question 2.11.40

Does the holder (borrower) of a loan commitment qualify for the loan commitment scope exception if the loan's terms contain an embedded derivative?

Background: Assume that Borrower and Lender enter into an agreement under which Lender will make loans (up to a maximum of \$100 million) to Borrower over the next five years (the commitment period). Amounts will be advanced to Borrower when certain milestone events occur.

Once originated, the loans will require interest payments based on increases in the S&P 500 Index (an equity-indexed interest feature).

Borrower is required to make payments under the equity-indexed interest feature only to the extent it has drawn down a loan from Lender. Borrower has determined that the feature will be an embedded derivative requiring separate accounting once a loan has been drawn down.

Interpretive response: Yes, such a loan commitment meets the loan commitment scope exception. Therefore, in the arrangement described in the background, Borrower is not required to recognize the loan commitment or the embedded equity-indexed derivative feature during the commitment period. [815-10-15-69]

A loan commitment held by the holder (the potential borrower) is not subject to Topic 815. The loan commitment scope exception refers to 'loan commitments' in a general manner – it refers to mortgage loans and 'other types of loans' – and does not indicate that any specific types of loans are excluded from the scope exception. Therefore, we believe the loan commitment scope exception is applicable to loan commitments for which the loan, once originated, will include an embedded feature that will require bifurcation.

Further, the equity-indexed interest feature is required to be recognized (e.g., as a bifurcated embedded derivative) when a loan is issued – i.e. when the commitment has been drawn down.

2.11.30 Issuers (lenders)



Excerpt from ASC 815-10

>>> Certain Loan Commitments

15-71 Notwithstanding the characteristics discussed in paragraph 815-10-15-83, loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 948-310-25-3, shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender).

The loan commitment scope exception is applied by an issuer of loan commitments related to the origination of:

- mortgage loans that will be held-for-investment; and
- nonmortgage loans – e.g. commitments to extend credit to commercial or industrial entities that will not give rise to mortgage loans.

In contrast, the scope exclusion is not available for loan commitments that relate to the origination of mortgage loans that will be held-for-sale. In fact, such instruments are automatically included in the scope of Topic 815 and therefore are required to be accounted for as derivatives even if they do not meet the definition of a derivative. [815-10-15-71]



Question 2.11.50

Why are an issuer's loan commitments related to the origination of mortgage loans that will be held-for-sale automatically required to be accounted for as derivatives?

Interpretive response: The FASB decided to require loan commitments that relate to the origination of mortgage loans that will be held-for-sale to be automatically included as derivatives for the issuer for practical reasons. This recognizes that a distinct accounting model exists in Topic 948 (mortgage banking) for mortgage loans originated to be held-for-sale. Further, the ability to convert the underlying loan to cash is inherent in the business activity of entering into loan commitments to originate mortgage loans to be held-for-sale. [FAS 149.BC30]

That distinct accounting model does not apply to originations of nonmortgage loans or to originations of mortgage loans that will be held-for-investment. Instead, those loans are accounted for in accordance with Subtopic 310-20 (receivables – nonrefundable fees and costs).



Question 2.11.60

If the issuer can terminate the loan commitment agreement, does it account for the loan commitment as a derivative?

Interpretive response: It depends on whether the loan commitment is a legally binding contract. We believe an issuer of a loan commitment to originate a mortgage loan that will be held-for-sale is required to account for the commitment as a derivative as long as the loan commitment is a legally binding contract.

This is the case even if the loan commitment includes a material adverse change clause that may be invoked by the issuer to terminate the agreement based on either:

- a subjective evaluation that a material adverse change has occurred; or
- criteria that are objectively determinable.



Question 2.11.70

Are commitments to purchase or sell mortgage loans automatically accounted for as derivatives?

Interpretive response: No. The automatic inclusion of loan commitments applies only to commitments related to the origination of mortgage loans that will be held-for-sale, and not to commitments to purchase or sell mortgage loans – e.g. a forward commitment to purchase loans or a forward commitment to sell loans. [815-10-15-70]

A purchaser or seller of loans under a forward commitment needs to determine whether the commitment meets the definition of a derivative. Paragraph 815-20-55-12 implies that a mortgage banker's forward sale commitments (and consequently forward purchase commitments) are derivatives (see section 3.5.20). [815-10-15-70]

If such a commitment meets the definition of a derivative, it is required to be recognized at fair value with changes in fair value recognized in earnings. However, such a commitment may qualify as a hedging instrument in a cash flow hedge of the forecasted sale of a mortgage loan. [815-10-15-70, 815-20-55-12]



Question 2.11.80

How does a lender account for the origination of a mortgage loan held-for-sale that previously was the subject of a loan commitment accounted for as a derivative?

Interpretive response: Unless the lender elects the fair value option for the loan, the derivative's carrying amount is recognized as part of the basis of the loan.

Subsequent to initial measurement, the lender accounts for the mortgage loan held-for-sale under Topic 948 (mortgage banking).

- The basis adjustment resulting from recording the loan commitment is not amortized; rather, it is recognized as part of the gain or loss on the sale when the loan is sold. [948-310-25-3]
- the carrying amount of the loan (including the basis adjustment) is subject to impairment assessment from origination through the date of the loan's sale; impairment is measured based on the lower of cost and fair value. [948-310-35-1]

However, if the lender elects the fair value option for the loan, the issuer initially and subsequently measures the loan at fair value. Further, if the loan is transferred from held-for-sale to held-for-investment, the basis adjustment is amortized as an adjustment to the yield. [948-310-35-2A, 35-4]

Fair value of servicing rights obtained through a loan commitment



Excerpt from ASC 815-10

815-10-S99 SEC Materials

General Note: As more fully described in About the Codification, the Codification includes selected SEC and SEC Staff content for reference by public companies. The Codification does not replace or affect how the SEC or SEC Staff issues or updates SEC content. SEC Staff content does not constitute Commission-approved rules or interpretations of the SEC.

General

> SEC Staff Guidance

>> Staff Accounting Bulletins

>>> SAB Topic 5.DD, Written Loan Commitments Recorded at Fair Value through Earnings

S99-1 The following is the text of SAB Topic 5.DD, Written Loan Commitments Recorded at Fair Value through Earnings.

Facts: Bank A enters into a loan commitment with a customer to originate a mortgage loan at a specified rate. As part of this written loan commitment, Bank A expects to receive future net cash flows related to servicing rights from servicing fees (included in the loan's interest rate or otherwise), late charges, and other ancillary sources, or from selling the servicing rights to a third party. If Bank A intends to sell the mortgage loan after it is funded, pursuant to FASB ASC paragraph 815-10-15-83 (Derivatives and Hedging Topic), the written loan commitment is accounted for as a derivative instrument and recorded at fair value through earnings (referred to hereafter as a "derivative loan commitment"). If Bank A does not intend to sell the mortgage loan after it is funded, the written loan commitment is not accounted for as a derivative under FASB ASC Subtopic 815-10, Derivatives and Hedging—Overall. However, FASB ASC subparagraph 825-10-15-4(c) (Financial Instruments Topic), permits

Bank A to record the written loan commitment at fair value through earnings (referred to hereafter as a "written loan commitment"). Pursuant to FASB ASC Subtopic 825-10, Financial Instruments—Overall, the fair value measurement for a written loan commitment would include the expected net future cash flows related to the associated servicing of the loan.

Question 1: In measuring the fair value of a derivative loan commitment accounted for under FASB ASC Subtopic 815-10, should Bank A include the expected net future cash flows related to the associated servicing of the loan?

Interpretive Response: Yes. The staff believes that, consistent with FASB ASC Subtopic 860-50, Transfers and Servicing—Servicing Assets and Liabilities, FN60, and FASB ASC Subtopic 825-10, the expected net future cash flows related to the associated servicing of the loan should be included in the fair value measurement of a derivative loan commitment. The expected net future cash flows related to the associated servicing of the loan that are included in the fair value measurement of a derivative loan commitment or a written loan commitment should be determined in the same manner that the fair value of a recognized servicing asset or liability is measured under FASB ASC Subtopic 860-50. However, as discussed in FASB ASC paragraph 860-50-25-1, a separate and distinct servicing asset or liability is not recognized for accounting purposes until the servicing rights have been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained.

FN60 FASB ASC Subtopic 860-50 permits an entity to subsequently measure recognized servicing assets and servicing liabilities (which are nonfinancial instruments) at fair value through earnings.

The views in Question 1 apply to all loan commitments that are accounted for at fair value through earnings. However, for purposes of electing fair value accounting pursuant to FASB ASC Subtopic 825-10, the views in Question 1 are not intended to be applied by analogy to any other instrument that contains a nonfinancial element.

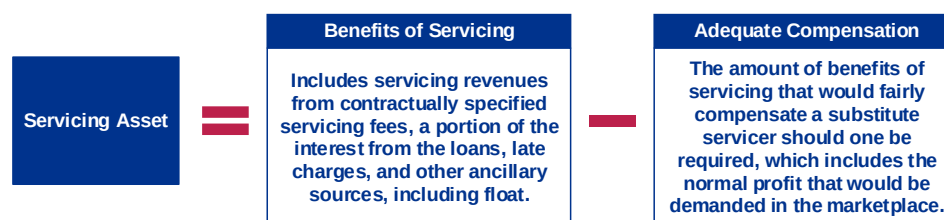
Question 2: In measuring the fair value of a derivative loan commitment accounted for under FASB ASC Subtopic 815-10 or a written loan commitment accounted for under FASB ASC Subtopic 825-10, should Bank A include the expected net future cash flows related to internally-developed intangible assets?

Interpretive Response: No. The staff does not believe that internally-developed intangible assets (such as customer relationship intangible assets) should be recorded as part of the fair value of a derivative loan commitment or a written loan commitment. Such nonfinancial elements of value should not be considered a component of the related instrument. Recognition of such assets would only be appropriate in a third-party transaction. For example, in the purchase of a portfolio of derivative loan commitments in a business combination, a customer relationship intangible asset is recorded separately from the fair value of such loan commitments. Similarly, when an entity purchases a credit card portfolio, FASB ASC paragraph 310-10-25-7 (Receivables Topic) requires an allocation of the purchase price to a separately recorded cardholder relationship intangible asset.

The view in Question 2 applies to all loan commitments that are accounted for at fair value through earnings.

Loan commitments that are recognized as derivatives are measured initially and subsequently at fair value. That fair value includes the value of associated servicing rights but excludes the value of internally developed intangible assets. [815-10-S99-1]

By way of background, on the sale of a loan, a servicing asset is recognized under Subtopic 860-50 (servicing assets and liabilities) when the benefits of servicing exceed 'adequate compensation'. [860-50-05-3 – 05-4, 30-2]



The fair value of a loan commitment includes the fair value associated with loan servicing activities even though a separate and distinct servicing asset or liability is not recognized for accounting purposes until the underlying loan has been originated and sold and the servicing rights have been contractually separated from the underlying loan – e.g. by sale or securitization of the loan with servicing retained.

Question 2.11.90 How is the fair value of servicing rights included in a loan commitment's fair value measured?

Interpretive response: The fair value of servicing rights included in a loan commitment's fair value is measured in the same manner as the fair value of a separately recognized servicing asset or liability. It may be determined using a discounted cash flow analysis. Under that method, projections of the cash flows are developed using assumptions that market participants would use.

The following table summarizes whether certain cash flows should be included in that fair value measurement. [815-10-S99-1]

Description of cash flows	Included in the fair value measurement
- Expected net future cash flows related to the associated servicing of the loan, including: - contractually specified servicing fees - a portion of the interest from the loans - late charges - other ancillary sources, including float	✓
Expected net future cash flows related to internally developed intangible assets (e.g. customer relationship intangible assets).	✗

The market interest rate used to determine changes in fair value of the loan commitment cannot include (implicitly or explicitly) any components of the stated interest rate for the loan commitment that relate to the expected future cash flows from internally developed intangible assets – e.g. customer relationship intangible assets. [815-10-S99-1]



Example 2.11.20

Fair value measurement – components of loan commitments

Bank issues a loan commitment to extend a conforming loan (e.g. a loan that is Fannie Mae or Freddie Mac eligible) to a customer that bears interest at 6% and matures in 30 years. The customer can exercise the commitment any time within the next 30 days, after which the commitment expires and ABC is no longer obligated to fund the loan.

Component of commitment	Fair value measurement
Yet-to-be-funded loan without associated servicing	Bank measures the loan commitment using inputs from loan securitization prices as an input to the valuation technique and adjusts the securitization prices for the costs that would be incurred and the estimated profit margin that would be considered by a market participant to securitize the funded loans. At inception of this loan commitment, Bank identifies an appropriate mortgage backed security and adjusts its yield for the transaction costs that would be incurred by a market participant to securitize the underlying loan (including agency guarantee fees) and an estimate of the profit required in the market place. The adjusted yield of 5.70% represents the market interest rate of the yet-to-be funded loan at inception of the loan commitment without the value of servicing rights. The difference between the stated interest rate of the loan commitment (6.00%) and the market interest rate of the yet-to-be-funded loan (5.70%) results in a residual amount of 0.30% for Bank.
Servicing rights	Bank also concludes that a market participant would estimate the expected future net cash flows related to the associated servicing of the loan and other ancillary sources of cash flows using a model that includes assumptions about prepayments, discount rate, servicing costs and risk premiums. Bank determines that the amount of benefits of servicing that would fairly compensate a substitute servicer (should one be required) is 23 bps, which includes the profit that would be demanded in the marketplace.
Other assumptions	Bank's other assumptions are consistent with market participant assumptions. For example, Bank's assumptions about fall-out rate profiles (i.e. the rate of loan commitments that will not result in funded loans) take into account information that a market participant would have about fall-out rates, such as changes in the market interest rate environment that could significantly affect fall-out rates.

As a result, Bank recognizes a gain for the value of the loan commitment related to the residual amount of 0.07% at inception of the commitment. That amount is related to the excess of the above-market contractual interest rate of 5.77% (6% specified in the loan commitment less adequate servicing of 0.23%) over the market interest rate of 5.70%.

Bank performs a similar process when measuring the commitment in subsequent periods, taking into account any changes in relevant inputs and assumptions.

See also KPMG Handbook, [Fair value measurement](#), including Questions E70 and G90.



Question 2.11.100

How does an entity reflect late charges that the servicer is entitled to receive?

Interpretive response: When estimating the fair value of servicing assets and liabilities, the objective is to calculate a value that a market participant would expect to pay for the right to that benefit.

When the benefits of servicing depend on future transactions (e.g. collecting late charges), fair value is not represented by the value of the expected cash flows to be derived from those future transactions. Instead, it is the value of the right to benefit from the cash flows of those potential future transactions. [860-50-30-6]

2.12 Certain interest-only and principal-only strips

2.12.10 Overview



Excerpt from ASC 815-10

>>> Interests in Securitized Financial Assets

15-11 The holder of an interest in securitized financial assets (other than those identified in paragraphs 815-10-15-72 through 15-73) shall determine whether the interest is a freestanding derivative instrument or contains an embedded derivative that under Section 815-15-25 would be required to be separated from the host contract and accounted for separately.

>>> Certain Interest-Only Strips and Principal-Only Strips

15-72 An interest-only strip or principal-only strip is not subject to the requirements of this Subtopic provided the strip has both of the following characteristics:

- a. It represents the right to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument or a specified proportion of the contractual principal cash flows of that debt instrument.
- b. It does not incorporate any terms not present in the original debt instrument.

15-73 An allocation of a portion of the interest or principal cash flows of a specific debt instrument as reasonable compensation for stripping the instrument or to provide adequate compensation to a servicer (as defined in Topic 860) would meet the intended narrow nature of the scope exception provided in this paragraph. However, an allocation of a portion of the interest or principal cash flows of a specific debt instrument to provide for a guarantee of payments, for servicing in excess of adequate compensation, or for any other purpose would not meet the intended narrow nature of the scope exception.

Subtopic 815-10 provides a narrow scope exception for certain interest-only (IO) and principal-only (PO) strips. The FASB intended for this scope exception to apply to only the simplest separations of interest payments from principal payments. [\[815-10-15-72, FAS 155.BCA11\]](#)

For a strip to meet the scope exception, it must: [\[815-10-15-72\]](#)

- represent the right to receive only a specified proportion of either the contractual interest or the principal cash flows of a specific debt instrument (but not both, see Example 2.12.10); and
- not incorporate any terms not present in the original debt instrument.

Evaluating whether a strip has these characteristics requires analysis of the specific original debt instrument's terms.

When an interest in securitized financial assets does not qualify for the IO/PO strip scope exception, an entity evaluates whether it is a derivative in its entirety (freestanding derivative instrument). If it is not, the entity evaluates whether it contains embedded features that require bifurcation. [\[815-10-15-11\]](#)



Question 2.12.10

Does allocating a portion of an instrument's cash flows to compensate for stripping or servicing the instrument disqualify an IO or PO strip from the scope exception?

Interpretive response: No, not if the allocation reflects reasonable compensation for stripping or servicing the debt instrument. However, if the allocation provides for a guarantee of payments for servicing in excess of adequate compensation (or for any other purpose), the IO or PO strip does not meet the IO/PO scope exception. [\[815-10-15-73\]](#)



Question 2.12.20

Do beneficial interests in securitized financial instruments with multiple tranches qualify for the IO/PO strip scope exception?

Interpretive response: Generally, no. Those beneficial interests typically do not represent rights to receive either contractual principal or contractual interest without incorporation of terms not present in the underlying debt instruments. For example, the tranches typically include rights to receive portions of both principal and interest cash flows or include subordination between the tranches when such subordination is not present in the underlying debt instruments. As a result, an entity generally evaluates whether such an interest is a freestanding derivative instrument or contains embedded features that require bifurcation.

A scope exception also may apply to embedded derivative features related to the transfer of credit risk that is only in the form of subordination of one financial instrument to another – e.g. between tranches of beneficial interests issued by a securitization entity. [\[815-15-15-9\]](#)



Example 2.12.10 IO and PO strips

A bond is originally issued with an 8% fixed rate and a principal amount of \$1,000.

An IO strip is created from the bond that entitles the holder to receive 100% of the interest payments plus 10% of the principal payments. A PO strip is also created from the bond that entitles the holder to receive 90% of those principal payments. Neither the IO nor PO strip includes any terms not present in the original bond.

IO strip

The IO strip is not eligible for the IO/PO strip scope exception. To meet this scope exception, a strip must represent rights to receive a specified proportion of either the contractual interest cash flows or contractual principal cash flows of a specific debt instrument (not both). In this example, the IO strip entitles its holder to receive a proportion of both contractual interest cash flows and contractual principal cash flows.

PO strip

The PO strip is eligible for the IO/PO strip scope exception. The PO strip represents rights to receive only a specified proportion of the contractual principal cash flows of the debt instrument and does not contain any terms that are not present in the original bond.



Example 2.12.20

IO and PO strips with terms not present in the original bond

A bond is originally issued with a 7% fixed rate and a principal amount of \$2,000.

An IO strip and PO strip are created from the bond with the following terms:

- **IO strip.** Entitles the holder to receive 100% of the bond's interest payments. If interest rates decline by 200 bp, the IO strip will also receive 10% of the bond's principal payments.
- **PO strip.** Entitles the holder to receive 100% of the bond's principal payments. If interest rates decline by 200 bp, the PO strip will only receive 90% of those principal payments.

Neither the IO strip or the PO strip are eligible for the IO/PO strip scope exception because both strips contain terms that are not present in the original bond – namely, the contingent feature requires a reallocation between the IO strip and the PO strip if interest rates decline by 200 bp.

2.13 Certain contracts involving an entity's own equity

2.13.10 Overview

Topic 815 includes scope exceptions for the following contracts that involve an entity's own equity. [815-10-15-74]

Contracts indexed to the entity's own shares and classified in equity (section 2.13.20)

Certain share-based payments (section 2.13.30)

Certain contracts related to a business combination (section 2.13.40)

Certain forward purchase contracts for an entity's own shares that require physical settlement (section 2.13.50)



Question 2.13.10

Are there circumstances in which the scope exceptions cannot be applied?



Excerpt from ASC 815-10

15-75 The scope exceptions in the preceding paragraph do not apply to either of the following:

- a. The counterparty in those contracts. For example, the scope exception in (b) in the preceding paragraph related to stock-based compensation arrangements does not apply to equity instruments (including stock options) received by nonemployees as compensation for goods and services.
- b. 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. That contract can be a derivative instrument for the issuer under paragraphs 815-10-15-13 through 15-139, in which case it would be accounted for as a liability or an asset in accordance with the requirements of this Subtopic. For example, a forward contract that is indexed to both an entity's own stock and currency exchange rates does not qualify for the exception in (a) in the preceding paragraph with respect to that entity's accounting because the forward contract is indexed in part to something other than that entity's own stock (namely, currency exchange rates).

Interpretive response: Yes. There are two situations when the scope exceptions do not apply. [\[815-10-15-75\]](#)

The scope exceptions do not apply to the parties other than the one whose own equity underlies the contract, except for certain contracts related to a business combination (see section 2.13.40). As a result, the exceptions generally cannot be applied by the counterparty to the contract or a third party entity that subsequently purchases the contract.

The scope exceptions do not apply when a contract is indexed in part or in full to something other than an entity's own equity, even if the contract can or must be settled in the entity's own equity.

2.13.20 Indexed to the entity's own shares and classified in equity



Excerpt from ASC 815-10

>>> Certain Contracts Involving an Entity's Own Equity

15-74 Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

- a. Contracts issued or held by that reporting entity that are both:
 1. Indexed to its own stock
 2. Classified in stockholders' equity in its statement of financial position.

15-75A For purposes of evaluating whether a financial instrument meets the scope exception in paragraph 815-10-15-74(a)(1), a **down round feature** shall be excluded from the consideration of whether the instrument is indexed to the entity's own stock.

15-76 Temporary equity is considered stockholders' equity for purposes of the scope exception in paragraph 815-10-15-74(a) even if it is required to be displayed outside of the permanent equity section.

15-77 For guidance on determining whether a freestanding financial instrument or embedded feature is not precluded from qualifying for the first part of the scope exception in paragraph 815-10-15-74(a), see the guidance beginning in paragraph 815-40-15-5.

15-78 Paragraph 815-40-25-39 explains that, for purposes of evaluating under this Subtopic whether an embedded derivative indexed to an entity's own stock would be classified in stockholders' equity if freestanding, the additional considerations necessary for equity classifications beginning in paragraph 815-40-25-7 do not apply if the hybrid contract is a conventional convertible debt instrument in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).

Derivative instruments by definition are assets or liabilities. Therefore, Topic 815 excludes from derivative accounting contracts issued or held by an entity that are indexed to its own equity and are classified in stockholders' equity on its balance sheet. [815-10-10-1(a), 15-74(a)]

How a contract is treated for accounting purposes when it is indexed to, and potentially settled in, an entity's own stock is addressed by Subtopic 815-40 (contracts in an entity's own equity).

The following instruments are in the scope of Subtopic 815-40:

- Embedded features that have all of the characteristics of a derivative instrument and otherwise meet the requirements to be bifurcated under Subtopic 815-15 – before considering whether it qualifies for the own equity scope exception from derivative accounting.

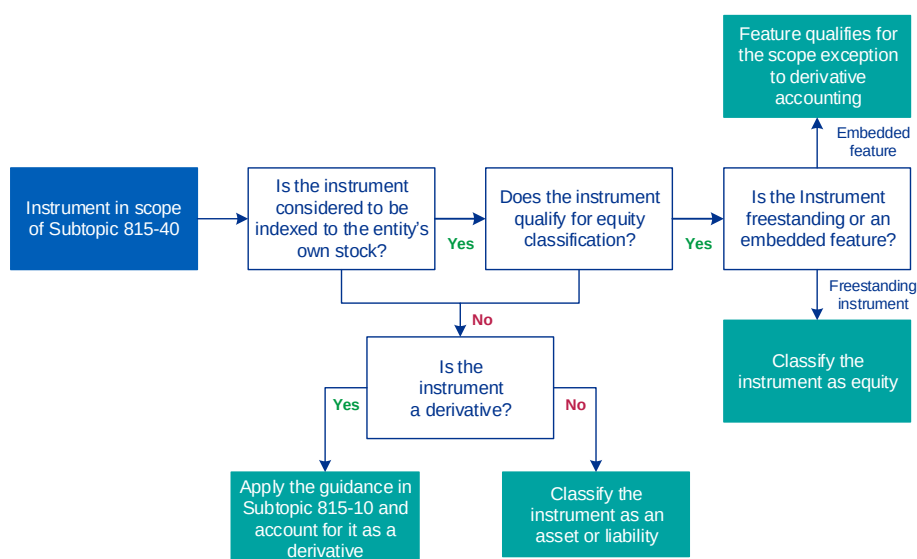
- Freestanding financial instruments that are potentially settled in an entity's own stock that are not in the scope of Topic 480 (distinguishing liabilities from equity) – regardless of whether they have all of the characteristics of a derivative instrument.

Instruments in the scope of Subtopic 815-40 are referred to in this section as 'equity-linked financial instruments'.

To determine the accounting treatment of equity-linked financial instruments under Subtopic 815-40, they are analyzed against two criteria.

- The indexation guidance determines whether an instrument is considered indexed to the entity's own stock.
- The equity classification guidance determines whether the entity is required or is permitted to settle an instrument in its own shares (either physically or net in shares).

These two criteria and the additional steps in determining the appropriate accounting for an equity-linked financial instrument or feature are illustrated in the following decision tree.



See further discussion on equity-linked financial instruments in chapter 8 of KPMG Handbook, [Debt and equity financing](#).

FASB Example

Subtopic 815-10's Example 15 illustrates that a contract that is partially indexed to something other than an entity's own equity does not qualify for the own equity scope exception. In this case, a derivative instrument is indexed both to the entity's equity price and a foreign currency exchange rate.



Excerpt from ASC 815-10

>> Example 15: Contracts Involving an Entity's Own Equity—Derivative Instrument Indexed to Both the Issuer's Equity Price and a Foreign Currency Exchange Rate

55-144 This Example illustrates the application of paragraph 815-10-15-74(a). Assume that Entity A, whose functional currency is the U.S. dollar (USD), and the Counterparty enter into a one-year forward contract that is indexed to Entity A's common share price translated into euros (EUR) at **spot rates** and that will be settled in net shares of Entity A. If the value of Entity A's common stock in EUR appreciates, then Entity A will receive from the Counterparty a number of shares of Entity A stock equal to the appreciation. If the value of Entity A's stock in EUR depreciates, then Entity A will pay Counterparty a number of shares of Entity A stock equal to the depreciation. Thus, the forward contract is indexed both to Entity A's common stock and the USD/EUR currency exchange rates.

55-145 Assume further that Entity A's common stock price at inception is USD 100 per share, and the forward exchange rate of USD to EUR is 1:1.2. The strike price of the forward contract is then set at EUR 120. One year later, the share price of Entity A rises to USD 150, and the spot exchange rate of USD to EUR is 1:1. Then, the share price of Entity A translated is EUR 150. At settlement, Entity A will receive from the Counterparty 20 shares of its own common stock according to the following calculation:

$(\text{EUR } 150 - \text{EUR } 120) \times 100 \text{ shares} = \text{EUR } 3,000$

$\text{EUR } 3,000 \div \text{EUR } 150 \text{ per share} = 20 \text{ shares}$

55-146 A forward contract that is indexed to both an entity's own stock and currency exchange rates should be accounted for as a derivative instrument in its entirety by both parties to the contract if the contract in its entirety meets the definition of a derivative instrument in paragraphs 815-10-15-83 through 15-139.

55-147 Paragraph 815-20-25-71(a)(2) prohibits separating a derivative instrument into components based on different risks. Consequently, it would be inappropriate to bifurcate the forward contract described in this Example according to its differing exposures to changes in Entity A's stock price and changes in the USD/EUR exchange rate and then attempt to apply paragraph 815-10-15-74(a) only to the exposure to changes in Entity A's stock price. That paragraph must be applied to an entire contract.

2.13.30 Share-based payments



Excerpt from ASC 815-10

>>> Certain Contracts Involving an Entity's Own Equity

15-74 Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

- b. Contracts issued by the entity that are subject to Topic 718. If any such contract ceases to be subject to Topic 718 in accordance with paragraphs 718-10-35-9 through 35-14, the terms of that contract shall then be analyzed to determine whether the contract is subject to this Subtopic. An award that ceases to be subject to Topic 718 in accordance with those paragraphs shall be analyzed to determine whether it is subject to this Subtopic.

>> Options Granted to Employees and Nonemployees

45-10 Subsequent changes in the fair value of an option that was granted to a grantee and is subject to or became subject to this Subtopic shall be included in the determination of net income. (See paragraphs 815-10-55-46 through 55-48A and 815-10-55-54 through 55-55 for discussion of such an option.) Changes in fair value of the option award before vesting shall be characterized as compensation cost in the grantor's income statement. Changes in fair value of the option award after vesting may be reflected elsewhere in the grantor's income statement.

>>> Equity Options Issued to Employees

>>> Equity Options Issued to Employees and Nonemployees

55-46 Some entities issue stock options to their grantees in which the underlying shares are stock of an unrelated entity. Consider the following example:

- a. Entity A awards an option to a grantee.
- b. The terms of the option award provide that, if the grantee continues to provide services to Entity A for 3 years, the grantee may exercise the option and purchase 1 share of common stock of Entity B, a publicly traded entity, for \$10 from Entity A.
- c. Entity B is unrelated to Entity A and, therefore, is not a subsidiary or accounted for by the equity method.

55-47 The option award in this example is not within the scope of Topic 718 because the underlying stock is not an equity instrument of the grantor.

55-48 The option award is not subject to Topic 718. Rather, the option award in the example in paragraph 815-10-55-46 meets the definition of a derivative instrument in this Subtopic and, therefore, should be accounted for by the grantor as a derivative instrument under this Subtopic. After vesting, the option award would continue to be accounted for as a derivative instrument under this Subtopic.

55-48A

Paragraphs 718-10-35-9 through 35-14 contain the concept that equity instruments that are granted in share-based payment transactions may initially be subject to that Subtopic, but after certain events or circumstances, those equity instruments may cease being subject to that Subtopic. The terms of an award that ceases to be subject to Topic 718 in accordance with paragraphs 718-10-35-9 through 35-14 should be analyzed to determine whether the award is subject to this Subtopic.

>>> Equity Instruments (Including Options) Issued to Nonemployees

>>>> Holder's Accounting

55-54 The exception in paragraph 815-10-15-74(b) does not apply to the holder of those derivative instruments.

55-55 Thus, paragraph 815-10-15-75(a) explains that equity instruments (including stock options) received by nonemployees as compensation for goods and services are included in the scope of this Subtopic assuming the contract has all the characteristics of a derivative instrument.

> Compensation—Stock Compensation

60-2 For circumstances in which an instrument ceases to be subject to the requirements of Topic 718 and may become subject to the scope of this Subtopic, see paragraphs 718-10-35-9 through 35-14.

Topic 815 includes a scope exception for contracts issued by an entity that are in the scope of Topic 718 (stock compensation). This exception is applicable to the issuer of the share-based payment and not to the holder. [815-10-15-74(c)]

The guidance in Topic 718 applies to share-based payment transactions in which: [718-10-15-2 – 15-3]

- a grantor acquires goods or services to be used or consumed in the grantor's own operations, or provides consideration payable to a customer;
- by:
 - issuing (or offering to issue) its shares, share options, or other equity instruments; or
 - incurring liabilities to an employee or a nonemployee.

An instrument that is subject to Topic 718 when issued continues to be subject to Topic 718's recognition and measurement provisions throughout the instrument's life unless certain events occur. This is summarized in the following table. [718-10-35-9A – 35-12]

Type of instrument	Event after which Topic 718 no longer applies
Convertible instrument granted to a nonemployee in exchange for goods or services	Convertible instrument vests.

Type of instrument	Event after which Topic 718 no longer applies
All other instruments	Terms are modified subsequent to vesting when the holder is no longer an employee (e.g. due to retirement), is no longer providing goods or services, or is no longer a customer. However, Topic 718 continues to apply when a change to the terms of an award is made solely to reflect an equity restructuring, provided certain conditions are met.

See chapter 3 of KPMG Handbook, [Share-based payment](#), for guidance related to the scope of Topic 718.

When an instrument is no longer subject to Topic 718, the entity must analyze the contract to determine whether it is subject to derivative accounting, including whether it is indexed to the issuer's own equity and is classified in equity (see section 2.13.20). The contract also might fall within the scope of other Topics, such as Topic 480. [718-10-35-11 – 35-12]



Question 2.13.20

How does an entity account for the change in fair value of an instrument that was equity-classified under Topic 718 and requires derivative accounting when Topic 718 ceases to apply?

Interpretive response: We believe the change in fair value of the instrument before reclassification (i.e. before liability classification), should be reflected in stockholders' equity on reclassification.

Subtopic 815-10 does not provide specific guidance related to this issue. We believe an entity should analogize to Subtopic 815-40, which provides guidance on how to account for contract classification changes. Under Subtopic 815-40, if a contract is reclassified from permanent or temporary equity to an asset or a liability, the change in fair value before the date of reclassification is accounted for as an adjustment to stockholders' equity.

By analogy, we believe that when an equity instrument granted in a share-based payment transaction is reclassified from equity to a liability, the change in fair value of the instrument during the period of equity classification (i.e. before liability classification) should be reflected in stockholders' equity on reclassification of the instrument. [815-40-35-8 – 35-10]

See KPMG Handbook, [Debt and equity financing](#), including section 8.14, for further discussion.



Example 2.13.10

Share-based payment to a nonemployee

ABC Corp., whose common shares are publicly traded, issues options to Supplier for services related to the installation of a new computer system. Supplier is not a customer, and is considered a nonemployee service provider.

The options permit Supplier to buy 1,000 ABC common shares and are exercisable when the new computer system is completed. The strike price of the options is fixed at a 5% premium over the market price of ABC's share price at the date the options were issued. The fair value of the options is equal to the fair value of the services rendered.

The option is subject to Topic 718 throughout the life of the instrument unless its terms are modified when Supplier is no longer providing services to ABC. If such a modification is made, ABC would evaluate whether the options should be accounted for as derivatives under Topic 815.

When evaluating the options under Topic 815, ABC would consider (among other things) whether the contract is indexed to ABC's own equity and is classified in equity (see section 2.13.20).

2.13.40 Business combinations



Excerpt from ASC 815-10

>>> Certain Contracts Involving an Entity's Own Equity

15-74 Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

- c. Any of the following contracts:
 - 1. A contract between an acquirer and a seller to enter into a business combination
 - 2. A contract to enter into an **acquisition by a not-for-profit entity**
 - 3. A contract between one or more NFPs to enter into a **merger of not-for-profit entities**.

Topic 815 provides a scope exception for contracts between an acquirer and a seller to enter into a business combination at a future date. This scope exception applies to: [\[815-10-15-74\(c\)\]](#)

- a contract between an acquirer and a seller to enter into a business combination
- a contract to enter into an acquisition by a NFP entity
- a contract between one or more NFPs to enter into a merger of NFPs.

2.13.50 Forward purchase contracts for an entity's own shares that require physical settlement



Excerpt from ASC 815-10

>>> Certain Contracts Involving an Entity's Own Equity

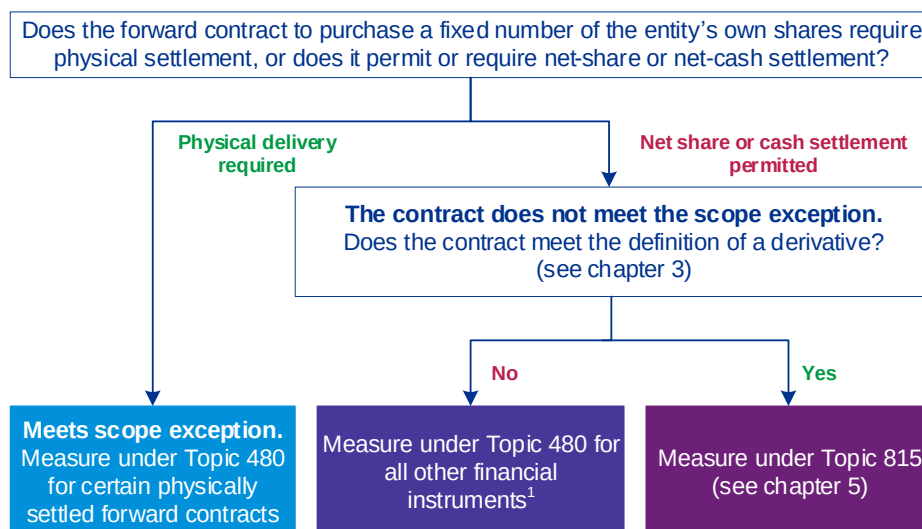
15-74 Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

- d. Forward contracts that require settlement by the reporting entity's delivery of cash in exchange for the acquisition of a fixed number of its equity shares (forward purchase contracts for the reporting entity's shares that require physical settlement) that are accounted for under paragraphs 480-10-30-3 through 30-5, 480-10-35-3, and 480-10-45-3.

Topic 815 provides a scope exception for certain physically settled forward contracts. Specifically, forward contracts that require settlement by delivery of cash in exchange for the acquisition of a fixed number of an entity's own equity shares – forward purchase contracts for the entity's own shares that require physical settlement – are accounted for under Topic 480 and are excluded from the scope of Topic 815. [815-10-15-75(d), 480-10-30-3 – 30-5, 35-3, 45-3]

Topic 480 requires a forward contract to purchase an entity's own shares to be classified as a liability (or in some cases, an asset) by the entity. As such, any such forward contract does not meet the own equity scope exception in section 2.13.20 because the contract cannot be classified in stockholder's equity.

The decision tree below illustrates the application of this scope exception to a forward contract to purchase an entity's own shares.



Note:

1. Instruments other than mandatorily redeemable contracts and certain physically settled forward contracts.

See chapter 6 of KPMG Handbook, [Debt and equity financing](#), for further accounting guidance for forward purchase contracts for an entity's own shares that are accounted for under Topic 480.

2.14 Leases



Excerpt from ASC 815-10

>>> Leases

15-79 Leases that are within the scope of Topic 842 are not derivative instruments subject to this Subtopic, although a derivative instrument embedded in a lease may be subject to the requirements of paragraph 815-15-25-1.



Excerpt from ASC 842-10

> Other Considerations

15-43 Paragraph 815-10-15-79 explains that **leases** that are within the scope of this Topic are not derivative instruments subject to Subtopic 815-10 on derivatives and hedging although a derivative instrument embedded in a lease may be subject to the requirements of Section 815-15-25. Paragraph 815-10-15-80 explains that **residual value guarantees** that are subject to the guidance in this Topic are not subject to the guidance in Subtopic 815-10. Paragraph 815-10-15-81 requires that a third-party residual value guarantor consider the guidance in Subtopic 815-10 for all residual value guarantees that it provides to determine whether they are derivative instruments and whether they qualify for any of the scope exceptions in that Subtopic.

Topic 815 provides a scope exception for leases that are in the scope of Topic 842 (leases). However, lease contracts frequently include non-lease components, which may include embedded derivatives requiring separate accounting. Therefore, lease contracts need to be analyzed for potential embedded derivatives. [\[815-10-15-79\]](#)

2.15 Residual value guarantees



Excerpt from ASC 815-10

>>> Residual Value Guarantees

15-80 Residual value guarantees that are subject to the requirements of Topic 842 are not subject to the requirements of this Subtopic.

15-81 A third-party residual value guarantor shall consider the guidance in this Subtopic for all residual value guarantees that it provides to determine whether they are derivative instruments and whether they qualify for any of the scope exceptions in this Subtopic. The guarantees described in paragraph 842-10-15-43 for which the exceptions of paragraphs 460-10-15-7(b) and 460-10-25-1(a) do not apply are subject to the initial recognition, initial measurement, and disclosure requirements of Topic 460.

Topic 815 provides a scope exception for residual value guarantees that are in the scope of Topic 842. A residual value guarantee is a guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount. Residual value guarantees can be provided by the lessee or by a third party unrelated to the lessee or the lessor. [\[842 Glossary\]](#)

Although residual value guarantees may be structured in a variety of ways, they are usually settled on a net basis and therefore many meet the definition of a derivative (derivatives are measured at fair value, see chapter 5). However, under Topic 842, both the lessor and the lessee account for residual value guarantees based on the stated amount of the guarantee, rather than the fair value of the guarantee. The residual value guarantee scope exception resolves this potential conflict between lease accounting under Topic 842 and derivative accounting under Topic 815. See sections 2.2.1 and 5.4.6 of KPMG Handbook, [Leases](#), for further discussion on residual value guarantees. [\[815-10-15-80, 842-10-15-43\]](#)



Question 2.15.10

Do all residual value guarantees meet the residual value guarantee scope exception?

Interpretive response: No. Only residual value guarantee contracts that are accounted for under Topic 842 meet this scope exception. Generally, this includes residual value guarantees (1) provided by the lessee to the lessor or (2) obtained by the lessor from a third party (e.g. a residual value insurer) at or before lease commencement.

In contrast, third parties that provide residual value guarantees to lessors or lessees do not account for them under Topic 842; nor do lessees that obtain residual value guarantees from third parties (e.g. insurance to cover their

guarantee to the lessor). As a result, this scope exception does not apply to them.

Residual value guarantees that are not accounted for under Topic 842 must be evaluated to determine whether they are derivatives and whether they qualify for another scope exception.

See also Example 2.15.10.



Example 2.15.10

Third-party residual value guarantee

Lessor leases a car to Lessee for a period of three years. The lease qualifies as a direct financing lease for Lessor based on the requirements of Topic 842. Lessor purchased a residual value guarantee from Guarantor (a third party) for \$450 at lease commencement.

The terms of the residual value guarantee require Guarantor to pay Lessor any shortfall between the following amounts at the end of the lease term:

- \$5,000, which is the expected retail value of the car at the end of the lease term based on current market conditions at inception of the lease; and
- the Blue Book retail value of the car at that time – based on the retail value for the car's year, make and model, assuming it is in good condition with normal mileage.

If the Blue Book retail value of the car at the end of the lease term is equal to or greater than \$5,000, Guarantor is not required to pay Lessor.

This contract meets the definition of a derivative because:

- it contains an underlying (the Blue Book retail value of the car) and a payment provision (\$5,000 less the Blue Book retail value of the car);
- the \$450 initial net investment is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- its terms require net cash settlement.

Lessor accounting

Lessor is required to account for the residual value guarantee as part of its lease accounting under Topic 842. Therefore, the guarantee contract between Lessor and Guarantor qualifies for the residual value guarantee scope exception and the guarantee is not subject to Topic 815, even though it meets the definition of a derivative.

Guarantor accounting

Guarantor does not have a lease under Topic 842; the guarantee is a freestanding contract. Therefore, the residual value guarantee scope exception does not apply.

Further, this contract does not qualify for the nonfinancial asset scope exception (see section 2.7.30) because settlement is based on a Blue Book value that is not specific to the leased car.

2.16 Registration payment arrangements



Excerpt from ASC 815-10

>>> Registration Payment Arrangements

15-82 Registration payment arrangements within the scope of Subtopic 825-20 are not subject to the requirements of this Subtopic. The exception in this paragraph applies to both the issuer that accounts for the arrangement pursuant to that Subtopic and the counterparty.

> Derivative Financial Instruments Subject to a Registration Payment Arrangement

25-16 Paragraphs 825-20-25-2 and 825-20-30-2 require that a **financial instrument** subject to a registration payment arrangement be recognized and measured in accordance with other applicable GAAP (for example, this Subtopic) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. That is, those paragraphs require that an entity recognize and measure a registration payment arrangement as a separate unit of account from the financial instrument(s) subject to that arrangement.

Topic 815 provides a scope exception for arrangements in the scope of Subtopic 825-20 (registration payment arrangements). Subtopic 825-20 applies to a registration payment arrangement regardless of whether it is issued as a separate agreement or included as a provision of a financial instrument or other agreement. [\[825-20-15-2\]](#)

This scope exception is applicable to both the issuer and the counterparty. [\[815-10-15-82\]](#)



Question 2.16.10

What are some examples of registration payment arrangements that do not qualify for the scope exception?

Background: Sometimes an equity-linked financial instrument is issued together with a registration payment arrangement. A registration payment arrangement has both of the following characteristics: [\[815-40 Glossary, 825-20 Glossary, 825-20-55-2, 55-11\]](#)

- it requires the issuer to endeavor (i.e. use its 'best efforts' or apply 'commercially reasonable efforts') to either (1) file a registration statement for the resale of a specified financial instrument and/or the equity shares issuable on exercise of the instrument, and for that registration statement to be declared effective; or (2) maintain an effective registration statement for a period of time (or in perpetuity);

- it requires the issuer to transfer consideration to the holder of the financial instrument if the registration statement is not declared effective or does not remain effective.

The consideration to be transferred to the holder of the financial instrument is often calculated as a percentage of the proceeds from the issuance of the security, and may be in the form of cash, equity shares or as an adjustment to the terms of the instrument(s) that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument).

Interpretive response: The following table provides examples of some common arrangements for which Subtopic 825-20 is not applicable. Because these arrangements are not in the scope of Subtopic 825-20, they do not meet the registration payments scope exception. As a result, an entity must determine whether such arrangements are derivatives and whether another scope exception applies.

Arrangement terms	Explanation
Consideration is an adjustment to the conversion ratio of a convertible instrument	Subtopic 825-20 does not apply to arrangements for which the consideration that would be transferred is an adjustment to the conversion ratio of a convertible instrument. Further, if such an arrangement is not in the scope of Topic 815, Subtopic 470-20 (debt with conversion and other options) provides guidance on the accounting for such instruments. [825-20-15-4(a)]
Amount of consideration linked to observable index	Subtopic 825-20 does not apply to arrangements that determine the amount of consideration to be paid by reference to an observable index or market other than the market for the issuer's own shares. For example, Subtopic 825-20 does not apply to an arrangement if the consideration is determined by reference to the price of a commodity. [825-20-15-4(b)]
Financial instruments settled when consideration is transferred	Subtopic 825-20 does not apply to arrangements in which the financial instrument(s) subject to the arrangement are settled when the consideration is transferred. For example, Subtopic 825-20 does not apply to a warrant that is contingently puttable if an effective registration statement for the resale of the equity shares issuable on exercise of the warrant is not declared effective by the SEC within a specified grace period. [825-20-15-4(c)]
Arrangement requires delivery of registered shares	Subtopic 825-20 contemplates that the issuer will use best efforts or commercially reasonable efforts to register shares. Therefore, we believe it does not apply to arrangements that obligate the issuer to deliver registered shares on exercise or conversion of the related security. [815-40-25-11 – 25-13, 825-20-55-2, 55-11]



Question 2.16.20

Can this scope exception be applied by analogy to registration payment arrangements not in the scope of Subtopic 825-20?

Interpretive response: No. We believe that Subtopic 825-20 cannot be applied by analogy to the accounting for contracts that are not registration payment arrangements in its scope. For example, a building contract that includes a provision requiring the contractor to obtain a certificate of occupancy by a certain date or pay a penalty each month until the certificate of occupancy is obtained is not in the scope of Subtopic 825-20.

Likewise, we believe that the registration payment arrangement scope exception under Topic 815 cannot be applied by analogy to arrangements that are not within the scope of Subtopic 825-20.

2.17 Certain fixed-odds wagering contracts



Excerpt from ASC 815-10

>>> Certain Fixed-Odds Wagering Contracts

15-82A Fixed-odds wagering contracts for an entity operating as a casino and for the casino operations of other entities are within the scope of Topic 606 on revenue from contracts with customers. See paragraph 924-815-15-1.

Topic 815 provides a scope exception for certain fixed-odds wagering contracts. These are wagering contracts placed by bettors for which the odds of winning at the time the bets are placed with a casino are known or knowable – e.g. certain sports and race wagers. [815-10-15-82A, 924-815-25-1]

For a casino or an entity with casino operations, these contracts are in the scope of Topic 606 and, therefore, are accounted for as revenue transactions, rather than as derivative instruments under Topic 815. [815-10-15-82A, 924-815-15-1, 25-1, ASU 2016-20.BC40-41]

2.18 SEC staff's longstanding position on written options



Excerpt from ASC 815-10

815-10-S99 SEC Materials

General Note: As more fully described in About the Codification, the Codification includes selected SEC and SEC Staff content for reference by

public companies. The Codification does not replace or affect how the SEC or SEC Staff issues or updates SEC content. SEC Staff content does not constitute Commission-approved rules or interpretations of the SEC.

General

> SEC Staff Guidance

>> Comments Made by SEC Observer at Emerging Issues Task Force (EITF) Meetings

>>> SEC Observer Comment: Accounting for Written Options

S99-4 The following is the text of the SEC Observer Comment: Accounting for Written Options

SEC staff's longstanding position is that written options that do not qualify for equity classification initially should be reported at fair value and subsequently marked to fair value through earnings.

Topic 815 reproduces the SEC staff's longstanding position on written options. Under this position, written options that do not qualify for equity classification are recognized and measured (both initially and subsequently) at fair value, with changes in fair value included in earnings. This is the case even if a written option does not meet the definition of a derivative. [\[815-10-S99-4\]](#)

3. Definition of a derivative**

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This is a new chapter added in this edition **

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- 3.5.190 When do assets satisfy the net settlement criterion using the 'readily convertible to cash' method?
- 3.5.200 What are some examples of assets that may be readily convertible to cash?
- 3.5.210 Why does delivery of a derivative or asset that is readily convertible to cash meet the net settlement characteristic?
- 3.5.220 What are 'interchangeable, fungible' units?
- 3.5.230 What kinds of markets contain quoted market prices?
- 3.5.240 How does an entity determine whether quantities to be delivered can be rapidly absorbed into an active market without significantly affecting the quoted market price?
- 3.5.250 How do costs to convert assets into cash affect whether assets are readily convertible to cash?
- 3.5.260 Does an entity assess the significance of conversion costs continuously throughout a contract's life?
- 3.5.270 Are publicly traded securities deliverable upon exercise of a warrant issued by an entity on its own shares readily convertible to cash if they are restricted from sale or transfer?

Examples

- 3.5.10 Structured payout of net gain
- 3.5.20 Significance of transaction costs
- 3.5.30 Evaluating net settlement in common contracts

3.6 Ongoing evaluation

Question

- 3.6.10 Can a financial instrument or other contract that does not initially meet the definition of a derivative later meet it (or vice versa)?

3.1 How the standard works

A derivative instrument is a financial instrument or nonfinancial contract that has all of the following characteristics.



The first characteristic is present if a financial instrument or nonfinancial contract has both of the following:

- one or more underlyings.
- one or more notional amounts or payment provisions (or both).

The second characteristic is present if a financial instrument or nonfinancial contract requires:

- no initial net investment; or
- an initial net investment that is smaller than would be required for other types of instruments or contracts expected to have a similar response to changes in market factors.

The third characteristic is present if a financial instrument or nonfinancial contract contains a net settlement provision. Net settlement is generally defined as a one-way transfer of an asset (usually cash) from the counterparty in a loss position to the counterparty in a gain position. This only can be accomplished either:

- directly, via contractual net settlement between the two parties; or
- indirectly, via a market mechanism that facilitates net settlement, or through settlement involving delivery of either a derivative or an asset that is readily convertible to cash.

3.2 Definition of a derivative

3.2.10 Overview

A derivative instrument is a financial instrument or other contract that has all of the following basic characteristics. [815-10-15-83]

Underlying + notional amount or payment provision (section 3.3)	The financial instrument or other contract has both: — one or more underlyings; and — one or more notional amounts or payment provisions (or both).
Initial net investment (section 3.4)	The financial instrument or other contract requires no, or a small, investment at inception of the contract – i.e. the initial net investment is zero, or smaller than would be required for other types of contracts expected to have similar responses to changes in market factors.
Net settlement (section 3.5)	The net settlement characteristic is met if the financial instrument or other contract: — requires or permits net settlement; — can be readily settled net by a means outside of the contract; or — provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.



Example 3.2.10

Examples of contracts that meet the derivative definition

The following are examples of common contracts, identifying whether they meet the definition of a derivative.

Description of Contract	Evaluation
ABC Corp. pays \$100 to purchase an option that will expire in six months to acquire 1,000 shares of DEF Corp.'s common stock at a fixed price of \$5 per share. DEF's shares are publicly traded, and the option provides for net cash settlement.	Contract has all the characteristics of a derivative: — Underlying: DEF's share price — Notional amount: 1,000 DEF shares — Initial net investment: \$100 is a small initial investment at inception of the contract (compared to the total price of 1,000 shares of DEF's shares of \$5,000) — Net settlement: The option provides for net cash settlement.
Farmer enters into a futures contract to deliver 80,000 bushels of wheat in two months at a specified price per	Contract has all the characteristics of a derivative: — Underlying: Price of wheat

Description of Contract	Evaluation
bushel. Farmer does not pay (or receive) any amount when the contract is entered into. A market mechanism exists to settle the contract on a net basis and Farmer must settle the contract net.	— Notional amount: 80,000 bushels — Initial net investment: There was no initial investment at inception of the contract. — Net settlement: A market mechanism exists to settle the contract on a net basis.



Question 3.2.10

Is the definition of a derivative consistent with the marketplace's perception of a derivative?

Interpretive response: Not necessarily.

When developing the definition of a derivative instrument, the FASB initially considered referencing instruments commonly understood to be derivative instruments (e.g. swaps, options, forwards). However, the FASB recognized that examples could quickly become inadequate or obsolete because of the continued expansion of financial markets and development of innovative financial instruments and other contracts. As a result, the FASB defined a derivative instrument based on its distinguishing characteristics, even though the definition does not always coincide with what some market participants consider to be a derivative instrument. [\[FAS 133.BC212, BC235–BC236, BC245\]](#)

The FASB also considered limiting the definition of a derivative instrument to financial instruments. This would have excluded contracts that settle net for a commodity or other types of nonfinancial contracts. However, the FASB believes that some of these contracts have essentially the same characteristics as (and present risks similar to) a financial derivative instrument. To prevent accounting for and measuring similar contracts differently, it decided not to restrict the definition of a derivative instrument to financial instruments. [\[FAS 133.BC268–BC269\]](#)

3.3 Underlying + notional amount or payment provision

3.3.10 Overview



Excerpt from ASC 815-10

> Definition of Derivative Instrument

15-83 A derivative instrument is a financial instrument or other contract with all of the following characteristics:

- a. Underlying, notional amount, **payment provision**. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:
1. One or more underlyings
 2. One or more notional amounts or payment provisions or both.



To be a derivative, a financial instrument or other contract must have both:

- at least one underlying (see section 3.3.20).
- at least one notional amount *or* at least one payment provision (or both) (see section 3.3.30).

3.3.20 Underlying



Excerpt from ASC 815-10

>>> Underlying

15-88 An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument. An underlying usually is one or a combination of the following:

- a. A security price or security price index
- b. A commodity price or commodity price index
- c. An interest rate or interest rate index
- d. A credit rating or credit index
- e. An exchange rate or exchange rate index
- f. An insurance index or catastrophe loss index
- g. A climatic or geological condition (such as temperature, earthquake severity, or rainfall), another physical variable, or a related index
- h. The occurrence or nonoccurrence of a specified event (such as a scheduled payment under a contract).

15-89 However, an underlying may be any variable whose changes are observable or otherwise objectively verifiable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

15-90 Reference to either a notional amount or a payment provision is needed in relation to an underlying to compute the contract's periodic settlements and resulting changes in fair value.

15-91 Example 3 (see paragraph 815-10-55-77) illustrates the determination of an underlying if a commodity contract includes a fixed element and a variable element.

An underlying is any variable factor (usually a price or an index) whose changes are observable or otherwise objectively verifiable and that – along with either the notional amount or payment provision – determines the cash flows or other exchanges (i.e. settlement) required by the derivative instrument. [815-10-15-88]

An underlying is not the asset or liability referenced in the derivative instrument. Rather, it is (for example) a price or rate associated with a referenced asset or liability, which is usually one or some combination of the following: [815-10-15-88]

- security price or security price index;
- commodity price or commodity price index;
- interest rate or interest rate index;
- credit rating or credit index;
- exchange rate or exchange rate index;
- insurance or catastrophe loss index;
- climatic or geological condition (e.g. temperature, earthquake severity, rainfall), another physical variable, or a related index; or
- occurrence or nonoccurrence of a specific event.

The following table provides examples of derivative instruments and the associated underlying.

Derivative instrument	Underlying
Interest rate swap	Interest rate index (e.g. LIBOR, SOFR, Prime)
Debt or equity forward	Security price (e.g. stock price of ABC Corp.)
Commodity forward	Commodity price (e.g. oil or corn price)
Foreign currency swap	Applicable exchange rate (e.g. US dollar/euro or US dollar/Mexican pesos exchange rates)
Credit derivative	Credit rating or index of the named party

An underlying does not by itself determine the value or settlement of a derivative instrument. Instead, a derivative instrument's value is generally affected by changes in the underlying(s) because the instrument's settlement is affected by the interaction between changes in the underlying(s) and the notional amount (which is the number of units specified in the contract) or payment provision (see section 3.3.30). [815-10-15-89]



Example 3.3.10 Interest rate underlying

ABC Corp. enters into an interest rate swap that has a notional amount of \$100 million, a receive-fixed leg of 5% and a pay-variable leg at the Prime rate. The interest rate swap reprices and net settles once per year.

The underlying in this example is the Prime rate, which is the variable whose changes interact with the notional amount to derive the settlement amount.

The following table illustrates how the settlement amount changes each period, depending on the Prime rate.

If Prime rate is...	Then the net settlement amount ¹ for the period is...
4%	ABC receives \$1 million
5%	ABC neither receives nor pays (i.e. net settlement is \$0)
6%	ABC pays \$1 million
<i>Note:</i> 1. \$100 million (i.e. the notional amount) × (Prime rate - 5% fixed-rate).	



Question 3.3.10

Is an underlying required to be a price or index?

Interpretive response: No. Although an underlying is typically a price or index, an underlying can be any variable or factor whose changes are observable or otherwise objectively verifiable. For example, the occurrence or nonoccurrence of a specified event is a variable or factor that qualifies as an underlying.

Assume a contract requires payment if certain conditions are met and does not require payment if those conditions are not met. In that contract, the underlying is the occurrence (or nonoccurrence) of the specified conditions.

Such underlyings are sometimes referred to as on/off switches:

- when the switch is on, the specified conditions occurred and a payment is required; and
- when the switch is off, the specified conditions did not occur and a payment is not required.



Question 3.3.20

Can a fixed price or rate be an underlying?

Interpretive response: No. An underlying is any variable factor whose changes are observable or otherwise objectively verifiable. It is not a fixed price or rate. Although many derivative instruments contain a fixed price or rate, that fixed price or rate represents the exercise price or strike price of the contract, and not the contract's underlying.

For example, an interest rate swap with a \$100 million notional has a variable leg based on the three-month USD LIBOR rate plus 200 bps and has a fixed leg of 5%. The underlying of the swap is not the fixed leg of the swap. Rather, the underlying is the three-month USD LIBOR rate, which is the index on which the variable leg is calculated each settlement period. The underlying does not include the fixed spread of 200 bps.



Question 3.3.30

Can a derivative instrument with a variable exercise price or rate have an underlying?

Interpretive response: Yes. A contract can have an underlying even if its exercise price (or rate) is variable. A contract can also have an underlying if it has both a fixed and variable exercise price; these contracts are referred to as 'mixed-attribute' or 'fixed-basis' contracts and are common in the commodities industry.

The following table illustrates identifying an underlying in contracts having fixed versus variable exercise prices.

Fixed exercise price	Contract terms: Contract to purchase 100 shares of ABC Corp.'s publicly traded stock in six months at \$10 per share. Underlying: Market price per share of ABC Corp.'s publicly traded stock. Contract value: As ABC Corp.'s stock price changes, the changes in value of the contract are attributable to the interaction between the exercise price, the underlying and the notional amount.
Variable exercise price	Contract terms: Contract to purchase 100 shares of ABC Corp.'s publicly traded stock in six months at the then-prevailing market price for the stock. Underlying: Market price per share of ABC Corp.'s publicly traded stock. Contract value: As ABC Corp.'s stock price changes, the fair value of the contract is expected to be at or near zero because the exercise price of the contract (the then-prevailing market price for ABC Corp.'s publicly traded stock) is the same as the underlying for the contract.



Question 3.3.40

Is the underlying affected by the nature of the asset delivered at settlement?

Interpretive response: Not necessarily.

For example, ABC Corp. pays a small premium to enter into a six-month forward contract to purchase 10,000 ounces of gold. The contract may be settled in net cash, net gold, or through delivery of a quantity of a unique metal sufficient to settle the contract. Because the value of and amount of settlement in this contract are determined by the price of gold, we believe the underlying in this contract is the price of gold. The fact that a unique metal may be delivered in lieu of cash or gold affects only the manner in which the contract will be settled, not the value or amount of the settlement.

FASB Examples: Determining an underlying if a commodity contract includes both fixed and variable price elements

Subtopic 815-10's Example 3 (reproduced below) illustrates how to determine the underlying in commodity contracts.

- **Case A (fixed price).** The underlying for a commodity contract to transact a fixed quantity of a commodity at a fixed price at a specified future date is the price of the commodity.
- **Case B (variable price).** The underlying for a commodity contract to transact a fixed quantity of a commodity at the prevailing market price at a specified future date is the price of the commodity, similar to the underlying in Case A.
- **Case C.** A contract to purchase crude oil at the prevailing market price at a specified future date plus or minus a fixed basis differential contains two underlyings:
 - market price for WTI crude oil; and
 - basis differential between the specific type of crude oil to be purchased at a specific location (e.g. WTI at Cushing, Oklahoma) and the actual crude oil to be purchased at the specified location.

These types of crude oil contracts are common in locations where the value of oil moves in tandem with a common pricing location (e.g. Cushing, Oklahoma for NYMEX contracts); however, due to physical distance from the related pricing point and regional supply and demand for oil, the price of the oil in locations outside the common pricing location is different.



Excerpt from ASC 815-10

>> Example 3: Underlying—Determination of an Underlying If a Commodity Contract Includes Both Fixed and Variable Price Elements

55-77 The following Cases illustrate the determination of an underlying if a commodity contract includes a fixed element and a variable element:

- a. A commodity contract between two parties to transact a fixed quantity at a specified future date at a fixed price (such as the commodity's forward price at the inception of the contract) (Case A)
- b. A commodity contract between two parties to transact a fixed quantity at a specified future date at whatever the prevailing market price might be at that future date (Case B)
- c. A commodity contract having features of both a fixed-price contract and variable-price contract; specifically, an agreement to purchase a commodity in the future at the prevailing market index price at that future date plus or minus a fixed basis differential set at the inception of the contract (Case C).

55-78 Assume that each of the contracts in Cases A, B, and C has the characteristics of notional amount, underlying, and no initial net investment and that the commodity to be delivered is readily convertible to cash as discussed beginning in paragraph 815-10-15-119.

>>> Case A: Fixed-Price Commodity Contract

55-79 This fixed-price commodity contract is a derivative instrument because it meets all the criteria in paragraph 815-10-15-83, including having an underlying (namely, the price of the commodity), as required by paragraph 815-10-15-83(a)(1). The contract's fair value will change as the underlying changes because the contract price is not the prevailing market price at the future transaction date. A party to this contract would need to determine if the normal purchases and normal sales exception (see discussion beginning in paragraph 815-10-15-22) applies to the contract.

>>> Case B: Variable-Price Commodity Contract

55-80 This variable-price commodity contract is a derivative instrument because it meets all the criteria in paragraph 815-10-15-83, including having an underlying (namely, the price of the commodity), as required by paragraph 815-10-15-83(a)(1). However, because the contract price is the prevailing market price at the future transaction date, the variable-price commodity contract would not be expected to have a fair value other than zero. A party to this contract would need to determine if the normal purchases and normal sales exception (see discussion beginning in paragraph 815-10-15-22) applies to the contract.

>>> Case C: Mixed-Price Commodity Contract

55-81 In a commodity contract between a buyer and seller of crude oil, the buyer is a refinery that seeks to use the crude oil in the production of unleaded gasoline. The buyer agrees in January to buy 1,000,000 barrels of a specific type of crude oil in July from the seller at the July 1 West Texas Intermediate index price plus \$1.00 per barrel. The contract appears to be primarily a variable-price contract, but includes a fixed margin above that price. (If the buyer or the seller no longer wants exposure to fluctuations in the West Texas Intermediate index between January and July, it will separately use the futures market to fix the West Texas Intermediate index portion of the contract.)

55-82 The fixed \$1.00 differential is commonly referred to as the basis differential, but it reflects multiple factors, such as timing, quality, and location. If not fixed, the basis differential can be very volatile, because it captures the passage of time (a financing element), changes in relative value of different qualities (or grades) of crude to each other (light versus heavy, sweet versus sour), and changes in the attractiveness of locations from the central pricing hub (Cushing, Oklahoma) relative to each other factor. Supply and demand is a critical factor in influencing the changes in basis due to quality and location; for example, an increase in imports of light crude through the Gulf of Mexico corridor will tend to lower the basis differential for light crude (falling prices due to increased supply) and tend to direct domestic supplies of light crude to northern U.S. locations (because the foreign oil fills southern U.S. demand), lowering the basis differential for contracts calling for delivery at northern points (again due to increased supply in the North). The basis differential therefore is not a simple fixed transport charge, but rather a complex and volatile variable in itself. For this reason, energy traders may specialize solely in **trading** basis and seeking the most attractive differential at all times relative to the West Texas Intermediate index—fixing and unfixing basis by selling

contracts back to counterparties or entering into offsetting contracts with third parties.

55-83 The whole mixed-attribute contract is a derivative instrument because the basis differential is a market variable in determining the final transaction price under the contract, and this variable has been fixed in the contract, producing an underlying. (If the differential was a market pricing convention that typically would not be expected to change, the contract would be a derivative instrument with very minor, if any, fluctuations in fair value.) The fact that the base commodity price in the contract is variable will help to mute the fluctuations in fair value of the contract as a whole, but there still will be potential changes in fair value of the overall contract because of the fixed-basis element. A party to this contract would need to determine if the normal purchases and normal sales exception applies to the contract. (Paragraph 815-20-55-47 explains why such a mixed-attribute contract that is a derivative instrument would generally not be sufficiently effective if designated as the sole hedging instrument in a **cash flow hedge** of the anticipated purchase or sale of the commodity.)

3.3.30 Notional amount or payment provision



Excerpt from ASC 815-10

>>> Notional Amount

15-92 A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. Other names are used, for example, the notional amount is called a **face amount** in some contracts. 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. As defined in the glossary, the **effective notional amount** is the stated notional amount adjusted for any leverage factor. If a requirements contract contains explicit provisions that support the calculation of a determinable amount reflecting the buyer's needs, then that contract has a notional amount. See paragraphs 815-10-55-5 through 55-7 for related implementation guidance. For implementation guidance on identifying a commodity contract's notional amount, see paragraph 815-10-55-5.

>>> Payment Provision

15-93 As defined in the glossary, a payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner. For example, a derivative instrument might require a specified payment if a referenced interest rate increases by 300 basis points.

To be a derivative, a financial instrument or other contract must either reference a notional amount or contain a payment provision to compute the contract's periodic settlements (and resulting changes in fair value). When a derivative

instrument has a notional amount, its settlement or value is typically determined by the interaction of the notional amount with the underlying. In contrast, when a derivative instrument has a payment provision, that provision specifies the fixed or determinable settlement amount if the underlying behaves in a specified manner. [815-10-15-93]

Notional amount [815-10-15-92]	A notional amount is the contractual amount (or factor) that will be used to determine the cash flows or other exchanges required under the contractual terms of the derivative instrument. It is the number of units specified in the contract (e.g. an amount of currency, number of shares, number of bushels, weight) that is applied to the change in one or more underlyings to assist in determining the settlement or value of the derivative instrument. In addition to the notional amount and change in value of one or more underlyings, a contract may specify that the settlement amount includes other factors, such as leverage.
Payment provision [815-10-15-92, 815-10 Glossary]	A payment provision specifies a fixed or determinable settlement if the underlying behaves in a specified manner. For example, an instrument may include a payment provision that requires a specified payment if a referenced interest rate increases by 300 bps.

The following are examples of common derivative instruments and the associated underlying and notional amount or payment provision.

Derivative instrument	Underlying	Notional amount or payment provision
\$10,000 interest rate swap to pay 7% interest and receive LIBOR plus 300 bps	LIBOR	\$10,000 (notional amount)
Futures contract to purchase 100,000 barrels of crude oil	Price of crude oil	100,000 barrels of crude oil (notional amount)
Forward contract to sell 100,000 ounces of gold for \$30,000,000	Price of gold	100,000 ounces of gold (notional amount)
Forward contract to purchase 100,000 ounces of gold at the market price on the settlement date	Price of gold	100,000 ounces of gold (notional amount)
Put option on 10,000 shares of Company A at \$10 per share	Price of Company A's shares of stock	10,000 shares (notional amount)
Contract to pay \$15,000 if Company X's share price falls below \$30 per share	Price of Company X's shares of stock	\$15,000 (payment provision with a fixed settlement amount)

Derivative instrument	Underlying	Notional amount or payment provision
Contract that requires Company B to pay Company C the difference between \$1,000 and the market price of a bond issued by Company D if Company D's creditworthiness declines	Occurrence or nonoccurrence of a decline in Company D's creditworthiness	The difference between \$1,000 and the market price of a bond issued by Company D (payment provision with a determinable amount)



Question 3.3.50

Is a contract that has a payment provision also required to have a notional amount?

Interpretive response: No. A contract is only required to have either a payment provision or a notional amount. [\[810-10-15-83\(a\)\]](#)

For example, ABC Corp. purchases a financial instrument for \$250,000 that requires \$5,000,000 to be paid to ABC if LIBOR exceeds 10% during the next two years. Although the instrument does not have a notional amount, it does include a payment provision and is accounted for as a derivative if it meets the other characteristics of a derivative.

Note: The type of instrument in this example is viewed similarly to a purchased option that pays if LIBOR exceeds 10%. If LIBOR does not exceed 10%, the option does not pay and expires worthless.



Question 3.3.60

What information is considered when determining whether a contract contains a notional amount?

Interpretive response: Determining whether a contract contains a notional amount must be based on information in the contract, attachments, appendices or other legally binding side agreements.

Although the notional amount is readily determinable in many financial contracts (e.g. interest rate derivatives, foreign currency derivatives, equity derivatives), determining whether a nonfinancial contract (e.g. commodity contract) includes a notional amount can be a complex judgment when the contract lacks a specific number of units to be bought or sold.

One technique an entity may use to quantify and objectively validate the notional amount in a contract that lacks a specific notional amount is to consider the contract's settlement and default provisions. If the settlement or default provisions refer to anticipated quantities or the use of average historical quantities to calculate settlement, the contract generally contains a notional amount.

A notional amount should not be estimated. If a notional amount cannot be reliably and objectively quantified with information explicitly contained in the contract, attachments, appendices or other legally binding side agreements, the contract does not have a notional amount.



Question 3.3.70

Does a contract have a notional if the purchaser is required to notify the supplier of the units to be purchased in a subsequent quarter?

Interpretive response: Yes. We believe a requirement for a buyer to notify the seller of its purchases for the next quarter is an explicit provision in the contract that satisfies the requirement to determine the notional amount over the life of the contract. Because the entity is required to communicate this amount in advance for each quarter, the contract is considered to have a notional amount equal to the communicated purchase quantity for the next quarter.

Requirements vs nonrequirements contracts

Determining the notional amount of a contract, and whether that contract contains optionality, depends on whether the contract is a requirements or nonrequirements contract.



Question 3.3.80

What is a requirements contract?

Interpretive response: A requirements contract represents an agreement to purchase or sell as many units as needed of a specified item (with or without defined limits) by/to the end-user of the item being purchased or sold. Requirements contracts are common in most industries that use commodities as either a raw material or energy source in the production process.

To be a requirements contract, we believe the contract must contain language that limits the use of the subject item to consumption by the buyer and its affiliates – and therefore does not allow the buyer to be a reseller of the subject item to other entities.

Whether a contract is a requirements contract or a nonrequirements contract affects both the determination of whether a notional amount exists and, if it does, the amount of the notional. This is because optionality is disregarded for a requirements contract, but is not disregarded for a nonrequirements contract.

- **Whether a notional amount exists.** Disregarding optionality may result in a requirements contract not having a notional amount and, therefore, not meeting the definition of a derivative. For example, a requirements contract that does not include a determinable quantity or contractually-specified minimum does not have a notional amount, even if it has a contractually-specified maximum – see Question 3.3.100.

- **The notional amount.** When determining the notional amount of a requirements contract, optionality in excess of the deemed notional is disregarded, and therefore a requirements contract is always considered a forward contract. In contrast, a nonrequirements contract does not ignore optionality and may be considered a forward contract, an option contract, or a combination of an option and forward contract. Therefore, a requirements contract with optionality may have a different notional amount than a similar contract that is a nonrequirements contract.

Further, contracts with optionality generally are not eligible for the NPNS scope exception (see section 2.4). However, because optionality is disregarded for a requirements contract, requirements contracts may be eligible for that exception even if the contract includes optionality.



Question 3.3.90

How does optionality in a contract affect its notional amount?

Interpretive response: Some contracts contain a range of notional amounts, which is referred to as 'optionality.' How optionality affects notional amounts depends on the nature of notional amounts indicated and on whether the contract is a requirements or nonrequirements contract.

- **Determinable quantity.** If the contract contains explicit provisions that support the presence of a determinable quantity, the contract is deemed to have a notional amount (see also Question 3.3.60).
- **Contractually specified minimum.** If a contract includes a contractually specified minimum quantity, the contract is deemed to have a notional amount for at least the minimum amount.
 - The notional amount will be greater than the minimum if the contract has a determinable quantity that is greater than the minimum.
 - Further, the notional may be greater than the minimum if the contract includes a contractually specified maximum quantity that is greater than the minimum.
- **Contractually specified maximum.** Whether a contractually specified maximum affects the notional amount depends on whether the contract is a requirements or nonrequirements contract:
 - If a nonrequirements contract includes a contractually specified maximum quantity, the contract is deemed to have a notional amount that considers that maximum.
 - For a requirements contract, optionality in excess of a minimum amount or determinable quantity generally is disregarded.

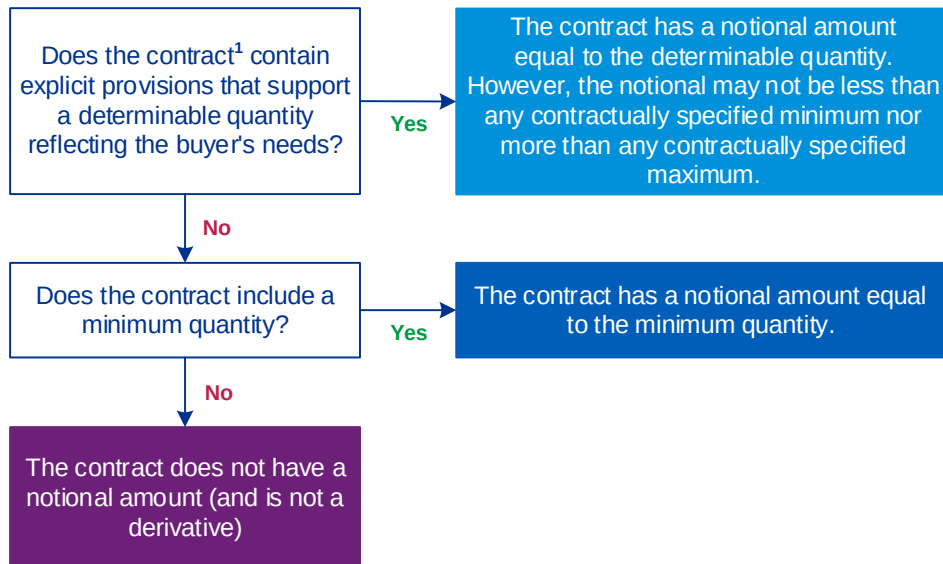
See also Questions 3.3.100 and 3.3.110 regarding identifying the notional amount in requirements and nonrequirements contracts, respectively.



Question 3.3.100

How is the notional amount identified in a requirements contract?

Interpretive response: The nature of a requirements contract is a forward contract. The following decision tree summarizes considerations in identifying the notional amount of a requirements contract.



¹ See also Question 3.3.60

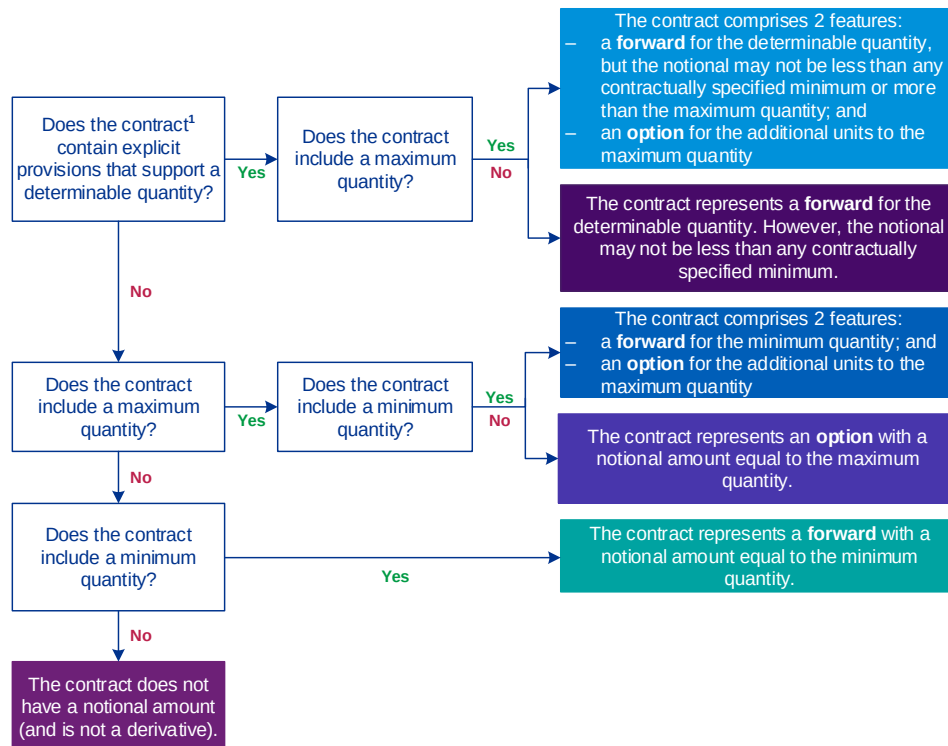


Question 3.3.110

How is the notional amount identified in a nonrequirements contract?

Interpretive response: The nature of a nonrequirements contract may be a forward contract, an option contract, or a combination of both. This is because optionality is not disregarded in a nonrequirements contract (see Question 3.3.90).

The following decision tree summarizes considerations in identifying the nature and notional amount of a nonrequirements contract.



¹ See also Question 3.3.60

Examples

The following FASB Examples (paragraphs 815-10-55-5 to 55-7) illustrate identifying a notional amount in various requirements contracts. They are followed by Example 3.3.20, which is adapted in part from the FASB Examples to further illustrate identifying the notional amount in various requirements and nonrequirements contracts.



Excerpt from ASC 815-10

>>> Notional Amount—Identifying a Commodity Contract's Notional Amount

55-5 Many commodity contracts specify a fixed number of units of a commodity to be bought or sold under the pricing terms of the contract (for example, a fixed price). However, some contracts do not specify a fixed number of units. For example, consider the following four contracts that require one party to buy the following indicated quantities:

- a. Contract 1: As many units as required to satisfy its actual needs (that is, to be used or consumed) for the commodity during the period of the contract (a requirements contract). The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).

- b. Contract 2: Only as many units as needed to satisfy its actual needs up to a maximum of 100 units. The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).
- c. Contract 3: A minimum of 60 units and as many units needed to satisfy its actual needs in excess of 60 units. The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).
- d. Contract 4: A minimum of 60 units and as many units needed to satisfy its actual needs in excess of 60 units up to a maximum of 100 units. The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).

55-6 Generally, the anticipated number of units covered by a requirements contract is equal to the buyer's needs. When a requirements contract is negotiated between the seller and buyer, both parties typically have the same general understanding of the buyer's estimated needs. Given the buyer's often exclusive reliance on the seller to supply all its needs of the commodity, it is imperative from the buyer's perspective that the supplier be knowledgeable with respect to anticipated volumes. In fact, the pricing provisions within requirements contracts are directly influenced by the estimated volumes.

55-7 This guidance focuses solely on whether the contracts under consideration have a **notional amount** pursuant to the definition in this Subtopic. These types of contracts may not satisfy certain of the other required criteria in this Subtopic for them to meet the definition of a **derivative instrument**. The conclusion that a requirements contract has a notional amount as defined in this Subtopic can be reached only if a reliable means to determine such a quantity exists. Application of this guidance to specific contracts is as follows:

- a. Contract 1—requirements contract. The identification of a requirements contract's notional amount may require the consideration of volumes or formulas contained in attachments or appendixes to the contract or other legally binding side agreements. The determination of a requirements contract's notional amount must be performed over the life of the contract and could result in the fluctuation of the notional amount if, for instance, the default provisions reference a rolling cumulative average of historical usage. If the notional amount is not determinable, making the quantification of such an amount highly subjective and relatively unreliable (for example, if a contract does not contain settlement and default provisions that explicitly reference quantities or provide a formula based on historical usage), such contracts are considered not to contain a notional amount as that term is used in this Subtopic. One technique to quantify and validate the notional amount in a requirements contract is to base the estimated volumes on the contract's settlement and default provisions. Often the default provisions of requirements contracts will specifically refer to anticipated quantities to utilize in the calculation of penalty amounts in the event of nonperformance. Other default provisions stipulate penalty amounts in the event of nonperformance based on average historical usage quantities of the buyer. If those amounts are determinable, they shall be considered the notional amount of the contract.
- b. Contract 2—requirements contract with a specified maximum quantity. Whether the contract has a notional amount depends. The same

- considerations discussed in (a) with respect to Contract 1 also apply to Contract 2; however, the notional amount cannot exceed 100 units.
- c. Contract 3—requirements contract with a specified minimum quantity. The contract has a notional amount. The same considerations discussed in (a) with respect to Contract 1 also apply to Contract 3; however, the notional amount of Contract 3 cannot be less than 60 units. A contract that specifies a minimum number of units always has a notional amount at least equal to the required minimum number of units. Only that portion of the requirements contract with a determinable notional amount would be accounted for as a derivative instrument under this Subtopic.
- d. Contract 4—requirements contract with a specified maximum and minimum quantities. The contract has a notional amount. The same considerations discussed in (a) with respect to Contract 1 also apply to Contract 4; however, the notional amount of Contract 4 cannot be less than 60 units or greater than 100 units. A contract that specifies a minimum number of units always has a notional amount at least equal to the required minimum number of units. Only that portion of the requirements contract with a determinable notional amount would be accounted for as a derivative instrument under this Subtopic.



Example 3.3.20

Identifying the notional amount in requirements and nonrequirements contracts

This example illustrates identifying the notional amount in requirements contracts as contrasted with nonrequirements contracts.

In each scenario, ABC Corp. has a contract to purchase units of a commodity from DEF Corp. at a fixed price. The contract's default provisions reference a rolling cumulative average of historical usage (see Question 3.3.60). At contract inception, that rolling cumulative average is calculated as 55 units.

In all scenarios, the requirements contract limits the use of the commodity to consumption by ABC, and therefore does not allow ABC to resell the commodity to other entities. The nonrequirements contracts do not include such limits. See also Question 3.3.90.

Analysis for requirements contract	Analysis for nonrequirements contract
Scenario 1: The contract permits ABC to purchase as many units as it wants (subject to the use limit for the requirements contract). It does not specify a minimum or maximum amount to be purchased.	
Because the contract's default provisions reference a rolling cumulative average of historical usage, the contract has a determinable quantity; this is the notional amount. As a result, the contract is considered a forward contract with a notional amount of 55 units at contract inception.	Similar to the analysis for the requirements contract, the contract's default provisions result in the contract having a determinable quantity, which constitutes the notional amount. As a result, the contract is considered a forward contract with a notional amount of 55 units.

Analysis for requirements contract	Analysis for nonrequirements contract
The ability of ABC to purchase more units (if needed) represents optionality that is disregarded for a requirements contract. Therefore, if the contract meets the definition of a derivative, it may be eligible for the NPNS scope exception (see section 2.4).	The ability of ABC to purchase more units (if needed) represents optionality for which there is no notional amount because there is no maximum specified.
Scenario 2: The same as Scenario 1, except that the contract entitles ABC to purchase a maximum of 100 units.	
As in Scenario 1, the contract represents a forward to purchase 55 units. The ability of ABC to purchase an additional 45 units (if needed) represents optionality that is disregarded for a requirements contract. Therefore, if the contract meets the definition of a derivative, it may be eligible for the NPNS scope exception (see section 2.4).	The contract comprises two features: — a forward component to purchase 55 units (the determinable quantity based on the contract's default provisions, as in Scenario 1); and — an option component to purchase 45 units (the maximum of 100 units less the determinable quantity of 55 units).. Note: If the contract's default provisions had not provided for a determinable quantity, the contract would represent an option to purchase 100 units.
Scenario 3: The same as Scenario 1, except that the contract requires ABC to purchase a minimum of 60 units.	
Although the contract's default provisions reference a rolling cumulative average (which is a determinable quantity), that determinable quantity of 55 units is less than the contractually specified minimum of 60 units. A contract that specifies a minimum number of units always has a notional amount equal to at least the required minimum number of units. As a result, the contract represents a forward to purchase 60 units (the contractually specified minimum). The ability of ABC to purchase more units (if needed) represents optionality that is disregarded for a requirements contract. Therefore, if the contract meets the definition of a derivative, it may be eligible for the NPNS scope exception (see section 2.4).	Similar to the analysis for the requirements contract, this contract comprises a forward contract to purchase 60 units (the contractually specified minimum). The ability of ABC to purchase more units (if needed) represents optionality for which there is no notional amount because there is no maximum specified.
Scenario 4: The same as Scenario 1, except that the contract requires ABC to purchase a minimum of 60 units and entitles ABC to purchase a maximum of 100 units.	
As in Scenario 3, the contract represents a forward to purchase 60 units (the contractually specified minimum).	This contract comprises two features: — a forward component to purchase 60 units (the contractually specified minimum); and

Analysis for requirements contract	Analysis for nonrequirements contract
The ability of ABC to purchase 40 more units (if needed) represents optionality that is disregarded for a requirements contract. Therefore, if the contract meets the definition of a derivative, it may be eligible for the NPNS scope exception (see section 2.4).	— an option component to purchase 40 units (the difference between the maximum and minimum requirements).

3.4 Initial net investment

3.4.10 Overview



Excerpt from ASC 815-10

> Definition of Derivative Instrument

15-83 A derivative instrument is a financial instrument or other contract with all of the following characteristics: ...

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

>> Initial Net Investment

15-94 Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for one or both of the following:

- a. Time value (for example, a premium on an option)
- b. 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.

15-95 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. For example:

- a. 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).

- b. A swap or forward contract generally does not require an initial net investment unless the terms favor one party over the other.
- c. 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.

15-96 If the initial net investment in the contract (after adjustment for the time value of money) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying or to incur the obligation related to the underlying, the characteristic in paragraph 815-10-15-83(b) is met. The amount of that asset acquired or liability incurred should be comparable to the effective notional amount of the contract. This does not imply that a slightly off-market contract cannot be a derivative instrument in its entirety. That determination is a matter of facts and circumstances and shall be evaluated on a case-by-case basis. Example 16, Case C (see paragraph 815-10-55-166) illustrates the guidance in this paragraph.

15-97 A contract that requires an initial net investment in the contract that is in excess of the amount determined by applying the effective notional amount to the underlying is not a derivative instrument in its entirety. Example 16, Case A (see paragraph 815-10-55-150) illustrates such a contract.

15-98 The phrase *initial net investment* is stated from the perspective of only one party to the contract, but it determines the application of this Subtopic for both parties. Even though a contract may be a derivative instrument as described in paragraphs 815-10-15-13 through 15-139 for both parties, the scope exceptions in paragraphs 815-10-15-74 through 15-75 apply only to the issuer of the contract and will result in different reporting by the two parties. The normal purchases and sales scope exception (beginning in paragraph 815-10-15-22) also may apply to one of the parties but not the other.



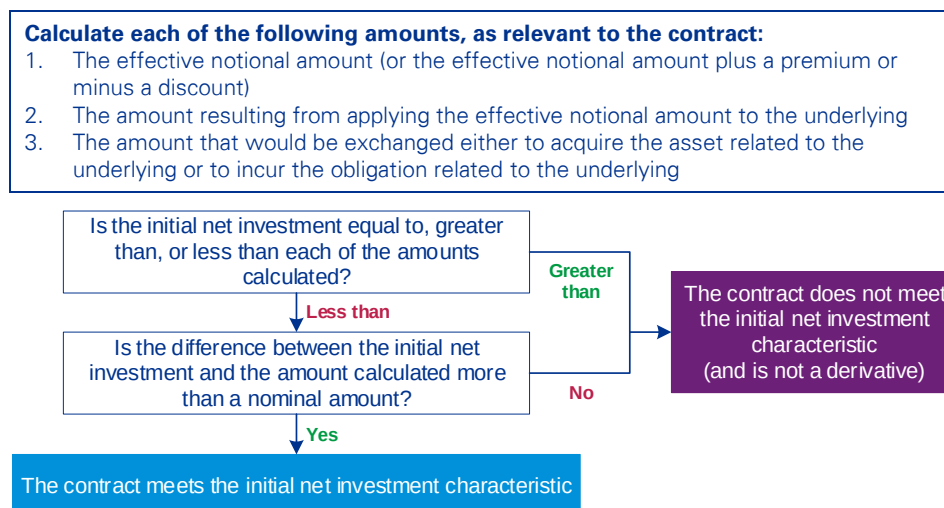
Many derivatives require no initial net investment (e.g. many interest rate swaps), while other derivatives require an investment to compensate one party for time value and/or for off-market terms (e.g. an option).

Under Topic 815, one of the characteristics of a derivative is that a contract requires no initial net investment, or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. This is referred to as the 'initial net investment characteristic'. This characteristic is stated from the perspective of only one party to the contract, but it determines the application of Topic 815 for both parties. [815-10-15-83(b), 15-98]

To meet the initial net investment characteristic, the following three criteria must all be met.

Criterion 1 [815-10-15-95]	The initial net investment is not equal to (1) the effective notional amount, or (2) the effective notional amount plus a premium or minus a discount. In general, the FASB concluded that providing the opportunity to participate in some or all of the price changes of an underlying without actually having to own an associated asset or owe a liability is a basic feature that distinguishes most traditional derivative instruments (e.g. futures contracts on specified Treasury bonds) from nonderivative instruments (e.g. Treasury bonds on which the futures contracts are based). [FAS 133.BC255] Therefore, the FASB decided that a contract that requires the holder or writer to invest or receive an amount approximating the notional amount does not meet the initial net investment characteristic, and therefore is not a derivative instrument. However, instruments for which an initial investment is made solely to compensate for the time value of money or for terms that are more or less favorable than market meets the initial net investment characteristic. Those instruments are derivatives if they also meet the other derivative characteristics. [815-10-15-94, FAS 133.BC255]
Criterion 2 [815-10-15-95]	The initial net investment is not determined by applying the effective notional amount to the underlying.
Criterion 3 [815-10-15-96]	The initial net investment (after adjustment for the time value of money) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying, or to incur the obligation related to the underlying.

The following decision tree summarizes how an entity determines whether a contract meets the initial net investment characteristic.





Question 3.4.10

Does an entity consider all three criteria to determine whether a contract has the initial net investment characteristic?

Interpretive response: Topic 815 does not explicitly allow an entity to disregard any criterion when evaluating different types of contracts. However, an entity may find that only certain criteria are relevant to a particular type of contract, such as when a contract contains an underlying that:

- does not relate to a specific asset – e.g. a contract that relates to interest rates or foreign exchange rates; in this case, Criterion 2 is relevant.
- relates to a specific asset – e.g. a forward purchase contract for an unrelated entity's stock; in this case, Criteria 1 and 3 are relevant.



Question 3.4.20

What does 'effective notional amount' mean?

Interpretive response: The effective notional amount is the stated notional amount adjusted for any leverage factor. [\[815-10 Glossary\]](#)

When a contract has leverage, the stated notional amount must be adjusted to an effective notional amount before applying any of the initial net investment criteria. For example, a prepaid interest rate swap has a stated notional amount of \$10 million and pays interest at a rate of two times LIBOR. The effective notional amount is \$20 million: \$10 million (stated notional amount) × 2 (leverage factor).



Question 3.4.30

Does Topic 815 include a quantitative threshold for evaluating whether the initial net investment characteristic is met?

Interpretive response: No. Instead, paragraph 815-10-15-96 provides broad qualitative guidance. It states that the initial net investment must be "*less, by more than a nominal amount*, than the initial net investment that would be commensurate with the amount that would be exchanged..." [\[Emphasis added\]](#)

We believe the 'less, by more than a nominal amount' concept should be used in evaluating all of the criteria for determining whether the initial net investment characteristic is met. Further, we believe that an initial net investment of less than 90% of the amount calculated under each criterion should generally result in a contract meeting the initial net investment characteristic.

However, we believe the substance of an arrangement should also be considered when evaluating whether this characteristic is met, especially when a transaction is structured to achieve a specific accounting result. For example,

when a forward contract requires an initial investment at inception of the contract, the buyer ordinarily is the party required to make that initial investment. If the seller (rather than the buyer) under a forward contract is required to make an initial investment in exchange for an exercise price that is greater than the market price, we believe analyzing the arrangement's substance may indicate that the seller's investment should be disregarded when evaluating the net investment criterion.



Question 3.4.40

Does a fully prepaid non-option contract meet the initial net investment characteristic?

Interpretive response: No. Under Criteria 2 and 3, a non-option contract that is fully prepaid does not meet the initial net investment characteristic because such a contract would involve either:

- one party investing all future cash outflows that it would be required to make under the contract and no longer having to sacrifice additional assets to settle the contract – see Example 3.4.20 Scenarios 1 and 2, and Example 3.4.40 Scenario 1; or
- one party investing an amount equal to the amount that would be exchanged to acquire the underlying asset(s) or to incur the obligation related to the underlying – see Example 3.4.50 Scenario 2.



Question 3.4.50

Does the initial exchange of currencies in a currency swap preclude it from meeting the initial net investment characteristic?



Excerpt from ASC 815-10

>>> Initial Net Investment—Initial Exchange Under Currency Swap Is Not an Initial Net Investment

55-8 The definition of a derivative instrument includes contracts that require gross exchanges of currencies (for example, currency swaps that require an exchange of different currencies at both inception and maturity). 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.

Interpretive response: No. Currency swaps generally require an exchange of the notional amounts of the different currencies at inception and again at maturity. The FASB decided that the initial exchange of currencies does not represent an investment of the notional amount of the contract. Instead, it is the exchange of one kind of cash for another kind of cash of equal value. [815-10-15-94, 55-8]

For purposes of applying the initial net investment characteristic, a currency swap can be analyzed by dividing it into two transactions. [815-10-55-8]

- The first transaction is an exchange of foreign currencies, which generally occurs at inception of the contract. This is the exchange of one kind of cash for another kind of cash of equal value, which is not a transaction that gives rise to a derivative instrument.
- The second transaction is a forward contract to re-exchange the currencies for a specified price at a specified date in the future. This transaction obligates and entitles both parties to exchange specified currencies on specified dates at specified prices and is accounted for as a derivative instrument if it meets the other characteristics of a derivative instrument.



Question 3.4.60

Does a repurchase agreement meet the initial net investment characteristic when the initial transfer of a financial asset is accounted for as a sale?



Excerpt from ASC 815-10

>>> Repurchase Agreements and Wash Sales

55-56 Repurchase agreements and wash sales that are accounted for as sales (as described in paragraphs 860-10-55-55 and 860-10-55-57) and in which the transferor is both obligated and entitled to repurchase the transferred asset at a fixed or determinable price contain two separate features, one of which may be a derivative instrument. 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 as discussed beginning in paragraph 815-10-15-99, it is subject to the requirements of this Subtopic.

Background: A repurchase agreement (repo agreement) is an agreement under which the transferor (repo party) transfers a financial asset to a transferee (repo counterparty or reverse party) in exchange for cash; and concurrently agrees to reacquire that financial asset at a future date for an amount equal to the cash

exchanged plus or minus a stipulated interest factor. Instead of cash, other securities or letters of credit are sometimes exchanged. Some repo agreements call for repurchase of financial assets that need not be identical to the financial assets transferred. [860-10 Glossary]

Under Topic 860, the initial transfer is accounted for as a sale if certain criteria are met.

Interpretive response: Yes. When the initial transfer of a financial asset is accounted for as a sale, the repo agreement is a forward contract that does not require any initial net investment.

When a repurchase agreement is accounted for as a sale, it can be analyzed by dividing it into two transactions.

- The initial exchange is a transfer of financial assets for cash (or noncash) consideration. This is not a transaction that gives rise to a derivative instrument.
- The second transaction is a forward contract to repurchase the transferred financial asset. This transaction gives the transferor the right and obligation to repurchase or redeem the assets and does not require an initial net investment in the forward contract.

The repo agreement is accounted for as a derivative instrument if it meets the other characteristics of a derivative instrument.



Question 3.4.70

Do short sales meet the initial net investment characteristic?



Excerpt from ASC 815-10

>>> Short Sales (Sales of Borrowed Securities)

55-57 The following discussion applies only to short sales with the characteristics described. 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. Short sales (sales of borrowed securities) typically involve all of the following activities:

- a. Selling a security (by the short seller to the purchaser)
- b. Borrowing a security (by the short seller from the lender)
- c. Delivering the borrowed security (by the short seller to the purchaser)
- d. Purchasing a security (by the short seller from the market)
- e. Delivering the purchased security (by the short seller to the lender).

Those five activities involve three separate contracts.

55-58 A contract that distinguishes a short sale involves activities in (b) and (e) in the preceding paragraph, 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, no initial net investment or an initial net investment that is smaller by more than a nominal amount than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, is not present. (See paragraphs 815-10-15-94 through 15-96.) The borrowed security is the lender's initial net investment in the contract. Consequently, the contract relating to activities in (b) and in (e) in the preceding paragraph is not a derivative instrument.

55-59 The other two contracts (one for activities in paragraph 815-10-55-57[a] and in paragraph 815-10-55-57[c] and the other for activity in paragraph 815-10-55-57[d]) are routine and do not generally involve derivative instruments. However, if a forward purchase or forward sale is involved, and the contract does not qualify for the exception in paragraphs 815-10-15-15 through 15-17, it is subject to the requirements of this Subtopic.

Background: ABC Corp. owns 1,000 shares of DEF Corp. that it plans to sell at the end of a one-month restriction period. The DEF shares cost ABC \$10 per share and they are now trading at \$20 per share.

ABC is concerned that DEF's share price will decline in the coming month and wants to mitigate this exposure. To do so, ABC borrows 1,000 shares of DEF from Bank for one month. ABC immediately sells these shares in the open market for \$20 per share.

At the end of the month, ABC satisfies its obligation to Bank by providing the 1,000 shares of DEF that it owns (which are no longer restricted).

Interpretive response: ABC's arrangement with Bank is a short sale arrangement. The FASB intentionally did not address whether short sale arrangements always (or never) meet the definition of a derivative instrument because the terms and related customary practices of the contracts vary. Instead, the specific terms of a contract must be evaluated to determine whether it meets the definition of a derivative instrument.

However, Topic 815 does address the specific short sale arrangement described in the example and indicates that it does not meet the initial net investment characteristic because the initial net investment is equal to the notional amount. Specifically, ABC is required to obtain (when it borrows the shares) and deliver (when it sells the shares) 1,000 shares of DEF, which is the notional amount. [\[815-10-55-57\]](#)

Topic 815 also addresses the following other types of contracts typically involved in a short sale arrangement: [\[815-10-55-57\]](#)

- the short seller selling a security to the purchaser;
- the short seller delivering a borrowed security to the purchaser; and
- the short seller purchasing a security from the market.

Topic 815 states that these types of contracts are routine and are not generally derivative instruments. However, if a forward purchase or sale is involved and the contract does not qualify for a relevant scope exception (e.g. the scope

exception for regular way trades discussed in section 2.3), it may be a derivative. [815-10-55-59]



Question 3.4.80

What amount is considered to be the net investment when an existing derivative is amended or modified, resulting in recognition of a new instrument?

Background: Derivative counterparties may agree to amend the terms of a derivative. In some cases, the amendment is viewed as a termination of the existing derivative and an issuance of a new instrument. This may occur if, for example, the derivative's substantive terms – such as its strike price or maturity date – are changed (see also section 6.10.30, including Question 6.10.70). In these cases, it is necessary to determine whether the newly-issued instrument meets the definition of a derivative, including whether it meets the initial net investment characteristic.

Interpretive response: When an amended derivative is viewed as the issuance of a new instrument, we believe the fair value of the existing (unamended) derivative should be used when determining whether the newly-issued (amended) instrument meets the initial net investment characteristic.

For example, assume ABC Corp previously entered into a pay-fixed, receive-variable interest rate swap with DEF Bank. Market interest rates (including the forward rate curve) have decreased since the swap's inception resulting in the swap's fair value being recorded as a \$5 million liability in ABC's financial statements at June 30, Year 1. On July 1, Year 1, ABC and DEF agree to amend the terms of the swap to extend its maturity date and to modify the fixed-rate leg of the swap. No other consideration is exchanged. Although the fixed rate is reduced, it is higher than market terms on July 1. The higher than market rate results in ABC making fixed payments over the extended term of the swap that effectively repays its \$5 million obligation under the existing (unamended) swap. In determining whether the initial net investment characteristic is met, ABC would consider the fair value of the existing (unamended) swap (\$5 million) to be its initial net investment in the amended (i.e. newly-issued) swap.

3.4.20 Examples

The initial net investment characteristic is met when one (or more) of the three criteria discussed in section 3.4.10 are met. The following examples illustrate whether each individual criterion is met. When an individual criterion is not met, additional analysis of the other initial net investment criteria should be performed (see Question 3.4.10).

- **Criterion 1:** Example 3.4.10 illustrates determining whether Criterion 1 is met for the purchase of a security and a forward contract to purchase a security.

- **Criterion 2:** Subtopic 815-10's Example 16 illustrates determining whether Criterion 2 is met for three prepaid interest rate swaps – i.e. interest rate swaps that required an initial net investment to be made. It is followed by:
 - Example 3.4.20, which is adapted from Example 16 to further illustrate whether Criterion 2 is met for three prepaid interest rate swaps; and
 - Example 3.4.30, which illustrates whether Criterion 2 is met for an off-market interest rate swap.
- **Criterion 3:** Subtopic 815-10's Example 2 illustrates how to determine whether Criterion 3 is met for a prepaid forward contract. It is followed by:
 - Example 3.4.40, which is adapted in part from Example 2 to further illustrate whether Criterion 3 is met for two forward contracts; and
 - Example 3.4.50, which illustrates whether Criterion 3 is met for two option contracts to purchase an equity security.



Example 3.4.10

Purchase of security versus forward contract to purchase security

This example is adapted from an example in the basis for conclusions to Statement of Financial Accounting Standards No. 133. [FAS 133.BC256]

ABC Corp. wishes to participate in changes in the fair value of 10,000 shares of DEF Corp's common stock, which is a marketable equity security.

Scenario 1: ABC purchases DEF's common stock

ABC purchases 10,000 shares of DEF's common stock. The purchase requires ABC to make an initial investment equal to the current price of those shares. It also results in ABC participating in other benefits of security ownership – e.g. being entitled to receive any dividends and to vote the shares.

This transaction is not a derivative instrument because it requires an initial investment commensurate with the amount that would be exchanged to acquire the asset related to the underlying. In this scenario, the asset is acquired.

Scenario 2: ABC enters into a forward contract to purchase DEF's common stock

ABC enters into a forward purchase contract with a notional amount of 10,000 shares of DEF's common stock; no consideration is exchanged in connection with entering into the forward contract. The purchase price under the contract is fixed at the forward price of 10,000 shares of DEF's common stock on the date the forward contract was entered into.

The forward contract meets Criterion 1 because the contract does not require ABC to make an initial investment equal to (1) the effective notional amount, or (2) the effective notional amount plus a premium or minus a discount. It is accounted for as a derivative instrument if it meets the other characteristics of a derivative instrument.



Excerpt from ASC 815-10

>> Example 16: Prepaid Interest Rate Swap

55-148 The following Cases illustrate the accounting for a **prepaid interest rate swap**:

- a. Prepaid interest rate swap (Case A)
- b. Prepaid interest rate swap that must be bifurcated (Case B)
- c. Prepaid interest rate swap variation (Case C).

55-149 Cases A, B, and C assume both parties to the contract have the same AA credit rating. If the party that is obligated to make the variable payments has a different credit rating (such as BBB), the effect of that different creditworthiness should be reflected in the discount rate used to determine the present value of the amounts payable by that party under the contract.

>>> Case A: Prepaid Interest Rate Swap

55-149A Case A illustrates the application of paragraph 815-10-15-97.

55-150 Entity A pays \$1,228,179 to enter into a prepaid interest rate swap contract that requires the counterparty to make quarterly payments based on a \$10,000,000 **effective notional amount** and a variable interest rate equal to 3-month U.S. dollar- (USD-) denominated **London Interbank Offered Rate (LIBOR)**. The prepaid interest rate swap contract is characterized as an at-the-money 2-year interest rate swap with a \$10,000,000 notional amount, a fixed interest rate of 6.65 percent, and a variable interest rate of the 3-month USD LIBOR (that is, the same terms as the swap in Example 6 [see paragraph 815-30-55-24], which has a zero fair value at inception), for which the fixed leg has been fully prepaid. The amount of \$1,228,179 is the present value of the 8 quarterly fixed payments of \$166,250—that is, $\$10,000,000 \times \text{LIBOR swap rate of } 6.65 \text{ percent} / 4$). The present value is based on the implied spot rate for each of the 8 payment dates under the assumed initial yield curve in that Example.

55-151 The prepaid interest rate swap contract could also be characterized as a 2-year, structured note (contract) with a principal amount of \$1,228,179 and loan payments based on a formula equal to 8.142 times 3-month USD LIBOR. (Note that $8.142 = 10,000,000 / 1,228,179$.) The terms of the structured note specify no repayment of the principal amount either over the two-year term of the structured note or at the end of its term. The 8.142 leverage factor causes the **effective notional amount** of the structured note also to be \$10,000,000.

55-152 The prepaid interest rate swap contract meets the characteristic of a derivative instrument in paragraph 815-10-15-83(a) because it has an underlying and an effective notional amount. It also meets the characteristic of a derivative instrument in paragraph 815-10-15-83(c) because neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (see paragraph 815-10-15-100). At issue is whether the prepaid interest rate swap contract meets the

characteristic of a derivative instrument described in paragraph 815-10-15-83(b) related to the initial net investment in a contract.

55-153 The prepaid interest rate swap contract does not meet the definition of a derivative instrument because it does not satisfy the characteristic of a derivative instrument described in paragraph 815-10-15-83(b) related to the initial net investment in the contract. Specifically, the prepaid interest rate swap contract is excluded from the definition of a derivative instrument by the clarifying guidance on initial net investment beginning in paragraph 815-10-15-94. The prepaid interest rate swap contract in this Case requires an initial net investment that is determined by applying the effective notional amount of \$10,000,000 to the underlying (3-month USD LIBOR) for each of the 8 payment dates specified by the terms of the contract. The initial net investment of \$1,228,179 required to enter into the contract is the present value of the 8 quarterly fixed-leg swap payments of \$166,250—that is, $\$10,000,000 \times 6.65 \text{ percent} / 4$. Because the LIBOR swap rate reflects the applicable portions of the forward three-month USD LIBOR rate curve for the settlement dates that relate to the specific payments under the swap, the initial net investment is considered to have been determined by applying the effective notional amount to the underlying and then adjusted for the time value of money.

55-154 That is, as stated in paragraph 815-10-15-97, a contract that requires an initial net investment in the contract that is in excess of the amount determined by applying the effective notional amount to the underlying is also not a derivative instrument in its entirety.

55-155 See related analysis in Case B.

>>> Case B: Prepaid Interest Rate Swap that Must Be Bifurcated

55-156 Entity B pays \$1,782,245 to enter into a prepaid interest rate swap contract that requires the counterparty to make quarterly payments based on a \$10,000,000 effective notional amount and a variable interest rate equal to the sum of 3-month USD LIBOR and 300 basis points. The prepaid interest rate swap contract is characterized as an at-the-money 2-year interest rate swap with a \$10,000,000 notional amount, a fixed interest rate of 9.65 percent, and a variable interest rate of 3-month USD LIBOR plus 300 basis points, for which the fixed leg has been fully prepaid. The amount of \$1,782,245 is the present value of the 8 quarterly fixed payments of \$241,250—that is, $\$10,000,000 \times \text{the fixed rate of } 9.65 \text{ percent} / 4$. The present value is based on the implied spot rate for each of the 8 payment dates under the assumed initial yield curve in Example 6 (see paragraph 815-30-55-24).

55-157 In this Case, the underlying is 3-month USD LIBOR (even though the variable rate is 3-month USD LIBOR plus 300 basis points) and the amount determined by applying the effective notional amount to the underlying (and then adjusted for the time value of money) is \$1,228,179, the same as in Case A. The initial net investment for the prepaid interest rate swap in this Case is \$1,782,245, an amount that is in excess of \$1,228,179—the amount referred to in paragraph 815-10-15-95 as being determined by applying the effective notional amount to the underlying. Consequently, the prepaid interest rate swap in this Case is not a derivative instrument in its entirety.

55-158 Because the prepaid interest rate swap contract is not a derivative instrument in its entirety, it should be evaluated to determine whether the

contract contains an embedded derivative that, pursuant to paragraph 815-15-25-1, requires separate accounting as a derivative instrument.

55-159 The prepaid interest rate swap contracts in Cases A and B are hybrid instruments that are composed of a debt instrument (the host contract) and an embedded derivative based on three-month USD LIBOR.

55-160 The embedded derivative contains a provision that could result in the investor (that is, the entity receiving the variable payments) not recovering substantially all of its initial recorded investment in the hybrid instrument under its contractual terms. That is, LIBOR may possibly decrease to such a level that the investor may not recover its initial net investment.

55-161 Therefore, the embedded interest rate swap is not considered clearly and closely related to the host contract under paragraph 815-15-25-26(a) with respect to the accounting by both parties to the contract.

55-162 That paragraph states that if an embedded interest rate derivative contains a provision that permits any possibility whatsoever that the investor's (or creditor's) undiscounted net cash inflows over the life of the instrument would not enable the investor to recover substantially all of its initial recorded investment in the hybrid instrument under its contractual terms, the embedded derivative and the debt host contract are not clearly and closely related.

55-163 Therefore, unless the contracts described in Cases A and B are remeasured at fair value with changes in value recorded in earnings as they occur, both prepaid interest rate swap contracts should be bifurcated by both parties to the contract into a debt host contract whose initial carrying amount is equal to the fair value of the prepaid interest rate swap contracts (\$1,228,179 and \$1,782,245, respectively) and an interest rate swap whose fair value is zero at inception of the hybrid instrument, consistent with the guidance in paragraph 815-15-30-4.

55-164 The bifurcated interest rate swap contains no financing element that would require special cash flow reporting under paragraphs 815-10-45-11 through 45-15.

55-165 The reporting of the cash flows for the related debt host contract would be subject to the provisions of Topic 230.

>>> Case C: Prepaid Interest Rate Swap Variation

55-166 Entity C pays \$1,043,490 to enter into a contract that requires the counterparty to make quarterly payments based on a \$10,000,000 effective notional amount and a variable interest rate equal to the 3-month USD LIBOR minus 100 basis points. In the event that 3-month USD LIBOR is less than 100 basis points, Entity C is obligated to make payments to the counterparty. The prepaid interest rate swap contract is characterized as an at-the-money 2-year interest rate swap with a \$10,000,000 notional amount, a fixed interest rate of 5.65 percent, and a variable interest rate of 3-month USD LIBOR minus 100 basis points, for which the fixed leg has been fully prepaid. The amount of \$1,043,490 is the present value of the 8 quarterly fixed payments of \$141,250—that is, $\$10,000,000 \times \text{the fixed rate of } 5.65 \text{ percent} / 4$. The present value is based on the implied spot rate for each of the 8 payment dates under the assumed initial yield curve in Example 6 (see paragraph 815-30-55-24).

55-167 In this Case, the underlying is 3-month USD LIBOR (even though the variable rate is 3-month USD LIBOR minus 100 basis points) and the amount determined by applying the effective notional amount to the underlying (and then adjusted for the time value of money) is \$1,228,179, the same as in Case A. The initial net investment for the contract in this Case is \$1,043,490, an amount that is less than \$1,228,179. (The contract is considered not to be fully prepaid because Entity C has not prepaid all obligations imposed on it by the contract; Entity C is obligated to make future payments under certain conditions, as noted in the preceding paragraph.) The difference of \$184,689 (about 15 percent) is more than a nominal amount if compared to \$1,228,179. Consequently, the contract in this Case is a derivative instrument in its entirety.

55-168 The amounts in this Case are not intended to provide quantitative guidance for distinguishing between being less by more than a nominal amount and being less by only a nominal amount. The initial net investment for a contract could be less than the amount determined by applying the effective notional amount to the underlying by a percentage lower than 15 percent and still be considered to be *less, by more than a nominal amount* under paragraph 815-10-15-96.



Example 3.4.20 Prepaid interest rate swaps

The following example is adapted from Subtopic 815-10's Example 16.

ABC Corp. enters into a pay-fixed, receive-variable interest rate swap with Bank. The following information related to the swap is relevant to all scenarios in this example.

- The swap has a notional (and effective notional) amount of \$10,000,000 and a two-year term.
- The underlying is three-month USD LIBOR.
- The present value of the payments under the fixed leg is based on the implied spot rate for each of the eight payment dates (i.e. quarterly payments for two years) under an assumed initial yield curve.
- There are no differences in the credit risks of ABC and Bank.
- ABC's initial net investment represents the present value of payments to be made under the fixed leg. In essence, ABC has fully prepaid the amounts it will owe under the fixed leg of the swap (as adjusted for the time value of money). However, in Scenario 3, ABC could potentially be required to make payments under the variable leg, and as a result the swap is not fully prepaid.

	Scenario 1	Scenario 2	Scenario 3
Additional terms of prepaid interest rate swap			
Required initial net investment (A)	\$1,228,179	\$1,782,245	\$1,043,490

	Scenario 1	Scenario 2	Scenario 3
Additional terms of prepaid interest rate swap			
Variable leg	three-month USD LIBOR	three-month USD LIBOR + 300 bps	three-month USD LIBOR - 100 bps ¹
Fixed leg	6.65%	9.65%	5.65%
Present value of payments to be made under the fixed leg (at an assumed yield curve)	\$1,228,179	\$1,782,245	\$1,043,490
Analysis of initial net investment characteristic – Criterion 2			
Amount determined by applying the underlying (three-month USD LIBOR) to the effective notional (\$10 million), adjusted for the time value of money (B)	\$1,228,179 ²	\$1,228,179 ²	\$1,228,179 ²
Is the initial net investment characteristic met? <i>(i.e. is (A) less than (B) by more than a nominal amount?)</i>	No. The required initial net investment (A) is <i>equal to</i> the amount determined by applying the effective notional to the underlying, adjusted for the time value of money (B) . This swap is fully prepaid.	No. The required initial net investment (A) is <i>greater than</i> the amount determined by applying the effective notional to the underlying, adjusted for the time value of money (B) . This swap is fully prepaid.	Yes. The required initial net investment (A) is <i>less than</i> the amount determined by applying the effective notional to the underlying, adjusted for the time value of money (B) . The difference of \$184,689 (\$1,228,179 - \$1,043,490) represents a 15% ³ shortfall, which is considered to be more than nominal (see also Question 3.4.30). This swap is not fully prepaid. ¹

	Scenario 1	Scenario 2	Scenario 3
Additional terms of prepaid interest rate swap			
Nature of the prepaid interest rate swap contract	Debt instrument (host contract) with an embedded derivative (based on three-month USD LIBOR) that may require bifurcation ⁴	Debt instrument (host contract) with an embedded derivative (based on three-month USD LIBOR) that may require bifurcation ⁴	Derivative instrument in its entirety
Notes: 1. If three-month USD LIBOR is less than 100 bps, ABC will be required to make payments under both the fixed and variable legs. As a result, ABC has not fully prepaid all amounts that it may be obligated to pay under the interest rate swap. 2. The amount determined by applying the effective notional amount to the underlying, adjusted for the time value of money, is the present value of 8 quarterly fixed payments of \$166,250: $(\\$10,000,000 \times \text{LIBOR swap rate of } 6.65\%) \div 4$. The present value is based on the implied spot rate for each of the 8 payment dates under an assumed initial yield curve. This is the same in all scenarios because the underlying is three-month USD LIBOR in all scenarios, even when the variable leg includes a fixed spread above or below three-month USD LIBOR. See section 3.3.20 for discussion of identifying the underlying. 3. $\\$184,689 \div \\$1,228,179$. 4. ABC would evaluate whether the contract includes an embedded interest rate swap that requires bifurcation			



Example 3.4.30 Off-market interest rate swap

ABC Corp. enters into a pay-fixed, receive-variable interest rate swap with Bank.

- The swap has a notional (and effective notional) amount of \$50 million and a five-year term.
- The receive-variable leg is three-month USD LIBOR (the underlying) plus 1%.
- The pay-fixed leg is 8.5%, although an interest rate swap with comparable terms would be paying a fixed rate of 8.55% in the market at inception of the contract.
- ABC is required to pay Bank \$10,000 at inception of the transaction. This payment represents compensation for the fact that the interest rate swap is off-market – i.e. ABC will pay 8.5% under the fixed leg of the swap rather than a market rate of 8.55%.

The interest rate swap meets the initial net investment characteristic. Many derivative instruments require an initial investment to compensate for terms that are more or less favorable than market conditions. However, the initial net investment on the interest rate swap in this example does not equal the notional amount of \$50 million or the notional amount plus a premium or minus a discount (Criterion 1), and is not determined by applying the notional

amount to the underlying (Criterion 2). Rather, it is less than those amounts by more than a nominal amount. [815-10-15-94 – 15-95, 15-97]



Excerpt from ASC 815-10

>> Example 2: Initial Net Investment—Forward Contract Embedded with Equity Derivative

55-73 This Example illustrates whether a contract meets the criterion in paragraph 815-10-15-83(b) related to initial net investment and therefore meets the definition of a derivative instrument and, if not, whether there is an embedded derivative that warrants separate accounting.

55-74 An entity enters into a forward contract that requires the purchase of 1 share of an unrelated entity's common stock in 1 year for \$110 (the market forward price) and at inception of the contract, the entity elects to prepay the contract pursuant to its terms for \$105 (the current price of the share of common stock).

55-75 If no prepayment is made at inception, the contract would meet the criterion in paragraph 815-10-15-83(b) because it does not require an initial net investment but, rather, contains an unexercised election to prepay the contract at inception. If the contract gives the entity the option to prepay the contract at a later date during its 1-year term (at \$105 or some other specified amount), exercise of that option would be accounted for as a loan that is repayable at \$110 at the end of the forward contract's 1-year term. If, instead, the entity elects to prepay the contract at inception for \$105, the contract does not meet the definition of a freestanding derivative instrument. The initial net investment of \$105 is equal to the initial price of the 1 share of stock being purchased under the contract and therefore is equal to the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors. That is, the initial net investment is equal to the amount that would be exchanged to acquire the asset related to the underlying.

55-76 However, the entity must assess whether that nonderivative instrument contains an embedded derivative that, pursuant to paragraph 815-15-25-1, requires separate accounting as a derivative unless the fair value election is made pursuant to paragraph 815-15-25-4. In this instance, the prepaid contract is a hybrid instrument that is composed of a debt instrument as the host contract (that is, a loan that is repayable at \$110 at the end of the forward contract's 1-year term) and an embedded derivative based on equity prices. The host contract is a debt instrument because the holder has none of the rights of a shareholder, such as the ability to vote the shares and receive distributions to shareholders. (See paragraph 815-15-25-16.) Unless the hybrid instrument is remeasured at fair value with changes in value recorded in earnings as they occur, the embedded derivative must be separated from the host contract because the economic characteristics and risks of a derivative based on equity prices are not clearly and closely related to a debt host contract, and a separate instrument with the same terms as the embedded

derivative would be a derivative instrument subject to the requirements of this Subtopic.



Example 3.4.40

Prepaid forward contract to purchase equity security

This example is adapted from Subtopic 815-10's Example 2.

ABC Corp. wishes to participate in price changes of one share of DEF common stock. ABC enters into a forward contract to purchase one share of DEF common stock in one year. DEF's common stock is publicly traded.

The following information is relevant to both scenarios in this example.

- The forward contract's underlying is the market price of DEF common stock, and the asset related to this underlying is DEF common stock.
- The forward contract is assumed to meet the net settlement characteristic because DEF's common stock is readily convertible to cash (see section 3.5.40).
- The fixed purchase price of DEF common stock under the forward contract is \$110 (the market forward price).
- The current price of DEF common stock at inception of the forward contract is \$105.
- The forward contract terms require ABC to fully (Scenario 1) or partially (Scenario 2) prepay the contract. ABC will not take possession of the stock.
 - **Scenario 1:** ABC pays \$105 at inception of the forward contract. No additional amounts are due at the settlement date.
 - **Scenario 2:** ABC pays \$94 at inception of the forward contract and an additional \$13 at the settlement date.

	Scenario 1	Scenario 2
Initial net investment – The amount ABC elects to prepay at inception of the contract under its terms (A)	\$105	\$94
Payments required under the contract when the contract settles (and the security is delivered) in one year	None (contract is fully prepaid)	\$13 (the contract is partially – rather than fully – prepaid)
Analysis of initial net investment characteristic – Criterion 3		
Amount that would be exchanged to acquire the share of DEF common stock (B)	\$105 ¹	\$105 ¹
Is the initial net investment characteristic met?	No. The initial net investment (A) is <i>equal to</i> – and therefore commensurate	Yes. The initial net investment (A) is <i>less than</i> the amount that would be

	Scenario 1	Scenario 2
(i.e. is (A) less than (B) by more than a nominal amount?)	with – the amount that would be exchanged to acquire the share of DEF common stock (B) .	exchanged to acquire the share of DEF common stock (B) . The difference of \$11 (\$105 - \$94) represents a 10.5% ² shortfall. This shortfall is considered to be more than nominal (see also Question 3.4.30).
Nature of the prepaid forward contract	Debt instrument (host contract) with an embedded derivative (based on equity prices) that may require bifurcation ³	Derivative instrument in its entirety
Notes: 1. Represents the market price of one share of DEF common stock at inception of the forward contract. 2. $\$11 \div \$105$. 3. ABC would evaluate whether the contract includes an embedded equity-based derivative that requires bifurcation		



Example 3.4.50

Option contract to purchase equity security

ABC Corp. wishes to participate in price appreciation – but not price declines – of one share of DEF common stock. ABC enters into a call option to purchase one share of DEF common stock. The option can be exercised anytime during its one year term – i.e. it is an American option.

The following information is relevant to both scenarios in this example.

- The option contract's underlying is the market price of DEF common stock, and the asset related to this underlying is DEF common stock.
- The current price of DEF common stock at inception of the option contract is \$100.
- The option contract is assumed to meet the net settlement characteristic (see section 3.5.20).
- ABC will not take possession of the stock or be entitled to the rights of security ownership (e.g. receiving dividends and voting the shares) unless or until it exercises the option.

	Scenario 1	Scenario 2
Initial net investment (A)	\$3	\$95.50
Strike price to exercise the option	\$105 (the option is in the money at issuance)	\$5 (the option is deeply out of the money at issuance)

	Scenario 1	Scenario 2
Analysis of initial net investment characteristic – Criterion 3		
Amount that would be exchanged to acquire the share of DEF common stock (B)	\$100 ¹	\$100 ¹
Is the initial net investment characteristic met? (i.e. is (A) less than (B) by more than a nominal amount?)	Yes. The initial net investment (A) is <i>less than</i> the amount that would be exchanged to acquire the share of DEF common stock (B) . The difference of \$97 (\$100 - \$3) represents a 97% ² shortfall, which is considered to be more than nominal.	No. The initial net investment (A) is <i>less than</i> the amount that would be exchanged to acquire the share of DEF common stock (B) . The difference of \$4.50 (\$100 - \$95.50) represents a 4.5% ³ shortfall. This shortfall is considered to be nominal (see also Question 3.4.30).
Notes: 1. Represents the market price of one share of DEF common stock at inception of the forward contract. 2. $\$97 \div \$100$. 3. $\$4.5 \div \$100$.		

3.5 Net settlement

3.5.10 Overview



Excerpt from ASC 815-10

> Definition of Derivative Instrument

15-83 A derivative instrument is a financial instrument or other contract with all of the following characteristics: ...

- c. Net settlement. The contract can be settled net by any of the following means:
 - 1. Its terms implicitly or explicitly require or permit net settlement.
 - 2. It can readily be settled net by a means outside the contract.
 - 3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

>> Net Settlement

15-99 A contract fits the description in paragraph 815-10-15-83(c) if its settlement provisions meet criteria for any of the following:

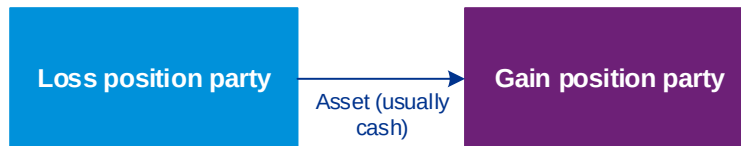
- a. Net settlement under contract terms
- b. Net settlement through a market mechanism
- c. Net settlement by delivery of derivative instrument or asset readily convertible to cash.



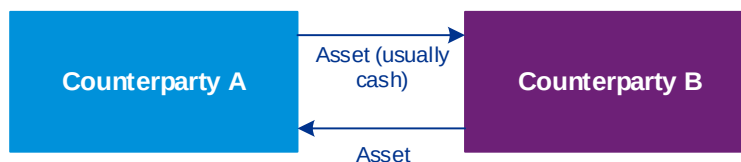
The net settlement criterion can be met by any one of the following methods.
[815-10-15-99]

Contractual net settlement (section 3.5.20)	The terms of the contract require or permit net settlement.
Market mechanism (section 3.5.30)	There is a market mechanism that facilitates net settlement of the contract, which means that the contract is readily settleable net by a means outside of the contract.
Delivery of a derivative or an asset that is readily convertible to cash (section 3.5.40)	An asset is delivered that puts the recipient in a position not substantially different from net settlement.

Net settlement is generally defined as a one-way transfer of an asset, usually cash, from the counterparty in a loss position to the counterparty in a gain position. This is depicted in the following diagram.



In contrast, **gross settlement** involves a two-way transfer, whereby Counterparty A transfers an asset (usually cash) to Counterparty B, and Counterparty B transfers an asset to Counterparty A. This is depicted in the following diagram.



For purposes of applying the net settlement criterion, gross settlement would not be considered net settlement unless either of the following applies:

- there is a market for the contract itself (i.e. a market mechanism); or
- the non-cash asset being delivered is readily convertible to cash.



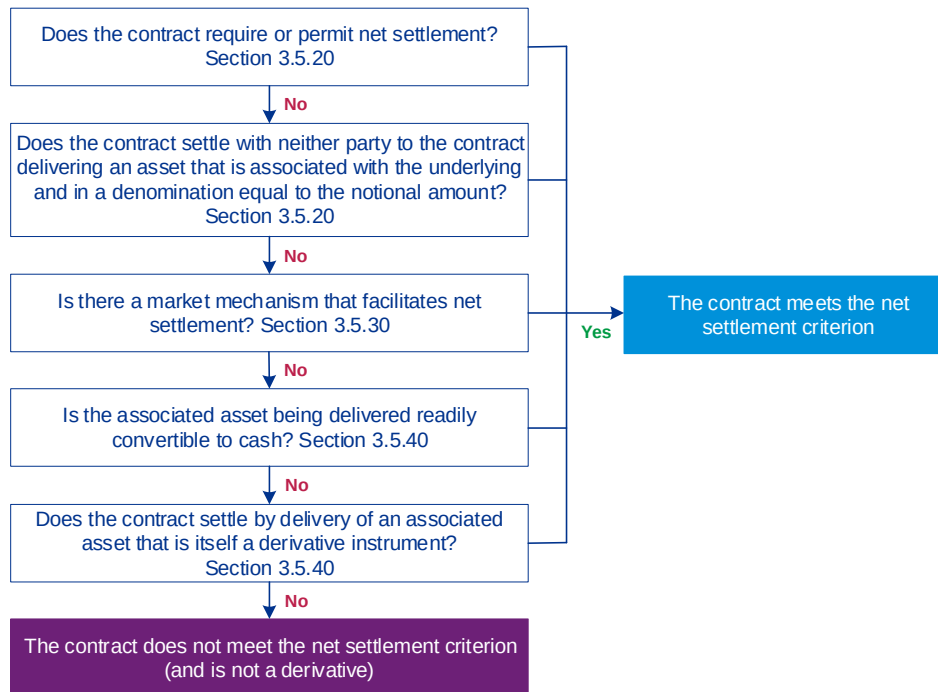
Question 3.5.10

What are the steps in determining whether a contract meets the net settlement characteristic?

Interpretive response: The net settlement characteristic is among the most complex of all the defining criteria of a derivative instrument. There are potentially a number of factors to consider before determining whether a contract meets the net settlement characteristic of the definition of a derivative instrument.

Although some contracts may meet all three methods of net settlement (e.g. certain exchange-traded forward contracts), only one method needs to be present for the instrument to meet the net settlement characteristic. Therefore, when determining whether a contract is a derivative instrument, an entity needs to consider all three methods before concluding that the net settlement criterion is not met.

The process for determining whether a contract meets the net settlement criterion is summarized in the following decision tree.



3.5.20 Contractual net settlement

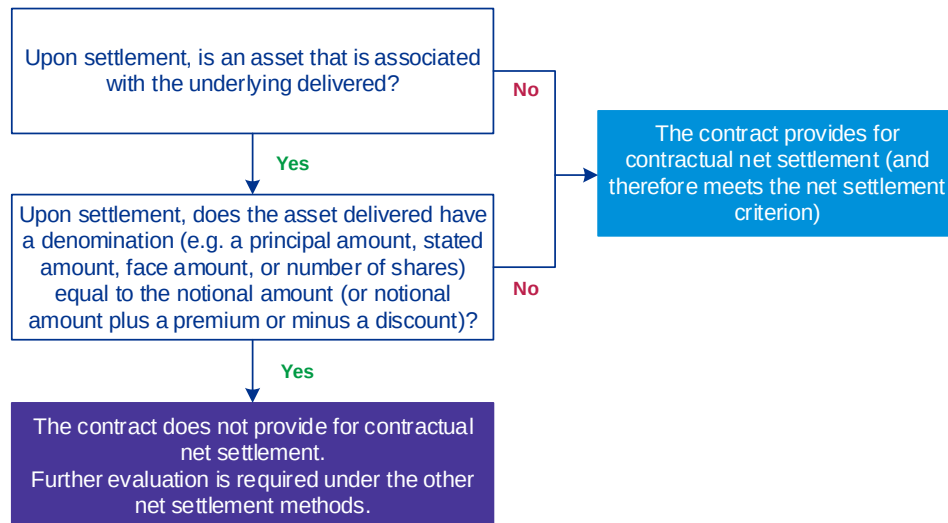


Excerpt from ASC 815-10

>>> Net Settlement Under Contract Terms

15-100 In this form of net settlement, neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). (For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.) Net settlement may be made in cash or by delivery of any other asset (such as the right to receive future payments—see the discussion beginning in paragraph 815-10-15-104), whether or not that asset is readily convertible to cash.

One way a contract can meet the net settlement criterion is through a contractual provision that provides for net settlement. The process for determining whether a contract provides for contractual net settlement is summarized in the following decision tree. [815-10-15-100]



For example, in most interest rate swap transactions, a net cash settlement occurs periodically whereby neither party is required to deliver an asset associated with the underlying in the swap (e.g. LIBOR) with a principal amount equal to the notional amount of the contract. Consequently, such a swap meets the net settlement criterion.

When a contract does not provide for contractual net settlement, it may meet the net settlement characteristic through either a market mechanism (section 3.5.30) or delivery of a derivative or an asset that is readily convertible to cash (section 3.5.40).



Question 3.5.20

Can a contract contain a contractual net settlement provision if net settlement is optional?

Interpretive response: Yes. A contract that implicitly or explicitly requires (or has an option for) net settlement meets the net settlement criterion. Contractual net settlement is met regardless of which party has the option because there is no requirement to deliver an asset that is associated with the underlying and that has a denomination (e.g. principal amount, stated amount, face value, number of shares) that is equal to the notional amount.

For example, a commodity contract that permits settlement by delivering cash in the amount of the difference between the contractual price and the current market price multiplied by the notional amount meets the condition for net settlement.



Question 3.5.30

Can a contract that contains a payment provision rather than a notional amount contain a contractual net settlement provision?

Interpretive response: Yes. In general, contracts that do not contain a notional amount but instead contain a payment provision meet the contractual net settlement condition because there is no requirement for the counterparty to deliver an asset associated with the underlying.

For example, ABC Corp. executes a contract that requires a payment of \$1 million if LIBOR increases by 300 bps. The required settlement of the instrument is the payment of \$1 million. This meets the contractual net settlement condition because neither party is required to deliver an asset associated with the underlying in a denomination (e.g. principal amount, stated amount, face amount or number of shares) that is equal to the notional amount (because there is no notional amount).

Contractual net settlement effected with assets other than cash

A contract provides for contractual net settlement if the asset delivered is associated with the underlying but does not have a denomination (e.g. principal amount, stated amount, face amount or number of shares) equal to the notional amount (or notional amount plus a premium or minus a discount) in the contract. This is the case even if the asset delivered is not readily convertible to cash.



Question 3.5.40

Does a contract that provides for net share settlement ('cashless exercise') contain contractual net settlement?



Excerpt from ASC 815-10

>>>> Net Share Settlement

15-102 The net settlement criterion as described in paragraph 815-10-15-83(c) and related paragraphs in this Subsection is met if a contract provides for **net share settlement** at the election of either party. Therefore, if either counterparty could net share settle a contract, then it would be considered to have the net settlement characteristic of a derivative instrument regardless of whether the net shares received were readily convertible to cash as described in paragraph 815-10-15-119 or were restricted for more than 31 days as discussed beginning in paragraph 815-10-15-130. While this conclusion applies to both investors and issuers of contracts, issuers of those net share settled contracts shall consider whether such contracts qualify for the scope exception in paragraph 815-10-15-74(a). See Example 5 (paragraph 815-10-55-90).

Interpretive response: Yes. Whether a contract meets the net settlement criterion does not depend on the form of net settlement. A net settlement can be in the form of cash or delivery of any other asset. [\[815-10-15-100, 15-102\]](#)

For example, an option, warrant or other contract may provide for net share settlement as a settlement alternative, whereby the party with a loss delivers to the party with a gain an amount of common stock (which is the asset related to the underlying) having a current fair value equal to the gain. This contract is deemed to meet the net settlement criterion because it provides for net settlement. This is the case even if the stock underlying the equity contract relates to a privately held entity and is not readily convertible to cash (see section 3.5.40).

See also Subtopic 815-10's Example 5, reproduced below.

The issuer of such a contract may not account for it as a derivative, if it qualifies for the scope exception for contracts that are indexed to the entity's own stock and classified in equity (see section 2.13.20). That scope exception is not available to the holder of the contract.



Excerpt from ASC 815-10

>> Example 5: Net Settlement Under Contract Terms—Net Share Settlement

55-90 This Example illustrates the concept of **net share settlement**. Entity A has a warrant to buy 100 shares of the common stock of Entity X at \$10 a share. Entity X is a privately held entity. The warrant provides Entity X with the choice of settling the contract physically (gross 100 shares) or on a net share basis. The stock price increases to \$20 a share. Instead of Entity A paying \$1,000 cash and taking full physical delivery of the 100 shares, the contract is net share settled and Entity A receives 50 shares of stock without having to pay any cash for them. (Net share settlement is sometimes described as a **cashless exercise**.) The 50 shares are computed as the warrant's \$1,000 fair value upon exercise divided by the \$20 stock price per share at that date.

Penalties for nonperformance



Excerpt from ASC 815-10

20 Glossary

Asymmetrical Default Provision – A nonperformance penalty provision that requires the defaulting party to compensate the nondefaulting party for any loss incurred but does not allow the defaulting party to receive the effect of favorable price changes.

>>>> Net Settlement in the Event of Nonperformance or Default

15-103 Penalties for nonperformance may give a contract the characteristic of 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.
- A fixed penalty for nonperformance is not a net settlement provision.
- A contract that contains a variable penalty for nonperformance based on changes in the price of the items that are the subject of the contract does not contain a net settlement provision as discussed beginning in paragraph 815-10-15-100 if it also contains an incremental penalty of a fixed amount (or fixed amount per unit) that would be expected to be significant enough at all dates during the remaining term of the contract to make the possibility of nonperformance remote. If a contract includes such a provision, it effectively requires performance, that is, requires the party to deliver an asset that is associated with the underlying. The assessment of the fixed incremental penalty shall be performed only at the contract's inception. The magnitude of the fixed incremental penalty shall be assessed on a standalone basis as a disincentive for nonperformance, not in relation to the overall penalty.

- d. An **asymmetrical default provision** does not give a commodity forward contract the characteristic described as net settlement beginning in paragraph 815-10-15-100. For related implementation guidance, see the discussion beginning in paragraph 815-10-55-10.

Some penalty provisions may result in a contract meeting contractual net settlement. For example, it is common for physical commodity contracts to require physical delivery of the underlying commodity. However, if a party to the contract defaults, the contract also requires penalties for nonperformance to be paid by the party with the loss (regardless of whether it is the defaulting party) to the party with the gain in an amount equal to the difference between the current spot price for the commodity and the price per the contract multiplied by the notional amount of the contract.



Question 3.5.50

Do all nonperformance penalties represent contractual net settlement?

Interpretive response: No. Whether a nonperformance penalty represents contractual net settlement depends on the type of penalty, with different considerations applicable to whether the type of penalty is fixed or variable.

The following table summarizes various types of nonperformance penalties and whether they represent contractual net settlement.

Type of nonperformance penalty	Does this type of penalty represent contractual net settlement?
Variable penalty based on changes in the price of items that are subject to the contract	It depends on whether the provision is symmetrical (see Question 3.5.60). — Symmetrical. Contractual net settlement <i>is</i> met. [815-10-15-103(a)] — Asymmetrical (i.e. the defaulting party is required to compensate the nondefaulting party for any loss incurred but is not entitled to receive the effect of favorable price changes). Contractual net settlement is <i>not</i> met. [815-10-15-103(d)] However, a pattern of having the asymmetrical default provision applied in contracts between two counterparties would indicate the existence of an implied agreement between those parties that the party in a loss position always would default, thereby resulting in the understanding that there always would be net settlement. This would represent contractual net settlement. [815-10-55-17]

Type of nonperformance penalty	Does this type of penalty represent contractual net settlement?
	See paragraphs 815-55-10 – 55-18 (reproduced below) for examples.
Fixed penalties	No. [815-10-15-103(b)]
Combination of variable and fixed penalties	No, provided the fixed component is significant enough at all times during the contract to make the possibility of nonperformance under the contract remote (see Question 3.5.70). [815-10-15-103(c)]



Excerpt from ASC 815-10

>>>> Asymmetrical Default Provision Does Not Constitute Net Settlement

55-10 Many commodity forward contracts contain default provisions that require the defaulting party (the party that fails to make or take physical delivery of the commodity) to reimburse the nondefaulting party for any loss incurred as illustrated in the following examples:

- If the buyer under the forward contract (Buyer) defaults (that is, does not take physical delivery of the commodity), the seller under that contract (Seller) will have to find another buyer in the market to take delivery. If the price received by Seller in the market is less than the contract price, Seller incurs a loss equal to the quantity of the commodity that would have been delivered under the forward contract multiplied by the difference between the contract price and the current market price. Buyer must pay Seller a penalty for nonperformance equal to that loss.
- If Seller defaults (that is, does not deliver the commodity physically), Buyer will have to find another seller in the market. If the price paid by Buyer in the market is more than the contract price, Seller must pay Buyer a penalty for nonperformance equal to the quantity of the commodity that would have been delivered under the forward contract multiplied by the difference between the contract price and the current market price.

55-11 For example, Buyer agreed to purchase 100 units of a commodity from Seller at \$1.00 per unit:

- Assume Buyer defaults on the forward contract by not taking delivery and Seller must sell the 100 units in the market at the prevailing market price of \$.75 per unit. To compensate Seller for the loss incurred due to Buyer's default, Buyer must pay Seller a penalty of \$25.00—that is, 100 units × (\$1.00 – \$.75).
- Similarly, assume that Seller defaults and Buyer must buy the 100 units it needs in the market at the prevailing market price of \$1.30 per unit. To compensate Buyer for the loss incurred due to Seller's default, Seller must pay Buyer a penalty of \$30.00—that is, 100 units × (\$1.30 – \$1.00).

55-12 Note that an **asymmetrical default provision** is designed to compensate the nondefaulting party for a loss incurred. The defaulting party cannot demand payment from the nondefaulting party to realize the changes in market price that would be favorable to the defaulting party if the contract were honored.

55-13 Under the forward contract in the example, if Buyer defaults when the market price is \$1.10, Seller will be able to sell the units of the commodity into the market at \$1.10 and realize a \$10.00 greater gain than it would have under the contract. In that circumstance, the defaulting Buyer is not required to pay a penalty for nonperformance to Seller, nor is Seller required to pass the \$10.00 extra gain to the defaulting Buyer.

55-14 Similarly, if Seller defaults when the market price is \$.80, Buyer will be able to buy the units of the commodity in the market and pay \$20.00 less than under the contract. In that circumstance, the defaulting Seller is not required to pay a penalty for nonperformance to Buyer, nor is Buyer required to pass the \$20.00 savings on to the defaulting Seller.

55-15 In a forward contract with only an asymmetrical default provision, neither Buyer nor Seller can realize the benefits of changes in the price of the commodity through default on the contract. That is, Buyer cannot realize favorable changes in the intrinsic value of the forward contract except in both of the following circumstances:

- a. By taking delivery of the physical commodity
- b. In the event of default by Seller (which is an event beyond the control of Buyer).

55-16 Similarly, Seller cannot realize favorable changes in the intrinsic value of the forward contract except in either of the following circumstances:

- a. By making delivery of the physical commodity
- b. In the event of default by Buyer, which is an event beyond the control of Seller.

55-17 However, a pattern of having the asymmetrical default provision applied in contracts between certain counterparties would indicate the existence of a tacit agreement between those parties that the party in a loss position would always elect the default provision, thereby resulting in the understanding that there would always be net settlement. In that situation, those kinds of commodity contracts would meet the characteristic described as net settlement in paragraph 815-10-15-100.

55-18 In contrast, a contract that permits only one party to elect net settlement of the contract (by default or otherwise), and thus participate in either favorable changes only or both favorable and unfavorable price changes in the **underlying**, meets the derivative characteristic described in paragraph 815-10-15-83(c) and discussed in paragraph 815-10-15-100 for all parties to that contract. Such a default provision allows one party to elect net settlement of the contract under any pricing circumstance and consequently does not require delivery of an asset that is associated with the underlying. That default provision differs from the asymmetrical default provision in the example contract in paragraph 815-10-55-10 because it is not limited to compensating

only the nondefaulting party for a loss incurred and is not solely within the control of the defaulting party.



Question 3.5.60

Why are symmetrical default provisions treated differently from asymmetrical default provisions?

Interpretive response: Topic 815 distinguishes between symmetrical and asymmetrical default provisions because the former equate to de facto contractual net settlement provisions while the latter do not.

Symmetrical default provisions allow the defaulting party to receive both the upside (i.e. a defaulting party in a gain position is entitled to that gain even though it is the defaulting party) and the downside inherent in the contract. Further, because each counterparty is in the same gain or loss position after a default as it was before the default, either counterparty could elect to default without any economic effect. As a result, a symmetrical default provision equates to a de facto contractual net settlement provision because each party to the contract is in the same position as if a contractual net settlement provision actually existed in the contract.

In contrast, in an asymmetrical default penalty provision, there is no economic incentive for either party to default. This is because the defaulting party gains nothing and the nondefaulting party is made whole only if it incurs a loss when it buys or sells the contract's asset at the current market price.



Question 3.5.70

How does an entity determine if a fixed component is significant enough to make the possibility of nonperformance remote?

Interpretive response: When a contract contains both fixed and variable penalties, the penalties do not represent contractual net settlement if the fixed component is significant enough to make the possibility of nonperformance under the contract remote (see Question 3.5.50).

To determine whether the fixed component is significant enough to make the possibility of nonperformance remote, an entity compares the fixed penalty amount to the total cash outlay under the contract, excluding any penalties. We believe a fixed penalty that exceeds 10% of this amount is significant enough to make the possibility of nonperformance under the contract remote, which means the provision does not result in contractual net settlement.

The analysis of the fixed incremental penalty should be assessed on a stand-alone basis (i.e. exclusive of the variable component) and not in relation to the overall penalty. This analysis is required only at inception of the contract. However, at inception of the contract the fixed incremental penalty must be expected to be significant enough at all times during the contract's term. For

example, a contract could not be structured to have a large fixed incremental penalty only at its inception and not thereafter. [815-10-15-103(c)]

Payment over time (structured payout)



Excerpt from ASC 815-10

>>>> Structured Settlement as Net Settlement

15-104 Upon settlement of a contract, in lieu of immediate net cash settlement of the gain or loss under the contract, the holder may receive a financial instrument involving terms that would provide for the gain or loss under the contract to be received or paid over a specified time period. A contract that provides for such a structured payout of the gain (or loss) resulting from that contract meets the characteristic of net settlement in paragraphs 815-10-15-100 through 15-109 if the fair value of the cash flows to be received (or paid) by the holder under the structured payout are approximately equal to the amount that would have been received (or paid) if the contract had provided for an immediate payout related to settlement of the gain (or loss) under the contract. The fact that a contract accomplishes settlement by requiring the party in a loss position under the contract to make cash payments over a specified timeframe to the party in a gain position (in lieu of immediate cash settlement of the gain) does not preclude the contract from meeting the characteristic of net settlement in those paragraphs.

15-105 A contract that requires additional investing or borrowing to obtain the benefits of the contract's gain only over time as a traditional adjustment of the yield on the amount invested or the interest element on the amount borrowed does not meet the characteristic of net settlement.

15-106 Contracts that require one party to the contract to invest funds in or borrow funds from the other party so that the party in a gain position under the contract can obtain the value of that gain over time as a nontraditional adjustment of the yield on the amount invested or the interest element on the amount borrowed may meet the characteristic of net settlement. See related implementation guidance beginning in paragraph 815-10-55-19.

>>>> Determining Whether a Structured Payout Constitutes Net Settlement

55-19 Paragraph 815-10-15-104 explains that, upon settlement of a contract, in lieu of immediate net cash settlement of the gain or loss under the contract, the holder may receive a **financial instrument** involving terms that would provide for the gain or loss under the contract to be received or paid over a specified time period. Such a structured payout of the gain on a contract could also be described as an abnormally high yield on a required investment or borrowing in which the overall return is related to the amount of that contract's gain, in which case the contract would be considered to have met the characteristic of net settlement in paragraph 815-10-15-100.

55-20 Assume, instead, that, upon settlement of a contract, in lieu of immediate net cash settlement of the gain or loss under the contract, the

holder is required to invest funds in or borrow funds from the other party so that the party in a gain position under the contract can obtain the value of that gain only over time as a traditional adjustment of the yield on the amount invested or the interest element on the amount borrowed. (A fixed-rate mortgage **loan commitment** is an example of a contract that requires the party in a gain position under the contract to borrow funds at a below-market interest rate at the time of the borrowing to obtain the benefit of that gain.) Paragraph 815-10-15-105 indicates that such a contract does not meet the characteristic of net settlement in paragraph 815-10-15-100.

55-21 In contrast, paragraph 815-10-15-106 explains that a contract that requires one party to the contract to invest funds in or borrow funds from the other party so that the party in a gain position under the contract can obtain the value of that gain over time as a nontraditional adjustment of the yield on the amount invested or the interest element on the amount borrowed may meet the characteristic of net settlement in paragraph 815-10-15-100. For example, if a contract required the party in a gain position under the contract to invest \$100 in the other party's debt instrument that paid an abnormally high interest rate of 5,000 percent per day for a term whose length is dependent on the changes in the contract's underlying, an analysis of those terms would lead to the conclusion that the contract's settlement terms were in substance a structured payout of the contract's gain and thus that contract would be considered to have met the characteristic of net settlement in that paragraph.

A structured payout exists when a contract has an implicit or explicit provision that allows the net gain or loss under the contract to be paid or received over several periods, as opposed to an immediate cash settlement. The parties to these contracts may enter into a financial instrument that provides for the gain or loss under the original contract to be received or paid over a specified period. In that case, the contract provides for net settlement but the contract is not immediately settled with cash. [\[815-10-15-104\]](#)

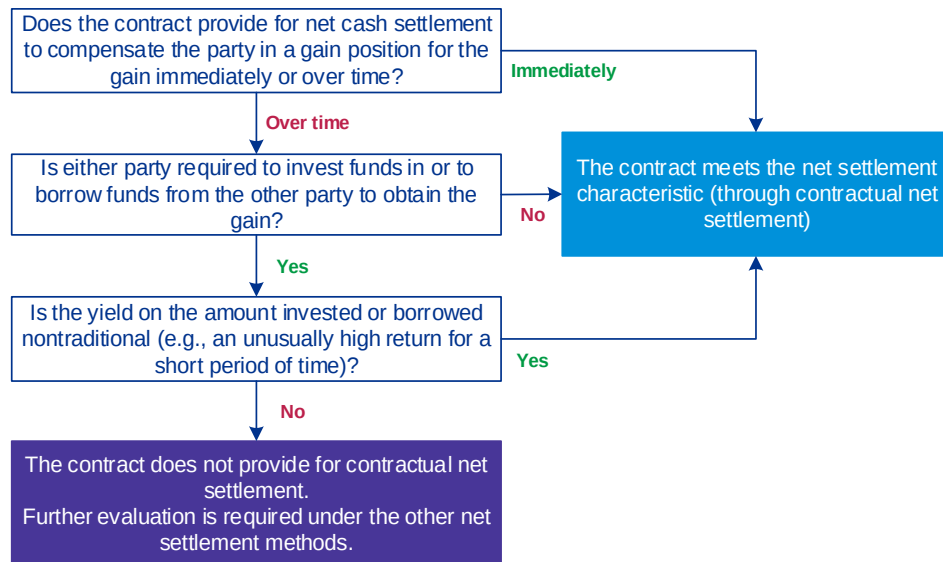


Question 3.5.80

Do all contracts with structured payouts contain contractual net settlement?

Interpretive response: Generally, a contract that provides for a structured payout (as opposed to an immediate cash settlement) contains contractual net settlement, unless additional investing or borrowing is required to obtain the benefits of the contract by either party.

The following decision tree summarizes considerations in determining whether a contract that provides for a structured payout meets the net settlement criterion. [\[815-10-15-104 – 15-106, 55-19 – 55-21\]](#)



Example 3.5.10 Structured payout of net gain

Scenario 1: Fixed-rate mortgage loan origination commitment

Mortgage Bank enters into a mortgage loan origination commitment with Prospective Borrower; under its terms, Mortgage Bank agrees to extend credit (via a mortgage loan) to Prospective Borrower during the 45 days following inception of the commitment. The mortgage loan, if originated, will bear interest at a fixed rate that is specified in the commitment (which is the market rate at the date the commitment was entered into).

If interest rates increase after inception of the fixed-rate mortgage loan commitment, Prospective Borrower (the holder of the commitment) is in a gain position because it has the right to borrow funds at an interest rate that is below-market when the loan is funded. To receive the benefit of that gain, Prospective Borrower must enter into the fixed-rate mortgage loan that underlies the commitment. In this situation, the gain is 'paid' over time through the borrower paying a below-market interest rate over time on the mortgage. This is considered a traditional yield adjustment, and therefore does not cause the commitment to have contractual net settlement.

See also sections 2.11.20 and 2.11.30 for further discussion about whether loan commitments are accounted for as derivatives.

Scenario 2: Non-traditional yield adjustment

Topic 815 provides as an example of a non-traditional yield adjustment a situation in which the party in the gain position is required to make an investment in the other party. However, the investment pays a 5000% interest rate for a short period to compensate the investor for its gain position. The

5000% rate is unusually high and represents a nontraditional yield. Such a contract provides for contractual net settlement.

Scenario 3: Forward contract for commodity

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

The deferred settlement of the contract represents a structured payout. The structured payout represents contractual net settlement if the fair value of the cash flows to be received (or paid) by the holder under the structured payout are approximately equal to the amount that would have been received (or paid) if the contract had provided for an immediate payout related to settlement of the gain (or loss) under the contract.

Effectively, the structured payout is a note receivable representing the payment under the contract.

Put and call options on debt instruments



Excerpt from ASC 815-10

>>>> Net Settlement of a Debt Instrument Through Exercise of an Embedded Put Option or Call Option

15-107 The potential settlement of the debtor's obligation to the creditor that would occur upon exercise of a put option or call option embedded in a debt instrument meets the net settlement criterion as discussed beginning in paragraph 815-10-15-100 because neither party is required to deliver an asset that is associated with the underlying. Specifically:

- a. The debtor does not receive an asset when it settles the debt obligation in conjunction with exercise of the put option or call option.
- b. The creditor does not receive an asset associated with the underlying.

15-108 The guidance in the preceding paragraph shall be applied under both of the following circumstances:

- a. When applying paragraph 815-15-25-1(c) to a put option or call option (including a prepayment option) embedded in a debt instrument
- a. When analyzing the net settlement criterion (see guidance beginning in paragraph 815-10-15-100) for a freestanding call option held by the debtor on its own debt instrument and for a freestanding put option issued by the debtor on its own debt instrument.

15-109 The guidance in paragraph 815-10-15-107 shall not be applied under either of the following circumstances:

- a. To put or call options that are added to a debt instrument by a third party contemporaneously with or after the issuance of a debt instrument. (In that circumstance, see paragraph 815-10-15-6.)

- b. By analogy to an embedded put or call option in a hybrid instrument that does not contain a debt host contract.

A debt instrument may be settled when a put option or a call option on that debt instrument is exercised. In that case, contractual net settlement is considered to be met in any of the following situations: [815-10-15-107 – 15-108]

- the put option or call option (including a prepayment option) is embedded in a debt instrument;
- a freestanding call option is held by a debtor on its own debt instrument; or
- a freestanding put option is issued by a debtor on its own debt instrument.



Question 3.5.90

Why is contractual net settlement present when a debt instrument is subject to certain call or put options?

Interpretive response: Contractual net settlement is present when a debt instrument (including a debt host included in a hybrid instrument) is subject to certain call or put options because the potential settlement of the debtor's obligation to the creditor that would occur upon exercise of the put or call option is considered to be the debtor settling its own *liability*. As a result, that settlement is not considered to involve the 'delivery of an asset'. [815-10-15-107]

This conclusion applies even if the creditor returns evidence of the debtor's indebtedness (e.g. the creditor returns a note payable marked paid to the debtor), even though some may believe that the creditor is delivering an asset (i.e. the note receivable due from the debtor). Also, the cash paid to the creditor in settling the debtor's obligation is not associated with the underlying (e.g. interest rates). Therefore, the net settlement characteristic is met because neither party is required to deliver an asset that is associated with the underlying. [815-10-15-107 – 15-108]



Question 3.5.100

Is a call or put option that is attached to a debt instrument by a third party considered to provide contractual net settlement?

Interpretive response: No. When a put or call option is attached to a debt instrument by a third party (e.g. investment banker) and requires physical settlement upon exercise of the option, the underlying debt instrument is considered an asset rather than a liability of the holder or writer of the option. As a result, we believe such options do not provide contractual net settlement.

Further, we believe such options do not meet the net settlement characteristic under the market mechanism method (see section 3.5.30). Rather, we believe that the debt itself (i.e. the asset required to be delivered upon exercise of the

option) needs to be readily convertible to cash to meet the net settlement characteristic (see section 3.5.40).



Question 3.5.110

Does an investor that acquires a debt instrument and a call or put option thereon need to evaluate whether the option was attached by a third party?

Interpretive response: Yes. It is important for investors/creditors to understand the terms of a put or call option on a debt instrument (i.e. the identity of the option counterparty) to properly evaluate whether the option should be accounted for as a derivative instrument. This is because an option that is attached by a third party does not provide for contractual net settlement (see Question 3.5.100).

For example, an investor may acquire a debt instrument together with a call or put option on that debt instrument (i.e. a call or put option that is not embedded in the contract) from an investment bank that is a third party to the obligor on the debt instrument. The investor must evaluate whether the call or put option was attached by the investment bank because an attached option does not provide for contractual net settlement (while a freestanding option with the debt issuer as the counterparty does). If the option does not provide for contractual net settlement, it is evaluated to determine whether it meets the net settlement characteristic through either a market mechanism (see section 3.5.30) or delivery of a derivative or an asset that is readily convertible to cash (see section 3.5.40).

3.5.30 Market mechanism



Excerpt from ASC 815-10

>>>> Primary Characteristics of Market Mechanism

15-110 In this form of net settlement, one of the parties is required to deliver an asset of the type described in paragraph 815-10-15-100, but there is an established market mechanism that facilitates net settlement outside the contract. (For example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.) Market mechanisms may have different forms. 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.

15-111 The term *market mechanism* is to be interpreted broadly and includes any institutional arrangement or other agreement having the requisite characteristics. Regardless of its form, an established market mechanism must have all of the following primary characteristics:

- a. It is a means to settle a contract that enables one party to readily liquidate its net position under the contract. A market mechanism is a means to realize the net gain or loss under a particular contract through a net payment. Net settlement may occur in cash or any other asset. A method of settling a contract that results only in a gross exchange or delivery of an asset for cash (or other payment in kind) does not satisfy the requirement that the mechanism facilitate net settlement.
- b. It results in one party to the contract becoming fully relieved of its rights and obligations under the contract. A market mechanism enables one party to the contract to surrender all future rights or avoid all future performance obligations under the contract. Contracts that do not permit assignment of the contract from the original issuer to another party do not meet the characteristic of net settlement through a market mechanism. The ability to enter into an offsetting contract, in and of itself, does not constitute a market mechanism because the rights and obligations from the original contract survive. The fact that an entity has offset its rights and obligations under an original contract with a new contract does not by itself indicate that its rights and obligations under the original contract have been relieved. This applies to contracts regardless of whether either of the following conditions exists:
 1. The asset associated with the underlying is financial or nonfinancial.
 2. The offsetting contract is entered into with the same counterparty as the original contract or a different counterparty (unless an offsetting contract with the same counterparty relieves the entity of its rights and obligations under the original contract, in which case the arrangement does constitute a market mechanism). (Example 6 [see paragraph 815-10-55-91] illustrates this guidance.)
- c. Liquidation of the net position does not require significant transaction costs. For purposes of assessing whether a market mechanism exists, an entity shall consider transaction costs to be significant if they are 10 percent or more of the fair value of the contract. Whether assets deliverable under a group of futures contracts exceeds the amount of assets that could rapidly be absorbed by the market without significantly affecting the price is not relevant to this characteristic. The lack of a liquid market for a group of contracts does not affect the determination of whether there is a market mechanism that facilitates net settlement because the test focuses on a singular contract. An exchange offers a ready opportunity to sell each contract, thereby providing relief of the rights and obligations under each contract. The possible reduction in price due to selling a large futures position is not considered to be a transaction cost.
- d. Liquidation of the net position under the contract occurs without significant negotiation and due diligence and occurs within a time frame that is customary for settlement of the type of contract. A market mechanism facilitates easy and expedient settlement of the contract. As discussed under the primary characteristic in (a), those qualities of a market mechanism do not preclude net settlement in assets other than cash.

>>>> Indicators of Primary Characteristics of Market Mechanism

15-113 Entities shall consider the indicators in the following paragraph for each of the primary characteristics in determining whether a method of settling a contract qualifies as an established market mechanism. All of the indicators

need not be present for an entity to conclude that a market mechanism exists for a particular contract.

15-114 The following are indicators that the primary characteristic in paragraph 815-10-15-111(a) is met:

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

15-115 The following are indicators that the primary characteristic in paragraph 815-10-15-111(b) is met:

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

15-116 The following are indicators that primary characteristic in paragraph 815-10-15-111(d) is met:

- a. Binding prices for the contract are readily obtainable.
- b. Transfers of the instrument involve standardized documentation (rather than contracts with entity-specific modifications) and standardized settlement procedures.
- c. Individual contract sales do not require significant negotiation and unique structuring.
- d. The closing period is not extensive because of the need to permit legal consultation and document review.

A contract for which there is an established market mechanism that facilitates net settlement outside the contract meets the net settlement characteristic. This form of net settlement focuses on the contract itself and not on the underlying assets to be delivered or received in the contract. The term market mechanism should be interpreted broadly – i.e. the market mechanism need not be limited to an active market. [\[815-10-15-111\]](#)

An entity is required to evaluate whether there is a market mechanism that facilitates net settlement at inception and on an ongoing basis throughout a contract's life. As a result, whether a financial instrument or other contract is a derivative may change over time; see Question 3.5.180 regarding the timing of assessing the significance of transaction costs and section 3.6 regarding the ongoing evaluation of whether a financial instrument or other contract meets the definition of a derivative. [\[815-10-15-118\]](#)

When there is not a market mechanism to facilitate net settlement outside the contract, the contract may meet the net settlement characteristic through either providing for contractual net settlement (see section 3.5.20) or delivery of a derivative or an asset that is readily convertible to cash (see section 3.5.40).



Question 3.5.120

What are the characteristics of a market mechanism?

Interpretive response: Topic 815 describes four primary characteristics of a market mechanism, all of which must be met for the net settlement characteristic to be met. These may be met through contracts that settle net in active markets (see Question 3.5.130) or through any other arrangement (e.g. an institutional agreement) that meets these characteristics.

The following table summarizes the characteristics – along with indicators that those characteristics are met. [815-10-15-111 – 15-116]

Description	Indicators that the characteristic is met (not all must be present)
Primary characteristic 1 – It is a means to settle a contract that enables one party to readily liquidate its net position under the contract	
A market mechanism is a means to realize a contract's net gain or loss through a net payment. That net settlement may occur in cash or another asset. See Question 3.5.140	— Access to potential counterparties is available regardless of the seller's size or market position. — Risks assumed by a market-maker as a result of acquiring a contract can be transferred by a means other than by repackaging the original contract into a different form.
Primary characteristic 2 – It results in one party to the contract becoming fully relieved of its rights and obligations under the contract	
A market mechanism enables one party to the contract to surrender all future rights or avoid all future performance obligations under the contract. The focus of this characteristic is whether a venue exists that will relieve either party of all rights and obligations under the contract and allow it to liquidate its net position without incurring significant transaction costs. See Questions 3.5.150 and 3.5.160	— There are multiple market participants willing and able to enter into a transaction at market prices to assume the seller's rights and obligations under the contract. — Both the level of market transaction volume for the contract and a relatively narrow observable bid/ask spread indicate sufficient liquidity. — The contract does not prohibit assignment to another party (see Question 3.5.150).
Primary characteristic 3 – Liquidation of the net position does not require significant transaction costs	
Transaction costs are significant if they are $\geq 10\%$ of the fair value of the contract. See Questions 3.5.170 and 180	

Description	Indicators that the characteristic is met (not all must be present)
Primary characteristic 4 – Liquidation of the net position under the contract occurs without significant negotiation and due diligence and occurs within a timeframe that is customary for settlement of the type of contract	
A market mechanism facilitates easy and expedient settlement of the contract. As discussed under primary characteristic 1, those qualities of a market mechanism do not preclude net settlement in assets other than cash.	— Binding prices for the contract are readily obtainable. — Transfers of the contract involve standardized documentation (rather than contracts with entity-specific modifications) and standardized settlement procedures. — Individual contract sales do not require significant negotiation and unique structuring. — The closing period is not extensive because of the need to permit legal consultation and document review.



Question 3.5.130

Why does a market mechanism outside a contract cause a contract to meet the net settlement characteristic?

Interpretive response: The FASB focused on whether there is a mechanism in the market for net settlement of the contract because it observed that many derivative instruments are actively traded and can be closed or settled before the contract's expiration or maturity by net settlement in active markets.

For example, most contracts traded on the national stock and commodities exchanges can be settled net on a daily basis, even though the contract may have a remaining term of several months or years. Once a contract is settled net on the national exchange, the party with the loss delivers to the party with the gain cash equal to the current gain/loss. Further, once net settlement has been completed, neither party to the original contract has any remaining rights or obligations pursuant to the contract. [815-10-15-110, FAS 133.BC260]



Question 3.5.140

If an entity holds several contracts, does it evaluate whether a market mechanism exists on an individual contract or an aggregate holdings basis?

Interpretive response: The assessment of whether a market mechanism exists is performed on an individual contract basis, and not on an aggregate holdings basis. [815-10-15-111(c)]

For example, if an entity holds several identical contracts, it analyzes whether each of the contracts could be liquidated on an individual basis. If so, then all of those identical contracts meet the net settlement criterion.

There is an argument that if the entity attempted to liquidate all of the contracts at once, it could suffer a loss from the market's downward reaction to its inability to absorb all of the contracts at once. However, because the market mechanism test is applied on a single-contract basis, the potential inability for the market to absorb all of the contracts at once does not matter.



Question 3.5.150

Does a permission (assignment) clause preclude a market mechanism from existing for a contract?



Excerpt from ASC 815-10

>>>> Effects of an Assignment Clause on Market Mechanism

15-117 As noted in the primary characteristic in paragraph 815-10-15-111(b), an assessment of the substance of any assignment clause is required to determine whether that assignment clause precludes a party from being relieved of all rights and obligations under the contract. Although permission to assign a contract shall not be unreasonably withheld by the counterparty in accordance with the terms of a contract, an assignment feature cannot be viewed simply as a formality because it may be invoked at any time to prevent the nonassigning party from being exposed to unacceptable credit or performance risk. Accordingly, the existence of an assignment clause may or may not permit a party from being relieved of its rights and obligations under the contract. If it is remote that the counterparty will withhold permission to assign the contract, the mere existence of the clause shall not preclude the contract from possessing the net settlement characteristic described in paragraph 815-10-15-110 as a market mechanism. Such a determination requires assessing whether a sufficient number of acceptable potential assignees exist in the marketplace such that assignment of the contract would not result in imposing unacceptable **credit risk** or performance risk on the nonassigning party. Consideration shall be given to past counterparty and industry practices regarding whether permission to be relieved of all rights and obligations under similar contracts has previously been withheld. However, if it is reasonably possible or probable that the counterparty will withhold permission to assign the contract, the contract does not possess the net settlement characteristic described in paragraph 815-10-15-110 as a market mechanism.

Interpretive response: Not necessarily. Some contracts require one of the parties to obtain the other's permission to assign rights and obligations under the contract to a third party. Such a requirement does not in and of itself preclude the contract from satisfying the market mechanism condition.

If there is a market mechanism exclusive of the permission clause, the entity evaluates the likelihood that the counterparty would withhold permission to assign the contract. If the likelihood that permission would be withheld is remote, there is a market mechanism (and the contract possesses a net settlement provision). However, if it is reasonably possible or probable that permission would be withheld, the contract does not.

We believe such likelihood should be reassessed each reporting period.



Question 3.5.160

Does the ability to enter into an offsetting contract represent a market mechanism?

Interpretive response: Not necessarily. The second primary characteristic of a market mechanism is that it results in one party becoming fully relieved of its rights and obligations under the contract. When there is an offsetting contract with the same counterparty, a market mechanism exists only if the offsetting contract relieves the entity of its rights and obligations under the original contract.

However, generally the offsetting contract carries a new set of legal rights and obligations that offset (rather than relieve) the original contract's set of legal rights and obligations. Therefore, the ability to enter into an offsetting contract in and of itself generally does not constitute a market mechanism because the rights and obligations from the original contract survive.

See Subtopic 815-10's Example 6 (reproduced below), which illustrates whether an ability to offset constitutes a market mechanism.



Excerpt from ASC 815-10

>> Example 6: Net Settlement Through a Market Mechanism—Ability to Offset Contracts

55-91 The following Cases illustrate whether an ability to offset constitutes a market mechanism as discussed under paragraph 815-10-15-111(b):

- a. Market mechanism relieves rights and obligations (Case A).
- b. Mechanism to offset does not relieve rights and obligations (Case B).
- c. Mechanism to offset relieves rights and obligations (Case C).

55-92 For Cases A and B, assume that the contract would not qualify for the normal purchases and sales exception (as discussed beginning in paragraph 815-10-15-22). Assume also for Cases A and B that the asset associated with the underlying is not readily convertible to cash (as discussed beginning in paragraph 815-10-15-119).

>>> Case A: Market Mechanism Relieves Rights and Obligations

55-93 Assume a broker-dealer stands ready to buy and sell a non-exchange-traded commodity forward contract that would relieve either party to the contract of its obligation to make (or right to accept) delivery of the commodity and its right to receive (or obligation to make) payment under the contract by arranging for a broker-dealer to make or accept delivery and paying the broker-dealer a commission plus any difference between the contract price and the current market price of the commodity.

55-94 The arrangement is considered a market mechanism under paragraph 815-10-15-110.

55-95 In contrast, an agreement whereby the broker-dealer will merely make (or accept) delivery on behalf of an entity does not relieve the entity of its rights and obligations under the contract and is thereby is not a market mechanism.

>>> Case B: Mechanism to Offset Does Not Relieve Rights and Obligations

55-96 Entity A contracts to sell a commodity such as iron ore to Entity B at a fixed price, and Entity B offsets its purchase contract by entering into a separate contract to sell the same commodity to Entity C at a different fixed price, instructing Entity A to deliver directly to Entity C. If Entity A fails to deliver to Entity C, Entity C will legally look to Entity B for remedy, not Entity A. Even absent failure to perform, Entity B will still pay Entity A, and Entity C will pay Entity B, even though Entity A may deliver directly to Entity C. Assume the contracts in this series have an underlying and a notional amount and, therefore, they will at any given point in time have a positive or negative fair value.

55-97 The arrangement is not a market mechanism because Entity B is not relieved of its rights and obligations from the original contract. The original contract survives and is not actually sold. The offsetting contract carries a new set of legal rights and obligations; however, those rights and obligations generally offset, rather than relieve, the original contract's set of legal rights and obligations.

>>> Case C: Mechanism to Offset Relieves Rights and Obligations

55-98 A mercantile exchange that trades futures contracts offers a ready opportunity to enter into an offsetting contract that can precisely cancel the rights and obligations of another futures contract (because the counterparty legally is the futures exchange itself), and thus the mercantile exchange does constitute a market mechanism.



Question 3.5.170

How is the significance of transaction costs determined?

Interpretive response: The third primary characteristic of a market mechanism is liquidation of the net position does not require significant transaction costs. An entity generally should consider transaction costs to be significant if they are

10% or more of the fair value of the contract. We believe this determination should be based on estimated fees and transaction costs that would be charged by third parties if the contract were liquidated through a market mechanism.

Determining whether transaction costs are significant can be complex because the focus is on whether the contract (i.e. the net gain or loss in the contract) can be settled in the market – not whether the underlying assets to be delivered under the contract can be sold in the market.



Question 3.5.180

Does an entity assess the significance of transaction costs continuously throughout a contract's life?

Interpretive response: No. We believe significance is assessed at the following times: [815-10-15-127]

- at inception of the contract; and
- whenever a condition – *other than* the significance of transactions costs – changes such that the contract would now otherwise qualify as a derivative. When such a change occurs, the contract must satisfy the 10% conversion costs significance test (if relevant) for the contract to be considered a derivative (see Questions 3.5.250 and 3.5.260).

3.5.40 Delivery of a derivative or an asset that is readily convertible to cash



Excerpt from ASC 815-10

20 Glossary

Readily Convertible to Cash – Assets that are readily convertible to cash have both of the following:

- a. Interchangeable (fungible) units
- b. Quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

(Based on paragraph 83(a) of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.)

>>> Net Settlement by Delivery of Derivative Instrument or Asset Readily Convertible to Cash

15-119 In this form of net settlement, one of the parties is required to deliver an asset of the type described in paragraph 815-10-15-100, but that asset is readily convertible to cash or is itself a derivative instrument.

15-120 An example of a contract with this form of net settlement 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 instrument.

15-121 Examples of assets that are readily convertible to cash include 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.

15-122 An asset (whether financial or nonfinancial) shall be considered to be readily convertible to cash only if the net amount of cash that would be received from a sale of the asset in an active market is either equal to or not significantly less than the amount an entity would typically have received under a net settlement provision. The net amount that would be received upon sale need not be equal to the amount typically received under a net settlement provision. Parties generally should be indifferent as to whether they exchange cash or the assets associated with the underlying, although the term *indifferent* is not intended to imply an approximate equivalence between net settlement and proceeds from sale in an active market.

15-123 The form of a financial instrument is important; individual instruments cannot be combined for evaluation purposes to circumvent compliance with the criteria beginning in paragraph 815-10-15-119. Example 8 (see paragraph 815-10-55-111) illustrates this guidance.

>>>> Asset's Suitability as Collateral Does Not Equate to Asset Being Readily Convertible to Cash

15-129 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.

>>>> Determining Whether Shares of Stock Are Readily Convertible to Cash

15-130 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.

>>>> Ongoing Evaluation of Readily Convertible to Cash

15-139 The evaluation of whether items to be delivered under a contract are readily convertible to cash shall be performed at inception and on an ongoing basis throughout a contract's life (except that, as stated in paragraph 815-10-15-127, the assessment of the significance of those conversion costs shall be performed only at inception of the contract). Example 4, Cases B, C, and D (see paragraphs 815-10-55-87 through 55-89) illustrate this guidance.

The third method of net settlement is the settlement of a contract through delivery of an asset that: [\[815-10-15-120 – 15-122\]](#)

- is associated with the underlying in a denomination equal to the notional amount of the contract (or the notional amount plus a premium or minus a discount); and
- is either:
 - readily convertible to cash (e.g. a security or commodity traded in an active market); or
 - itself a derivative (e.g. a swaption).

In effect, this settlement method puts the recipient in a position not substantially different from net settlement.

In general, this settlement alternative requires that the counterparties be indifferent about whether they receive gross cash, net cash or the asset associated with the underlying in settlement if all three settlement methods are economically similar. The methods are considered economically similar if the asset is readily convertible to cash or is itself a derivative instrument and therefore the conversion of such item into cash is readily available. [815-10-15-122]

The evaluation of whether items to be delivered under a contract are readily convertible to cash must be performed at inception of the contract and on an ongoing basis throughout the contract's life. As a result, the determination of whether an asset is readily convertible to cash may change over time – e.g. as markets for the subject of the contract change in liquidity or as instruments become listed on, or delisted from, stock exchanges; see Question 3.5.260 regarding the timing of assessing the significance of conversion costs and section 3.6 regarding the ongoing evaluation of whether a financial instrument or other contract meets the definition of a derivative. [810-15-15-139]

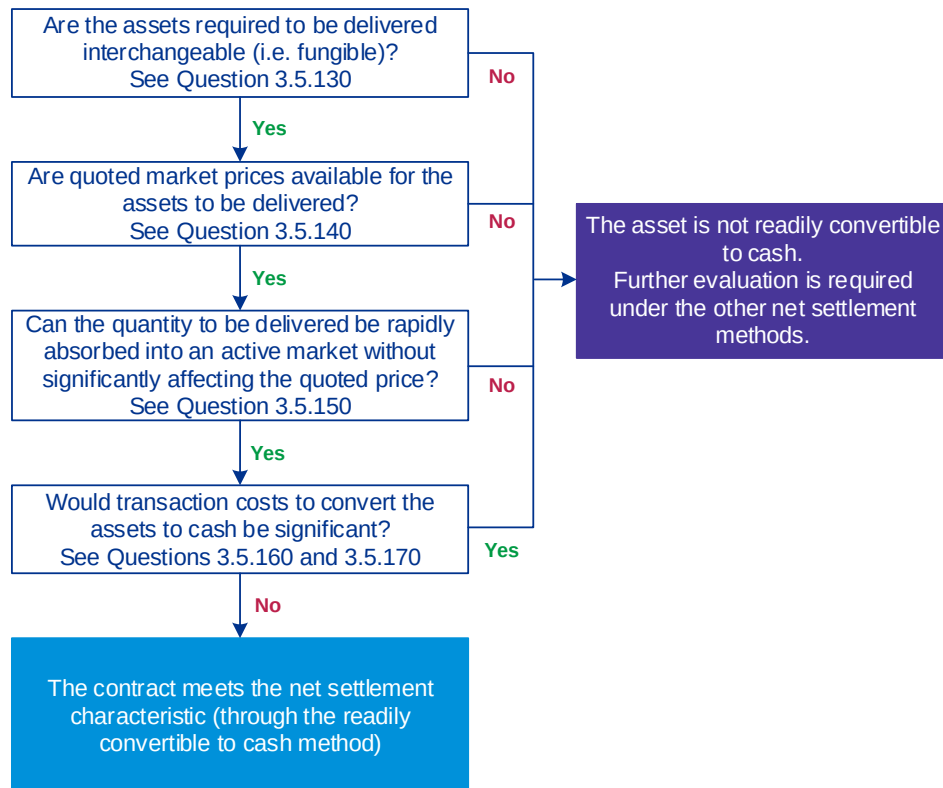
When a contract does not provide for delivery of a derivative or an asset that is readily convertible to cash, it may meet the net settlement characteristic through either contractual net settlement (see section 3.5.20) or a market mechanism that facilitates net settlement (see section 3.5.30).



Question 3.5.190

When do assets satisfy the net settlement criterion using the 'readily convertible to cash' method?

Interpretive response: The concept of readily convertible to cash is one of the most difficult and important concepts in Topic 815. The following decision tree summarizes the requirements for assets to satisfy the net settlement criterion using the 'readily convertible to cash' method. [815-10 Glossary, 15-125, 15-129]



Question 3.5.200

What are some examples of assets that may be readily convertible to cash?

Interpretive response: The following are some examples of assets that may be readily convertible to cash.

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

The ability to use an asset as collateral in a borrowing does not mean it is readily convertible to cash. For example, use of a security that is not publicly traded as collateral in a lending arrangement does not cause the security to be readily convertible to cash. [815-10-15-129]



Question 3.5.210

Why does delivery of a derivative or asset that is readily convertible to cash meet the net settlement characteristic?

Interpretive response: Net settlement distinguishes a derivative from a nonderivative by permitting a contract to be settled without either party accepting the risks and costs customarily associated with owning and delivering the asset associated with the underlying (e.g. storage, maintenance and resale).

However, if the assets to be exchanged or delivered are associated with the underlying of the contract and are themselves readily convertible to cash, or are derivative instruments, those risks are minimal or nonexistent. Settlement using those assets is not substantially different from net, or cash, settlement and therefore the parties to contracts involving those assets generally should be indifferent about whether they exchange cash or the assets associated with the underlying.

In view of this indifference, the FASB decided to include as one of the methods that facilitates net settlement, the settlement with assets that puts the recipient in a position not substantially different from net, or cash, settlement. [FAS 133.BC265]



Question 3.5.220

What are 'interchangeable, fungible' units?

Interpretive response: We believe that all commodity products as well as many manufactured products are interchangeable, fungible units.

Topic 815 does not define these terms. Based on their common usage, these terms are typically used to mean the following.

- **Fungible:** Being of such a nature that one part or quantity may be replaced by another equal part or quantity to satisfy an obligation.
 - **Interchangeable:** Capable of being interchanged; permitting mutual substitution.
-



Question 3.5.230

What kinds of markets contain quoted market prices?

Interpretive response: In general, there are four kinds of markets in which instruments can be bought, sold or originated. The following table describes each and whether it contains quoted market prices as contemplated in Subtopic 815-10's definition of readily convertible to cash.

Description	Contains quoted market prices? ¹
Exchange market	
An exchange or auction market provides high visibility and order to the trading of instruments. Exchange markets typically have readily available quoted market prices. Examples of exchange markets include stock markets and commodity markets.	Yes, exchange markets contain quoted market prices as that term is used in Subtopic 815-10's Glossary.
Dealer market	
Dealers stand ready to trade (either buy or sell) for their own account, thereby providing liquidity in the market. Dealer markets typically have readily available quoted market prices. Examples of dealer markets include over-the-counter markets.	Yes, we believe dealer markets contain quoted market prices as that term is used in Subtopic 815-10's Glossary.
Brokered market	
Brokers attempt to match buyers with sellers but do not stand ready to trade for their own account. Brokered markets typically do not have readily available quoted market prices.	No, we believe most brokered markets do not contain quoted market prices as that term is used in Subtopic 815-10's Glossary.
Principal-to-principal market	
Both originations and resales are negotiated independently, with no intermediary, and little information is readily available related to the transaction.	No, we believe principal-to-principal markets do not contain quoted market prices as that term is used in Subtopic 815-10's Glossary.
Note: 1. If the instrument can be bought, sold or originated in a market that contains quoted market prices, an entity also evaluates the other requirements for an asset to be readily convertible to cash (see Question 3.5.190). This includes that the quantities to be delivered can be rapidly absorbed into an active market without significantly affecting the quoted market price (see Question 3.5.240).	



Question 3.5.240

How does an entity determine whether quantities to be delivered can be rapidly absorbed into an active market without significantly affecting the quoted market price?



Excerpt from ASC 815-10

>>>> Contracts Involving Multiple Deliveries

15-128 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* in the definition of *readily convertible to cash* shall be applied separately to the expected quantity in each delivery.

Interpretive response: An entity considers the quantity of the asset under the contract relative to daily transaction volume and how the market price would be affected if that quantity were sold within a few days. This determination requires judgment.

Publicly traded securities

In general, a publicly traded security delivered in settlement of an instrument or contract can be rapidly absorbed into an active market without significantly affecting the quoted price if the number of shares or units of the security being delivered is small relative to the daily trading volume of that security.

Determining whether the number of shares or other units of the security is small relative to the daily trading volume of the security requires judgment, and should be based on whether it is considered economically feasible to convert the security into cash within a few days without significantly affecting the security price. See also Subtopic 815-10's Example 7, reproduced in section 3.5.50.

Contracts with multiple deliveries of the asset

For contracts that involve multiple deliveries of the asset, the phrase 'in an active market that can rapidly absorb the quantity held by the entity' should be applied separately to the expected quantity in each delivery. Therefore, an entity must determine whether an active market can rapidly absorb the quantity held by the entity for each expected quantity in each separate delivery for contracts that have multiple delivery dates. [815-10-15-128]

This concept is demonstrated in the following FASB Examples:

- In Subtopic 815-10's Example 7, Case A (reproduced in section 3.5.50), a convertible bond that is convertible into shares that are traded on an exchange may be converted in full or in increments. Because the number of shares underlying each increment can be sold rapidly into the market without the share price being significantly affected, the entire conversion option is considered to meet net settlement.

- In Subtopic 815-10's Example 8 (reproduced in section 3.5.50), a supply contract to deliver 100 units of a commodity monthly for five years is considered to meet the net settlement characteristic because the market can rapidly absorb the separate deliveries of 100 units at the respective delivery dates. The entity is not required to consider whether the total delivery of 6,000 units can be rapidly absorbed on a single date without significantly affecting the price.

Similarly, as discussed in section 5.3.10, Topic 815 generally uses an individual contract basis to determine whether a contract meets the definition of a derivative.



Question 3.5.250

How do costs to convert assets into cash affect whether assets are readily convertible to cash?



Excerpt from ASC 815-10

> > > Effect of Conversion Costs

15-125 If an entity determines that the estimated costs that would be incurred to immediately convert the asset to cash are not significant, then receipt of that asset puts the entity in a position not substantially different from net settlement. Therefore, an entity shall evaluate, in part, the significance of the estimated costs of converting the asset to cash in determining whether those assets are readily convertible to cash.

15-126 For purposes of assessing significance of such costs, an entity shall consider those estimated conversion costs to be significant only if they are 10 percent or more of the gross sales proceeds (based on the spot price at the inception of the contract) that would be received from the sale of those assets in the closest or most economical active market.

Interpretive response: Even if the assets under a contract are fungible, have quoted market prices and are in a quantity that can be rapidly absorbed into an active market without significantly affecting the quoted price, additional costs to convert the assets into cash must be considered. This is because these additional costs would affect whether the counterparties to a contract would be indifferent to settle the contract net in cash or by receiving the assets under the contract. [\[815-10-15-125\]](#)

An entity should consider the estimated conversion costs to be significant only if they are 10% or more of the gross sales proceeds (based on the spot price at inception of the contract) that would be received from the sale of those assets in the closest or most economical active market. If the entity determines that the estimated costs that would be incurred to immediately convert the asset to cash are not significant, then receipt of that asset puts the entity in a position not substantially different from net settlement. [\[815-10-15-126\]](#)

The costs that must be considered are not restricted to transaction-related conversion costs (e.g. sales commissions, transaction fees) but also include all costs incurred in taking possession of the asset and converting the asset to cash (e.g. transportation, temporary storage).



Question 3.5.260

Does an entity assess the significance of conversion costs continuously throughout a contract's life?



Excerpt from ASC 815-10

>>>> Effect of Conversion Costs

15-127 The assessment of the significance of those conversion costs shall be performed only at inception of the contract.

Interpretive response: No. Subtopic 815-10 states that the significance of conversion costs are assessed only at a contract's inception. We believe significance is also assessed whenever a condition – *other than* the significance of transactions costs – changes such that the contract would now otherwise qualify as a derivative. When such a change occurs, the contract must satisfy the 10% conversion costs significance test (if relevant) for the contract to be considered a derivative. [815-10-15-127]

If, at inception of the contract, the conversion costs are less than 10% of the gross proceeds based on the spot price at inception of the contract, the assets are considered readily convertible to cash. This is the case even if those costs rise over time and eventually exceed 10% of the gross sales price.

Conversely, if the costs equal or exceed 10% of the estimated gross sales proceeds at inception of the contract, the assets are not considered readily convertible to cash even if those costs decrease over time and eventually are less than 10%.



Example 3.5.20

Significance of transaction costs

ABC Corp. enters into a forward contract to purchase a fixed number of barrels of oil for \$500 million. The contract is to be settled by physical delivery of the oil. The oil is fungible and there are quoted prices available in an active market that can readily absorb the quantity of oil being purchased under the contract without significantly affecting the price.

The expected conversion costs and estimated gross proceeds that would be received from the subsequent sale of the oil are as follows.

Estimated gross proceeds (based on the spot price of oil at inception of the contract)	\$480 million
Conversion costs (Expected costs associated with transportation, temporary storage, and sales commissions in converting the oil to cash)	\$45 million
Conversion costs as a % of estimated gross proceeds	9.375%

The oil is considered readily convertible to cash and therefore this contract meets the net settlement criterion because:

- the oil is fungible;
- there are quoted prices available in an active market that can readily absorb the quantity of oil being purchased under the contract without significantly affecting the price; and
- the conversion costs are less than 10% of the estimated gross proceeds.



Question 3.5.270

Are publicly traded securities deliverable upon exercise of a warrant issued by an entity on its own shares readily convertible to cash if they are restricted from sale or transfer?



Excerpt from ASC 815-10

>>>> Determining Whether Shares of Stock Are Readily Convertible to Cash

15-131 Shares of stock in a publicly traded entity to be received upon the exercise of a stock purchase warrant do not meet the characteristic of being readily convertible to cash if both of the following conditions exist:

- a. The stock purchase warrant is issued by an entity for only its own stock (or stock of its consolidated subsidiaries).
- b. The sale or transfer of the issued shares is restricted (other than in connection with being pledged as collateral) for a period of 32 days or more from the date the stock purchase warrant is exercised.

15-132 Restrictions imposed by a stock purchase warrant on the sale or transfer of shares of stock that are received from the exercise of that warrant issued by an entity for other than its own stock (whether those restrictions are for more or less than 32 days) do not affect the determination of whether those shares are readily convertible to cash. The accounting for restricted stock to be received upon exercise of a stock purchase warrant shall not be analogized to any other type of contract.

15-133 Newly outstanding shares of common stock in a publicly traded company to be received upon exercise of a stock purchase warrant cannot be considered readily convertible to cash if, upon issuance of the shares, the sale

or transfer of the shares is restricted (other than in connection with being pledged as collateral) for more than 31 days from the date the stock purchase warrant is exercised (not the date the warrant is issued), unless the holder has the power by contract or otherwise to cause the requirement to be met within 31 days of the date the stock purchase warrant is exercised.

15-134 In contrast, if the sale of an actively traded security is restricted for 31 days or less from the date the stock purchase warrants are exercised, that limitation is not considered sufficiently significant to serve as an impediment to considering the shares to be received upon exercise of those stock purchase warrants as readily convertible to cash.

15-135 The guidance that a restriction for more than 31 days prevents the shares from being considered readily convertible to cash applies only to stock purchase warrants issued by an entity for its own shares of stock, in which case the shares being issued upon exercise are newly outstanding (including issuance of treasury shares) and are restricted with respect to their sale or transfer for a specified period of time beginning on the date the stock purchase warrant is exercised.

15-136 However, even if the sale or transfer of the shares is restricted for 31 days or less after the stock purchase warrant is exercised, an entity still must evaluate both of the following criteria:

- a. Whether an active market can rapidly absorb the quantity of stock to be received upon exercise of the warrant without significantly affecting the price
- b. Whether the other estimated costs to convert the stock to cash are expected to be not significant. (The assessment of the significance of those conversion costs shall be performed only at inception of the contract.)

Thus, the guidance in paragraph 815-10-15-122 shall be applied to those stock purchase warrants with sale or transfer restrictions of 31 days or less on the shares of stock.

15-137 If the shares of an actively traded common stock to be received upon exercise of the stock purchase warrant can be reasonably expected to qualify for sale within 31 days of their receipt, such as may be the case under SEC Rule 144, Selling Restricted and Control Securities, or similar rules of the SEC, any initial sales restriction is not an impediment to considering those shares as *readily convertible to cash*, as that phrase is used in paragraph 815-10-15-119. (However, a restriction on the sale or transfer of shares of stock that are received from an entity other than the issuer of that stock through the exercise of another option or the settlement of a forward contract is not an impediment to considering those shares readily convertible to cash, regardless of whether the restriction is for a period that is more or less than 32 days from the date of exercise or settlement.)

15-138 Paragraph 815-10-15-141 explains that the guidance in the Certain Contracts on Debt and Equity Securities Subsections applies to those warrants that are not derivative instruments subject to this Topic but that involve the acquisition of securities that will be accounted for under either Topic 320 or Topic 321. However, such warrants are not eligible to be hedging instruments.

Interpretive response: An entity may issue a warrant that requires it to deliver its own publicly traded securities at settlement, but that restricts the sale or transfer of those publicly traded securities for a specified period of time beginning on the date the warrant is exercised. Whether the underlying shares of common stock are readily convertible to cash depends on the length of the restriction period: [815-10-15-131, 15-134, 15-136]

- **31 days or less:** The underlying shares are readily convertible to cash if they otherwise meet that definition.
- **More than 31 days:** The underlying shares of common stock are not readily convertible to cash.

This guidance only applies to stock purchase warrants issued by one of the parties to the contract for its own shares of common stock or the stock of its consolidated subsidiary. We believe the term ‘stock purchase warrant’ encompasses any stock purchase options issued by one of the parties to the contract for its own shares of stock that are physically settled. [815-10-15-132, 15-135]

This guidance should not be analogized to other instruments with restrictions on tradability or disposal. For example, it should not be analogized to the following: [815-10-15-132, 15-135]

- forward contracts on an entity's shares;
- commodity contracts that contain a restriction about the transfer or sale of the shares or commodity to be delivered under the contract; or
- contracts that do not involve issuance of securities of one of the parties to the contract for its own shares of common stock (or stock of its consolidated subsidiary).

3.5.50 Examples

The net settlement characteristic is the most complex of all the defining criteria of a derivative instrument. This section includes the following examples that illustrate the net settlement concept:

- Example 3.5.30, Evaluating net settlement in common contracts. This example identifies common contracts and indicates whether each meets the net settlement characteristic.
- Subtopic 815-10's Example 4, Net Settlement at Inception and Throughout a Contract's Life. This example illustrates that a financial instrument or other contract may become a derivative (or cease to be a derivative) because of events that occur after contract inception:
 - Case A: A broker-dealer market for a commodity contract develops such that a market mechanism develops.
 - Case B: An IPO makes shares readily convertible to cash.
 - Case C: Trading activity of a public entity's stock increases such that the shares become readily convertible to cash.
 - Case D: A public entity becomes delisted from a stock exchange, such that its shares are no longer readily convertible to cash.
- Subtopic 815-10's Example 7, Net Settlement—Readily Convertible to Cash—Effect of Daily Transaction Volumes. This example illustrates how to

evaluate whether shares underlying conversion options in bonds are readily convertible to cash because the shares can be sold rapidly without the share price being significantly affected.

- Case A: A single bond that can be converted in full or in increments.
- Case B: Multiple bonds that each have a single conversion option.
- Subtopic 815-10's Example 8: Net Settlement—Effect of Multiple Deliveries. This example illustrates the effect of multiple deliveries on the consideration of net settlement.



Example 3.5.30

Evaluating net settlement in common contracts

The following table presents examples of common contracts and identifies whether each meets the net settlement characteristic.

Description of contract	Is net settlement present?
ABC Corp. enters into a transaction in which it will exchange non-exchange traded fixed-rate debt for highly liquid, publicly traded common stock in the future.	Yes. Because one of the parties is required to deliver an asset associated with one of the underlyings (changes in the price of the publicly traded stock) and that asset is readily convertible to cash, net settlement is present (through the readily convertible to cash method).
ABC Corp. enters into a transaction in which it will exchange cash for highly liquid publicly traded preferred stock in the future.	Yes. Because one of the parties is required to deliver an asset associated with one of the underlyings (changes in the price of the publicly traded stock) and that asset is readily convertible to cash, net settlement is present (through the readily convertible to cash method).
ABC Corp. enters into a transaction in which it will exchange an equity method investment in a private investee for highly liquid publicly traded common stock in the future.	Yes. Because one of the parties is required to deliver an asset associated with one of the underlyings (changes in the price of the publicly traded stock) and that asset is readily convertible to cash, net settlement is present (through the readily convertible to cash method).
ABC Corp. enters into a transaction in which it will exchange an equity method investment in a private investee for cash in the future.	No. — The contractual net settlement method is not met because one of the parties is required to deliver an asset associated with one of the underlyings (changes in the price of the equity method investment). — The market mechanism method is not met because there is no market

Description of contract	Is net settlement present?
	mechanism to facilitate net settlement of the contract. — A derivative or an asset that is readily convertible to cash is not delivered because the equity method investment is not a derivative and is an interest in a private entity.
In conjunction with the issuance of debt, ABC Corp. (nonpublic) issues an option that allows DEF Corp. to acquire 100 shares of ABC's stock at a specified price for a period of two years. The option requires physical settlement – i.e. upon exercise, the option is settled through physical delivery of the full stated amount of the shares and not with net shares or cash.	No, net settlement is not met for the option. — The contractual net settlement method is not met because the option contract requires physical settlement. The asset being delivered in settlement of the option contract (ABC shares) is associated with the underlying and in a denomination equal to the notional amount. — The market mechanism method is not met because there is no market mechanism to facilitate net settlement of the option contract. — A derivative or an asset that is readily convertible to cash is not delivered because ABC's shares are not a derivative and are not publicly traded (so are not readily convertible to cash).
In conjunction with the issuance of debt, ABC Corp. (nonpublic) issues an option that allows DEF Corp. to acquire 100 shares of ABC's stock at a specified price for a period of two years. The option permits DEF to elect to either settle through physical delivery of the gross number of shares or through net share settlement.	Yes, net settlement is met for the option contract. The option contract provides for net settlement, even if the shares with which it is net settled are not readily convertible to cash (see also Question 3.5.30).
ABC Corp. enters into a contract to purchase 100 units of a unique metal in 60 days at a fixed price. The contract requires physical settlement.	No. — The contractual net settlement method is not met because settlement is through delivery of an asset that is associated with the underlying and denominated in an amount equal to the notional amount. — The market mechanism method is not met because there is no market mechanism to facilitate net settlement of the contract. — The delivery of a derivative or an asset that is readily convertible to cash method is not met because the

Description of contract	Is net settlement present?
	unique metal is not a derivative and is not readily convertible to cash.
ABC Corp. enters into a contract to purchase 100 units of a unique metal in 60 days at a fixed price. The contract is settled through delivery of gold (not the unique metal).	Yes. The contract can be settled with the physical delivery of gold, which is an asset that is neither associated with the underlying nor in a denomination equal to the notional amount.
ABC Corp. expects to purchase raw material inventory for £30,000 in three months. ABC's functional currency is the US dollar. To ensure it has adequate pounds sterling on hand for the purchase, ABC enters into a forward contract to acquire £30,000 in three months at a rate of US\$1.60/£1.00 (i.e. a foreign currency forward contract).	Yes. Because the foreign currency forward contract is settled with an asset that is readily convertible to cash, net settlement is met. This is the case even though the contract is settled in an asset that is associated with the underlying and in a denomination equal to the notional amount (£30,000).



Excerpt from ASC 815-10

>> Example 4: Net Settlement at Inception and Throughout a Contract's Life

55-84 As required by paragraphs 815-10-15-110 through 15-118 and 815-10-15-119 through 15-120, respectively, the evaluation of whether a market mechanism exists and whether items to be delivered under a contract are readily convertible to cash must be performed at inception and on an ongoing basis throughout a contract's life. For example, if a market develops, if an entity effects an initial public offering, or if daily trading volume changes for a sustained period of time, then those events need to be considered in reevaluating whether the contract meets the definition of a derivative instrument. Similarly, if events occur after the inception or acquisition of a contract that would cause a contract that previously met the definition of a derivative instrument to cease meeting the criteria (for example, an entity becomes delisted from a national stock exchange), then that contract cannot continue to be accounted for under this Subtopic. The guidance in paragraphs 815-10-15-125 through 15-127 about assessing the significance of transaction costs is not relevant when determining whether such a contract no longer meets the definition of a derivative instrument.

55-85 The following Cases illustrate the importance of ongoing evaluation:

- Market mechanism develops after contract inception (Case A).
- Initial public offering makes shares readily convertible to cash after contract inception (Case B).
- Increased trading activity makes shares readily convertible to cash after contract inception (Case C).

- d. Delisting makes shares not readily convertible to cash after contract inception (Case D).

>>> Case A: Market Mechanism Develops After Contract Inception

55-86 A purchase contract for future delivery of commodity X is entered into and, at the inception of the contract, the market for contracts on commodity X is a relatively thin market, such that brokers do not stand ready to buy and sell the contracts. As time passes, the market for commodity X matures and broker-dealer networks develop. The existence of the broker-dealer market and the ability of the purchaser to be relieved of its rights and obligations under the purchase contract are consistent with the characteristics of a market mechanism as discussed beginning in paragraph 815-10-15-110. Accordingly, the purchase contract will have the characteristics of net settlement as defined by paragraph 815-10-15-110 as broker-dealer networks develop.

>>> Case B: Initial Public Offering Makes Shares Readily Convertible to Cash After Contract Inception

55-87 A nontransferable forward contract on a nonpublic entity's stock that provides only for gross physical settlement is generally not a derivative instrument because the net settlement criteria are not met. If the entity, at some point in the future, accomplishes an initial public offering of its shares and the original contract is still outstanding, the shares to be delivered would be considered to be readily convertible to cash (assuming that the shares under the contract could be rapidly absorbed in the market without significantly affecting the price).

>>> Case C: Increased Trading Activity Makes Shares Readily Convertible to Cash After Contract Inception

55-88 A nontransferable forward contract on a public entity's stock provides for delivery on a single date of a significant number of shares that, at the inception of the contract, would significantly affect the price of the public entity's stock in the market if sold within a few days. As a result, the contract does not satisfy the readily-convertible-to-cash criterion. However, at some later date, the trading activity of the public entity's stock increases significantly. Upon a subsequent evaluation of whether the shares are readily convertible to cash, the number of shares to be delivered would be minimal in relation to the new average daily trading volume such that the contract would then satisfy the net settlement characteristic.

>>> Case D: Delisting Makes Shares Not Readily Convertible to Cash After Contract Inception

55-89 A nontransferable forward contract on a public entity's stock meets the net settlement criteria (as discussed beginning in paragraph 815-10-15-119) in that, at inception of the contract, the shares are expected to be readily convertible to cash when delivered under the contract. Assume that there is no other way that the contract meets the net settlement criteria. The public entity subsequently becomes delisted from the stock exchange, thus causing the shares to be delivered under the contract to no longer be readily convertible to cash.

>> Example 7: Net Settlement—Readily Convertible to Cash—Effect of Daily Transaction Volumes

55-99 The following Cases illustrate consideration of the relevance of daily transaction volumes to the characteristic of net settlement in deciding whether, from the investor's perspective, the convertible bond contains an embedded derivative that must be accounted for separately:

- a. Single bond with multiple conversion options (Case A)
- b. Multiple bonds each having single conversion option (Case B).

55-100 The Cases illustrate that the form of the financial instrument is important; paragraph 815-10-15-123 explains that individual instruments cannot be combined for evaluation purposes to circumvent compliance with the criteria beginning in paragraph 815-10-15-119. Further, paragraph 815-10-15-111(c) explains that contracts shall be evaluated on an individual basis, not on an aggregate-holdings basis.

>>> Case A: Single Bond with Multiple Conversion Options

55-101 Investor A holds a convertible bond classified as an available-for-sale security under Topic 320. The bond has all of the following additional characteristics:

- a. It is not exchange-traded and can be converted into common stock of the debtor, which is traded on an exchange.
- b. It has a face amount of \$100 million and is convertible into 10 million shares of common stock.
- c. It may be converted in full or in increments of \$1,000 immediately or at any time during the next 2 years.
- d. If it were converted in a \$1,000 increment, Investor A would receive 100 shares of common stock.

55-102 Assume further that the market condition for the debtor's stock is such that up to 500,000 shares of its stock can be sold rapidly without the share price being significantly affected.

55-103 The embedded conversion option meets the criteria in paragraph 815-10-15-83(a) through (b) but does not meet the criteria in paragraphs 815-10-15-100 and 815-10-15-110, in part because the option is not traded and it cannot be separated and transferred to another party.

55-104 It is clear that the embedded equity conversion feature is not clearly and closely related to the debt host instrument.

55-105 The bond may be converted in \$1,000 increments and those increments, by themselves, may be sold rapidly without significantly affecting price, in which case the criteria discussed beginning in paragraph 815-10-15-119 would be met. However, if the holder simultaneously converted the entire bond, or a significant portion of the bond, the shares received could not be readily converted to cash without incurring a significant block discount.

55-106 From Investor A's perspective, the conversion option should be accounted for as a compound embedded derivative in its entirety, separately from the debt host, because the conversion feature allows the holder to convert the convertible bond in 100,000 increments and the shares converted in each increment are readily convertible to cash under the criteria discussed

beginning in paragraph 815-10-15-119. Investor A need not determine whether the entire bond, if converted, could be sold without affecting the price.

55-107 Because the \$100 million bond is convertible in increments of \$1,000, the convertible bond is essentially embedded with 100,000 equity conversion options, each with a notional amount of 100 shares. Each of the equity conversion options individually has the characteristic of net settlement discussed beginning in paragraph 815-10-15-119 because the 100 shares to be delivered are readily convertible to cash. Because the equity conversion options are not clearly and closely related to the host debt instrument, they must be separately accounted for. However, because an entity cannot identify more than 1 embedded derivative that warrants separate accounting, the 100,000 equity conversion options must be bifurcated as a single compound derivative. (Paragraphs 815-15-25-7 through 25-10 say an entity is not permitted to account separately for more than one derivative feature embedded in a single hybrid instrument.)

55-108 There is a substantive difference between a \$100 million convertible debt instrument that can be converted into equity shares only at one time in its entirety and a similar instrument that can be converted in increments of \$1,000 of tendered debt; the analysis of the latter should not presume equality with the former.

>>> Case B: Multiple Bonds Each Having Single Conversion Option

55-109 Investor B has 100,000 individual \$1,000 bonds that each convert into 100 shares of common stock. Assume those bonds are individual instruments but they were issued concurrently to Investor B.

55-110 From Investor B's perspective, the individual bonds each contain an embedded derivative that must be separately accounted for. Each individual bond is convertible into 100 shares, and the market would absorb 100 shares without significantly affecting the price of the stock.

>> Example 8: Net Settlement—Effect of Multiple Deliveries

55-111 This Example illustrates the effect of multiple deliveries on the consideration of net settlement described in Section 815-10-15. An entity has a five-year supply contract that obligates it to deliver at a specified price each month a specified quantity of a commodity that has interchangeable (fungible) units and for which quoted prices are available in an active market. However, the quoted prices that are available are for either a spot sale or a forward sale of the commodity with a maturity of 12 months or less. In other words, the forward market for the commodity beyond the next 12 months does not currently exist and is not expected to develop. There are brokers who are willing to take over the rights and obligations relating to the next 12 months of the supply contract, but not for periods beyond the next 12 months. With respect to the active spot market for the commodity, it can rapidly absorb the quantity specified in the supply contract for each individual month but not the total quantity for the entire five-year period in a single transaction (or in multiple transactions over the course of a day or so).

55-112 The supply contract does not contain a net settlement provision as described in paragraphs 815-10-15-100 through 15-109.

55-113 The 5-year commodity supply contract does not meet the net settlement characteristic in paragraph 815-10-15-110 at its inception because there is no market mechanism to net settle the entire 5-year contract—the forward market exists only for the next 12 months while the contract period is for the next 5 years. Accordingly, there is no market mechanism for the entity to settle the entire contract on a net basis. However, if the contract contained contractually separable increments that individually met the net settlement criteria, those contractually separable increments may be embedded derivatives. In this instance, the brokers in the market will not assume the rights and obligations of the entire contract. Note that the market mechanism in the net settlement characteristic in paragraph 815-10-15-110 relates to whether a party to the contract can be relieved of its rights and obligations under the entire contract, not merely whether an independent broker in the market stands ready to assume the selected rights and obligations.

55-114 The definition of a derivative instrument in this Subtopic must be applied based on the actual terms of the contract, including its maturity date and the total quantity of the underlying. This Subtopic does not permit bifurcation of a 5-year contract into 5 annual contracts, 60 monthly contracts, or 1,826 daily contracts in an attempt to assert that only a portion of the contract meets the definition of a derivative instrument. To do so would be to disregard one of the critical terms of the contract, that is, the term to the maturity date of the contract.

55-115 Based on the guidance in paragraph 815-10-15-3, the five-year commodity supply contract in the example, would, at the beginning of the fifth year, be reevaluated to determine whether the contract meets the net settlement characteristic in paragraph 815-10-15-110 and would likely meet the characteristic because a forward market for the contract would then exist for the remaining term of the contract.

55-116 The five-year commodity supply contract meets the net settlement characteristic as discussed beginning in paragraph 815-10-15-119. The criterion discussed beginning in that paragraph is met because an active spot market for the commodity exists today and is expected to be in existence in the future for each delivery date (for example, for quantities to be delivered each day or each month for the next five years) under the multiple delivery supply contract. The spot market can rapidly absorb the quantities specified for each monthly delivery without significantly affecting the price. The fact that the spot market may not be able to absorb within a few days the quantity specified in the entire five-year contract is irrelevant because the performance of the contract is spread out over a five-year period and, therefore, is not expected to occur within a few days.

55-117 This Example does not address whether or not the contract would qualify for the normal purchases and normal sales scope exception as discussed beginning in paragraph 815-10-15-22.

3.6 Ongoing evaluation



Excerpt from ASC 815-10

> Instruments

15-3 If events occur after the inception or acquisition of a contract that cause the contract to meet the definition of a derivative instrument, then that contract shall be accounted for at that later date as a derivative instrument under this Subtopic unless one of the scope exceptions in this Subsection applies.

>>>> Ongoing Evaluation of Market Mechanism

15-118 The evaluation of whether a market mechanism exists shall be performed at inception and on an ongoing basis throughout a contract's life. Example 4, Case A (see paragraph 815-10-55-86) illustrates this guidance.



Question 3.6.10

Can a financial instrument or other contract that does not initially meet the definition of a derivative later meet it (or vice versa)?

Interpretive response: Yes. An entity is required to evaluate whether a financial instrument or other contract meets the definition of a derivative at inception and on an ongoing basis. As a result, whether a financial instrument or other contract is a derivative may change over time. Additionally, events may occur that result in a financial instrument or contract that previously met the definition of a derivative no longer meeting that definition. [815-10-15-118, 30-3]

As a practical matter, whether a contract has an underlying and a notional or payment provision, and whether the initial net investment characteristic is met generally will not change over time. Further, an entity evaluates whether transaction costs or conversion costs, as applicable, are significant at certain points in time (see Questions 3.5.180 and 3.5.260).

The following table summarizes whether each derivative characteristic is evaluated each reporting period after inception.

Derivative characteristic	Reassessed each reporting period?
Underlying + Notional amount or Payment provision (section 3.3)	Generally, no. This is because whether a contract has an underlying and either a notional or a payment provision generally does not change after contract inception. Although whether a contract has a notional amount generally is not reassessed each reporting period, the determination of a contract's notional amount must be performed over the life of the contract and potentially can fluctuate. For example, if the default provisions reference a rolling cumulative average of historical

Derivative characteristic	Reassessed each reporting period?
	usage, the notional amount will fluctuate with fluctuations in the rolling cumulative average.
Initial net investment (section 3.4)	Generally, no. This is because whether the initial net investment characteristic is met for a contract generally does not change after contract inception.
Net settlement – contractual net settlement (section 3.5.20)	Generally, no. This is because whether a contract provides for contractual net settlement generally does not change after contract inception.
Net settlement – market mechanism (section 3.5.30)	Yes. A market mechanism may develop (or cease to exist) after a contract's inception. As a result, when evaluating whether a contract meets the net settlement characteristic each period, an entity evaluates whether a market mechanism to facilitate net settlement exists. However, one of the primary characteristics of a market mechanism is that liquidation of the net position does not require significant transaction costs. An entity only assesses significance of transaction costs at inception of a contract and when a condition (other than significance of transaction costs) changes such that the contract would now otherwise qualify as a derivative; see Question 3.5.180.
Net settlement – delivery of a derivative or an asset that is readily convertible to cash (section 3.5.40)	Yes. Whether an asset to be delivered is a derivative or is readily convertible to cash may change after a contract's inception. As a result, when evaluating whether a contract meets the net settlement characteristic each period, an entity evaluates whether an asset to be delivered under the contract is a derivative or is readily convertible to cash. However, determining whether an asset is readily convertible to cash includes considering whether costs to convert the assets into cash are significant. An entity only assesses significance of conversion costs at inception of a contract and when a condition (other than significance of transaction costs) changes such that the contract would now otherwise qualify as a derivative; see Question 3.5.260.

5. Accounting for derivatives**

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This is a new chapter added in this edition **

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Example

- 5.5.10 Accounting for a debt instrument and bifurcated embedded derivative

5.1 How the standard works

A derivative instrument is recorded on the balance sheet as an asset or liability. It is measured both initially and subsequently at fair value.

The following table summarizes how changes in fair value of derivatives are reported.

Type of derivative	How changes in fair value are reported
Freestanding derivatives (section 5.4.10)	
Nonhedging	Changes in fair value are reported in earnings.
Hedging instrument	Depends on the type of hedge and risk(s) being hedged. However, under all types of hedges, the timing of recognizing changes in fair value is generally matched with the offsetting losses and gains from the hedged item or forecasted transaction. For further information about accounting for hedging relationships, see the following guidance: — Fair value hedges (chapter 8) — Cash flow hedges (chapter 10) — Net investment hedges (section 12.5).
Embedded derivatives (section 5.5.10)	
Hybrid instrument is measured at fair value in its entirety	Changes in fair value of the hybrid instrument (in its entirety) are reported in earnings. However, if the hybrid instrument is a liability measured at fair value due to an election made by the entity, the portion of the total change in the fair value that results from a change in the instrument-specific credit risk is reported in OCI. These instruments are not eligible as hedging instruments; see section 6.7.40 for limitations on hybrid instruments and component derivatives as hedging instruments.
Embedded derivative is separated and is not designated as a hedging instrument	Changes in fair value of the embedded derivative are reported in earnings.
Embedded derivative is separated and is designated as a hedging instrument	Similar to freestanding derivatives (above) that are designated as hedging instruments. See section 6.7.40 for limitations on hybrid instruments and component derivatives as hedging instruments.

5.2 Fundamentals of Topic 815



Excerpt from ASC 815-10

10-1 Four fundamental decisions serve as cornerstones underlying the guidance in this Topic:

- 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.

Topic 815 provides comprehensive guidance on accounting for all derivative instruments and hedging activities. In finalizing the Topic in its current form, the FASB made four fundamental decisions that serve as the cornerstones of accounting for derivative instruments and hedging activities.

Those four decisions and their accounting implications are summarized as follows.

Derivative instruments are assets or liabilities

The FASB concluded that derivative instruments are assets or liabilities because they represent rights or obligations and embody the characteristics of assets and liabilities described in FASB Concepts Statement No. 6, Elements of Financial Statements (CON 6). [FAS 133.BC218–BC219]

- The ability to settle a derivative instrument in a gain position by receiving cash, another financial asset or a nonfinancial asset is evidence of a right to a future economic benefit and is compelling evidence that the derivative instrument is an asset.
- The payment of cash, a financial asset or a nonfinancial asset to settle a derivative instrument in a loss position is evidence of an obligation to sacrifice assets in the future and indicates that the derivative instrument is a liability.

As assets or liabilities, derivative instruments are recognized to make financial statements more complete and more informative. [FAS 133.BC219]

The only relevant measure for derivative instruments is fair value¹	The FASB concluded that fair value is the only relevant measurement attribute for derivative instruments for many of the same reasons that fair value is relevant for financial instruments in general. [FAS 133.BC220–BC222] — Fair value for financial assets and liabilities provides more relevant and understandable information than cost or cost-based measures, particularly when assessing an entity's liquidity or solvency. — Fair value measurements are practical for most financial assets and liabilities. Fair value measurements can be observed in markets or estimated by reference to markets for similar instruments. When market information is not available, fair value can be estimated using other measurement techniques (e.g. discounted cash flow analyses, pricing models). Further, amortized cost is not a relevant measure for a derivative instrument because its historical cost is often zero even though it generally can be settled at any time for an amount equal to its fair value.¹ [FAS 133.BC223] Note: 1. When applying the simplified hedge accounting approach, a private entity may elect to measure the interest rate swap at settlement value instead of at fair value (see section 16.2).
Only assets and liabilities should be recorded as such	Because derivative instruments are recognized and measured at fair value on the balance sheet, the losses and gains resulting from changes in fair value must also be reported in the financial statements. However, those losses or gains do not have the essential characteristics of assets or liabilities under CON 6. [FAS 133.BC229] — A loss on a derivative instrument is not an asset because no future economic benefit is associated with it. It cannot be exchanged for cash, a financial asset or a nonfinancial asset used to produce something of value, or used to settle liabilities. — A gain on a derivative instrument is not a liability because no obligation exists to sacrifice assets in the future. As a result, the FASB concluded that losses or gains on derivative instruments should not be deferred on the balance sheet.
Special hedge accounting should be provided only for qualified transactions	Because hedge accounting is elective and relies on management's intent, it is limited to transactions that meet certain criteria. This includes that the derivative (or nonderivative in very limited circumstances) hedging instrument is expected to be, and actually is, highly effective at offsetting changes in fair values or cash flows of the hedged item or forecasted transaction. This offset requirement precludes hedge accounting for certain risk management techniques (e.g. hedges of strategic risk). [FAS 133.BC230 – BC231] See summary of types of hedges and related hedge accounting in section 5.4.10. See detailed discussion of hedge criteria and accounting for hedging relationships in chapters 6 to 12.

5.3 Unit of account

5.3.10 Overview

The unit of account when applying Topic 815 is typically an individual contract or embedded feature within a contract. However, in certain situations, the following may occur:

- an embedded feature may be treated as if it were freestanding; or
- two separate contracts may be treated as if they were one.

Additionally, Topic 815 provides guidance for determining when attached and/or embedded options having the same terms should be combined.

Embedded feature treated as freestanding



Excerpt from ASC 815-10

>>> Viewing a Contract as Freestanding or Embedded

15-5 The notion of an **embedded derivative**, as discussed in paragraph 815-15-25-1, does not contemplate features that may be sold or traded separately from the contract in which those rights and obligations are embedded. Assuming they meet this Subtopic's definition of a derivative instrument, such features shall be considered attached **freestanding** derivative instruments rather than embedded derivatives by both the writer and the current holder.

15-6 A put or call option that is added or attached to a debt instrument by a third party contemporaneously with or after the issuance of the debt instrument shall be separately accounted for as a derivative instrument under this Subtopic by the investor (that is, by the creditor). An option that is added or attached to an existing debt instrument by another party results in the investor having different counterparties for the option and the debt instrument and, thus, the option shall not be considered an embedded derivative. Paragraph 815-15-25-2 states that notion of an embedded derivative in a hybrid instrument refers to provisions incorporated into a single contract, and not to provisions in separate contracts between different counterparties.

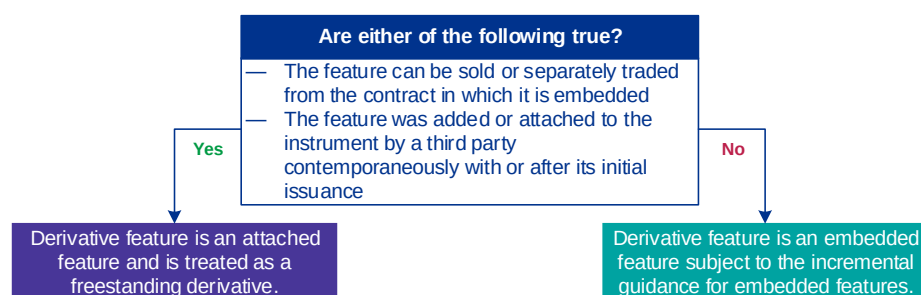
15-7 If a debt instrument includes in its terms at issuance an option feature that is explicitly transferable independent of the debt instrument and thus is potentially exercisable by a party other than either the issuer of the debt instrument (the debtor) or the holder of the debt instrument (the investor), that option shall be considered under this Subtopic as an attached freestanding derivative instrument, rather than an embedded derivative, by both the writer and the holder of the option.

>>> A Transferable Option Is Considered Freestanding, Not Embedded

55-3 Certain structured transactions involving the issuance of a bond incorporate transferable options to call or put the bond. As such, those options are potentially exercisable by a party other than the debtor or the investor. For example, certain put bond structures involving three separate parties—the debtor, the investor, and an investment bank—may incorporate options that

are ultimately held by the investment bank, giving that party the right to call the bond from the investor. For example, a call option that is transferable either by the debtor to a third party and thus is potentially exercisable by a party other than the debtor or by the original investor based on the legal agreements governing the debt issuance can result in the investor having different counterparties for the option and the original debt instrument. Accordingly, even if incorporated into the terms of the original debt agreement, such an option may not be considered an **embedded derivative** by either the debtor or the investor because it can be separated from the bond and effectively sold to a third party.

Topic 815 requires both freestanding derivative instruments and embedded derivative components to be accounted for as derivatives, unless a scope exception applies. However, there is incremental guidance that applies when determining whether an embedded derivative component must be accounted for as a derivative. As a result, it is important to determine whether features of a contract are considered embedded or are simply attached and therefore should be treated as freestanding. [815-10-15-5 – 15-7]



The following are examples of attached features; see also Subtopic 815-10's Example 1, reproduced in section 5.3.20. [815-10-15-5 – 15-7]

- a put or call option that is added or attached by a third party either contemporaneously with or after initial issuance of the debt instrument.
- a put or call option that is explicitly transferable independent of the debt instrument under the terms of the debt instrument.

Combining attached and/or embedded options with the same terms



Excerpt from ASC 815-10

>> Viewing Combinations of Options as Separate Options or as a Single Forward Contract

25-7 This guidance addresses a combination of two options—one that is a purchased call (put) option and another that is a written put (call) option—having all of the following characteristics:

- a. They have the same strike price, **notional amount**, and exercise date.
- b. They have the same **underlying**.
- c. Neither is required to be exercised.

25-8 The guidance addresses such options in two contexts:

- a. Combinations of two freestanding options or a freestanding and embedded option
- b. Combinations of two embedded options.

25-9 Derivative instruments that are transferable are, by their nature, separate and distinct contracts. Accordingly, a separate **freestanding** purchased call (put) option and written put (call) option with all of the characteristics in paragraph 815-10-25-7 convey rights and obligations that are distinct whether involving the same or different counterparties and do not warrant bundling as a single forward contract for accounting purposes under this Subtopic by any party to the contracts. (The separate purchased option and written option can be viewed in combination and jointly designated as the hedging instrument pursuant to paragraph 815-20-25-45.)

>>> Combinations of Two Freestanding Options or a Freestanding and Embedded Option

25-9A A combination of a freestanding purchased call (put) option and a freestanding or embedded (nontransferable) written put (call) option shall be considered for accounting purposes as separate option contracts, rather than a single forward contract, by both parties to the contracts even though all of the following conditions are met:

- a. The options have the same terms.
- b. The options have the same underlying.
- c. The options are entered into contemporaneously with the same counterparty at inception.

25-9B Both a combination of a freestanding purchased call (put) option and a freestanding or embedded (nontransferable) written put (call) option and a combination of a freestanding written call (put) option and an embedded (nontransferable) purchased put (call) option shall be considered for accounting purposes as separate option contracts, rather than a single forward contract, by both parties to the contracts even though all of the following conditions are met:

- a. The options have the same terms.
- b. The options have the same underlying.
- c. The options are entered into contemporaneously with different counterparties at inception.

>>> Combinations of Two Embedded Options

25-10 A combination of an embedded (nontransferable) purchased call (put) option and an embedded (nontransferable) written put (call) option in a single **hybrid instrument** with all of the characteristics in paragraph 815-10-25-7 and that are entered into contemporaneously with the same counterparty shall be considered as a single forward contract for purposes of applying the provisions of this Subtopic. The notion of the same counterparty encompasses contracts entered into directly with a single counterparty and contracts entered into with a single party that are structured through an intermediary. (Note that a share of

stock being puttable by the holder and callable by the issuer under the same terms does not render the stock mandatorily redeemable under the provisions of Topic 480.) Topic 480 requires that **mandatorily redeemable financial instruments** be classified as liabilities.

25-11 The embedded options are in substance an embedded forward contract because they meet both of the following conditions:

- They convey rights (to the holder) and obligations (to the writer) that are equivalent from an economic and risk perspective to an embedded forward contract.
- They cannot be separated from the hybrid instrument in which they are embedded.

25-12 Even though neither party is required to exercise its purchased option, the result of the overall structure is a hybrid instrument that will likely be redeemed at a point earlier than its stated maturity. That result is expected by both the hybrid instrument's issuer and investor regardless of whether the embedded feature that triggers the redemption is in the form of two separate options or a single forward contract.

25-13 However, if either party is required to exercise its purchased option before the stated maturity date of the hybrid instrument, the hybrid instrument shall not be viewed for accounting purposes as containing one or more **embedded derivatives**. In substance, the debtor (issuer) and creditor (investor) have agreed to terms that accelerate the stated maturity of the hybrid instrument and the exercise date of the option is essentially the hybrid instrument's actual maturity date. As a result, it is inappropriate to characterize the hybrid instrument as containing either of the following:

- Two embedded option contracts that are exercisable only on the actual maturity date
- An embedded forward contract that is a combination of an embedded purchased call (put) and a written put (call) with the same terms.

Topic 815 identifies scenarios where purchased and written options are either embedded or attached to a hybrid instrument. In all scenarios, the purchased call (put) option and the written call (put) option have the same strike price, notional amount, exercise date and underlying, and neither option is required to be exercised. Those three situations are summarized in the following table. [815-10-25-7 – 25-13]

Scenario	Are the options combined?
Both the purchased call (put) option and written put (call) option are embedded (nontransferable) in a hybrid instrument	Yes. The options are combined into one compound derivative. Essentially, the compound derivative feature is a synthetic forward because the terms of the options are the same. An embedded put or call option that is not separated from the host contract may be designated as the hedged item in a fair value hedge. When a purchased call (put) option and written put (call) option are combined into one compound derivative, an entity cannot separately designate either the purchased put option or the written put option as the hedged item. See also discussion in section 7.3.90 about using embedded put or call options as hedged items in a fair value hedge.

Scenario	Are the options combined?
The purchased call (put) option and/or the written put (call) option is freestanding (transferable) – e.g. attached options	No. When one or both options are freestanding (e.g. attached), the options are accounted for separately rather than as one compound derivative. This is the case even if the options are with the same counterparty. Because the options are accounted for separately, each can be separately designated as a hedging instrument . Additionally, an entity can treat a combination of a freestanding purchased call (put) option and a written put (call) option as one hedging instrument. See also discussion in chapter 6, including section 6.6.40 about using a combination of derivatives as the hedging instrument.

Two separate contracts are treated as one

An entity must view two or more contracts in combination to determine whether the contracts (in combination) represent a derivative instrument if the contracts were entered into separately simply to circumvent the provisions of Topic 815 (see Question 5.3.10).



Question 5.3.10

When are two contracts viewed as a single unit to determine whether the derivative definition is met?



Excerpt from ASC 815-10

>>> Viewing Two or More Contracts as a Unit in Applying the Scope of This Subtopic

15-8 In some circumstances, an entity could enter into two or more legally separate transactions that, if combined, would generate a result that is economically similar to entering into a single **transaction** that would be accounted for as a derivative instrument under this Subtopic. For guidance on circumstances in which two or more contracts that have been determined to be derivative instruments within the scope of this Subtopic must be viewed as a unit, see the guidance beginning in paragraph 815-10-25-6. For guidance on circumstances in which two or more contracts that have been determined to be options within the scope of this Subtopic must be viewed in combination, see the guidance beginning in paragraph 815-10-25-7.

15-9 If two or more separate transactions may have been entered into in an attempt to circumvent the provisions of this Subtopic, the following indicators shall be considered in the aggregate and, if present, shall cause the transactions to be viewed as a unit and not separately:

- The transactions were entered into contemporaneously and in contemplation of one another.
- The transactions were executed with the same counterparty (or structured through an intermediary).

- c. The transactions relate to the same risk.
- d. There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

Interpretive response: Topic 815 generally requires contracts to be evaluated individually to determine whether they meet the definition of a derivative. However, certain transactions can be structured so that the combination of two or more separate contracts do not meet the definition of a derivative.

For example, an entity simultaneously executes:

- a contract to sell 2,000,000 bushels of corn to a counterparty; and
- a contract to purchase 1,900,000 bushels of corn from the same counterparty.

If 1,900,000 bushels of corn is considered significant to the corn market then neither contract – on a gross basis – is readily convertible to cash; this is because the market cannot rapidly absorb the specified quantities without significantly affecting the price. However, on a net basis the entity has a forward sale contract for 100,000 bushels of corn, a quantity that can be rapidly absorbed by the market and therefore is readily convertible to cash. Section 3.5.40 discusses assets that are readily convertible to cash.

As another example, an entity enters into two contracts having mirror terms with the same counterparty, each of which individually meets the definition of a derivative but results in the entity having no net exposure. The entity may intend to use one of the contracts as a hedging instrument and achieve hedge accounting for the hedged item.

When evidence exists that an entity entered into two or more separate contracts simply to circumvent the provisions of Topic 815, the contracts must be evaluated together as one transaction. Topic 815 provides indicators that transactions should be viewed as a unit – rather than separately – when determining whether the derivative definition is met; see indicators in Excerpt from 815-10 above. These indicators are considered in the aggregate. [815-10-15-8 – 15-9]

In our experience, identifying separate transactions to be combined can be difficult in practice. Further, judgment is required to conclude that there was no substantive business purpose for separately structuring the transactions.

See also Subtopic 815-10's Examples 18 and 19, reproduced in section 5.3.20.

5.3.20 FASB Examples

The following FASB Examples illustrate the unit of account concepts.

- FASB Example 1 illustrates whether an attached (Case A) and a transferable (Case B) call option should be viewed as a freestanding or embedded feature.
- FASB Examples 18 and 19 illustrate evaluating whether two separate transactions should be combined.



Excerpt from ASC 815-10

>> Example 1: Viewing a Contract as Freestanding or Embedded

55-66 The following Cases illustrate the application of paragraph 815-10-15-6:

- a. Attached call option (Case A)
- b. Transferable call option (Case B).

>>> Case A: Attached Call Option

55-67 This Case presents a transaction that involves the addition of a call option contemporaneously with or after the issuance of debt.

55-68 Entity X issues 15-year puttable bonds to an Investment Banker for \$102. The put option may be exercised at the end of five years. Contemporaneously, the Investment Banker sells the bonds with an attached call option to Investor A for \$100. (The call option is a written option from the perspective of Investor A and a purchased option from the perspective of the Investment Banker.) The Investment Banker also sells to Investor B for \$3 the call option purchased from Investor A on those bonds. The call option has an exercise date that is the same as the exercise date on the embedded put option. At the end of five years, if interest rates increase, Investor A would presumably put the bonds back to Entity X, the issuer. If interest rates decrease, Investor B would presumably call the bonds from Investor A.

55-69 As required by paragraph 815-10-15-6, the call option that is attached by the Investment Banker is a separate derivative instrument from the perspective of Investor A.

>>> Case B: Transferable Call Option

55-70 This Case presents a group of transactions with a similar overall effect to that in Case A.

55-71 Entity Y issues 15-year puttable bonds to Investor A for \$102. The put option may be exercised at the end of five years. Contemporaneously, Entity Y purchases a transferable call option on the bonds from Investor A for \$2. Entity Y immediately sells that call option to Investor B for \$3. The call option has an exercise date that is the same as the exercise date of the embedded put option. At the end of five years, if rates increase, Investor A would presumably put the bonds back to Entity Y, the issuer. If rates decrease, Investor B would presumably call the bonds from Investor A.

55-72 As required by paragraph 815-10-15-6, the call option is a separate freestanding derivative instrument that must be reported at fair value with changes in value recognized currently in earnings unless designated as a hedging instrument.



Excerpt from ASC 815-10

>> Example 18: Recognition—Viewing Separate Transactions as a Unit

55-171 The following Cases illustrate when separate transactions should be viewed as a unit:

- a. Swaps that should be viewed as a unit (Case A)
- b. Swaps that should not be viewed as a unit (Case B).

55-172 In Cases A and B, an entity that is the issuer of fixed-rate debt enters into an interest rate swap (Swap 1) and designates it as a hedge of the fair value exposure of the debt to **interest rate risk**. The **fair value hedge** of the fixed-rate debt involving Swap 1 meets the required criteria in Section 815-20-25 to qualify for hedge accounting. The entity simultaneously enters into a second interest rate swap (Swap 2) with the same counterparty with the exact mirror terms as Swap 1 and does not designate Swap 2 as part of that hedging relationship.

>>> Case A: Swaps that Should Be Viewed as a Unit

55-173 If Swap 2 was entered into in contemplation of Swap 1 and the overall transaction was executed for the sole purpose of obtaining fair value accounting treatment for the debt, it should be concluded that the purpose of the transaction was not to enter into a bona fide hedging relationship involving Swap 1. In that instance, the two swaps should be viewed as a unit and the entity would not be permitted to adjust the carrying value of the debt to reflect changes in fair value attributable to interest rate risk.

>>> Case B: Swaps that Should Not Be Viewed as a Unit

55-174 If Swap 2 was not entered into in contemplation of Swap 1 or there is a substantive business purpose for structuring the transactions separately, and if both Swap 1 and Swap 2 were entered into in arm's-length transactions (that is, at market rates), then the swaps should not be viewed as a unit. For example, some entities have a policy that requires a centralized dealer subsidiary to enter into third-party derivative contracts on behalf of other subsidiaries within the entity to hedge the subsidiaries' interest rate risk exposures. The dealer subsidiary also enters into **internal derivative** contracts with those subsidiaries to operationally track those hedges within the entity. (As discussed beginning in paragraph 815-20-25-61, internal derivatives do not qualify in consolidated financial statements as hedging instruments for risks other than **foreign exchange risk**.)



Excerpt from ASC 815-10

>> Example 19: Recognition—Viewing Separate Transactions as a Unit for Purposes of Evaluating Net Settlement

55-175 The following Cases illustrate the guidance in paragraphs 815-10-15-8 through 15-9 on whether separate transactions should be viewed as a unit for purposes of evaluating the characteristic of net settlement:

- a. Two forward contracts viewed as a unit (Case A)
- b. Borrowing and lending transactions viewed as a unit (Case B).

55-176 In Cases A and B, the transactions were entered into with the same counterparty, were executed simultaneously, and relate to the same risk.

>>> Case A: Two Forward Contracts Viewed as a Unit

55-177 Entity A enters into a forward contract to purchase 1,500,000 units of a particular commodity in 3 months for \$10 per unit. Simultaneously, Entity A enters into a forward contract to sell 1,400,000 units of the same commodity in 3 months for \$10 per unit. The purchase and sale contracts are with the same counterparty. There is no market mechanism to facilitate net settlement of the contracts, and both contracts require physical delivery of the commodity at the same location in exchange for the forward price. On a gross basis, neither contract is readily convertible to cash because the market cannot rapidly absorb the specified quantities without significantly affecting the price. However, on a net basis, Entity A has a forward purchase contract for 100,000 units of the commodity, a quantity that can be rapidly absorbed by the market and thus is readily convertible to cash.

55-178 In this Case, it appears that there is no clear business purpose for structuring the transactions separately. Therefore, the facts point to the conclusion that the purchase and sale were done as a structured transaction with one counterparty to circumvent the definition of a derivative instrument under this Subtopic. However, if the facts indicated that both contracts required physical delivery of the commodity at different locations that are significantly distant from one another and each counterparty is expected to deliver the gross amount of the commodity to the other, those facts may reflect a valid substantive business purpose for the transaction.

>>> Case B: Borrowing and Lending Transactions Viewed as a Unit

55-179 Entity C loans \$100 to Entity B. The loan has a 5-year bullet maturity and an 8 percent fixed interest rate, payable semiannually. Entity B simultaneously loans \$100 to Entity C. The loan has a five-year bullet maturity and a variable interest of LIBOR, payable semiannually and reset semiannually. Entity B and Entity C enter into a netting arrangement that permits each party to offset its rights and obligations under the agreements. The netting arrangement meets the criteria for offsetting in Subtopic 210-20. The net effect of offsetting the contracts for both Entity B and Entity C is the economic equivalent of an interest rate swap arrangement, that is, one party receives a fixed interest rate from, and pays a variable interest rate to, the other.

55-180 In this Case, based on the facts presented, there is no clear business purpose for the separate transactions, and they should be accounted for as an interest rate swap under this Subtopic. However, in other instances, a clear substantive business purpose for entering into two separate loan transactions may exist (for example, as a means to overcome foreign currency expatriation restrictions).

5.4 Accounting for freestanding derivatives

5.4.10 Overview



Excerpt from ASC 815-10

General

05-4 This Topic requires that an entity recognize derivative instruments, including certain derivative instruments embedded in other contracts, 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, under this Topic, to designate a derivative instrument in any one of the following ways:

- a. A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized **firm commitment**, that are attributable to a particular risk (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 any one of the following:
 1. An unrecognized firm commitment (a foreign currency fair value hedge)
 2. An available-for-sale debt security (a foreign currency fair value hedge)
 3. A forecasted transaction (a foreign currency cash flow hedge)
 4. A net investment in a foreign operation.

05-5 An unrecognized firm commitment can be viewed as an executory contract that represents both a right and an obligation. If a previously unrecognized firm commitment that is designated as a hedged item is accounted for in accordance with this Topic, 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 Topic include a firm commitment.

05-6 This Topic generally provides for matching the timing of gain or loss recognition on the hedging instrument with the recognition of either of the following:

- a. The changes in the fair value of the hedged asset or liability that are attributable to the hedged risk
- b. The earnings effect of the hedged forecasted transaction.

General

25-1 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.

25-4 Synthetic instrument accounting is prohibited.

General

30-1 All derivative instruments shall be measured initially at **fair value**.

General

35-1 All derivative instruments shall be measured subsequently at **fair value**.

35-2 The accounting for changes in the fair value (that is, gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Subtopic 815-20 discusses the accounting for the gain or loss on a derivative instrument that is designated as a hedging instrument. Except as noted in the following paragraph, the gain or loss on a derivative instrument not designated as a hedging instrument shall be recognized currently in earnings.

> Fair Value Measurements and Disclosures

60-3 For an illustration of situations in which the price in a **transaction** involving a **derivative instrument** might (and might not) represent the **fair value** of the derivative instrument, see Example 5 (paragraph 820-10-55-46).

Derivative instruments are assets or liabilities that are recorded on the balance sheet at fair value, both initially and subsequently. Fair value is measured under Topic 820. [815-10-05-4, 25-1, 30-1, 35-1]

When changes in fair value are recognized in income depends on whether the derivative instrument is designated as a hedging instrument.

- **Not designated as a hedging instrument.** Derivative instrument is treated as a speculative instrument, and changes in fair value are reported in current net income. [815-10-35-2]
- **Designated as a hedging instrument.** Derivative instrument is subject to special accounting models that generally offset the instrument's changes in fair value against the hedged item's (or forecasted transaction's) gains or losses. The accounting under these models varies based on the type of risk(s) being hedged and the type of hedge. [815-10-05-4, 05-6]



Observation

Need for hedge accounting models

Entities frequently enter into derivative instruments for the purpose of mitigating (hedging against) risk exposure. Topics other than Topic 815 address accounting for the hedged items or forecasted transactions and in many cases require that those activities be recognized and measured at amounts other than fair value. For example, recognized assets and liabilities are often measured at amortized cost, and firm commitments and forecasted transactions might not be recognized on the balance sheet at all.

As a result, without special hedge accounting models, a requirement to measure all derivative instruments at fair value with changes recorded in earnings would result in a timing mismatch between when gains and losses are recognized for derivative instruments versus when they are recognized for the related hedged item or forecasted transaction.



Example 5.4.10

Examples of derivative transactions and relationships

The following table provides an overview of the accounting framework for different types of derivative transactions.

Example	Accounting for derivative instrument	Accounting for hedged item or transaction
Derivative instrument that does not qualify for hedge accounting		
Equity call options are written by a mutual fund manager to enhance the yield of a mutual fund	Recorded on the balance sheet at fair value with changes in fair value reported in earnings.	Not applicable
Fair value hedge (chapter 8)		
A purchased put option is used to hedge declines in the fair value of a fixed-rate loan receivable.	Recorded on the balance sheet at fair value with changes in fair value reported in earnings, other than amounts related to excluded components (if any) that are recognized through an amortization approach.	Changes in the fair value of the loan receivable that are attributable to the hedged risk are recognized on the balance sheet as an adjustment to the amortized cost basis of the loan receivable. The offsetting entry is a gain or loss that is recognized in the same income statement line item as the gain or loss on the hedging instrument .
Cash flow hedge (chapter 10)		
A bank enters into a receive-fixed, pay-variable interest rate swap used to hedge the cash flow exposure of its variable-rate loan receivable.	Recorded on the balance sheet at fair value. Changes in fair value that are included in the assessment of hedge effectiveness are reported in OCI. These amounts are reclassified from AOCI into earnings – in the same income statement line item as the effect of the hedged transaction – when the hedged transaction affects earnings.	Accounted for under other relevant GAAP – e.g. Topic 310 (receivables), 326 (credit losses), 825 (financial instruments).

Example	Accounting for derivative instrument	Accounting for hedged item or transaction
Hedges of foreign currency exposure (other than net investment hedges) (chapter 10)		
A foreign currency forward contract to sell foreign currency is used to hedge firmly committed sales revenue denominated in a foreign currency.	Use the fair value hedge model above.	Use the fair value hedge model above.
A purchased put option in yen is used to hedge forecasted sales that are denominated in yen.	Use the cash flow hedge model above.	Use the cash flow hedge model above.
Net investment hedge (hedge of foreign currency exposure inherent in a net investment in a foreign operation) (chapter 12)		
Debt denominated in pounds sterling is used to hedge the US parent's investment in a UK subsidiary with a pound sterling functional currency.	Foreign currency transaction gains or losses of the FCD nonderivative hedging instrument are recognized in CTA in AOCI.	When the net investment is translated into the US dollar (the parent's reporting currency), the effects of translation are recognized in CTA in AOCI.



Question 5.4.10

Does Topic 815 provide an exception if fair value measurement is not practicable?

Interpretive response: No. The FASB believes that prudent risk management generally requires an entity to measure the fair value of any derivative instrument that it holds as well as any item (or portion of the item attributable to the identified risk) designated as being hedged in a **fair value hedge**. Therefore, an entity must determine the fair value of derivative instruments in all circumstances. [FAS 133.BC318]



Question 5.4.20

Is a Day 1 gain or loss recognized if a derivative instrument's transaction price differs from its fair value?

Interpretive response: Yes. Although a difference is expected to occur only in limited circumstances, there may be situations in which the transaction price might not be representative of fair value at initial recognition. In these circumstances, an entity recognizes a Day 1 gain or loss because Topic 815

requires a derivative instrument to be initially measured at fair value without exception. [815-10-60-3]

In determining whether fair value at initial recognition equals the transaction price, an entity considers factors specific to the transaction and to the asset or liability. Before concluding that fair value at initial recognition is different from the transaction price, the entity: [820-10-30-3A]

- identifies the specific attributes of the transaction that generate the difference between the transaction price and the entity's estimate of fair value; and
- considers the guidance and examples in Topic 820.

Recognition of the Day 1 gain or loss is not dependent on where in the fair value hierarchy the entity's fair value measurement falls (i.e. Level 1, 2 or 3). As such, an entity can recognize a Day 1 gain or loss even when the fair value measurement is categorized in Level 3 of the hierarchy.

However, the transaction price remains an important piece of objective evidence for measuring the fair value of financial instruments. Therefore, as the significance of the assumptions made by an entity increases in importance to the overall measurement of fair value, the entity needs to consider whether the transaction price for the instrument provides better evidence of the fair value of the instrument than its own estimate of fair value.

See Subtopic 820-10's Example 5 from Topic 820 (reproduced below) for an illustration of when the price in a transaction involving a derivative instrument might (and might not) equal its fair value at initial recognition.

See also KPMG Handbook, [Fair value measurement](#), including section I (fair value at initial recognition). In particular, see the following:

- Question I10, which addresses whether there can be a difference between the transaction price and fair value at initial recognition;
- Question I20, which addresses whether an entity must recognize a Day 1 gain or loss if there is such a difference.



Excerpt from ASC 820-10

>> Example 5: Transaction Prices and Fair Value at Initial Recognition – Interest Rate Swap at Initial Recognition

55-46 This Topic (see paragraphs 820-10-30-3 through 30-3A) clarifies that in many cases the transaction price, that is, the price paid (received) for a particular asset (liability), will represent the fair value of that asset (liability) at initial recognition, but not presumptively. This Example illustrates when the price in a transaction involving a derivative instrument might (and might not) equal the fair value of the instrument at initial recognition.

55-47 Entity A (a retail counterparty) enters into an interest rate swap in a retail market with Entity B (a dealer) for no initial consideration (that is, the transaction price is zero). Entity A can access only the retail market. Entity B

can access both the retail market (that is, with retail counterparties) and the **dealer market** (that is, with dealer counterparties).

55-48 From the perspective of Entity A, the retail market in which it initially entered into the swap is the principal market for the swap. If Entity A were to transfer its rights and obligations under the swap, it would do so with a dealer counterparty in that retail market. In that case, the transaction price (zero) would represent the fair value of the swap to Entity A at initial recognition, that is, the price that Entity A would receive to sell or pay to transfer the swap in a transaction with a dealer counterparty in the retail market (that is, an **exit price**). That price would not be adjusted for any incremental (transaction) costs that would be charged by that dealer counterparty.

55-49 From the perspective of Entity B, the dealer market (not the retail market) is the principal market for the swap. If Entity B were to transfer its rights and obligations under the swap, it would do so with a dealer in that market. Because the market in which Entity B initially entered into the swap is different from the principal market for the swap, the transaction price (zero) would not necessarily represent the fair value of the swap to Entity B at initial recognition.

5.4.20 Ongoing evaluation of derivative definition



Excerpt from ASC 815-10

General

25-2 If a contract that did not meet the definition of a derivative instrument at acquisition by the entity meets the definition of a derivative instrument after acquisition by the entity, the contract shall be recognized immediately as either an asset or liability with the offsetting entry recorded in earnings.

25-3 If a contract ceases to be a derivative instrument pursuant to this Subtopic and an asset or liability had been recorded for that contract, the carrying amount of that contract becomes its cost basis and the entity shall apply other generally accepted accounting principles (GAAP) that are applicable to that contract prospectively from the date that the contract ceased to be a derivative instrument. If the derivative instrument had been designated in a cash flow hedging relationship and a gain or loss is recorded in accumulated other comprehensive income, then the guidance in Sections 815-30-35 and 815-30-40 shall be applied accordingly.

> Contract that Is a Derivative Instrument After Acquisition

30-3 A contract recognized under paragraph 815-10-25-2 because it meets the definition of a derivative instrument after acquisition by an entity shall be measured initially at its then-current fair value.

Whether a financial instrument or other contract is a derivative may change over time; therefore, an instrument may become or may cease to be a derivative after inception. This can occur because an entity must evaluate whether an

instrument contains the net settlement characteristic (see section 3.5.50) at inception and on an ongoing basis. [815-10-15-118, 30-3]

The following table summarizes the accounting for changes in whether an instrument meets the definition of a derivative.

Event	Accounting
Instrument becomes a derivative	If events occur after inception or acquisition of a financial instrument or contract that result in it meeting the definition of a derivative, an entity commences accounting for it as a derivative at that point – i.e. recognizes a derivative asset or liability for its then-current fair value with an offsetting entry to earnings. [815-10-15-3, 25-2] A derivative is eligible to be designated as the hedging instrument in a hedging relationship once it meets the definition of a derivative (and not before then).
Instrument ceases to be a derivative	During the time a financial instrument or other contract meets the definition of a derivative, it is presented as an asset or liability and measured at its fair value. When that definition is no longer met, the holder of the contract applies other US GAAP applicable to the contract (and related asset or liability recorded when it was a derivative) prospectively. [815-10-25-3]



Question 5.4.30

What US GAAP applies to a contract (and related asset or liability) when it ceases to be a derivative?

Interpretive response: When a contract is no longer subject to the guidance in Topic 815, other applicable US GAAP applies. In some cases, the other US GAAP is clearly identifiable. In other cases, there may not be accounting principles that deal specifically with the instrument concerned – e.g. an entity's previous practice may have been not to recognize any asset or liability for such an instrument until physical settlement.

When the accounting principles are not clearly identifiable, the entity should not automatically eliminate the contract's carrying amount (i.e. the contract's new cost basis). Instead, the entity should adopt an accounting approach consistent with the fundamental recognition and measurement criteria contained in FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises (CON 5), and CON 6.

The entity should consider whether the instrument underlying any asset or liability balance continues to meet the definition of an asset or liability. The holder should also consider the requirement to provide for any probable and estimable loss contingency or asset impairment in accordance with other applicable GAAP.



Question 5.4.40

If a hedging instrument in a cash flow hedge ceases to be a derivative, how does an entity account for the related derivative gains or losses in AOCI?

Interpretive response: A contract that meets the definition of a derivative may be designated as a **hedging instrument** in a cash flow hedge and later cease to meet the definition of a derivative. In this situation, the accumulated gain or loss included in AOCI is accounted for in accordance with the guidance in section 10.3.

In summary, the amount in AOCI is reclassified into earnings in the same periods in which the hedged forecasted transaction affects earnings, or when it becomes probable that the forecasted transaction will not occur. However, if the continued reporting of a loss in AOCI would lead to recognizing a net loss on the hedging instrument and the hedged transaction, the combined loss that is not recoverable is reclassified into earnings immediately. [\[815-10-25-3\]](#)

5.4.30 Derecognition



Excerpt from ASC 815-10

General

40-1 Extinguishments of **derivative instruments** that are liabilities are addressed by paragraph 405-20-40-1. Transfers of derivative instruments that are financial assets are addressed by Section 860-10-40.

40-2 Transfers of assets that are derivative instruments and subject to the requirements of this Subtopic but that are not financial assets shall be accounted for by analogy to Subtopic 860-10. This guidance is limited to transfers of nonfinancial assets that are derivative instruments that are or will be subject to the requirements of this Subtopic. An example would be a transfer to another entity of a derivative instrument, such as a forward contract to purchase gold that requires physical settlement and is or will be subject to the requirements of this Subtopic.

40-3 If a derivative instrument has the potential to be both a nonfinancial asset and a nonfinancial liability (such as a commodity forward contract that is a nonfinancial derivative instrument), then, as described in paragraph 860-10-40-40, the criteria of both Sections 405-20-40 and 860-10-40 shall be met to qualify for derecognition.

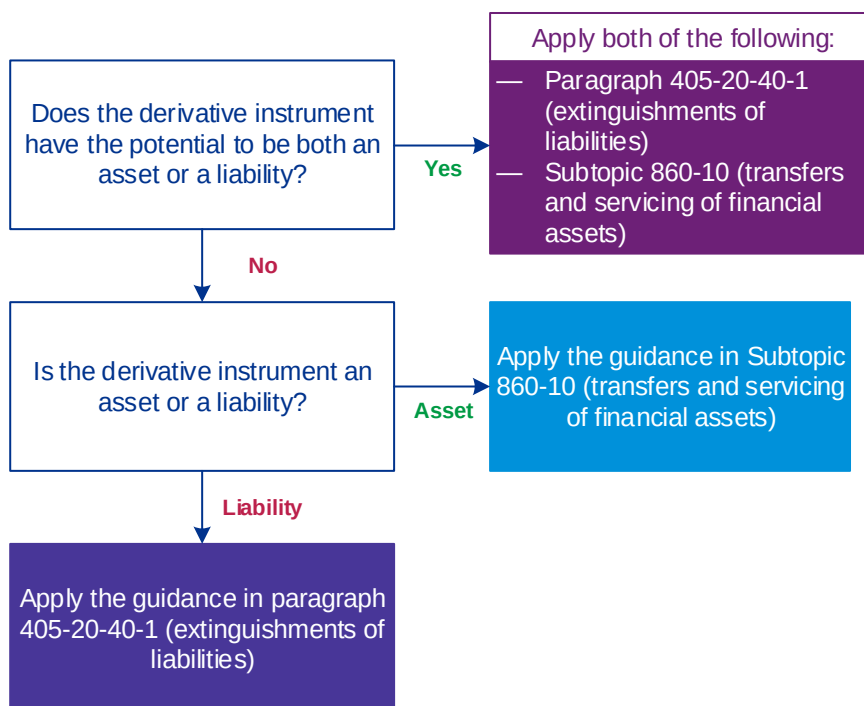


Excerpt from ASC 860-10

> Application of the Sale Criteria for Financial Instruments That Have the Potential to Be Assets or Liabilities

40-40 Certain recognized financial instruments, such as forward contracts and swaps, have the potential to be financial assets or financial liabilities. Accordingly, transfers of those financial instruments must meet the conditions of both paragraphs 405-20-40-1 and 860-10-40-5 to be derecognized. Paragraph 815-10-40-2 states that transfers of assets that are derivative instruments and subject to the requirements of Subtopic 815-10 but that are not financial assets shall be accounted for by analogy to this Subtopic. The same criteria shall be applied to transfers of nonfinancial derivative instruments that have the potential to become either assets or liabilities (for example, forward contracts and swaps).

The guidance for determining whether a derivative instrument should be derecognized is provided in Subtopic 405-20 (extinguishments of liabilities) and/or Subtopic 860-10 (transfers and servicing of financial assets). The following decision tree summarizes considerations for determining the applicable Subtopic(s).



5.5 Accounting for embedded derivatives

5.5.10 Overview



Excerpt from ASC 815-15

> Fair Value Election for Hybrid Financial Instruments

25-4 An entity that initially recognizes a hybrid financial instrument that under paragraph 815-15-25-1 would be required to be separated into a host contract and a derivative instrument may irrevocably elect to initially and subsequently measure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings and, if paragraph 825-10-45-5 is applicable, other comprehensive income). A financial instrument shall be evaluated to determine that it has an embedded derivative requiring bifurcation before the instrument can become a candidate for the fair value election.

25-6 The fair value election shall not be applied to the hybrid instruments described in paragraph 825-10-50-8.

> Entity Unable to Reliably Identify and Measure Embedded Derivative

25-52 An entity that enters into sophisticated investment and funding strategies such as structured notes or other contracts with embedded derivatives should be able to obtain the information necessary to reliably identify and measure the separate components. It should be unusual that an entity would conclude that it cannot reliably separate an embedded derivative from its host contract.

25-53 If an entity cannot reliably identify and measure the embedded derivative that paragraph 815-15-25-1 requires be separated from the host contract, paragraphs 815-15-30-1(b) and 815-15-35-2 require that the entire contract be measured at fair value with gain or loss recognized in earnings, but that contract may not be designated as a hedging instrument pursuant to Subtopic 815-20.

> Host Contract After Separation

25-54 If an embedded derivative is separated from its host contract, the host contract shall be accounted for based on GAAP applicable to instruments of that type that do not contain embedded derivatives.

> Hybrid Instruments That Are Not Separated

30-1 An entity shall measure both of the following initially at **fair value**:

- a. A hybrid financial instrument that under paragraph 815-15-25-1 would be required to be separated into a host contract and a **derivative instrument** that an entity irrevocably elects to initially and subsequently measure in its entirety at fair value (with changes in fair value recognized in earnings)
- b. An entire **hybrid instrument** if an entity cannot reliably identify and measure the **embedded derivative** that paragraph 815-15-25-1 requires be separated from the host contract.

> Hybrid Instruments That Are Separated

30-2 The allocation method that records the embedded derivative at fair value and determines the initial carrying value assigned to the host contract as the difference between the basis of the hybrid instrument and the fair value of the embedded derivative shall be used to determine the carrying values of the host contract component and the embedded derivative component of a hybrid instrument if separate accounting for the embedded derivative is required by this Subtopic. (Note that Section 815-15-25 allows for a fair value election for hybrid financial instruments that otherwise would require bifurcation.)

>> Fair Value Election

35-1 If an entity irrevocably elected to initially and subsequently measure a hybrid financial instrument in its entirety at **fair value**, changes in fair value for that hybrid financial instrument shall be recognized in earnings. Paragraph 815-20-25-71(a)(3) states that the entire contract shall not be designated as a hedging instrument pursuant to Subtopic 815-20.

>> Inability to Reliably Identify and Measure Embedded Derivative

35-2 If an entity cannot reliably identify and measure the **embedded derivative** that paragraph 815-15-25-1 requires be separated from the host contract, the entire contract shall be measured subsequently at fair value with gain or loss recognized in earnings. Paragraph 815-20-25-71(a)(4) states that the entire contract shall not be designated as a hedging instrument pursuant to Subtopic 815-20.

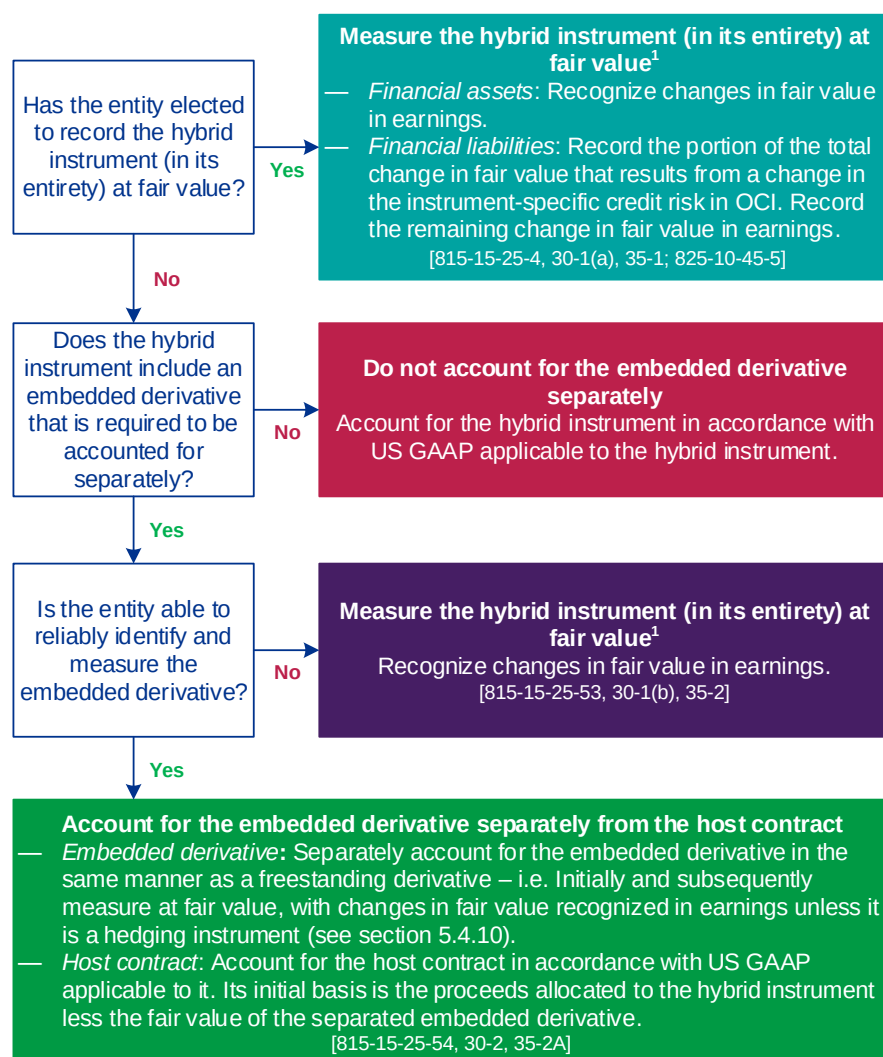
> Hybrid Instruments That Are Separated

35-2A Paragraph 815-15-25-1 requires that an embedded derivative be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the criteria in paragraph 815-15-25-1 are met.

A hybrid instrument is a contract that embodies both an embedded derivative and a host contract. As discussed in chapter 4, each embedded derivative is evaluated to determine whether it must be bifurcated from the host instrument and accounted for separately. [\[815-15 Glossary\]](#)

The following decision tree demonstrates the steps for determining the appropriate accounting for hybrid instruments – i.e. host contracts with

embedded derivatives that require bifurcation and therefore separate accounting.



¹ The instrument is not eligible to be designated as a hedging instrument. See section 6.7.40.



Example 5.5.10

Accounting for a debt instrument and bifurcated embedded derivative

On January 1, Year 1, ABC Corp. issues a \$1,000, five-year bond at face value with a coupon interest rate of 5%. Interest is payable annually on January 1. The bond contains an equity-indexed feature payable in cash if it is in the money at maturity of the debt and which requires bifurcation.

At issuance, the put option has a fair value of \$100. Its fair value at December 31, Year 1 is \$250.

Journal entries – January 1, Year 1

ABC records the following journal entry. The initial allocation of \$100 to the embedded derivative liability results in the host contract having an effective interest rate of 7.5% (rounded).

	Debit	Credit
Cash	1,000	
Discount on bond payable ¹	100	
Bond payable		1,000
Derivative liability		100
<i>To recognize issuance of a bond and bifurcated derivative.</i>		
Note:		
1. The discount is presented gross in this journal entry.		

Journal entries – December 31, Year 1

ABC records the following journal entries.

	Debit	Credit
Loss on embedded derivative ¹	150	
Derivative liability		150
<i>To recognize change in fair value of embedded derivative.</i>		
Interest expense ²	67	
Discount on bond payable ³		17
Accrued interest payable ⁴		50
<i>To recognize interest expense on bond using effective interest method.</i>		
Notes:		
1. Change in fair value of the embedded derivative from issuance to December 31, Year 5 (\$250 – \$100).		
2. Beginning amortized cost balance of \$900 × the effective interest rate of 7.5% (rounded).		
3. The discount is presented gross in this journal entry. The adjustment to the discount is calculated as interest expense (\$67) – interest based on the stated rate (\$50).		
4. \$1,000 face value – 5% stated rate of the bond.		

Financial statement excerpts

At the end of Year 1, ABC's financial statements reflect the following.

Account	Year 1
Balance sheet – liabilities	
Bond payable, net of discount ¹	\$917
Derivative liability ²	250
Accrued interest payable	50
Income statement	
Interest expense	\$ 67
Loss on embedded derivative	150
Notes:	
1. ABC presents the bond payable net of the related discount on the face of its balance sheet.	
2. ABC presents the embedded derivative separately from its host contract. See Question 14.2.80 regarding presentation of embedded derivatives when the host contract is not measured at fair value in its entirety.	



Question 5.5.10

What fair value options are available for hybrid financial instruments?

Interpretive response: US GAAP provides two different fair value options, both of which are irrevocable:

- Subtopic 815-15 provides a 'hybrid' fair value option for hybrid financial instruments that contain an embedded derivative that Subtopic 815-15 would require to be bifurcated if the instrument was not otherwise measured at fair value. [815-15-25-4 – 25-6]
- The fair value option subsections of Subtopic 825-10 provide a 'general' fair value option for certain items, including for recognized financial assets or financial liabilities and for a host financial instrument resulting from separation of an embedded nonfinancial derivative from a nonfinancial hybrid instrument. [825-10-15-4 – 15-5]

The scope of Subtopic 825-10's general fair value option is broader than that of Subtopic 815-15. Further, hybrid financial instruments that would be eligible for the Subtopic 815 fair value option may be eligible for Subtopic 825-10's fair value option. Therefore, in practice, most entities elect Subtopic 825-10's fair value option, if applicable, because its election does not require an entity to determine that the subject financial instrument has an embedded derivative that would require bifurcation.



Question 5.5.20

Can Subtopic 815-15's hybrid fair value option be elected for all hybrid instruments?

Interpretive response: No. The fair value option can only be elected for hybrid financial instruments that contain an embedded derivative that Subtopic 815-15 would otherwise require to be bifurcated. [815-15-25-4 – 25-5]

A financial instrument is cash, evidence of an ownership interest in an entity, or a contract that requires the parties to the contract to either: [815-15 Glossary]

- deliver or receive cash or another financial instrument to the other party to the contract; or
- exchange other financial instruments on potentially favorable or unfavorable terms with the other party to the contract.

Further, fair value cannot be elected for the instruments listed in paragraph 825-10-50-8 (reproduced below). [815-15-25-6]



Excerpt from ASC 825-10

>> Transactions

50-8 In part, this Subsection requires disclosures about fair value for all financial instruments, whether recognized or not recognized in the statement of financial position, except that the disclosures about fair value prescribed in paragraphs 825-10-50-10 through 50-13 and 825-10-50-15 are not required for any of the following:

- a. Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements (see Topics 710, 712, 715, 718, and 960)
- b. Substantively extinguished debt subject to the disclosure requirements of Subtopic 405-20
- c. Insurance contracts, other than financial guarantees (including financial guarantee insurance contracts within the scope of Topic 944) and investment contracts, as discussed in Subtopic 944-20
- d. Lease contracts as defined in Topic 842 (a contingent obligation arising out of a cancelled lease and a guarantee of a third-party lease obligation are not lease contracts and are subject to the disclosure requirements in this Subsection)
- e. Warranty obligations (see Topic 450 and the Product Warranties Subsections of Topic 460)
- f. Unconditional purchase obligations as defined in paragraph 440-10-50-2
- g. Investments accounted for under the equity method in accordance with the requirements of Topic 323

- h. Noncontrolling interests and equity investments in consolidated subsidiaries (see Topic 810)
- i. Equity instruments issued by the entity and classified in stockholders' equity in the statement of financial position (see Topic 505)
- j. Receive-variable, pay-fixed interest rate swaps for which the simplified hedge accounting approach is applied (see Topic 815)
- k. **Fully benefit-responsive investment contracts** held by an employee benefit plan.
- l. Investments in equity securities accounted for under the measurement guidance for equity securities without readily determinable fair values (see Topic 321)
- m. Trade receivables and payables due in one year or less
- n. Deposit liabilities with no defined or contractual maturities.
- o. Liabilities resulting from the sale of prepaid stored-value products within the scope of paragraph 405-20-40-3.



Question 5.5.30

When can an entity elect Subtopic 815-15's option to measure a hybrid financial instrument (in its entirety) at fair value?



Excerpt from ASC 815-15

25-5 The fair value election shall be supported by concurrent documentation or a preexisting documented policy for automatic election. That recognized hybrid financial instrument could be an asset or a liability and it could be acquired or issued by the entity. The fair value election is also available when a previously recognized **financial instrument** is subject to a **remeasurement event (new basis event)** and the separate recognition of an embedded derivative. The fair value election may be made instrument by instrument. For purposes of this paragraph, a remeasurement event (new basis event) is an event identified in generally accepted accounting principles, other than the recording of a credit loss under Topic 326, or measurement of an impairment loss through earnings under Topic 321 on equity investments, that requires a financial instrument to be remeasured to its fair value at the time of the event but does not require that instrument to be reported at fair value on a continuous basis with the change in fair value recognized in earnings. Examples of remeasurement events are business combinations and significant modifications of debt as defined in Subtopic 470-50.

Interpretive response: Yes. An entity can make this election when: [\[815-15-25-5\]](#)

- the instrument is initially issued (or acquired); or
- a previously recognized hybrid financial instrument is subject to a remeasurement event – i.e. new basis event.

A remeasurement event is an event that triggers a US GAAP requirement to remeasure the financial instrument to its fair value at the time of the event – e.g. a business combination or significant modification of debt. However, it does not include: [815-15 Glossary]

- recording a credit loss under Topic 326; or
- measuring an impairment loss through earnings under Topic 321 for an equity investment.

The election may be made on an instrument-by-instrument basis and is irrevocable. Further, the election must be supported by concurrent documentation or by a previously established documentation policy for automatic election. [815-15-25-4 – 25-5]



Question 5.5.40

Is it common for an entity to be unable to reliably identify and measure an embedded derivative?

Interpretive response: No. We believe an entity should rarely, if ever, conclude that it cannot separate an embedded derivative component from a host contract in a reliable manner. This is because an entity entering into sophisticated investment and funding strategies such as structured notes or other complex contracts with embedded derivative components should be able to obtain the information necessary to identify and measure the separate components. [815-15-25-52]



Question 5.5.50

If both the host contract and embedded derivative are recorded at fair value, can their combined fair values exceed that of the hybrid instrument?



Excerpt from ASC 815-15

>> Limitation on Sum of Component Fair Values

35-3 If the host contract component of a **hybrid instrument** is reported at fair value with changes in fair value recognized in earnings or **other comprehensive income**, then the sum of the fair values of the host contract component and the embedded derivative shall not exceed the overall fair value of the hybrid instrument.

Interpretive response: No. When both an embedded derivative and the host contract from which it is bifurcated are measured at fair value, Topic 815 prohibits the sum of their fair values from exceeding the hybrid instrument's overall fair value. As a result, an entity must track the fair value of separately

recorded components of a hybrid instrument after separation to ensure their sums do not exceed the hybrid instrument's overall fair value. [815-15-35-3]

If the sum of the fair values of the host contract and bifurcated embedded derivative exceeds the entire hybrid instrument's fair value, an entity reevaluates the methods or models it used to measure the fair value of each instrument to ensure they are appropriate. If the entity determines that the fair value of each instrument is appropriate and one of the components is reported at fair value with changes in fair value recognized in OCI, we believe the excess fair value should be allocated to that component.

5.5.20 Defining the terms of an embedded derivative



Excerpt from ASC 815-15

> Hybrid Instruments That Are Separated

30-3 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 shall reflect all relevant features of each component. 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.

>> Separating a Non-Option Embedded Derivative

>>> Hybrid Instrument Acquired at Its Inception

30-4 In separating a non-option embedded derivative from the host contract under paragraph 815-15-25-1, the terms of that non-option embedded derivative shall be determined in a manner that results in its fair value generally being equal to zero at the inception of the hybrid instrument. Because a loan and an embedded derivative can be bundled in a structured note that could have almost an infinite variety of stated terms, it is inappropriate to necessarily attribute significance to every one of the note's stated terms in determining the terms of the non-option embedded derivative. If a non-option embedded derivative has stated terms that are off-market at inception, that amount shall be quantified and allocated to the host contract because it effectively represents a borrowing. (This paragraph does not address the bifurcation of the embedded derivative by a holder who has acquired the hybrid instrument from a third party after the inception of that hybrid instrument.) The non-option embedded derivative shall contain a **notional amount** and an **underlying** consistent with the terms of the hybrid instrument. Artificial terms shall not be created to introduce leverage, asymmetry, or some other risk exposure not already present in the hybrid instrument. Generally, the appropriate terms for the non-option embedded derivative will be readily apparent. Often, simply adjusting the referenced forward price (pursuant to documented legal terms) to be at the market for the purpose of separately accounting for the embedded derivative will result in that non-option embedded derivative having a fair value of zero at inception of the hybrid instrument.

>>> Hybrid Instrument Acquired After Its Inception

30-5 In separating a non-option embedded derivative from the host contract under paragraph 815-15-25-1 if the holder has acquired the hybrid instrument in a secondary market after the inception of the hybrid instrument, the terms of the embedded derivative shall be determined by the holder so as to result in the derivative instrument having a fair value generally equal to zero at the date the holder enters into (that is, acquires) the hybrid instrument. The initial accounting by the holder of the hybrid instrument shall not be affected by whether it purchased the hybrid instrument at inception or after inception in a secondary market.

>> Separating an Option-Based Embedded Derivative

30-6 The terms of an option-based embedded derivative shall not be adjusted to result in the embedded derivative being at the money at the inception of the hybrid instrument. In separating an option-based embedded derivative from the host contract under paragraph 815-15-25-1, the strike price of the embedded derivative shall be based on the stated terms documented in the hybrid instrument. As a result, the option-based embedded derivative at inception may have a strike price that does not equal the market price of the asset associated with the underlying. The guidance in this paragraph addresses both of the following:

- a. The bifurcation of the option-based embedded derivative by a holder who has acquired the hybrid instrument from a third party either at inception or after inception of that hybrid instrument
- b. The bifurcation of the option-based embedded derivative by the issuer when separate accounting for that embedded derivative is required.

When an embedded derivative is bifurcated, the fair value of its features must be estimated separately from the fair value of nonderivative features present in the contract. All relevant features must be reflected in the fair values of each component. [815-15-30-3]

The following table summarizes how the terms of each option and non-option based embedded derivative should be defined when they are bifurcated from the host contract.

Type	Guidance for defining the embedded derivative's terms
Non-option based	The terms generally should be defined such that fair value is zero at inception. This means the embedded derivative's terms for accounting purposes may differ from the legal terms (see Question 5.5.60). [815-15-30-4] If the hybrid instrument is acquired after its inception, the terms generally should be defined such that fair value is zero at the acquisition date. [815-15-30-5]
Option based	The strike price of the embedded derivative should be based on the stated terms of the hybrid instrument and should not be adjusted. As a result, the fair value may be an amount other than zero at inception (or the acquisition date). [815-15-30-6]



Question 5.5.60

Are the terms of a non-option embedded derivative based on its legal terms?

Interpretive response: Not necessarily. The entity recording the embedded derivative should select a set of terms that results in the fair value of the embedded derivative being zero at inception (or the acquisition date). These terms may be different from the instrument's legal terms. [815-15-30-4 – 30-5]

As a result, the entity will maintain two sets of documentation – one for the legal terms of the hybrid instrument, and the other for the terms of the host contract and embedded derivative that were modified to obtain a fair value of zero for the embedded derivative. The entity uses the modified terms for all subsequent accounting for the host contract and derivative.



Question 5.5.70

Which terms of a non-option embedded derivative are modified to result in a zero fair value?

Interpretive response: Generally, adjusting the forward price to the market forward price will result in a fair value of zero for accounting purposes. The notional amount and underlying should remain consistent with the legal terms of the instrument. Further, the modified terms should not artificially create leverage, asymmetry, or other risk exposures not already contained in the instrument itself. [815-15-30-4]



Question 5.5.80

Why aren't the terms of an option-based embedded derivative modified to result in a zero fair value at inception?

Interpretive response: Adjusting the strike price of an option-based embedded derivative fundamentally alters the economics of the hybrid instrument. Adjusting the forward price of a forward-based (non-option) embedded derivative does not have this effect. This represents a substantive, fundamental difference between option and non-option based embedded derivatives.

The strike price of an option-based embedded derivative that is stated in the agreement is not adjusted, even if that strike price does not equal the market price of the asset associated with the underlying at inception (or acquisition). Further, using the stated terms of an option-based embedded derivative will typically result in a non-zero fair value of the bifurcated derivative. [815-15-30-6]

FASB Example

The following example illustrates the application the concepts for separating embedded derivatives. [815-15-55-160]



Excerpt from ASC 815-15

>> Example 12: Separating a Non-Option Embedded Derivative

55-160 This Example illustrates the application of paragraph 815-15-30-4 and assumes that the illustrative non-option embedded derivative is a plain-vanilla forward contract with symmetrical risk exposure and that the hybrid instrument was newly entered into by the parties to the contract. Assume that the hybrid instrument is not a derivative instrument in its entirety.

55-161 Entity A plans to advance Entity X \$900 for 1 year at a 6 percent interest rate and concurrently enter into an equity-based derivative instrument in which it will receive any increase or pay any decrease in the current market price (\$200) of XYZ Corporation's common stock. Those two transactions (that is, the loan and the derivative instrument) can be bundled in a structured note that could have almost an infinite variety of terms. The following presents 5 possible contractual terms for the structured note that would be purchased by Entity A for \$900:

- a. Note 1: Entity A is entitled to receive at the end of 1 year \$954 plus any excess (or minus any shortfall) of the current per-share market price of XYZ Corporation's common stock over (or under) \$200.
- b. Note 2: Entity A is entitled to receive at the end of 1 year \$955 plus any excess (or minus any shortfall) of the current per-share market price of XYZ Corporation's common stock over (or under) \$201.
- c. Note 3: Entity A is entitled to receive at the end of 1 year \$755 plus any excess (or minus any shortfall) of the current per-share market price of XYZ Corporation's common stock over (or under) \$1.
- d. Note 4: Entity A is entitled to receive at the end of 1 year \$1,054 plus any excess (or minus any shortfall) of the current per-share market price of XYZ Corporation's common stock over (or under) \$300.
- e. Note 5: Entity A is entitled to receive at the end of 1 year \$1,060 plus any excess (or minus any shortfall) of the current per-share market price of XYZ Corporation's common stock over (or under) \$306.

55-162 All of these five terms of a structured note will provide the same cash flows, given a specified market price of XYZ Corporation's common stock. If the market price of XYZ Corporation's common stock at the end of 1 year is still \$200, Entity A will receive \$954 under all 5 note terms. If the market price of XYZ Corporation's common stock at the end of 1 year increases to \$306, Entity A will receive \$1,060 under all 5 note terms.

55-163 For simplicity in constructing this Example, it is assumed that an equity-based cash-settled forward contract with a strike price equal to the stock's current market price has a zero fair value. In many circumstances, a zero-value forward contract can have a strike price greater or less than the stock's current market price.

55-164 The differences in the terms for these five notes are totally arbitrary because those differences have no effect on the ultimate cash flows under the structured note; thus, those differences are nonsubstantive and should have no influence on how the terms of an embedded derivative are identified. Therefore, the separation of the hybrid instrument into an embedded derivative and a host debt instrument should be the same for all five terms described above for the structured note (because they are merely different descriptions of the same ultimate cash flows). That bifurcation would generally result in the structured note being accounted for as a debt host contract with an initial carrying amount of \$900 and a fixed annual rate of interest of 6 percent and an embedded forward contract with a \$200 forward price, which results in an initial fair value of zero. Instead, if the five notes were bifurcated based on all their contractual terms, such bifurcation would be the equivalent of simply marking an arbitrary portion of a debt instrument to market based on nonsubstantive arbitrary differences in those contractual terms—an inappropriate outcome.

5.5.30 Reevaluation of embedded derivatives



Excerpt from ASC 815-15

> Embedded Conversion Option That No Longer Meets Bifurcation Criteria

35-4 If an embedded conversion option in a convertible debt instrument no longer meets the bifurcation criteria in this Subtopic, an issuer shall account for the previously bifurcated conversion option by reclassifying the carrying amount of the liability for the conversion option (that is, its fair value on the date of reclassification) to shareholders' equity. Any debt discount recognized when the conversion option was bifurcated from the convertible debt instrument shall continue to be amortized.

> Embedded Conversion Option that No Longer Meets Bifurcation Criteria

>> Option Is Exercised

40-1 If a holder exercises a conversion option for which the carrying amount has previously been reclassified to shareholders' equity pursuant to paragraph 815-15-35-4, the issuer shall recognize any unamortized discount remaining at the date of conversion immediately as interest expense.

>> Option Is Extinguished Before Stated Maturity

40-4 If a convertible debt instrument with a conversion option for which the carrying amount has previously been reclassified to shareholders' equity pursuant to the guidance in paragraph 815-15-35-4 is extinguished for cash (or other assets) before its stated maturity date, the entity shall do both of the following:

- a. The portion of the reacquisition price equal to the **fair value** of the conversion option at the date of the extinguishment shall be allocated to equity.

- b. The remaining reacquisition price shall be allocated to the extinguishment of the debt to determine the amount of gain or loss.

An entity is reevaluates whether an embedded derivative is required to be bifurcated from its host contract each period. As a result, an embedded derivative that is initially bifurcated and recorded separately may cease to require bifurcation. Conversely, an embedded feature that was not bifurcated at inception of a contract may later be required to be bifurcated and recorded as a derivative.



Question 5.5.90

How does an entity account for an embedded feature that qualifies for bifurcation after contract inception?

Interpretive response: We believe embedded derivatives that are reassessed and qualify for bifurcation after contract inception should be accounted for as follows.

Instrument / contract type	Applicable accounting
Embedded feature previously accounted for as a separate component of equity	The fair value of the embedded feature on the reassessment date is reclassified from stockholders' equity to an asset or liability.
All other embedded derivatives	Measured at fair value on the reassessment date and bifurcated from the then-carrying amount of the host contract. We believe the terms of the embedded derivative should be determined based on the guidance in Section 5.5.20. It includes that a non-option based embedded derivative's terms should be defined such that fair value is zero at the contract's inception (or acquisition date, if later). The bifurcation likely creates a discount or premium on the host contract that is accounted for under other applicable GAAP. For example, bifurcation of an embedded derivative from a debt instrument would result in a premium or discount to be amortized using the effective interest method over the remaining life of the debt instrument.



Question 5.5.100

How does an entity account for a bifurcated derivative that subsequently ceases to qualify for bifurcation?

Interpretive response: We believe a bifurcated embedded derivative that, when reassessed, no longer qualifies for bifurcation should be accounted for as follows.

Instrument / contract type	Applicable accounting
Previously bifurcated embedded derivative is a conversion option ¹ or other equity-linked derivative related to an entity's own stock	— Remeasured to fair value on the reassessment date with changes in fair value recognized in earnings, then reclassified to stockholders' equity. [815-15-35-4] — Topic 815 provides the following incremental guidance for certain situations related to the issuer's accounting for convertible debt: — an entity continues to amortize any discount on the convertible debt that was recognized when the option was bifurcated. [815-15-35-4] — an entity immediately recognizes any remaining unamortized discount as interest expense if the option is subsequently exercised. [815-15-40-1] — if the convertible debt is extinguished (reacquired) before maturity, an entity allocates a portion of the reacquisition price to the conversion option based on the conversion option's fair value, and recognizes an extinguishment gain or loss on the debt based on the remainder of the reacquisition price. [815-15-40-4]
All other previously bifurcated embedded derivatives	— Remeasured to fair value on the reassessment date with changes in fair value recognized in earnings, and then reclassified to the carrying amount of the host instrument. — Any gains or losses recorded before the reclassification (i.e. while the embedded derivative was bifurcated) are not reversed.
Note: 1. A convertible option for this purpose is a feature embedded in a debt or equity instrument that requires or allows a holder to convert the instrument into equity shares of the instrument's issuing entity. [470-20-05-4 - 05-6]	

6. General hedging requirements

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Item significantly updated in this edition: #

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6.1 How the standard works

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

The basic risks that an entity may hedge include:



Interest rate risk



Foreign currency risk



Credit risk

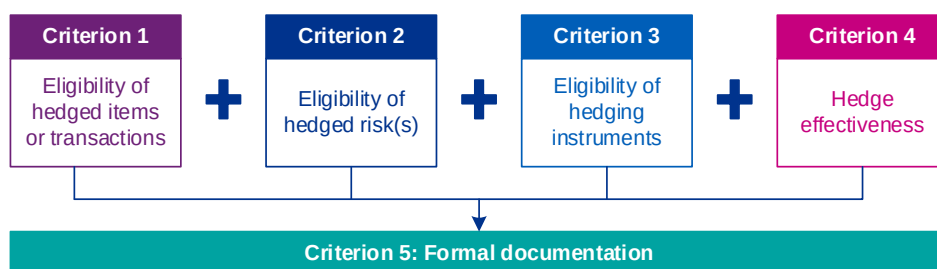


Price risk

Topic 815 provides for three different types of hedges.

- **Fair value hedge.** A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that is attributable to a particular risk.
- **Cash flow hedge.** A hedge of the exposure to variability in the future cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk.
- **Net investment hedge.** A hedge of the exposure to foreign currency risk of a net investment in a foreign operation.

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



Hedge accounting is permitted only if all of the applicable criteria are met.

General qualifying criteria (chapter 6)	The five general criteria that apply to fair value hedges and cash flow hedges are described in this chapter. Some of the general qualifying criteria also apply to net investment hedges , as discussed in section 12.2.
Qualifying criteria for fair value hedges (chapter 7)	Qualifying criteria specific to the eligibility of hedged items, hedged risks and hedging instruments in a fair value hedge is described in chapter 7.
Qualifying criteria for cash flow hedges (chapter 9)	Qualifying criteria specific to the eligibility of hedged items, hedged risks and hedging instruments in a cash flow hedge is described in chapter 9.
 Qualifying criteria for hedges of foreign currency risk (chapter 11)	The general qualifying criteria applicable to all foreign currency hedges is described in section 11.3.10. This chapter also focuses on criteria specific to foreign currency fair value and cash flow hedges .
Qualifying criteria for net investment hedges (section 12.2)	Net investment hedges are only subject to certain qualifying criteria.
Hedge effectiveness (chapter 13)	This chapter discusses the general requirements for assessing hedge effectiveness and the specific requirements for various assessment methods.



Observation**

Optional expedients available in Topic 848

The guidance in this chapter does not consider the optional expedients that may be available in Topic 848 (reference rate reform).

LIBOR is a benchmark interest rate referenced in a variety of agreements that are used by all types of entities. At the end of 2021, banks will no longer be required to report information that is used to determine LIBOR. Regulators in other jurisdictions around the world have undertaken similar initiatives to replace other interbank offer rates. Topic 848 provides entities with optional guidance to ease the potential accounting burden associated with transitioning away from reference rates that are expected to be discontinued.

This discussion provides information about optional expedients in Topic 848 that apply to all types of hedge relationships. The observation sections in chapters 7 and 9 provide information related to optional expedients that apply specifically to either fair value hedges and/or cash flow hedges. The observation section in chapter 13 provides information on optional expedients related to assessing hedge effectiveness.

Entities can apply the expedients in Topic 848 immediately, although most are only available for a limited time (generally through December 31, 2022). An

entity may elect the expedients on an individual hedging relationship basis (i.e. a hedge-by-hedge basis), and may generally elect the expedients independently of one another.

Under Topic 815, an entity would be required to dedesignate a hedging relationship when the terms of the underlying hedged item or hedging instrument are changed. However, if a change to the critical terms of a hedging instrument, hedged item or hedged forecasted transaction designated in a fair value, cash flow or net investment hedge relates to the replacement of the reference rate, an entity may elect an optional expedient under Topic 848 to update its formal documentation without dedesignating the hedging relationship. [848-30-25-3 – 25-7]

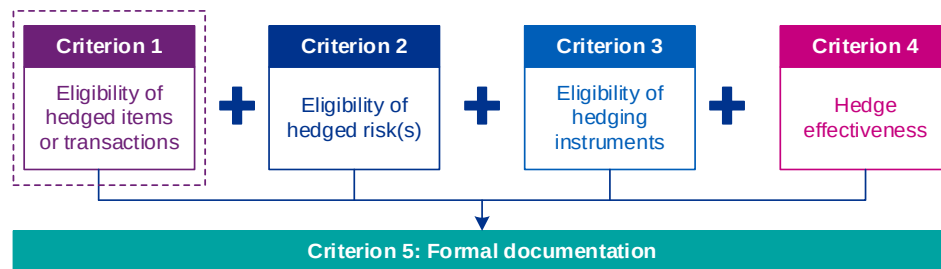
An entity may elect the following optional expedients for fair value and cash flow hedging relationships:

- Change the designated hedging instrument to combine two or more derivative instruments or proportions of those instruments to be jointly designated as the hedging instrument. To apply this expedient, the entity is required to assess the hedge effectiveness of the amended hedging relationship. [848-30-25-9]

An entity may elect the following optional expedients for any type of hedging relationship (i.e. fair value, cash flow or net investment):

- If a change in the hedging instrument’s contractual term is in the scope of Topic 848, an entity may elect to change the systematic and rational method used to recognize in earnings the components excluded from the assessment of effectiveness. [848-30-25-12]

6.2 Hedged items and transactions



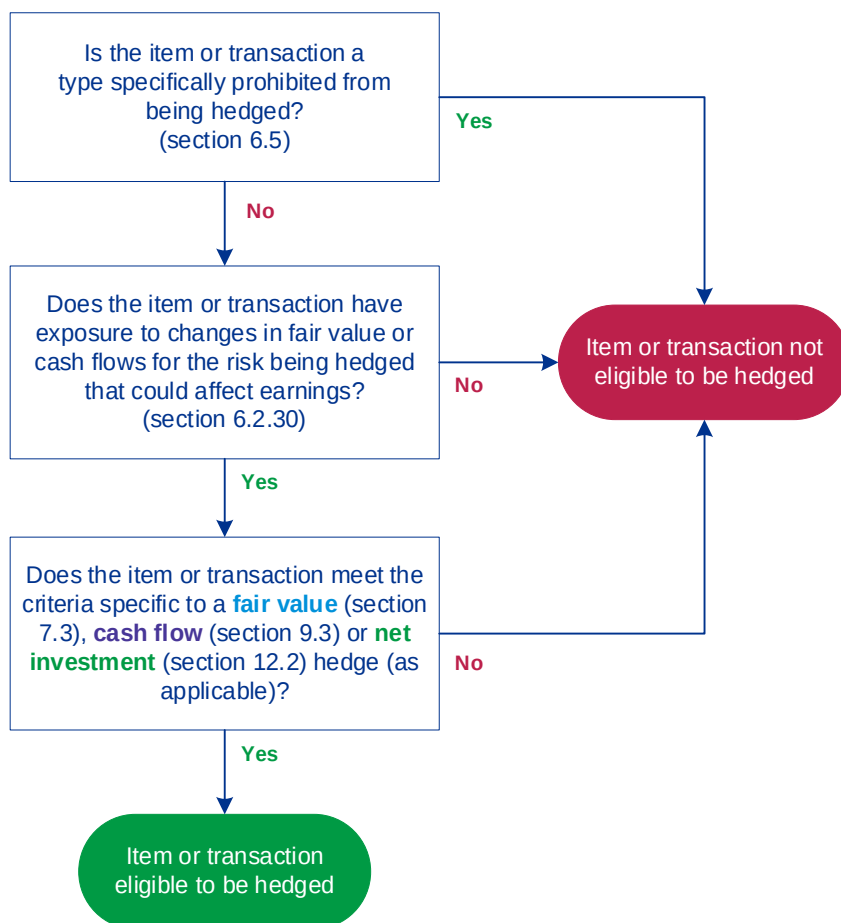
6.2.10 Overview

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

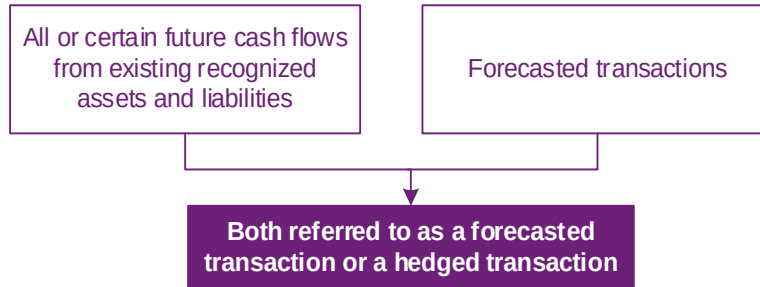
Criterion 1: Items and transactions eligible for hedge accounting		
	Fair value hedge (section 7.3)	Cash flow hedge (section 9.3)
Recognized financial instruments and nonfinancial assets / liabilities	All or a specific portion (or percentage) of a recognized asset or liability – e.g. a financial or nonfinancial asset or liability (section 7.3.10). [815-20-25-12(a)] Foreign currency denominated assets or liabilities (sections 11.4.30 and 11.4.40). [815-20-25-37(a) – 25-37(b)]	All or specified future cash flows from an existing recognized asset or liability – e.g. all or certain future interest payments on variable-rate debt (section 9.3.10). [815-20-25-13(a)] Foreign currency denominated assets or liabilities (section 11.6.50). [815-20-25-38(b)]
Firm commitments	All or a specific portion of an unrecognized firm commitment (section 7.3.20). [815-20-25-12(a)] Foreign currency denominated unrecognized firm commitments (section 11.4.50). [815-20-25-37(d)]	Firm commitments related only to the following: — firm commitments for which payment is fixed in a currency other than the functional currency of the entity (section 11.6.40); or — all-in-one hedges (section 9.3.90). [815-20-25-21, 25-42]
Forecasted transactions	Prohibited for fair value hedges.	A forecasted transaction – e.g. a forecasted purchase or sale (section 9.3.20). [815-20-25-13(b)] Foreign currency denominated transactions (section 11.6.30). [815-20-25-38]
Portfolio or group	A portfolio of similar assets or liabilities (section 7.3.40). [815-20-25-12(b)(1)] The last of layer associated with a closed portfolio of prepayable financial assets (section 7.3.100). [815-20-25-12A]	A group of similar forecasted transactions (section 9.3.60). [815-20-25-15(a)]
Portion (or percentage)	A specific portion (or percentage) of a recognized asset or liability or unrecognized firm commitment (section 7.3.60), including: — hedging only the benchmark interest	Any specified cash flows, including (but not limited to) the first cash flows received or paid in a particular period (sections 9.3.70 and 9.3.80). [815-20-55-21, 55-33A]

Criterion 1: Items and transactions eligible for hedge accounting		
	Fair value hedge (section 7.3)	Cash flow hedge (section 9.3)
	rate component (section 7.3.70); — partial-term hedge of interest rate risk (section 7.3.80); — embedded put or call options (section 7.3.90); or — residual value in a lessor's net investment in a lease. [815-20-25-12(b)(2), 815-25-35-13, 35-13B]	

Recognized financial instruments, nonfinancial assets and liabilities, firm commitments and forecasted transactions need to meet the following thresholds to be eligible hedged items.



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



Net investment hedges. In addition to the items and transactions eligible for fair value and cash flow hedges, an entity can hedge its net investment in a foreign operation. Investments in foreign operations include investments in incorporated and unincorporated foreign operations with a functional currency other than the functional currency of the parent. See section 12.2 for guidance on qualifying criteria specific to net investment hedges.



Question 6.2.10

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

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

Firm commitment	A firm commitment is a (legally) binding agreement between unrelated parties that specifies all significant terms and includes a disincentive for nonperformance that is sufficiently large to make performance probable. The key features of a firm commitment are the specificity of its terms (i.e. the quantity, fixed price and timing), probability of occurrence and enforceability. For further guidance and discussion of qualifying criteria related to firm commitments, see section 7.3.20.
Forecasted transaction	A forecasted transaction is essentially a future transaction that is probable and does not meet the definition of a firm commitment. Forecasted transactions can be contractually established or probable because of an entity's past or expected business practices. For further guidance and discussion of qualifying criteria related to forecasted transactions, see section 9.3.20.

One of the key differences is that firm commitments have fixed prices, which create exposures that are similar to those that exist for recognized assets and liabilities with fixed terms. In contrast, forecasted transactions will occur at

prevailing market rates or prices in the future, which cause exposure to variability in future cash flows.

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

-  **foreign currency risk** related to firm commitments for which payment is fixed in a currency other than the functional currency of the entity (see section 11.6.40)
- firm commitments that meet the definition of a derivative – i.e. all-in-one hedges (see section 9.3.90).

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

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

6.2.20 Overview of hedged risks

In addition to the requirements for hedged items and transactions, the risk associated with these items and transactions needs to qualify for hedge accounting. The primary requirement is that it must result in exposure to a change in fair values or cash flows that could affect reported earnings (see section 6.2.30).

The basic risks that an entity may hedge include:



Interest rate risk



Foreign currency risk



Credit risk



Price risk

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

Fair value hedge	Cash flow hedge
The hedged risks relate to changes in fair value due to fixed rates or prices. For example, a fixed-rate financial instrument exposes its owner to the risk of changes in the financial instrument's fair value because of its fixed terms.	The hedged risks relate to changes in cash flows due to variable rates and prices. For example, a variable-rate debt instrument exposes its issuer to changes in interest payments due to its variable terms.

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

Sections 6.3 and 6.4 provide an overview of the risks eligible to be hedged for both financial instruments and nonfinancial assets and liabilities, respectively.

Net investment hedges. Topic 815 allows an entity to hedge the foreign currency risk of a net investment in a foreign operation. An entity is exposed to foreign currency risk when the functional currency of the foreign operation is different from the functional currency of the parent. Section 12.2 provides guidance on qualifying criteria specific to net investment hedges.

6.2.30 Exposure to earnings requirement



Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-12(c) The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings. The reference to affecting reported earnings does not apply to an entity that does not report earnings as a separate caption in a statement of financial performance, such as a not-for-profit entity (NFP), in accordance with paragraph 815-20-15-1.

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15 A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

...

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

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



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

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

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

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

Section 6.5 outlines items and transactions that are not eligible for hedge accounting due to this requirement, along with other items that are explicitly prohibited from hedge accounting.

 **Foreign currency risk.** An entity is permitted to hedge intercompany transactions for foreign currency risk (see section 11.3.40). This risk is not eliminated in consolidation, and therefore affects consolidated earnings. [815-20-25-43(b)(4)]



Question 6.2.20

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



Excerpt from ASC 815-20

>>>> Exposure to Variability in Cash Flows

55-18 The future sale of an asset or settlement of a liability that exposes an entity (consistent with the criterion in paragraph 815-20-25-15(c)(2)) to the risk of a change in fair value may result in recognizing a gain or loss in earnings when the sale or settlement occurs. Changes in market price could change the amount for which the asset or liability could be sold or settled and, consequently, change the amount of gain or loss recognized. **Forecasted transactions** that expose an entity to cash flow risk have the potential to affect reported earnings because the amount of related revenue or expense may differ depending on the price eventually paid or received. Thus, an entity could designate the forecasted sale of a product at the market price at the date of sale as a hedged transaction because revenue will be recorded at that future sales price.

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

Cash flow hedges. For example, an insurance entity wants to enter into a cash flow hedge to hedge the possibility that it may need to voluntarily increase the interest rate used to credit interest on certain contract liabilities. The insurance entity is not precluded from designating the future interest to be credited on its contracts (either existing or newly written) provided that the interest-related cash flows are probable and there is a possibility that there will be variability in those cash flows that would affect earnings.

Notwithstanding this, it may be difficult for the insurance entity to identify a derivative that will qualify for cash flow hedge accounting because interest rates in the marketplace may not be highly effective at offsetting the entity's discretionary adjustment to the interest rate on the contract liabilities.

Fair value hedges. A mortgage bank wants to enter into a fair value hedge of a fixed-rate mortgage loan. That mortgage loan may present an earnings exposure to a bank because, as interest rates change, the amount at which the bank can sell the loan also would change. There is no requirement for the mortgage bank to sell the loan and realize the earnings effect. Nevertheless, the bank is able to hedge the exposure related to the fixed-rate mortgage loan.



Example 6.2.10

Future sale of inventory that does not create exposure to variations in cash flows

ABC Corp. wishes to hedge a forecasted sale of a product to a third party. The terms of the forecasted sale include a fixed sales price because the buyer agreed to purchase 100 units of the product for \$100/unit on March 31, Year 1.

The forecasted sale does not meet the definition of a firm commitment and the sale agreement does not meet the definition of a derivative.

Can ABC hedge the future sale in a cash flow hedge?

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

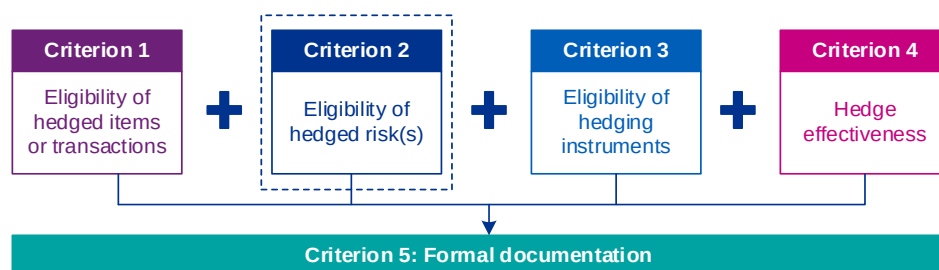
In contrast, if the sales price is based on the market price on March 31, Year 1, the forecasted transaction qualifies for designation in a cash flow hedging relationship, assuming all other criteria are met.

Can ABC hedge the future sale in a fair value hedge?

No. Forecasted transactions cannot be designated as hedged items in a fair value hedge.

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

6.3 Hedged risks of financial items and transactions



6.3.10 Overview



Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-12(f) If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is any of the following:

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

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15(j) If the hedged transaction is the forecasted purchase or sale of a financial asset or liability (or the interest payments on that financial asset or liability) or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is any of the following:

1. The risk of overall changes in the hedged cash flows related to the asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency)
2. For forecasted interest receipts or payments on an existing variable-rate financial instrument, the risk of changes in its cash flows attributable to changes in the contractually specified interest rate (referred to as interest rate risk). For a forecasted issuance or purchase of a debt instrument (or the forecasted interest payments on a debt instrument), the risk of changes in cash flows attributable to changes in the benchmark interest rate or the expected contractually specified interest rate. See paragraphs 815-20-25-19A through 25-19B for further guidance on the designation of interest rate risk in the forecasted issuance or purchase of a debt instrument.
3. The risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates (referred to as foreign exchange risk)
4. The risk of changes in its cash flows attributable to all of the following (referred to as credit risk):
 - i. Default
 - ii. Changes in the obligor's creditworthiness
 - iii. Changes in the spread over the contractually specified interest rate or benchmark interest rate with respect to the related financial asset's or liability's credit sector at inception of the hedge.

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

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

	Fair value hedge	Cash flow hedge
 Interest rate risk	Changes in the benchmark interest rate for recognized fixed-rate financial instruments. [815-20-25-12(f)(2)]	Either: - changes in a contractually specified interest rate for variable-rate financial instruments or forecasted issuances or purchases of variable-rate financial instruments; or - changes in the benchmark interest rate for forecasted issuances or purchases of fixed-rate financial instruments. [815-20-25-15(j)(2)]
 Credit risk	Includes: changes in the obligor's creditworthiness; and	Includes: - risk of default; - changes in the obligor's creditworthiness; and

	Fair value hedge	Cash flow hedge
	— changes in the credit spread over the benchmark interest rate. [815-20-25-12(f)(4)]	— changes in the credit spread over the contractually specified interest rate or the benchmark interest rate. [815-20-25-15(j)(4)]
 Foreign currency risk	— Changes in the related foreign currency exchange rates. [815-20-25-12(f)(3)]	— Changes in the related foreign currency exchange rates. [815-20-25-15(j)(3)]
 Price risk	— Total change in the fair value. [815-20-25-12(f)(1)]	— Total change in the cash flows related to the asset or liability – e.g. all changes in the purchase or sales price. [815-20-25-15(j)(1)]

Topic 815 focuses on these four risks because changes in the price associated with any of these risks will directly affect the fair value or cash flows of a financial asset or liability in a determinable or predictable manner.

Although recognized loan servicing rights and nonfinancial firm commitments with financial components are not financial assets or liabilities, an entity can hedge the same risks for them as those associated with financial items. [815-20-25-12(f)]

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

6.3.20 Interest rate risk



Excerpt from ASC 815-20

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

>>> Hedged Items Involving Interest Rate Risk

25-6 Hedges involving a **benchmark interest rate** are addressed in paragraphs 815-20-25-12(f) and 815-20-25-12A (for fair value hedges) and paragraph 815-20-25-15(j) (for cash flow hedges). Hedges involving a contractually specified interest rate are addressed in paragraph 815-20-25-15(j) (for cash flow hedges). The benchmark interest rate or the contractually specified interest rate being hedged in a hedge of **interest rate risk** shall be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Paragraphs 815-20-25-19A through 25-19B provide guidance on the interest rate risk designation of hedges of

forecasted issuances or purchases of debt instruments. An entity shall not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a **prepayable** instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the overall fair value of that prepayment option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an **embedded derivative** of the same risk class shall be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option shall be considered in designating a hedge of interest rate risk.

20 Glossary

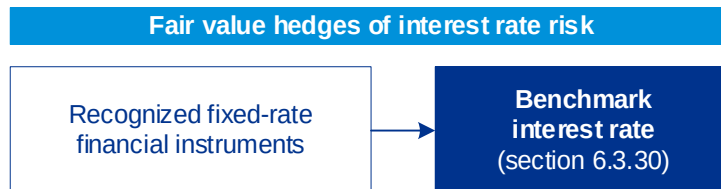
Interest Rate Risk – For recognized variable-rate financial instruments and forecasted issuances or purchases of variable-rate financial instruments, interest rate risk is the risk of changes in the hedged item's cash flows attributable to changes in the contractually specified interest rate in the agreement.

For recognized fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item's fair value attributable to changes in the designated benchmark interest rate. For forecasted issuances or purchases of fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item's cash flows attributable to changes in the designated benchmark interest rate.

The interest rate risks eligible for hedge accounting depend on whether the item or transaction has fixed or variable cash flows, and whether it is designated in a fair value or cash flow hedge.

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

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



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

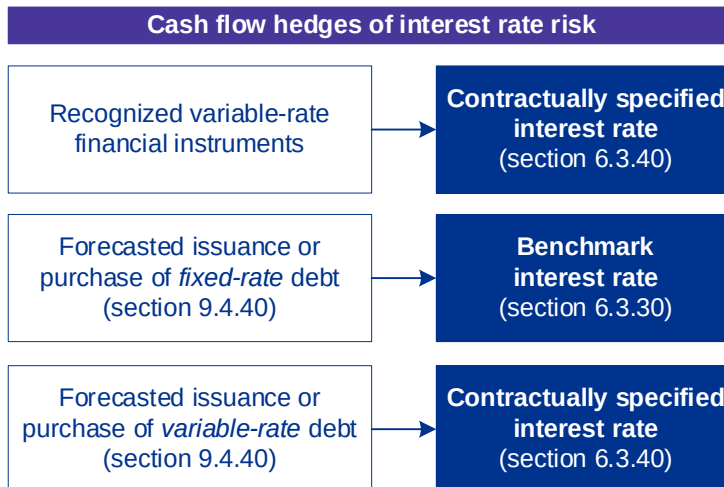
For recognized variable-rate financial instruments, interest rate risk is the risk of changes in cash flows attributable to changes in the interest rate that is contractually specified in the agreement (see section 6.3.40).

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

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

For further guidance related to hedging the forecasted issuance or purchase of debt instruments, see section 9.4.40. That section includes considerations for entities that do not know whether the debt instrument will be fixed- or variable-rate.

The following summarizes the interest rate risks for hedged transactions in cash flow hedges.



Question 6.3.10

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

Interpretive response: Yes, under certain circumstances. A variable-rate debt instrument is exposed to changes in fair value due to changes in interest rates between two interest reset dates. Therefore, an entity may be able to designate a fair value hedge of a variable-rate debt instrument for a partial term between the current and the next repricing dates. This is illustrated in Example 6.3.10.



Example 6.3.10

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

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

At the same time, ABC enters into a six-month interest rate swap agreement with a notional amount equal to the face amount of the debt instrument. Under the terms of the swap agreement, ABC will receive the six-month LIBOR rate and pay the one-month LIBOR rate.

ABC wants to designate the interest rate swap as a fair value hedge of changes in fair value of the variable-rate debt obligation attributable to changes in the benchmark interest rate.

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

For guidance on partial-term hedges, see section 7.3.80.



Question 6.3.20

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

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

Fair value hedges. Although prepayment risk cannot be designated as the hedged risk, an entity may achieve its objective of hedging prepayment risk by designating the embedded option component of the prepayable instrument as the hedged item in a fair value hedge (see section 7.3.90). Specifically, the exposure would be limited to changes in the overall fair value of the prepayment option. [815-20-25-6, 25-12(b)(2)(iii)]



Question 6.3.30

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

Interpretive response: It depends. Although an entity is prohibited from hedging prepayment risk (see Question 6.3.20), it is required to consider prepayment risk when assessing hedge effectiveness and measuring the change in fair value of the hedged item attributable to interest rate risk, with certain exceptions.

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

- partial-term hedges, depending on the term selected (see section 7.3.80); and
- last-of-layer method (see sections 7.3.100 and 13.2.100).

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

For further discussion of hedging interest rate risk on prepayable financial instruments, see section 7.4.10.

6.3.30 Interest rate risk: Benchmark interest rate#



Excerpt from ASC 815-20

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

>>> Hedged Items Involving Interest Rate Risk

>>>> Benchmark Interest Rate

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

20 Glossary

Benchmark Interest Rate – A widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates

attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions.

In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate.

The benchmark interest rate can be designated as the hedged risk in fair value hedges of interest rate risk for fixed-rate financial assets and cash flow hedges of interest rate risk for forecasted issuances or purchases of fixed-rate financial instruments (see section 9.4.40).

The benchmark interest rate is defined as a “widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market.” [\[815-20 Glossary\]](#)

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

US Treasury Rate
London Interbank Offered Rate (LIBOR) Swap Rate
Fed Funds Effective Rate Overnight Index Swap Rate
SIFMA Municipal Swap Rate
SOFR Overnight Index Swap Rate



Question 6.3.40

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

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

However, an entity may apply hedge accounting when a hedging relationship involves an interest rate swap with a variable leg based on an index other than one of the specified benchmark interest rates. This is on the condition that the risk being hedged is either the change in fair value or cash flows due to changes in a benchmark interest rate or the change in the total fair value or cash flows of the fixed-rate hedged item or forecasted transaction (assuming that such relationships are highly effective).

For example, an entity may hedge a fixed-rate debt instrument with an interest rate swap with a variable-rate leg based on the Prime rate if the risk being hedged is changes in the overall fair value of the debt instrument. In such a hedging relationship, the entity is required to determine whether the changes in the fair value of the Prime-based swap will be highly effective in offsetting the change in the total fair value of the debt instrument.

High effectiveness is more likely if the fair value of the debt instrument is not affected by changes in credit risk or foreign currency risk or both.



Question 6.3.50

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

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

For example, we believe the Euro Interbank Offered Rate (Euribor swap rate) may be used as the benchmark rate in euro currency countries. In Canada, the Canadian Treasury Rate, in addition to the Bankers' Acceptance Canadian Deposit Offering Rate (BA CDOR), may be used as the benchmark rate. In the United Kingdom, the Bank of England borrowing rate, in addition to the LIBOR swap rate, may be used as the benchmark rate.

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



Excerpt from ASC 815-20

>>> Effect of Interest Rate Indexes

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

55-62A An entity may designate as the hedged risk only the change in cash flows of the contractually specified interest rate, not an implied rate embedded

in the interest rate. For example, if an entity issues variable-rate debt based on its own prime rate, it cannot designate the change in cash flows of the Fed Funds Target rate or the Wall Street Journal prime rate as the hedged risk.

For cash flow hedges of interest rate risk of variable-rate financial instruments or forecasted issuances or purchases of variable-rate financial instruments, Topic 815 permits an entity to designate the hedged risk as the variability in cash flows attributable to a contractually specified interest rate explicitly referenced in the agreement. [815-20-25-15(j)(2)]

The contractually specified interest rate does not need to be a benchmark interest rate. An entity can designate non-benchmark rates (e.g. prime lending rates) as the hedged risk instead of hedging the overall changes in cash flows.

However, an entity is not permitted to designate an implied rate embedded in a contractually specified interest rate. For example, if an entity issues variable-rate debt based on its own prime rate, it cannot designate the hedged risk as exposure to the Fed Funds Target rate or the Wall Street Journal prime rate. [815-20-55-62A]

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

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



Question 6.3.60

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

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

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

At a September 2018 Board meeting, the FASB noted that an interest rate with a fixed component plus a variable rate inflation index must be considered together as the contractually specified interest rate. In addition, an entity could not separately designate the benchmark rate component of the fixed-rate coupon as the hedged risk in a **fair value hedge** (see Question 7.3.180). [FASB meeting 09-18]



Question 6.3.70

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



Excerpt from ASC 815-20

20 Glossary

Auction rate notes – Auction rate notes are notes that generally have long-term nominal maturities and interest rates that reset periodically through a Dutch auction process, typically every 7, 28, or 35 days. At an auction, existing holders of auction rate notes and potential buyers enter a competitive bidding process through a broker-dealer, specifying the number of shares (units) to purchase with the lowest interest rate they are willing to accept. Generally, the lowest bid rate at which all shares can be sold at the notes' par value establishes the interest rate (also known as the clearing rate) to be applied until the next auction.

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

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

Hedging instrument and hedge effectiveness. It may be difficult for an entity to find a derivative instrument indexed to the auction rates. An entity could designate a receive-variable, pay-fixed LIBOR interest rate swap as the hedging instrument. However, the entity would need to demonstrate the hedging relationship is highly effective at hedge inception and on an ongoing basis. This includes considering the basis difference between the auction rates and LIBOR (see section 13.2.10).

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

In addition, if the hedged transaction (i.e. the variable interest payments) is not probable or if the hedge is no longer highly effective as a result of a failed auction, hedge accounting must be discontinued. See section 6.10 for guidance on the discontinuation of hedge accounting.

6.3.50 Credit risk



Excerpt from ASC 815-20

20 Glossary

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

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

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

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

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

In theory, the benchmark rate represents the rate of interest required to compensate an investor for its investment without consideration of default (e.g. a risk-free rate). The credit spread represents the additional interest needed to compensate an investor for the increased credit risk of a nonrisk-free borrower.

This credit spread has two components: a component related to counterparty risk and a component related to credit sector risk.

Counterparty risk

Risk that a counterparty will fail to comply with its contractual obligations because of credit problems or other reasons.

Credit sector risk

Risk inherent in the counterparty’s sector (e.g. industry, geography and location). For example, a corporate bond issued by an entity in Venezuela would likely have a higher credit spread than a corporate bond issued by an entity in the United States.

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

6.3.60 Foreign currency risk



Excerpt from ASC 815-20

20 Glossary

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

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

For further guidance on foreign currency risk and hedges, see chapter 11.

6.3.70 Price risk

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



An entity is permitted to hedge more than one risk at a time, with the exception of price risk because it would result in the same risk being hedged more than once.

For example, an entity may not hedge the risk of overall changes in fair value of a fixed-rate financial instrument if interest rate risk is also designated as a hedged risk. However, an entity could designate both the interest rate risk and credit risk.

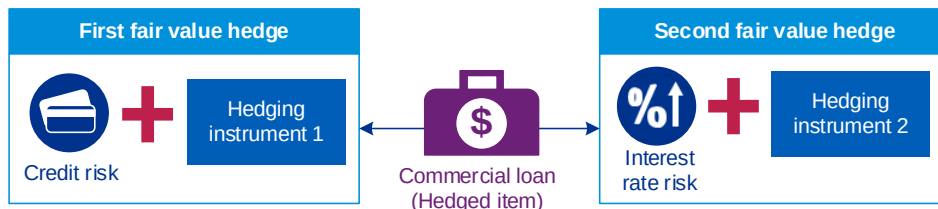
6.3.80 Hedging multiple risks: Simultaneous hedges

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

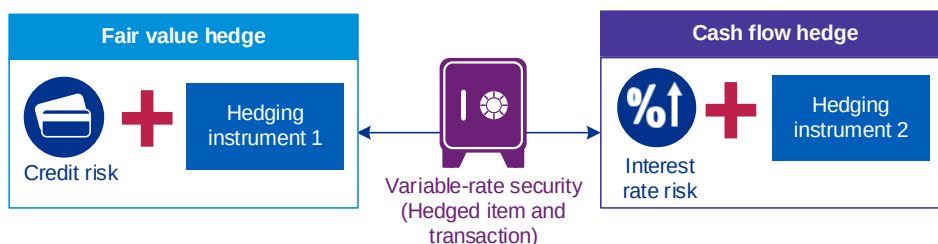
This includes:

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

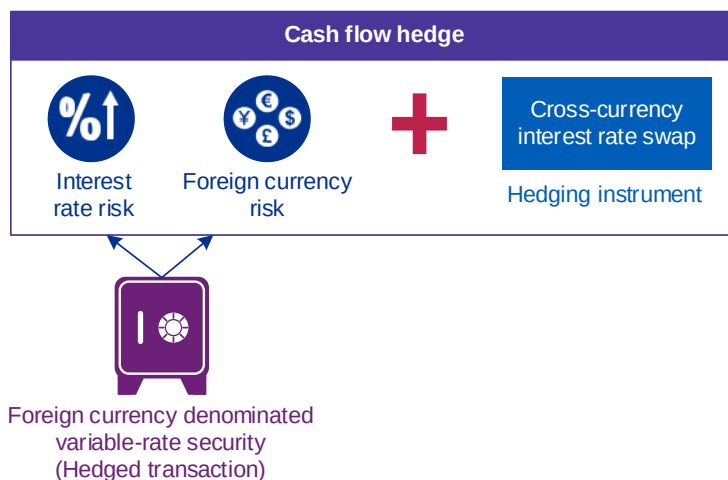
For example, an entity may designate the benchmark interest rate and credit risk related to the same commercial loan in simultaneous fair value hedges.



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



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



When the designated risk is the risk of overall changes in fair value or cash flows related to a financial asset or liability (i.e. price risk), an entity is prohibited from designating another risk associated with the same item. Otherwise the same risk would be hedged more than once. [815-20-25-12(f)(5), 25-15(j)]

Because simultaneous hedges are permitted and the hedged item or transaction may be subject to another hedge, it is critical to specify and document at inception which item or transaction and its associated risk are being hedged.



Example 6.3.20 Hedging more than one risk at a time

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

Assuming all hedge criteria have been met, Investor may designate any one or more of the following risks of changes in cash flows attributable to changes in:

- interest rate risk (benchmark interest rate);
- foreign currency exchange rates; or
- credit risk.

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

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

6.3.90 Limitations on hedged risks for HTM securities



Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-12(d) If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held to maturity in accordance with Topic 320, the designated risk being hedged is the risk of changes in its fair value attributable to **credit risk, foreign exchange risk**, or both. If the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component. If the hedged item is other than an option component of a held-to-maturity security that permits its prepayment,

the designated hedged risk also shall not be the risk of changes in its overall fair value.

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

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

1. Credit risk
2. Foreign exchange risk.

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

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

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

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

Type of risk	Eligible for HTM debt securities?
 Interest rate risk	
 Credit risk	
 Foreign currency risk	
 Price risk	

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

An entity is permitted to hedge the risk of changes in the fair value or cash flows of a HTM security attributable to credit risk and/or foreign currency risk. The FASB decided to allow credit risk to be a designated hedged risk because it is not inconsistent with Topic 320, which allows a sale or transfer of a HTM

debt security in response to significant deterioration in the credit quality of the issuer of the security. [815-20-25-12(d), 25-15(f), FAS 133.BC430]

Foreign currency denominated HTM securities are monetary assets that are exposed to changes in foreign exchange rates. Since guidance is provided in Topic 830 (foreign currency) for reflecting the effect of changes in foreign exchange rates on HTM securities, the Board concluded that the risk of changes in foreign exchange rates in those securities qualifies as a hedgeable risk. [FAS 133.BC411(c)]



Question 6.3.80

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

Interpretive response: Yes. We believe an entity may hedge variability in cash flows attributable to interest rate risk or price risk for a forecasted purchase of a debt security that *will* be classified as HTM at acquisition. This assumes all cash flow hedge criteria are met.

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

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

6.3.100 Limitations on financial assets and liabilities measured at fair value



Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15(e) If the forecasted transaction relates to a recognized asset or liability, the asset or liability is not remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.

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

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

- c. With respect to fair value hedges only:
 - 3. An asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings

An asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported in earnings is not eligible for hedge accounting.

[815-20-25-15(e), 25-43(c)(3)]

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

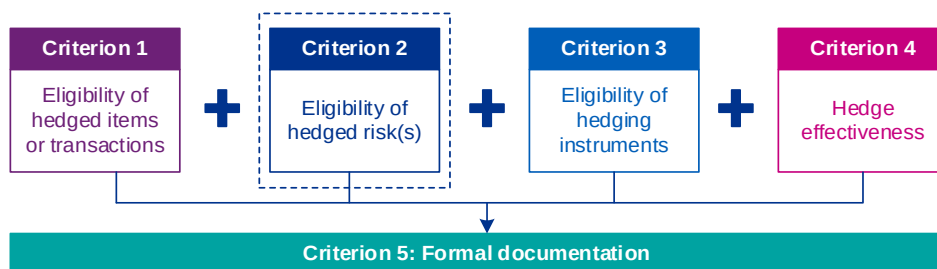
- debt securities classified as trading under Topic 320;
- assets or liabilities measured using the fair value option in Topic 825 (financial instruments) or Topic 815; or
- all equity securities in the scope of Topic 321 (see section 6.5.30).

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

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

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

6.4 Hedged risks of nonfinancial items and transactions



6.4.10 Overview



Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-12(e) If the hedged item is a nonfinancial asset or liability (other than a recognized loan servicing right or a nonfinancial firm commitment with financial

components), the designated risk being hedged is the risk of changes in the fair value of the entire hedged asset or liability (reflecting its actual location if a physical asset). That is, the price risk of a similar asset in a different location or of a major ingredient shall not be the hedged risk. Thus, in hedging the exposure to changes in the fair value of gasoline, an entity may not designate the risk of changes in the price of crude oil as the risk being hedged for purposes of determining effectiveness of the fair value hedge of gasoline.

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

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

1. The risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates
2. The risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset reflecting its actual location if a physical asset (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location.
3. The risk of variability in cash flows attributable to changes in a **contractually specified component**. (See additional criteria in paragraphs 815-20-25-22A through 25-22B for designating the variability in cash flows attributable to changes in a contractually specified component as the hedged risk.)

>>> Hedged Items in Cash Flow Hedges Only

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

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

20 Glossary

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

The following table outlines the risks associated with a nonfinancial asset or liability or transaction that are eligible to be hedged.

	Fair value hedge	Cash flow hedge
 Price risk	— Total change in the fair value. [815-20-25-12(e)]	Either: — all changes in the purchase price or sales price of the asset – i.e. price risk; or [815-20-25-15(i)(2)] — changes in a contractually specified component – i.e. a component of price risk (see section 9.4.10). [815-20-25-15(i)(3)]
 Foreign currency risk	— Changes in the related foreign currency exchange rates if the firm commitment is denominated in a foreign currency. [815-20-25-37]	— Changes in the related foreign currency exchange rates of foreign currency denominated forecasted transactions or firm commitments [815-20-25-15(i)(1)]

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

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



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

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

Example 6.4.10 illustrates the different cash flow hedging strategies available for a forecasted transaction to sell inventory. Section 9.4.10 provides guidance for designating the contractually specified component as the hedged risk in a cash flow hedge.

For a cash flow hedge of total price risk involving a forecasted transaction to acquire a nonfinancial asset with a purchase price denominated in a foreign currency, an entity is allowed to exclude the foreign currency component of a hedged transaction (see Example 6.4.20). In other words, an entity is not required to hedge the risk of changes in its functional currency equivalent cash flows (i.e. all cash flows). [815-20-25-15(i)(2)]

Fair value hedges. For a fair value hedge, Topic 815 does not allow an entity to designate a component of price risk. Rather, the designated risk is required to be changes in the fair value of the *entire* asset or liability – i.e. total price risk. For further discussion, see section 7.4.20.

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

 See guidance on **foreign currency risk** and hedges in chapter 11.

Hedge effectiveness. Entities commonly use standardized contracts traded on exchanges (e.g. futures contracts) to hedge risk exposures related to nonfinancial items or transactions. These contracts may have critical terms that do not exactly match the hedged item or transaction – i.e. different quantities, locations, etc. A hedging relationship may not be perfectly effective when there is a mismatch between the hedged item or transaction and the hedging instrument (see section 13.2.10).



Example 6.4.10 Comparison of cash flow hedges and fair value hedges of inventory

Cash flow hedges

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

Total price risk

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

Contractually specified component price risk

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

Assuming that the forward contract is outside the scope of Topic 815 (for example, if Candy applies the NPNS scope exception), Candy may designate

the contractually specified component (the sugarcane index) of the forward contract as the hedged risk in the forecasted sale of chocolate bars.

See guidance on the conditions that must be met for a contractually specified component in an existing contract to be designated as the hedged risk in section 9.4.20.

Foreign currency risk

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

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

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

Fair value hedges

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

Total price risk

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

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

Foreign currency risk

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

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

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



Example 6.4.20

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

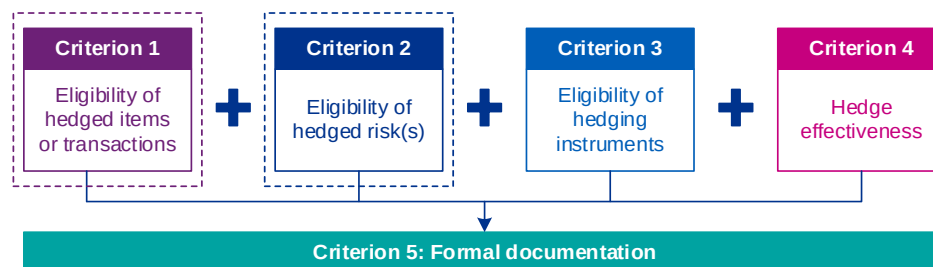
Goldco, an Australian gold producer, uses the Australian dollar (A\$) as its functional currency. Goldco wishes to hedge its exposure to US dollar denominated forecasted gold sales and enters into a gold futures contract denominated in US dollars (which are more readily available).

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

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

If Goldco was required to hedge the risk of changes in its functional currency equivalent cash flows (i.e. all cash flows), high effectiveness may be difficult to achieve.

6.5 Limitations on hedged items, transactions and risks



6.5.10 Overview



Excerpt from ASC 815-20

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

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

- a. Subparagraph not used
- b. With respect to both fair value hedges and cash flow hedges:

1. An investment accounted for by the equity method in accordance with the requirements of Subtopic 323-10 or in accordance with the requirements of Topic 321
 2. A noncontrolling interest in one or more consolidated subsidiaries
 3. Transactions with stockholders as stockholders, such as either of the following:
 - i. Projected purchases of treasury stock
 - ii. Payments of dividends.
 4. Intra-entity transactions (except for foreign-currency-denominated forecasted intra-entity transactions) between entities included in consolidated financial statements
 5. The price of stock expected to be issued pursuant to a stock option plan for which recognized compensation expense is not based on changes in stock prices after the date of grant.
- c. With respect to fair value hedges only:
1. If the entire asset or liability is an instrument with variable cash flows, an implicit fixed-to-variable swap (or similar instrument) perceived to be embedded in a host contract with fixed cash flows
 2. For a held-to-maturity debt security, the risk of changes in its fair value attributable to interest rate risk
 3. An asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings
 4. An equity investment in a consolidated subsidiary
 5. A firm commitment either to enter into a business combination or to acquire or dispose of a subsidiary, a noncontrolling interest, or an equity method investee
 6. An equity instrument issued by the entity and classified in stockholders' equity in the statement of financial position
 7. A component of an embedded derivative in a hybrid instrument—for example, embedded options in a hybrid instrument that are required to be considered a single forward contract under paragraph 815-10-25-10 cannot be designated as items hedged individually in a fair value hedge in which the hedging instrument is a separate, unrelated freestanding option.
- d. With respect to cash flow hedges only:
1. Subparagraph not used
 2. If variable cash flows of the forecasted transaction relate to a debt security that is classified as held-to-maturity under Topic 320, the risk of changes in its cash flows attributable to interest rate risk

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

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15 A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met: ...

- d. The forecasted transaction is not the acquisition of an asset or incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.
- e. If the forecasted transaction relates to a recognized asset or liability, the asset or liability is not remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.
- f. If the variable cash flows of the forecasted transaction relate to a debt security that is classified as held to maturity under Topic 320, the risk being hedged is the risk of changes in its cash flows attributable to any of the following risks:
 - 1. Credit risk
 - 2. Foreign exchange risk.
- g. The forecasted transaction does not involve a business combination subject to the provisions of Topic 805 or a combination accounted for by an NFP that is subject to the provisions of Subtopic 958-805.
- h. The forecasted transaction is not a transaction (such as a forecasted purchase, sale, or dividend) involving either of the following:
 - 1. A parent entity's interests in consolidated subsidiaries
 - 2. An entity's own equity instruments.

In addition to those items and transactions that fail to meet the eligibility criteria for designation in a hedge outlined in section 6.2, Topic 815 specifically prohibits certain items and transactions from hedge accounting.

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

6.5.20 Equity method investments and noncontrolling interests

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

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

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

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

These restrictions also apply to firm commitments or forecasted transactions to acquire or dispose of these investments. [815-20-25-15(h)(1), 25-43(c)(5)]

Net investment hedges. Topic 815 allows an entity to hedge the foreign currency risk of a net investment in a foreign operation, which includes subsidiaries, joint ventures and equity method investments (see chapter 12).



Question 6.5.10

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

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

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

This is because there is no direct exposure to changes in fair value or variability in cash flows that is attributable to an entity's interest in the equity method investment. Topic 815 does not necessarily require a subsidiary with exposure to the hedged risk to be a party to the hedging instrument to apply hedge accounting at the consolidated level (see Question 6.7.20). However, this only applies to a consolidated subsidiary and is not available for equity method investees. [815-20-25-46A]

Fair value hedges. A firm commitment between an entity and its equity method investee is not permitted. This is because a firm commitment must be between two unrelated parties (see section 7.3.20).

Cash flow hedges. An entity is *not* precluded from designating forecasted transactions *with* equity method investees as hedged transactions, assuming the effects of the forecasted transaction will not be eliminated and other eligibility criteria are met (see Question 9.3.40).



Example 6.5.10

Forecasted transaction of an equity method investee

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

ABC is concerned that fluctuations in LIBOR may adversely affect the earnings of JV and thereby affect its share of the earnings. To mitigate this risk, ABC enters into a pay-fixed, receive-LIBOR interest rate swap to lock in the cost of JV's debt obligation.

Is ABC permitted to use cash flow hedge accounting?

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

1. be a transaction; and

2. present an exposure to cash flows for the hedged risk that could affect reported earnings.

The effect of changes in LIBOR on JV's income statement is not a transaction from ABC's perspective. In addition, neither ABC nor any of its consolidated subsidiaries have any direct exposure to variability in cash flows that is attributable to JV's debt obligation. Therefore, we believe ABC may not use cash flow hedge accounting in this instance.



Example 6.5.20

Contract to sell a wholly owned subsidiary

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

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

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

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

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



Question 6.5.20

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

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

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

6.5.30 Equity securities in scope of Topic 321

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

This includes the following:

- equity securities with readily determinable fair values that are measured at fair value with gains/losses recognized currently in earnings; and [321-10-35-1]
- equity securities without readily determinable fair values that are measured either (1) at fair value with gains/losses recognized currently in earnings, or (2) using a measurement alternative (cost +/- fair value changes when there are observable prices less impairment). [321-10-35-2]

6.5.40 Equity instruments issued by the entity and transactions with shareholders

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

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

This restriction also applies to the following transactions:

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



Question 6.5.30

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

Interpretive response: No. We believe that items classified in temporary or mezzanine equity (e.g. certain preferred stock instruments) cannot be designated as hedged items because they do not meet the definition of an asset or liability.



Question 6.5.40

Can an entity hedge compensation expense related to stock appreciation rights?



Excerpt from ASC 815-20

>>> Hedged Items in Cash Flow Hedges Only

>>>> Stock-Appreciation-Right Obligation as a Hedged Item

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

Background: A stock appreciated right (SAR) is a form of compensation that entitles employees to receive cash, stock or a combination of cash and stock in

an amount equivalent to any excess of the market value over a stated price based on a stated number of shares of the employer's stock.

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

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

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

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

There are also considerations around whether the purchased call option would meet the definition and scope of a derivative, which is a requirement to be designated as the hedging instrument (see section 6.6). For the purchased call option to be a derivative instrument, it needs to be classified as an asset. However, certain contracts involving an entity's own equity are classified as equity, and therefore are not eligible to be considered a derivative instrument. [815-10-15-74(a)]

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

6.5.50 Intercompany transactions

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

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

In contrast, the risk of variable cash flows attributable to foreign currency exchange risk related to a subsidiary's intercompany debt denominated in a foreign currency could be hedged because the earnings of the consolidated

entity are affected by the resulting foreign currency remeasurement gain or loss related to the debt.

 **Foreign currency risk.** An entity is permitted to hedge intercompany transactions for foreign currency risk (see section 11.3.40). This risk is not eliminated in consolidation, and therefore affects consolidated earnings. [815-20-25-43(b)(4)]



Question 6.5.50

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

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

6.5.60 Business combinations

The following items and transactions are ineligible for hedge accounting:

- firm commitment to either enter into a business combination or to acquire or dispose of a subsidiary; [815-20-25-43(c)(5)]
- forecasted transaction involving a business combination; and [815-20-25-15(g)]
- forecasted purchase or sale involving a parent entity's interest in a consolidated subsidiary. [815-20-25-15(h)(1)]

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

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

The FASB prohibited firm commitments and forecasted transactions involving a business combination from being designated as a hedged item or transaction for reasons similar to the prohibition of equity method investments (see section 6.5.20) and equity investments in a consolidated entity (see section 6.5.50). [FAS 133.BC456, BC472–BC473]



Question 6.5.60

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

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

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

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

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

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

If the forecasted issuance of debt that is contingent on a business combination qualifies for designation as a hedged transaction, an entity may wish to use a deal contingent interest rate swap as the hedging instrument to hedge the interest rate risk. This requires the entity to assess whether the deal contingent swap is expected to be highly effective at achieving offsetting cash flows attributable to the hedged risk. However, a deal contingent term in this type of hedging instrument would generally be expected to reduce the effectiveness of the hedging relationship, and could result in the hedging relationship being less than highly effective. See Question 13.7.50 for further guidance on assessing effectiveness of a hedging relationship that includes a deal contingent swap.



Question 6.5.70

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

Interpretive response: No. Topic 205 (presentation) requires an entity to present total assets and total liabilities of a disposal group classified as held-for-sale on the face of the balance sheet. [\[205-20-45-10\]](#)

The assets or liabilities of a disposal group classified as held-for-sale would not qualify for fair value or cash flow hedge accounting. This is because (like hedges of forecasted business combinations) they represent a group of dissimilar assets and liabilities.

6.5.70 Assets and liabilities remeasured with changes in fair value reported in earnings

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

Specifically, the FASB believes that hedge accounting should not provide an opportunity to change the accounting for an asset or liability that would otherwise be reported at fair value with changes currently recognized in earnings. [\[FAS 133.BC405\]](#)

Section 6.3.100 provides guidance on this restriction as it relates to financial assets and liabilities.

Topic 815 requires items that meet the definition of a derivative to be measured at fair value, unless the item qualifies for any of the scope exceptions in Subtopic 815-10. Therefore, contracts that meet the definition of a derivative may not be designated as the hedged item or transaction unless they qualify for one of the scope exceptions. Section 7.3.30 (**fair value hedges**) and Question 9.3.10 (**cash flow hedges**) provide further guidance on the eligibility of contracts that meet the definition of a derivative and a commonly used scope exception (e.g. NPNS scope exception).



Question 6.5.80

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

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

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

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



Example 6.5.30

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

Cash flow hedge

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

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

Fair value hedge

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



Example 6.5.40

Forecasted transaction to purchase a derivative instrument

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

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

6.5.80 Strategic risk



Excerpt from ASC 815-20

>>> Strategic Risk Ineligible as Hedged Risk

55-40 The offset criterion in paragraph 815-20-25-75 precludes hedge accounting for certain risk management techniques, such as hedges of strategic risk. For example, a U.S. manufacturer, with no export business, that designates a forward contract to buy U.S. dollars (USD) for Japanese yen (JPY) as a hedge of its USD sales would fail the requirement that the cash flows of the derivative instrument are expected to be highly effective in achieving offsetting cash flows on the hedged transaction. A weakened JPY might allow a competitor to sell goods imported from Japan more cheaply, undercutting the domestic manufacturer's prices and reducing its sales volume and revenues. However, it would be difficult for the U.S. manufacturer to expect a high degree of offset between a decline in U.S. sales revenue due to increased competition and cash inflows on a foreign currency derivative instrument. Any relationship between the exposure and the hedging derivative typically would be quite indirect, would depend on price elasticities, and would be only one of many factors influencing future results. In addition, the risk that a desired or expected number of transactions will not occur, that is, the potential absence of a transaction, is not a hedgeable risk for accounting purposes.

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

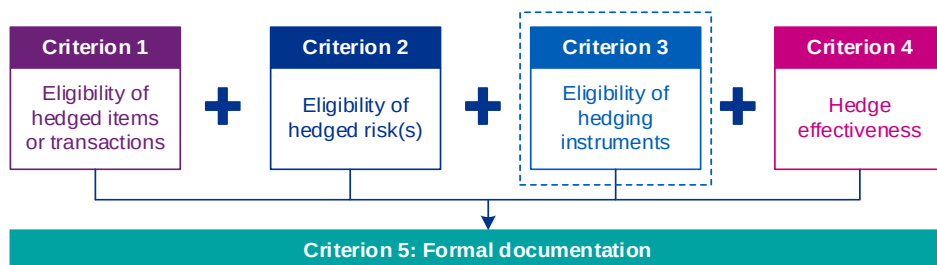
An entity may engage in various activities to control or reduce other types of economic risks (e.g. strategic risks); however, these may not be as determinable or predictable. As such, these types of economic risks are not eligible for hedge accounting.

6.5.90 Macro hedges

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

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

6.6 Hedging instruments



6.6.10 Overview



Excerpt from ASC 815-20

> Eligibility of Hedging Instruments

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

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



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

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

- all of a derivative instrument;
- a proportion of a derivative instrument (see section 6.6.30); or
- a combination of two or more derivative instruments (see section 6.6.40).

There are also limitations on certain derivatives being hedging instruments (see section 6.7).

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

 **Foreign currency risk.** For guidance on the eligibility of hedging instruments in foreign currency hedges, see chapter 11.

Net investment hedges. For guidance on the eligibility of hedging instruments in net investment hedges, see section 12.3.

6.6.20 Common types of derivative instruments

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

Swaps	Futures/Forwards	Options
— Interest rate swaps — Commodity swaps — Equity swaps — Foreign currency swaps — Cross-currency interest rate swaps — Credit default swaps — Total return swaps	— Futures contracts (standardized and exchange traded) — Forward contracts	— Call options — Put options — Interest rate caps — Interest rate floors — Interest rate collars

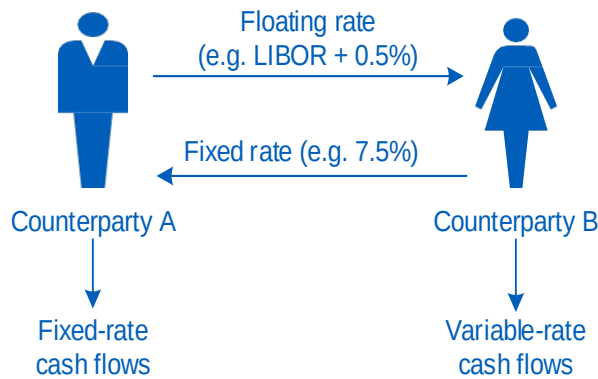
There are other types of instruments that are a combination of two categories of derivatives. For example, a forward-starting swap is an agreement to enter into a swap that starts at a future date. Likewise, a swaption is an option to enter into an interest rate swap when exercised.

Interest rate swaps

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

The most widely used swap is the interest rate swap. An interest rate swap is a contractual agreement between two parties to exchange one type of interest-rate-based cash flows for another type of interest-rate-based cash flows on specified dates in the future.

One type of interest rate swap that is typically used in both fair value and cash flow hedging relationships is a fixed-for-floating interest rate swap. This type of swap involves the exchange of fixed interest rate cash flows for floating interest rate cash flows that change with a specific reference or index (e.g. LIBOR, Commercial Paper, and Prime).



The fixed rate of the swap is typically set for the entire term of the swap, whereas the floating rate is reset on specified reset dates. The frequency with which the floating rate is reset is usually at the discretion of the two parties.

To determine the net settlements of a fixed-for-floating interest rate swap, the applicable fixed rate and floating rate as of the reset date are multiplied by the notional amount in effect at that date. The computed swap payments (i.e. the computed difference) are then paid to or received from the counterparty, as applicable, on designated settlement dates.

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

Fair value hedge	Cash flow hedge
Converts fixed interest payments (or receipts) to variable.	Converts variable-rate cash flows to fixed cash flows.

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

Basis swaps	An interest rate swap that exchanges two variable-rate interest payments (e.g. a floating-for-floating interest rate swap). For limitations on designating basis swaps in a cash flow hedge, see section 9.5.10.
Cross-currency interest rate swaps	A contractual agreement between two parties to exchange interest payments and principal denominated in two different currencies. This exchange includes the following at different points in time. — Initial exchange (at inception): a fixed principal amount of one currency for a fixed principal amount of a different currency (usually based on the spot rate on the date of the transaction). — Periodic exchanges: periodic interest cash flows in the two currencies of denomination based on the fixed principal amounts of the two currencies exchanged at inception at either a fixed or variable rate of interest. — Final exchange (at maturity): fixed principal amounts exchanged at inception. A cross-currency interest rate swap (CCIRS) can be structured to accomplish different objectives. For example, an entity can hedge its exposure to both interest rate risk and foreign exchange risk – e.g. a foreign currency denominated variable-rate debt hedged

using a receive-variable, pay-fixed CCIRS. Alternatively, it could hedge its exposure only to foreign currency risk – e.g. a foreign currency denominated fixed-rate debt hedged using a receive-fixed, pay-fixed CCIRS.



Example 6.6.10

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

Fair value hedge

ABC Corp. issues a fixed-rate debt instrument and wishes to hedge its exposure to changes in fair value related to interest rate risk (i.e. benchmark interest rate).

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

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

Cash flow hedge

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

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

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

Other swaps

The other basic types of swaps are summarized below.

Commodity swaps	Contractual agreement between two parties to exchange the market (or spot) price of an underlying commodity for a fixed price.
Equity swaps	Contractual agreement between two parties to exchange a set of future cash flows (i.e. 'legs' of the swap). One leg is usually based on a floating rate (e.g. the floating leg) and the other leg is based on the performance of shares or a share index (e.g. the equity leg).
Foreign currency swaps	Contractual agreement between two counterparties to exchange foreign currency.
Credit default swaps	Buyer makes periodic payments to a seller (i.e. fee or premium) in exchange for an agreement that the seller will compensate the

buyer in the event that a debt issuer (i.e. the reference entity) defaults or experiences a credit event.

Forwards/futures

Forward contracts are negotiated between two parties to purchase a specific quantity of a commodity, a financial instrument or a foreign currency at a specified price with delivery or settlement in the future.

Those contracts can be physically settled by receipt of the underlying for a payment of cash or can be net cash settled by the parties, with one party receiving a payment for the difference between the price of the underlying on the date of the settlement (i.e. the spot price) and the forward price agreed to in the contract multiplied by the notional amount of the contract (i.e. number of units).



Question 6.6.10

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

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

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

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

Options

Unlike swaps, forwards and futures contracts that require an entity to buy or sell an underlying instrument or to swap cash flows with another party, an option contract provides an option holder with the right, but not the obligation, to buy or sell an underlying instrument or to exchange cash flows with another party.

The key features of options are as follows.

Terms of contract	An option contract defines a price, referred to as the <i>strike price</i> , and establishes the term of the option, referred to as the <i>exercise period</i> .
Call or put option	An option contract normally provides an option holder a <i>call</i> option or a <i>put</i> option. — A call option is an agreement that gives the holder the right to buy an underlying asset. This enables the holder to benefit from an increase in the value of the underlying instrument above the exercise price. — A put option is an agreement that gives the holder the right to sell an underlying asset. This enables the holder to benefit from a decrease in the value of the underlying instrument below the exercise price.
American or European options	Options generally are either American or European depending on their exercisability. The holder of an American option can exercise the option at any time during the exercise period whereas the holder of a European option can exercise an option only at maturity.
Option holder (buyer)	An option holder usually pays a premium for the right to exercise the option. Because of the nature of an option, the holder benefits from favorable movements (either up or down depending on whether it is a call or a put) in the price of the underlying instrument while risking only the loss of the option premium that it paid for the contract.
Option writer (seller)	An option writer is exposed to virtually unlimited loss in exchange for the option premium.
Time value and intrinsic value	An option comprises time value and intrinsic value. — Time value represents the value of the time to the end of the exercise period, which is affected by volatility of the price of the underlying, the remaining option term, and other economic factors. — Intrinsic value, commonly characterized by the term 'in the money' is the amount by which the value of the underlying exceeds or is less than an option's strike price depending on whether the option is a call or put, respectively. In either case, it normally can only be a positive amount – meaning that an option cannot have an intrinsic value less than zero, even when (economically) the option is underwater.

Options can be combined with other options (e.g. an interest rate collar that combines a cap and a floor) or with other types of derivatives (e.g. an option within a swap).

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

If the option or combination is a net written option, the hedging relationship must meet the written option test for the option to be a hedging instrument. For further guidance, see sections 6.7.50 and 6.7.60.



Example 6.6.20

Hedging strategy using a purchased option

Fair value hedge

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

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

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

Cash flow hedge

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

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



Question 6.6.20

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

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

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

- The hedging relationship must be expected to be (and actually be) highly effective throughout the hedge period. It is not permissible to designate (as the hedged risk) a specific risk but only when another specific risk is also present, even when a complex option contains two or more underlyings that are economically related to those risks. For example, an entity cannot define its hedging strategy as hedging the risk of changes in fair value due to changes in the benchmark interest rate of a firm commitment to purchase a fixed-rate bond, but only when oil prices are above a certain level.
- If the hedged item or forecasted transaction is a group of individual items or transactions, each item in the group must share the same risk exposure for which they are designated as being hedged. See sections 7.3.30 and 9.3.60 regarding similarity for fair value and cash flow hedges, respectively.

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

FASB Example: Oil-linked interest rate cap as hedging instrument



Excerpt from ASC 815-20

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

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

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

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

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

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

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

55-161 The oil-linked interest rate cap cannot be designated in a hedge of the variability in the difference between interest payments and sales proceeds on oil. The oil-linked interest rate cap purchased by Entity A is attempting to hedge Entity A's exposure to variability in the net cash flows related to certain revenue inflows and certain expense outflows. Entity A wishes to reduce the risk that an increase in cash outflows due to increases in interest rates will occur without a concurrent increase in cash inflows due to increases in the

price of oil per barrel. Those are separate and dissimilar risks that Entity A wishes to hedge with a single derivative instrument. Thus, the hedged forecasted transaction cannot be a group of oil sales inflows and interest payment outflows. This Subtopic is not structured to permit hedge accounting for strategies involving hedges of a spread between revenues and expenses as Entity A is attempting to accomplish.

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

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

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

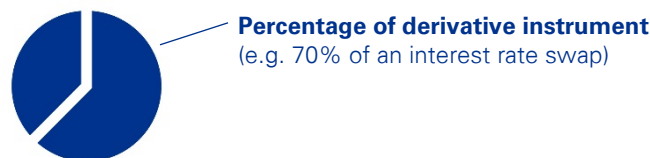
55-165 In the unlikely event that Entity A was able to conclude that the relationship was expected to be highly effective (because the complex option was expected to be highly effective for all changes in the three-month LIBOR rate above the contractually specified rate due to the remoteness that the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

55-166 The oil-linked interest rate cap cannot be designated in a hedge of the variability in proceeds from the forecasted sale of oil. If Entity A wanted to designate the oil-linked interest rate cap as a cash flow hedge of the risk of overall changes in the sales proceeds from the forecasted sale of oil below the contractually specified price per barrel in the interest rate cap, the hedging

relationship would fail to qualify under paragraph 815-20-25-75(b) because the cash inflows from the oil-linked interest rate cap are calculated based on the debt's principal amount and the excess of 3-month LIBOR over 7 percent. Because the cash inflows from the oil-linked interest rate cap are unrelated to the proceeds from oil sales, Entity A could not expect the proposed hedging relationship to be highly effective at achieving offsetting cash flows.

6.6.30 Proportion of a derivative

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



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

Similarly, an entity cannot separate a compound derivative instrument and designate one dissimilar component as the hedging instrument (see section 6.7.40). [\[815-20-25-71\(a\)\(2\)\]](#)

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

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

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

The designated portion of the item or transaction can have characteristics different from the entire item or transaction. For example, a call option embedded in a debt obligation could be separately designated as the hedged item. In contrast, as demonstrated in the table above, an embedded written

option within a derivative instrument cannot be separately designated as the hedging instrument.



Question 6.6.30

Can different proportions of the same derivative instrument be designated in different hedging relationships?

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

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

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



Question 6.6.40

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

Interpretive response: No. An entity is prohibited from separating a derivative instrument into components that represent different risks and designating one of those components as the hedging instrument.

We believe separating a derivative instrument into different segments based on the timing of interest payments or receipts would result in one portion of the contract having different risks from those attributable to the entire derivative contract.



Example 6.6.30

Separating an interest rate swap into components that represent different risks

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

ABC cannot hedge the variability in cash flows of the 10-year variable-rate debt obligation using the first 10 years of the 15-year interest rate swap because the

first 10 years of the swap represents a portion (as opposed to a proportion) of the entire derivative instrument.



Example 6.6.40

Interest rate swap to hedge a portion of a hedged item or transaction

Cash flow hedge

Assume the same facts as Example 6.6.30, except that ABC enters into a five-year interest rate swap.

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

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

Fair value hedge

ABC can designate a partial-term hedge for the last five years of a 10-year fixed-rate debt instrument using a five-year forward-starting interest rate swap that starts in Year 6. For guidance on partial-term hedges, see section 7.3.80.

6.6.40 Combination of derivatives

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

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

The following table demonstrates how an interest rate swap and an option contract could be designated in a fair value or cash flow hedge for a hedged item or transaction with an embedded option.

	Hedged item or transaction	+	Hedging instrument
Fair value hedge	Fixed-rate debt security with an embedded call option		Interest rate swap + Option contract
Cash flow hedge	Variable-rate debt security with an embedded option that caps the interest rate		Interest rate swap + Option contract

The debt security's fair value or cash flows could be affected in amounts that are different from the interest rate swap's fair value or cash flows due to the embedded option.

The combination of two or more derivatives must be **formally documented** (see section 6.9.20).



Example 6.6.50

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

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

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

For the interest rate swap to be designated as the hedging instrument, it needs to be highly effective in offsetting changes in fair value of the debt attributable to interest rate risk taking into account the effect of the embedded call option (see section 7.4.10). This is because the embedded prepayment option is exercisable during the hedge period – i.e. ten years.

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

To designate the combination of the interest rate swap and put option as the hedging instrument, Topic 815 requires symmetry of the gain and loss potential of the combined hedged position – i.e. the written option test (see section 6.7.50).



Example 6.6.60

Multiple instruments to hedge interest rate risk

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

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

In combination, these interest rate swaps would hedge the variability of the contractually specified interest payment cash flows on the Prime-based debt. ABC may jointly designate the swaps as the hedging instrument.



Question 6.6.50

Can additional derivative instruments be added to an existing hedging relationship?

Interpretive response: No. When using multiple derivatives in a hedge, they must be designated at the same time. An entity is not permitted to add derivative instruments to an existing hedging relationship. This would be considered a change in the hedging relationship and would require its dedesignation (see section 6.10.30).

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

For example, an entity has a 10-year financial instrument denominated in a foreign currency. In Year 1, the entity may wish to hedge interest rate risk by entering into an interest rate swap in the foreign currency. If the entity wishes to hedge foreign currency exposure at a later date, it could enter into a forward contract to lock in an exchange rate. These are simultaneous hedges and would be considered separate hedging relationships. For guidance on simultaneous hedges, see section 6.3.80.



Question 6.6.60

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

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

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

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

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

For example, an entity with a fixed-rate debt obligation may enter into an interest rate swap and designate that swap as the hedging instrument in a fair value hedge of the debt. Simultaneously it enters into another interest rate

swap with the same counterparty, with terms that are the exact mirror image of the first swap, and treats the second swap as speculative.

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

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

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



Example 6.6.70

Two concurrent swaps not viewed as a unit

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

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

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

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

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

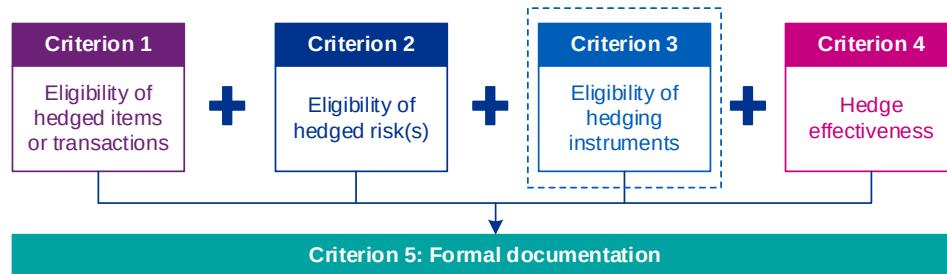
The swaps are entered into simultaneously with the same counterparty and relate to the same risk, both of which may indicate the overall intent of the transaction is to circumvent US GAAP.

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

If it was determined that ABC entered into the transaction to circumvent US GAAP, the two swaps would be viewed as a unit and ABC would not be

permitted to adjust the carrying amount of the debt to reflect changes in fair value attributable to interest rate risk.

6.7 Limitations on hedging instruments



6.7.10 Overview



Excerpt from ASC 815-20

>> Instruments Specifically Ineligible for Designation as Hedging Instruments

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

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

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

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

6.7.20 Nonderivative instruments

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

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

- hedge accounting may result in overriding the established measurement principles for the nonderivative instrument simply because it is part of a hedging relationship; and
- the accounting for nonderivative instruments is adequately addressed by existing accounting literature.

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

 **Foreign currency risk.** In a foreign currency **fair value hedge**, an unrecognized FCD firm commitment may be hedged with a derivative or nonderivative financial instrument (see section 11.4.60). [815-20-25-58]

Net investment hedges. An entity may designate a nonderivative FCD financial liability as a hedging instrument for a net investment hedge (see section 12.3.10).



Question 6.7.10

Can a contract that meets the definition of a derivative after acquisition by an entity qualify as a hedging instrument?



Excerpt from ASC 815-20

>>> Contingent Designation of a Hedging Instrument

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

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

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

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

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

6.7.30 Intercompany derivatives



Excerpt from ASC 815-20

> Eligibility of Hedging Instruments

>> Intra-entity Derivatives

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

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

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

Similarly, a derivative instrument contract between operating units within a single legal entity shall not be designated as the hedging instrument in a hedge of those risks. Only a derivative instrument with an unrelated third party can be designated as the hedging instrument in a hedge of those risks in consolidated financial statements.

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

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

Type of risk	Intercompany derivative permitted in consolidated financial statements?
 Interest rate risk	
 Credit risk	
 Foreign currency risk	

Type of risk	Intercompany derivative permitted in consolidated financial statements?
 Price risk	

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

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

- **Fair value hedges** (section 11.4.70);
- **Cash flow hedges** (section 11.6.60); and
- **Net investment hedges** (section 12.3.10).

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



Question 6.7.20

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

Interpretive response: There is no requirement in Topic 815 that a subsidiary with the exposure to the hedged risk(s) be a party to the hedging instrument.

For example, a parent entity's central treasury function can enter into a derivative contract with a third party and designate it as the hedging instrument in a hedge of a subsidiary's interest rate risk solely for purposes of the consolidated financial statements. However, if the subsidiary wishes to qualify for hedge accounting in its stand-alone financial statements, the subsidiary must be a party to the hedging instrument.

 **Foreign currency risk.** There are additional requirements when a subsidiary with exposure to foreign currency risk is not a party to the hedging instrument – i.e. the foreign currency derivative (see section 11.3.20): [815-20-25-30]

- another member of the consolidated group that has the same functional currency as the operating unit must be a party to the hedging instrument; and
- there is no intervening subsidiary with a different functional currency.



Question 6.7.30

Is an intercompany derivative eligible to be designated as a hedging instrument in the stand-alone financial statements of a subsidiary?

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

However, that intercompany derivative instrument cannot be the hedging instrument in the consolidated financial statements. Therefore, unless the parent entity enters into an offsetting third-party derivative (see Question 6.7.40), the hedge accounting applied at the subsidiary's stand-alone financial statements has to be reversed in consolidation.



Question 6.7.40

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

Interpretive response: Yes. If a parent entity's central treasury function enters into a derivative contract with an unrelated third party to completely offset the risk arising from an intercompany derivative, that third-party derivative could be designated as the hedging instrument in the consolidated financial statements.

However, the offset of the risk of those intercompany derivatives and third-party derivatives must be done on an individual basis, not on a net or aggregate basis.

Cash flow hedges. There is an exception for foreign currency cash flow hedges of a forecasted transaction or an unrecognized firm commitment, whereby the third-party derivative may offset the exposure to multiple intercompany derivatives on a net basis for each foreign currency (see section 11.6.70).

6.7.40 Hybrid instruments and compound derivatives

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

Type of instrument	Definition	Limitations on designation as hedging instruments
Hybrid instrument	A contract that contains both an embedded derivative and a host contract. [815-15 Glossary]	Hybrid instruments that are elected to be measured at fair value in their entirety cannot be designated as hedging

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

6.7.50 Special rule for written options



Excerpt from ASC 815-20

>>>> Hedge Effectiveness of Written Options

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

- At least as much potential for gains as a result of a favorable change in the fair value of the combined instruments (that is, the written option and the

hedged item, such as an embedded purchased option) as exposure to losses from an unfavorable change in their combined fair value (if a fair value hedge)

- b. At least as much potential for favorable cash flows as exposure to unfavorable cash flows (if a cash flow hedge).

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

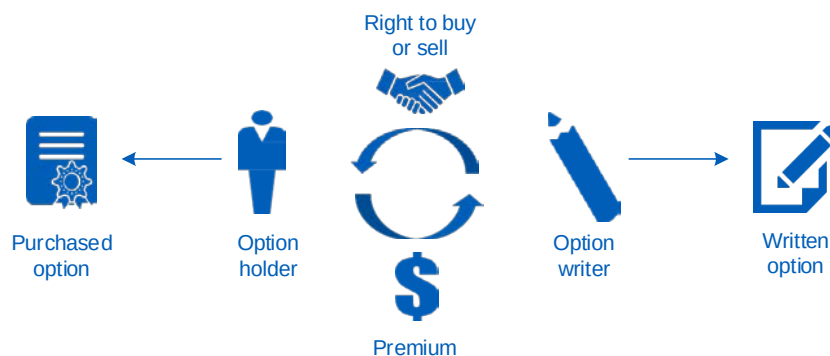
- a. At least as much gain as the loss that would be incurred from an unfavorable change in the underlying of the same percentage (if a fair value hedge)
- b. At least as much favorable cash flows as the unfavorable cash flows that would be incurred from an unfavorable change in the underlying of the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

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

25-97 When applying the written-option test to determine whether there is symmetry of the gain and loss potential of the combined hedged position for all possible percentage changes in the underlying, an entity is permitted to measure the change in the intrinsic value of the written option (or net written option) combined with the change in fair value of the hedged item.

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

In general, an option is a contract that provides the holder with the right, but not the obligation, to buy or sell something in exchange for payment of a premium. The premium compensates the writer of the option and is nonrefundable. The writer of the option receives the premium either through payment of cash or through favorable (i.e. nonmarket) terms contained in the option contract. The writer of an option is considered to have a written option while the other party to the contract holds a purchased option.



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

 Option holder	The option holder acquires the option to offset a possible future risk. The option is exercised when the terms are favorable to the option holder. When market conditions cause the option to have no value to the holder (i.e. the option is out of the money), the option is not exercised. Therefore, the maximum potential for loss is limited to the premium paid.
 Option writer	The option writer is compensated up-front by a premium and remains exposed to the risk of fluctuations in the price of the underlying. There is no limit to the option writer's downside exposure if the option is in the money, which is when terms are unfavorable to the option writer. The maximum potential for gain is limited to the initial premium received. This is because the holder will not exercise an option when it is out of the money, which is when terms are favorable to the option writer.

Consequently, only the holder of the option stands to gain from the intrinsic value of an option, while the writer is exposed to unlimited loss.

The FASB initially intended to prohibit hedge accounting for written options because written options serve to reduce the potential for gain in the hedged transaction while exposing the writer to unlimited loss. However, the FASB decided to allow written options to be the derivative hedging instrument in very limited circumstances. [\[FAS 133.BC396–BC397\]](#)

For a written option to be designated as a hedging instrument: [\[815-20-25-94 – 25-95\]](#)

- the hedged item or transaction must involve recognized assets or liabilities or unrecognized firm commitments; and
- there must be symmetry of the gain and loss potential of the combined hedged position (i.e. the written option test).

Hedge effectiveness. There are also a variety of issues associated with assessing hedge effectiveness in hedging relationships involving option contracts. These issues are discussed in section 13.2.90.



Question 6.7.50

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

Background: An interest rate swaption is an option to enter into a specified interest rate swap at maturity of the option. In exchange for an option premium, the buyer has the right, but not the obligation, to enter into a specified swap agreement or, in some cases, receive cash proceeds for the fair value of that swap agreement at the expiration of the option.

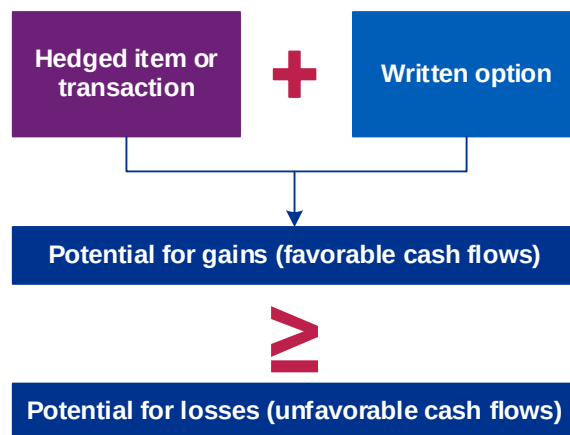
In essence, if the buyer of the swaption is in a gain position at the option's maturity, it will exercise the option. However, if the buyer is in a loss position at the option's maturity, it will not exercise the option.

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

In contrast, an interest rate swaption represents a written option from the perspective of the writer and must pass the written option test to be eligible as a hedging instrument (see Question 6.7.110).

Written option test

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



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

Fair value hedge	Cash flow hedge
Combination of the hedged item and written option provides at least as much potential for gains that result from a favorable change in the underlying as exposure to losses that result from an unfavorable change in the underlying of the same percentage. [815-20-25-95(a)]	Combination of the hedged transaction and written option provides at least as much potential for favorable cash flows resulting from a favorable change in the underlying as it provides exposure to unfavorable cash flows resulting from an unfavorable change in the underlying of the same percentage. [815-20-25-95(b)]

For example, this condition is met when the hedged item is an embedded purchased option and the written option has characteristics that offset those of the embedded purchased option. The purchased option must be one that is not required to be separated from the host contract (e.g. because they are clearly and closely related).

An entity may also use hedging strategies that involve a combination of option contracts, which is discussed in section 6.7.60.



Question 6.7.60

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

Interpretive response: For the written option test to be met, there needs to be symmetry of gains and losses (or favorable and unfavorable cash flows) for all possible percentage changes in the underlying. When applying the written option test, an entity is permitted to exclude the time value of a written option (or net written option) if the entity specifies that it will base its effectiveness assessment only on changes in the option's intrinsic value. For guidance on excluding the time value from effectiveness assessments when using options as the hedging instrument, see section 13.2.90. [\[815-20-25-96 – 25-97\]](#)

Therefore, when performing the written option test to determine whether there is symmetry of the gain and loss potential of the combined hedged position for all possible percentage changes in the underlying, an entity is permitted to measure the change in the intrinsic value of the written option (or net written option) combined with the change in fair value of the hedged item. Using this approach results in a higher chance of achieving a symmetrical return.

Examples 6.7.10, 6.7.20 and 6.7.30 illustrate how to perform a written option test considering only changes in the option's intrinsic value.



Question 6.7.70

How often should the written option test be performed?

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

The requirement to consider this test only at inception exists because the price of the underlying may change during the hedging relationship in such a way that the written option approaches having intrinsic value, in which case the symmetry requirement would not be met.

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



Question 6.7.80

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

Interpretive response: We believe the written option test should be performed by reference to the strike price contained in the written option contract, and not by reference to the current price of the underlying, with the exception of collar-based hedging relationships (see Example 6.7.50).

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

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



Question 6.7.90

Can a covered call strategy qualify for hedge accounting?



Excerpt from ASC 815-20

>>> No Hedge Accounting for Covered Call Strategies

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

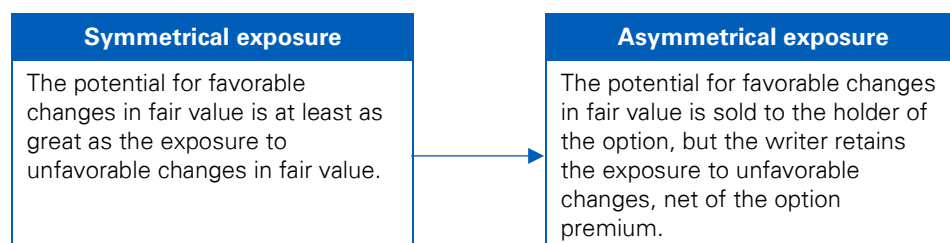
Background: A covered call strategy is when an entity owns an asset and writes a call option on that same asset in an attempt to generate premium income.

For example, ABC Corp. owns inventory with a market value of \$10,000. ABC writes a call option such that XYZ can purchase inventory from ABC at a price of

\$10,000 (i.e. the strike price) at any time over the next 12 months. ABC receives a premium of \$1,000 for entering into the contract.

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

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



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



Example 6.7.10

Written option does not qualify for hedge accounting

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

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

All other criteria for hedge accounting have been met.

Written option test

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

Potential for gain	Potential for loss
15% increase in market value of cotton to \$1.01 as compared to the 88 cent strike price. - Results in a cumulative net economic gain of \$10,000¹ on the combination of the written option and hedged item.	15% decrease in market value of cotton to 75 cents as compared to the 88 cent strike price. - Results in economic loss of \$120,000² from the combination of the written option and hedged item.

Notes:

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

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

Could Farm apply hedge accounting with a purchased option contract?

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

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

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



Example 6.7.20

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

ABC Corp. issues a five-year, \$100,000 debt obligation. The interest rate on the debt obligation is fixed at 10%. The debt obligation is callable by ABC in three years at par.

ABC wishes to hedge the risk of a decrease in the fair value of the embedded call option attributable to increases in interest rates. For guidance on designating embedded put or call options in a fair value hedge, see section 7.3.90.

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

All other criteria for hedge accounting have been met.

Written option test

Although many swaptions will not pass the written option test, in this instance the written option (i.e. the swaption) qualifies for hedge accounting. In this specific case, the combination of the written option and the embedded call option will always provide as much potential for gain as potential for loss because the terms of the written option are exactly the same as the terms of the embedded call option.

Potential for gain	Potential for loss
If interest rates decrease: — ABC will call the debt obligation; and — Bank will exercise its option.	If interest rates increase: — ABC will not call the debt obligation; and — Bank will not exercise its option.

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



Example 6.7.30

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

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

The contract meets the definition of a firm commitment and the embedded price cap is not required to be separated under Topic 815 (see Question 7.3.290).

ABC wishes to enter into a transaction to hedge the risk of changes in the fair value of the embedded price cap (a purchased call option) in the supply contract. For guidance on designating embedded put or call options in a fair value hedge, see section 7.3.90.

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

Written option test

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

Potential for gain	Potential for loss
If market prices rise to \$22 per pound: — the purchased call option will increase in value - i.e. there will be intrinsic value resulting from the ability to obtain the specified materials at \$20 per pound while the market price has risen; and — the intrinsic value of the written call option will have an equal but opposite value - i.e. from the requirement to deliver the specified materials at less than market prices.	If the price of materials remains below \$20 per pound, neither the purchased nor the written call option has intrinsic value.

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

FASB Example: Attempted hedge of a forecasted sale with a written call option



Excerpt from ASC 815-30

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

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

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

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

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



Excerpt from ASC 815-25

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

55-27 This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value

hedge of an embedded purchased option with a written option. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

55-28 Entity F issues five-year, fixed-rate debt with an embedded (purchased) call option and, with a different counterparty, writes a call option to neutralize the call feature in the debt. The embedded call option and the written call option have the same effective notional amount, underlying fixed interest rate, and strike price. (The strike price of the option in the debt usually is referred to as the call price.) The embedded option also can be exercised at the same times as the written option. Entity F designates the written option as a fair value hedge of the embedded prepayment option component of the fixed-rate debt.

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

6.7.60 Special rule: Combination of options



Excerpt from ASC 815-20

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

25-88 This guidance addresses how an entity shall determine whether a combination of options is considered a net written option subject to the requirements of paragraph 815-20-25-94. A combination of options (for example, an interest rate collar) entered into contemporaneously shall be considered a written option if either at inception or over the life of the contracts a net premium is received in cash or as a favorable rate or other term. Furthermore, a derivative instrument that results from combining a written option and any other non-option derivative instrument shall be considered a written option. The determination of whether a combination of options is considered a net written option depends in part on whether strike prices and notional amounts of the options remain constant.

An entity may use a hedging strategy that involves a combination of option contracts, for example an interest rate collar. If the combination of options includes a written option, an entity first determines whether the combination of options is a net purchased option or a net written option. This determination partially depends on whether the strike prices and notional amounts of the options remain constant (see further guidance below). [815-20-25-88]

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



Question 6.7.100 What is a collar?

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

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



Question 6.7.110 Is the written option test required for a combination of a written option and a non-option derivative?

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

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

In addition, when a derivative instrument is embedded in another derivative instrument (e.g. an embedded written option), the entire derivative instrument must qualify for hedge accounting. For example, an entity may not separate a compound derivative instrument into two derivative instruments so that one would qualify for hedge accounting, while the other would not (see section 6.7.40). [815-20-25-71(a)(2)]

Conditions for combination to be a net purchased option



Excerpt from ASC 815-20

>>>> Strike Prices and Notional Amounts Remain Constant

25-89 For a combination of options in which the strike price and the notional amount in both the written option component and the purchased option component remain constant over the life of the respective component, that combination of options would be considered a net purchased option or a zero cost collar (that is, the combination shall not be considered a net written option subject to the requirements of paragraph 815-20-25-94) provided all of the following conditions are met:

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

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

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

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

25-92 Even though that assessment is made on the date that a combination of options is designated as a hedging instrument (to determine the applicability of paragraph 815-20-25-94), it shall consider the receipt of a net premium (in cash or as a favorable rate or other term) from that combination of options at each point in time that either the strike prices or the notional amounts change, such as either of the following circumstances:

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

will typically be received in one or more periods within the contractual term from inception to maturity.

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

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

- no net premium is received – either through payment in cash or another asset, or through favorable terms contained in the contract – at inception or at any point during the life of the option contracts that the combination option comprises;
- the components of the combination option are based on the same underlying;
- the components of the combination option have the same maturity date; and
- the notional amount of the written option component is not greater than the notional amount of the purchased option component.

Strike prices and notional amounts remain constant

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

Strike prices and notional amounts do not remain constant

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

In addition, if any of the four conditions discussed above are not met at any date that either the strike prices or notional amounts change, the entire contract is considered a net written option. [\[815-20-25-89\]](#)



Question 6.7.120

When a hedging relationship is dedesignated and redesignated, is a combination of options reassessed to determine if it is a net written or net purchased option?

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

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

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



Example 6.7.40

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

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

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

- No net premium was received by ABC at inception of the collar contracts.
- Both option contracts that comprise the collars are based on the same underlying and have the same maturity date.
- The notional amounts of the purchased option component and the written option component that comprise the two collars are equal and constant over the life of the option contracts.
- The strike prices (cents per unit) of the two collars are as follows.

	Year 2	Year 3	Year 4	Year 5	Year 6	5-year avg.
Collar 1						
Purchased put	98.3	98.3	98.3	98.3	98.3	98.3
Written call	110.6	110.6	110.6	110.6	110.6	110.6
Collar 2						
Purchased put	108.5	108.5	91.5	91.5	91.5	98.3
Written call	108.5	108.5	108.5	110.4	117.2	110.6

When strike prices fluctuate over the life of a combination of options and no net premium is received at inception, it is necessary to determine whether a net premium is received as a favorable term in one or more periods within the contractual term of the option contracts (from inception to maturity).

Collar 1: Net written option assessment

Collar 1 is a zero-cost collar and not a net written option. Because the strike price and the notional amount in both the written option component and the purchased option component remain constant over the life of the respective components, the following conditions are assessed at inception of the hedging relationship:

- no net premium was received;
- the components of the combination option are based on the same underlying;
- the components of the combination option have the same maturity date; and
- the notional amount of the written option component is not greater than the notional amount of the purchased option component.

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

Collar 2: Net written option assessment

Collar 2 is a net written option. Because the strike prices of the written option component and the purchased option component are not constant over the life of the contract, ABC assesses whether the combination of options is a net written option as of each date on which the strike prices change from inception to maturity.

In general, when strike prices fluctuate over the life of a combination of options and no net premium is received at inception, a net premium typically will be received as a favorable term in one or more periods from inception to maturity.

For Collar 2, premiums are received in early periods as consideration for entering into net written options in later periods. Specifically, the purchased put option contains an average strike price over its life of 98.3. During Year 2 and Year 3, the strike price of the purchased put option (108.5) is greater than that average.

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

Although the *premium* is not received in cash, it is received in more favorable terms during the first two years of the contract when compared to the last three years of the contract. Therefore, the collar is a net written option and the additional written option test must be met for the collar to be the hedging instrument in a hedging relationship.



Example 6.7.50

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

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

ABC Corp. has LIBOR-indexed floating-rate debt. The current LIBOR rate is 6%.

To hedge its exposure to variability in expected future cash flows attributable to changes in LIBOR swap rate (the contractually specified interest rate), ABC enters into an interest rate collar with the following terms:

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

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

Net written option assessment

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

Written option test

The combination of the hedged transaction and the net written option must provide at least as much potential for favorable cash flows as exposure to unfavorable cash flows for all possible percentage changes in the LIBOR index. [815-20-25-95]

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

The interest rate collar does not pass the written option test. This is because the combined hedged position does not have symmetry of gain and loss

potential. Therefore, the combination of options is not an eligible hedging instrument.



Example 6.7.60

Indexed-amortizing swap considered to be a net written option

Interest rate swaps with notional amounts that amortize based on an index are referred to as indexed-amortizing swaps. They are considered to be written options because they combine an interest rate swap (a non-option derivative) with a written option. As such, they are subject to the written option test if an entity attempts to designate them in a hedging relationship.

The written option is the option provided to one of the parties to reduce the amount on which interest payments will be exchanged based on a strike price (the relevant index). As the index level is met, the party calls a portion of the notional amount based on the terms of the derivative, and subsequent payment provisions of the swap are based on that new notional amount.

When evaluating these instruments, an entity must consider whether it is the writer or the purchaser of the option. The writer of the option receives at inception or over the life of the contract a net premium either through payment in cash, another asset, or through favorable terms contained in the contract. If an entity receives a net premium, the combination of options will be considered a net written option and the written option test must be performed to determine if it is an eligible hedging instrument.

Indexed-amortizing swaps are different from *amortizing swaps*. The terms of *amortizing swaps* call for scheduled reductions in the notional amount on which the payment provisions are based and there is no optionality to that feature. Therefore, *amortizing swaps* are neither net written options nor a combination of options.



Question 6.7.130

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

Background: In certain derivative contracts, such as interest rate swaps and foreign currency and commodity forward contracts, the terms of the instrument contain knock-out or knock-out/knock-in provisions. These provisions allow the counterparty to cease or modify payments normally due under the derivative when the underlying exceeds a predetermined rate or price.

These features lower the cost of the derivative to the buyer by decreasing the possible gain that would be generated by the derivative in the absence of the feature that allows the counterparty to modify or cease payment.

For example, an entity enters into a pay-fixed, receive six-month LIBOR interest rate swap agreement with a fixed leg of 6% and a variable leg of LIBOR. The contract contains a knock-out/knock-in provision under which the net settlement

payments under the contract are \$0 when six-month LIBOR equals or exceeds 8%.

If six-month LIBOR subsequently drops below 8%, payments resume. Therefore, when the entity would be receiving a 200 or greater bps spread, the net settlement becomes \$0. If this provision were not included in the contract, the cost of the swap to the entity would be higher (e.g. the pay-fixed leg may have been more than 6%).

Interpretive response: These knock-out and knock-out/knock-in provisions are considered written options, because a net premium is received in the form of a favorable rate or other term in exchange for the provision.

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

Written option test

The combination of the hedged item or transaction and the net written option must provide at least as much potential for favorable cash flows as exposure to unfavorable cash flows for all possible percentage changes in the LIBOR index. [815-20-25-95]

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

This table indicates a lack of symmetry in the potential for gains and losses. Therefore, we believe circumstances are rare in which a derivative contract containing a knock-out or knock-in provision meets the written option test to qualify for hedge accounting.

FASB Example: Combination of options in which strike prices or notional amounts do not remain constant



Excerpt from ASC 815-20

>> Example 20: Combination of Options in Which Strike Prices or Notional Amounts Do Not Remain Constant

55-179 The following Cases illustrate the application of paragraph 815-20-25-91 to combinations of options in which either the strike price or the notional amount in either the written option component or the purchased option component can fluctuate over the life of the respective component:

- a. Changes in strike prices (Case A)
- b. Changes in notional amounts (Case B).

55-180 Cases A and B share the following assumptions:

- a. An entity wishes to hedge its forecasted sales of a commodity by entering into a five-year commodity-price collar.
- b. Under the collar, the entity will do both of the following:
 1. Purchase commodity-price put option components (a floor)
 2. Write commodity-price call option components (a cap).
- c. Each of the alternative collars discussed otherwise meets the criteria established in paragraphs 815-20-25-89 through 25-90 including all of the following:
 1. No net premium is received at inception of the combination of options. Paragraph 815-20-25-94 addresses, in part, whether a net premium is received at any point during the life of the combination of options that the strike price or notional amount is changed.
 2. The components of the combination of options are based on the same underlying (that is, the same commodity price).
 3. The components of the combination of options have the same maturity date.
 4. The notional amount of the written option component is not greater than the notional amount of the purchased option component. Paragraph 815-20-25-94 addresses, in part, whether this criterion should be applied to only the entire contractual term to maturity or to some part thereof.

>>> Case A: Changes in Strike Prices

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

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

The minimum prices for each collar represent the strike prices of the purchased put options. The maximum prices for each collar represent the strike prices of the written call options. (Assume that the notional amounts of

the two option components are identical and constant over the life of the option components.)

(Cents Per Unit)

	20X2	20X3	20X4	20X5	20X6	5-Year Average
Forward price	100.0	103.9	105.6	106.4	106.7	104.5
Collar 1						
Minimum	98.3	98.3	98.3	98.3	98.3	98.3
Maximum	110.6	110.6	110.6	110.6	110.6	110.6
Collar 2						
Minimum	108.5	108.5	91.5	91.5	91.5	98.3
Maximum	108.5	108.5	108.5	110.4	117.2	110.6

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

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

>>> Case B: Changes in Notional Amounts

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

(Notional Units)

	20X2	20X3	20X4	20X5	20X6	Total Notional Amount	5-Year Average
Collar 3							
Minimum	750	750	750	750	750	3,750	750
Maximum	750	750	750	750	750	3,750	750
Collar 4							
Minimum	1,240	1,240	1,240	15	15	3,750	750
Maximum	250	250	250	1,500	1,500	3,750	750

55-185 Note that both the sum and average of the notional amounts of the written option component for all periods are not greater than the sum and average of the notional amounts of the purchased option component for all periods.

55-186 For Collar 4, favorable terms are received in early periods (net purchased options) as consideration for entering into net written options in later periods. Specifically, the (higher-than-average) notional amounts on the purchased put option in years 20X2 through 20X4 are received in return for accepting a less favorable notional amount in years 20X5 and 20X6. Thus, at the inception of the hedge and over its life, Collar 4 in Case B would be subject to the provisions of paragraph 815-20-25-94.

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



Excerpt from ASC 815-20

>> Example 30: Application of the Net Written Option Test to Collar-Based Hedging Relationship

55-230 This Example illustrates the application of paragraph 815-20-25-95.

55-231 Entity X has LIBOR-indexed floating-rate debt. To hedge its exposure to variability in expected future cash outflows attributable to changes in **LIBOR swap rate** (the contractually specified interest rate), it enters into an interest rate collar with a bank when the current LIBOR swap rate is 6 percent. The collar also is indexed to LIBOR and consists of a purchased cap with the strike rate equal to 8 percent and a written floor with the strike rate equal to 5 percent. The purchased cap goes into effect when LIBOR increases above 8 percent, and the written floor goes into effect when LIBOR decreases below 5 percent. Thus, the interest collar has the effect of limiting the interest rate of the floating-rate debt to a range between 5 percent and 8 percent. On the basis of market conditions as of the collar transaction date, Entity X received a net premium from the bank.

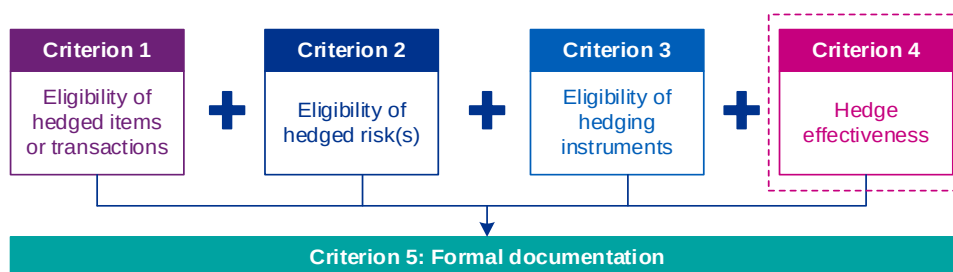
55-232 In accordance with paragraphs 815-20-25-88 through 25-90, the combination of options in the collar in this Example is a net written option from Entity X's perspective. Therefore, the written-option test in paragraphs 815-20-25-94 through 25-95 must be applied to determine whether the hedging relationship between the debt and the collar qualifies for cash flow hedge accounting. That test requires that the combination of the hedged item and the written option provides at least as much potential for favorable cash flows as exposure to unfavorable cash flows for all possible percentage changes (from zero percent to 100 percent) in the LIBOR index.

55-233 The following table shows the calculation of the favorable cash flows and unfavorable cash flows for LIBOR changes of 50 percent.

Potential Cash Flows of the Combination of the Hedged Item and the Net Written Option if LIBOR Moves Each Direction by the Same Percentage			
	LIBOR at Inception	LIBOR Increase 50%	LIBOR Decrease 50%
Cash outflows on LIBOR-indexed debt	6.00%	9.00%	3.00%
Cash outflows on written floor	0.00	0.00	2.00
Less: Cash inflows on purchased cap	0.00	1.00	0.00
Net cash flow (outflows + / inflows -)	6.00%	8.00%	5.00%
		Unfavorable	Favorable
Change in cash flows of combination from inception (in basis points)		200	-100
Percentage change in cash flows of combination from inception		33.33%	-16.67%

55-234 The calculations in the table in paragraph 815-20-55-233 demonstrate that for a 50 percent fluctuation in the LIBOR rate, the collar would fail the written-option test in paragraph 815-20-25-94 because a 50 percent favorable change in LIBOR (that is, a decrease) would not provide at least as much favorable cash flows as unfavorable cash flows that would result from a 50 percent unfavorable change in LIBOR (that is, an increase). Therefore, the combination of options would not be an eligible hedging instrument.

6.8 Hedge effectiveness



6.8.10 Overview

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

The following diagram summarizes how effectiveness is assessed.



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

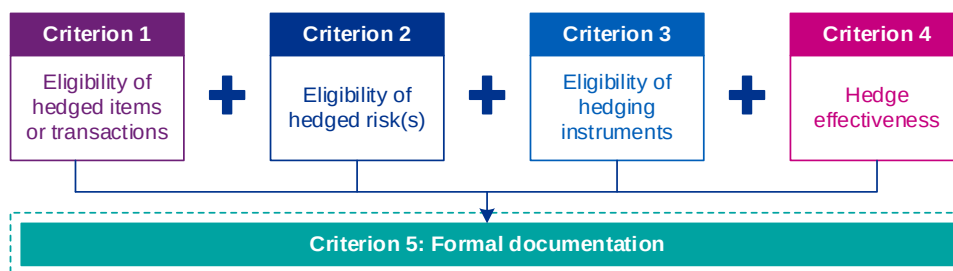
Additionally, Topic 815 provides the three methods that allow an entity to assume a hedging relationship is perfectly effective if certain conditions are met:

- shortcut method (see section 13.3);
- critical terms match method (see section 13.4); and
- simplified hedge accounting approach (see section 16.2).

Chapter 13 discusses the general requirements for assessing hedge effectiveness and the specific requirements for various assessment methods.

For a **net investment hedge**, the hedging instrument must be both designated and effective as an economic hedge of the net investment (see section 12.4).

6.9 Hedge documentation requirements



6.9.10 Overview



Excerpt from ASC 815-20

> Formal Designation and Documentation at Hedge Inception

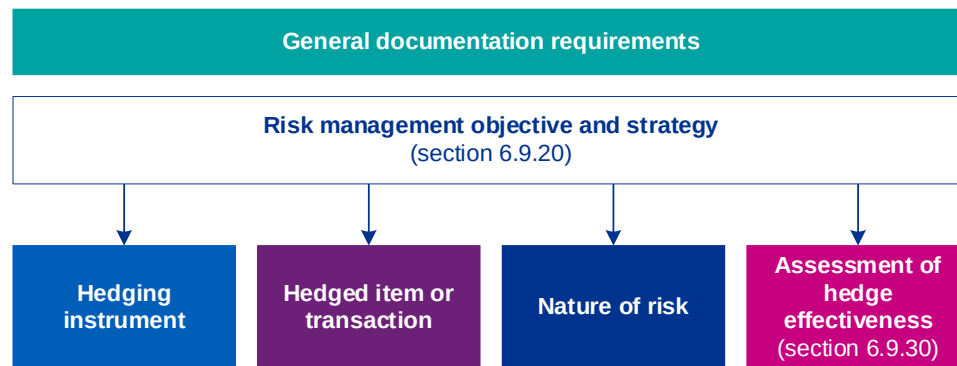
25-3 Concurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged **transaction**, or a method of assessing effectiveness to achieve a desired accounting result. To qualify for hedge accounting, there shall be, at inception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

- a. Subparagraph not used

- b. Documentation requirement applicable to fair value hedges, cash flow hedges, and net investment hedges:
1. The hedging relationship
 2. The entity's risk management objective and strategy for undertaking the hedge, including identification of all of the following:
 - i. The hedging instrument.
 - ii. The hedged item or transaction.
 - iii. The nature of the risk being hedged.
 - iv. The method that will be used to retrospectively and prospectively assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value (if a fair value hedge) or hedged transaction's variability in cash flows (if a cash flow hedge) attributable to the hedged risk. There shall be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness.

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

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



There are general documentation requirements that must be met for all types of hedges. In addition, there are incremental documentation requirements specific to **fair value hedges** (see section 6.9.50) and **cash flow hedges** (see section 6.9.60).

Section 6.9.40 explains when an entity must prepare the initial hedge documentation, including results of the initial effectiveness assessment.

There are certain exceptions for some private companies adopting the simplified hedge accounting approach and for private companies not adopting the simplified hedge accounting approach. For further discussion of private companies, see chapter 16.



Question 6.9.10

What is the level of detail needed to satisfy the hedge documentation requirements?

Interpretive response: The level of detail required in hedge documentation is a matter of judgment. However, the SEC staff has stated that the method used to assess hedge effectiveness must be documented with sufficient specificity that a third-party could perform the assessment and measurement based on the documentation and arrive at the same result as the entity applying hedge accounting. [\[1999 AICPA Conf\]](#)

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

6.9.20 Documenting the risk management objective and strategy

Topic 815 requires an entity to formally document, at inception of the hedge, its risk management objectives and strategy for undertaking the hedge. The primary objective of this requirement is to:

- identify the nature of the risk being hedged; and
- document how the derivative hedging instrument selected by the entity is expected to achieve the entity's objective of reducing its exposure to changes in fair values or cash flows attributable to the designated risk.

This documentation is important because the method of assessing the effectiveness of the relationship (discussed in chapter 13) must be consistent with the originally documented objective and strategy for that particular hedging relationship. [\[815-20-25-80\]](#)

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

Hedging instrument	Identify the derivative hedging instrument, including the proportion (i.e. all or some percentage) of the derivative instrument that is designated as the hedging instrument (see sections 6.6 and 6.7). [815-20-25-3(b)(i)] If the hedging relationship involves a combination of two or more derivatives, the documentation should identify the combination.
Hedged item or transaction	Specifically identify the recognized asset or liability, firm commitment, cash flows or forecasted transaction (see section 6.2.10). If applicable, this includes the specific portion of the hedged item or transaction, or the portfolio or group of hedged items or transactions. [815-20-25-3(b)(ii)] — If the fair value hedging relationship involves a portfolio of similar assets and liabilities, see section 7.3.40 for further discussion of hedge accounting qualifying criteria.

	— If the cash flow hedging relationship involves a group of similar forecasted transactions, see section 9.3.60 for further discussion of hedge accounting qualifying criteria. Document how the change in the fair value or cash flows on the hedged item or transaction attributable to the risk being hedged will be determined; this affects the assessment of effectiveness. Section 6.9.50 discusses incremental documentation requirements for fair value hedges related to: — firm commitments; and — last-of-layer method. Section 6.9.60 discusses incremental documentation requirements for cash flow hedges, including specific identification of the timing, nature and amount of a hedged forecasted transaction.
Nature of the risk being hedged	Identify the risk(s) being hedged – e.g. interest rate risk, credit risk, price risk and/or foreign exchange risk (see sections 6.3 and 6.4). [815-20-25-3(b)(i)] For hedges of interest rate risk, identify the benchmark interest rate (see section 6.3.30) or the contractually specified interest rate (see section 6.3.40). Section 6.9.60 discusses incremental documentation requirements for cash flow hedges related to certain hedged risks – e.g. specifying contractually specified components.
Assessment of hedge effectiveness	See section 6.9.30.

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

For example, an entity may hedge more than one risk at a time, as long as each designated risk is accounted for separately; for guidance on accounting for simultaneous hedges, see section 6.3.80. If a hedged item or transaction is already subject to another hedging relationship, it is critical to specify and document which item or forecasted transaction and its associated risk are being hedged.

Examples 6.9.30 and 6.9.40 illustrate the documentation requirements for **fair value hedges** and **cash flow hedges**, respectively.

6.9.30 Documenting assessment of hedge effectiveness



Excerpt from ASC 815-20

> Formal Designation and Documentation at Hedge Inception

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

- iv. The method that will be used to retrospectively and prospectively assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's **fair value** (if a fair value hedge) or hedged transaction's variability in cash flows (if a cash flow hedge) attributable to the hedged risk. There shall be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness.
- 01. An entity shall perform an initial prospective assessment of hedge effectiveness on a quantitative basis (using either a dollar-offset test or a statistical method such as regression analysis) unless one of the following applies:
 - A. In a cash flow or fair value hedge, the entity applies the shortcut method in accordance with paragraphs 815-20-25-102 through 25-117.
 - B. In a cash flow or fair value hedge, the entity determines that the critical terms of the hedging instrument and the hedged item match in accordance with paragraphs 815-20-25-84 through 25-85.
 - C. In a cash flow hedge, the hedging instrument is an option, and the conditions in paragraphs 815-20-25-126 and 815-20-25-129 through 25-129A are met.
 - D. In a cash flow hedge, a **private company** that is not a financial institution as described in paragraph 942-320-50-1 applies the simplified hedge accounting approach in paragraphs 815-20-25-133 through 25-138.
 - E. In a cash flow hedge, the entity assesses hedge effectiveness under the change in variable cash flows method in accordance with paragraphs 815-30-35-16 through 35-24, and all of the conditions in paragraph 815-30-35-22 are met.
 - F. In a cash flow hedge, the entity assesses hedge effectiveness under the hypothetical derivative method in accordance with paragraphs 815-30-35-25 through 35-29, and all of the critical terms of the hypothetical derivative and hedging instrument are the same.
 - G. In a net investment hedge, the entity assesses hedge effectiveness using a method based on changes in spot exchange rates, and the conditions in paragraph 815-35-35-5 (for derivative instruments) or 815-35-35-12 (for nonderivative instruments) are met.
 - H. In a net investment hedge, the entity assesses hedge effectiveness using a method based on changes in forward exchange rates, and the conditions in paragraph 815-35-35-17A are met.
- 02. The initial prospective quantitative hedge effectiveness assessment using information applicable as of the date of hedge inception is considered to be performed concurrently at hedge inception if it is completed by the earliest of the following:
 - A. The first quarterly hedge effectiveness assessment date
 - B. The date that financial statements that include the hedged transaction are available to be issued
 - C. The date that any criterion in Section 815-20-25 no longer is met
 - D. The date of expiration, sale, termination, or exercise of the hedging instrument
 - E. The date of dedesignation of the hedging relationship

- F. For a cash flow hedge of a forecasted transaction (in accordance with paragraph 815-20-25-13(b)), the date that the forecasted transaction occurs.
03. An entity also shall document at hedge inception whether it elects to perform subsequent retrospective and prospective hedge effectiveness assessments on a qualitative basis and how it intends to carry out that qualitative assessment. See paragraphs 815-20-35-2A through 35-2F for additional guidance on qualitative assessments of effectiveness. In addition, the entity shall document which quantitative method it will use if facts and circumstances of the hedging relationship change and the entity must quantitatively assess hedge effectiveness in accordance with paragraph 815-20-35-2D. An entity must document that it will perform the same quantitative assessment method for both initial and subsequent prospective hedge effectiveness assessments. The guidance in paragraphs 815-20-55-55 through 55-56 applies if the entity wants to change its quantitative method of assessing effectiveness after the initial quantitative effectiveness assessment.
04. An entity that applies the shortcut method in paragraphs 815-20-25-102 through 25-117 may elect to document at hedge inception a quantitative method to assess hedge effectiveness and measure hedge results if the entity determines at some point during the term of the hedging relationship that the use of the shortcut method was not or no longer is appropriate. See paragraphs 815-20-25-117A through 25-117D.
- v. Subparagraph superseded by Accounting Standards Update No. 2017-12.
- vi. If the entity is hedging foreign currency risk on an after-tax basis, that the assessment of effectiveness will be on an after-tax basis (rather than on a pretax basis).

Topic 815 requires an entity to document its assessment of **hedge effectiveness** at inception of a hedging relationship and on an ongoing basis. That is, an entity must provide documentation supporting why and how it expects changes in the fair value or cash flows of the derivative hedging instrument to offset changes in the fair value or cash flows of the hedged item or transaction attributable to the hedged risk. In addition, in periodic assessments, an entity must document how the derivative is expected to be and has been highly effective in offsetting changes in fair value or cash flows (hedge effectiveness testing – see chapter 13). [\[815-20-25-3\(b\)\(2\)\(iv\)\]](#)

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

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

	– Shortcut method. Under the shortcut method, an entity may elect to document at hedge inception a quantitative method to assess hedge effectiveness if it is determined at a later date that the shortcut method was not or is no longer appropriate (see section 13.3). – Critical terms match method and simplified hedge accounting approach. If one of these methods is applied, the entity follows the applicable guidance for subsequent assessments (see sections 9.4 and 10.2, respectively). – Qualitative. If subsequent effectiveness assessments will be performed on a qualitative basis, document how those assessments will be performed. Additionally, document which quantitative method will be used if facts and circumstances change and the entity must quantitatively assess hedge effectiveness; this method is required to be the same as that used to support the entity's initial prospective hedge effectiveness assessment. For guidance on electing qualitative effectiveness assessments, see section 13.5.10. – Quantitative. Document selected quantitative approach – i.e. dollar-offset or statistical analysis (see section 13.6).
Documentation during the hedging relationship	— Document analysis and results of subsequent prospective and retrospective effectiveness assessments. — For critical terms match method, continued documentation of matching of critical terms at each effectiveness period. See section 13.4.40 for further documentation criteria. [815-20-35-9]

See chapter 13 for comprehensive guidance on assessing hedge effectiveness, both at inception and during the hedging relationship.

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

While section 13.4 elaborates on the assessment of the critical terms match method of a forecasted transaction, the following example illustrates the documentation requirements of paragraph 815-20-25-3 for such a hedging relationship.



Excerpt from ASC 815-20

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

55-80A This Example illustrates the documentation requirements in paragraph 815-20-25-3 when the critical terms of the hedging instrument and hedged forecasted transaction match in accordance with paragraphs 815-20-25-84 through 25-85. On January 1, 20X1, Entity A, a U.S. dollar (USD)

functional currency entity, executes a forward contract to hedge a portion of its exposure to Canadian Dollar- (CAD-) denominated forecasted sales expected to occur in December 20X1. Entity A determines that all the critical terms of the hedging instrument and hedged forecasted transaction match. It documents the hedging relationship concurrently with the execution of the forward contract in accordance with paragraph 815-20-25-3 as follows:

- a. Risk management objective: To hedge against movements in the USD/CAD exchange rate that will affect the USD value of future CAD sales.
- b. Hedged forecasted transaction: The first CAD 500,000 sales in December 20X1.
- c. Hedging instrument: Foreign exchange forward contract to sell CAD 500,000 and receive USD 400,000 on December 31, 20X1. The fair value of the forward contract at hedge inception is zero.
- d. Method of assessing hedge effectiveness: Entity A will assess the effectiveness on a qualitative basis at hedge inception. The critical terms of the hedging instrument and hedged forecasted transaction can be considered to match because the notional amounts and underlyings of the hedging instrument and hedged forecasted transaction are the same and the forecasted sales are expected to occur in the same fiscal month as the maturity date of the hedging instrument. Therefore, the hedge is expected to be perfectly effective. Subsequent assessments of effectiveness will be performed by verifying and documenting whether the critical terms of the hedging instrument and hedged forecasted transaction have changed during the period in review and whether it remains probable that the counterparty to the hedged item and hedged forecasted transactions will not default. If there are no such changes in critical terms or counterparty credit risk, Entity A will continue to conclude that the hedging relationship is perfectly effective.

6.9.40 Timing of initial hedge documentation, including initial effectiveness assessment



Excerpt from ASC 815-20

>>> Timing of Initial Quantitative Prospective Effectiveness Assessment

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

>>>> Scenario A

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

>>>> Scenario B

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

>>>> Scenario C

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

The following table summarizes the required timing of the elements of initial hedge documentation, including initial hedge effectiveness assessment, for all entities other than certain private companies. See chapter 16 for requirements for certain private companies and certain NFPs.

Element of hedge documentation	Timing
All entities other than certain private companies and certain NFPs	
Initial prospective assessment of hedge effectiveness (if quantitative testing is required). [815-20-25-3(b)(2)(iv)]	Earliest of the following: [815-20-25-3(b)(2)(iv)(02)] — first quarterly hedge effectiveness assessment date; — date the financial statements that include the hedged transaction are available to be issued; — date any hedge accounting criterion is no longer met; — date the hedging instrument expires or is sold, terminated or exercised; — date the hedging relationship is dedesignated; or — for a cash flow hedge of a forecasted transaction (in accordance with paragraph 815-20-25-13(b)), date the forecasted transaction occurs.
All other elements of hedge documentation. [815-20-25-3]	Concurrent with hedge designation. [815-20-25-3]

As noted in the table above, certain elements of the hedging relationship must be documented at the designation of the hedging relationship, including the identification of the hedging instrument, the nature of the risk, and the hedged item or transaction. The hedging relationship cannot be designated retroactively, as an entity would then have the benefit of hindsight and could use that to designate hedging relationships that would provide a desired financial result.



Example 6.9.10

Importance of timing of formal documentation of the hedge

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

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

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

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



Example 6.9.20

Timing requirements for initial hedge documentation

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

The following scenarios demonstrate the required timing for preparing initial hedge documentation for a hedging relationship that is not eligible for the simplified hedge accounting approach (see Question 16.2.10) or documentation relief for certain private companies and certain NFPs (see Question 16.3.10).

The scenarios compare two different types of entities. This example does not demonstrate the timing of performing quarterly hedge effectiveness assessments, which is discussed in section 13.2.20.

Entities

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

- **Bank** is a private financial institution. Because Bank is a financial institution, it does not qualify for the special guidance applicable to certain private companies that is described in chapter 16.
- **PublicCo** is an SEC registrant.

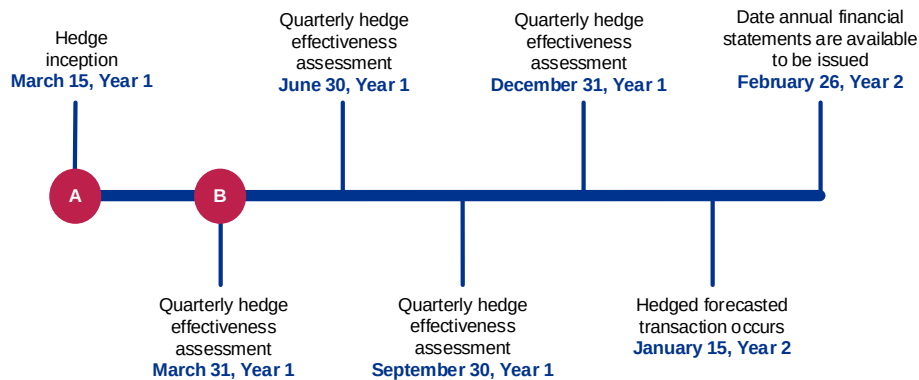
Both entities are required to document at hedge inception all elements of the hedging relationship except the initial prospective effectiveness assessment.

The following assumptions are relevant to all scenarios.

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

Scenario 1: Hedging relationship begins earlier in the quarterly period

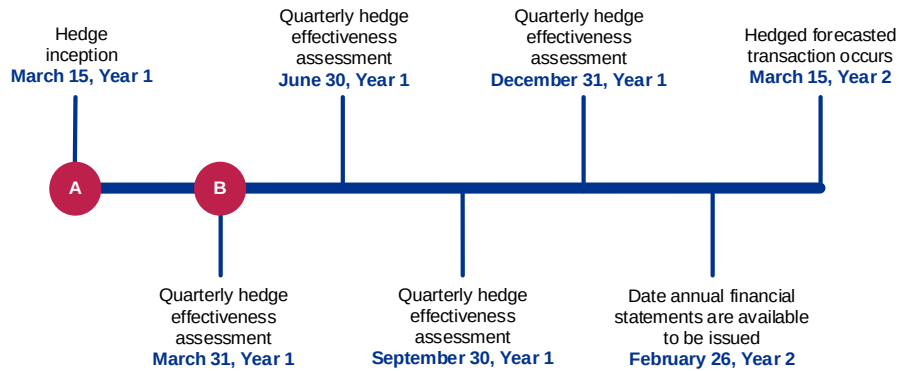
Bank and PublicCo each enter into a cash flow hedging relationship on March 15, Year 1, in which the hedged transaction is a forecasted transaction expected to occur in one year.



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

Scenario 2: Hedging relationship begins later in the quarterly period

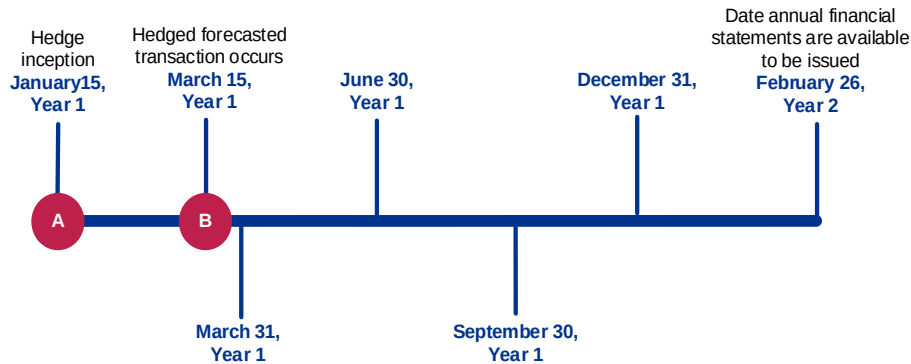
Bank and PublicCo each enter into a cash flow hedging relationship on March 15, Year 1, in which the hedged transaction is a forecasted transaction expected to occur in one year.



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

Scenario 3: Hedging relationship has a shorter duration

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



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



Observation

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

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

6.9.50 Documentation requirements for fair value hedges



Excerpt from ASC 815-20

> Formal Designation and Documentation at Hedge Inception

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

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

In addition to the general documentation requirements discussed above at section 6.9.10, there are incremental documentation requirements specific to **fair value hedges** relating to firm commitments and hedging relationships designated under the last-of-layer method.

Firm commitments (section 7.3.20)	Documentation includes a reasonable method for recognizing in earnings the asset or liability that represents the gain or loss on the hedged firm commitment. [815-20-25-3(c)(1)] Question 8.4.10 contains guidance on subsequent accounting for assets or liabilities recognized as a result of applying fair value hedge accounting to an unrecognized firm commitment.
Last-of-layer (section 7.3.100)	Analysis to support the entity's expectation that the hedged item (e.g. last-of-layer) will be outstanding at the hedged item's assumed maturity date. [815-20-25-3(c)(2)] Question 7.3.320 contains guidance on what is needed to support the entity's expectation that the last-of-layer will remain outstanding at the end of the hedge term.

The following is an example of the formal documentation expected for a fair value hedge of a firm commitment.



Example 6.9.30

Formal documentation for a fair value hedge of a firm commitment

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

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

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

Hedging relationship and risk management objective and strategy

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

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

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

Hedging instrument

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

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

Hedged item

Changes in the fair value of the firm commitment to purchase a machine from a British manufacturer for £10,000 in 12 months attributable to changes in the exchange rate for \$/£. The change in the fair value of the firm commitment caused by such exchange rate fluctuations will be measured based on the total changes in the forward exchange rates for \$/£.

Method for recognizing in earnings the firm commitment asset or liability

Any changes in the fair value of the firm commitment caused by fluctuations in the exchange rates during the period in which the hedge is in effect will be reflected as an asset or liability. When the forward contract is closed and the machine is purchased (December 31, Year 1), the firm commitment asset or liability balance will be reclassified as an addition to, or subtraction from, the carrying amount of the machine. This carrying amount will be recognized in earnings in accordance with ABC's normal depreciation policy.

Hedge effectiveness at inception

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

Hedge effectiveness testing method – documented at inception of the hedging relationship

On a quarterly basis, ABC will assess effectiveness by updating the analysis performed coincident with the hedge designation to reflect the quarter's fluctuations in the two exchange rates. It will consider the risk of default by the counterparty to the forward contract and its own nonperformance risk in this assessment.

Retrospectively	ABC will evaluate whether the hedging relationship has been highly effective during the quarter just ended by comparing the cumulative dollar fluctuations in the forward exchange rates for \$/€ and \$/£ (where the cumulative period is the period to date from the inception of the hedging relationship) at each quarter end.
Prospectively	On a quarterly basis, ABC will determine whether it expects the hedging relationship to continue to be highly effective based on the updated analysis.

If certain criteria are met, ABC may elect to perform the quarterly effectiveness testing on a qualitative basis. For further guidance on performing effectiveness testing on a qualitative basis, see section 13.5.

6.9.60 Documentation requirements for cash flow hedges



Excerpt from ASC 815-20

> Formal Designation and Documentation at Hedge Inception

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

- d. Documentation requirement applicable to cash flow hedges only:
 - 1. For a cash flow hedge of a **forecasted transaction**, documentation shall include all relevant details, including all of the following:
 - i. The date on or period within which the forecasted transaction is expected to occur.
 - ii. The specific nature of asset or liability involved (if any).
 - iii. Either of the following:
 - 01. The expected currency amount for hedges of foreign currency exchange risk; that is, specification of the exact amount of foreign currency being hedged
 - 02. The quantity of the forecasted transaction for hedges of other risks; that is, specification of the physical quantity (that is, the number of items or units of measure) encompassed by the hedged forecasted transaction.
 - iv. If a forecasted sale or purchase is being hedged for price risk, the hedged transaction shall not be specified in either of the following ways:
 - 01. Solely in terms of expected currency amounts
 - 02. As a percentage of sales or purchases during a period.
 - v. The current price of a forecasted transaction shall be identified to satisfy the criterion in paragraph 815-20-25-75(b) for offsetting cash flows.
 - vi. The hedged forecasted transaction shall be described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. Thus, a forecasted transaction could be identified as the sale of either the first 15,000 units of a specific product sold during a specified 3-month period or the first 5,000 units of a specific product sold in each of 3 specific months, but it could not be identified as the sale of the last 15,000 units of that product sold during a 3-month period (because the last 15,000 units cannot be identified when they occur, but only when the period has ended).
 - vii. If the hedged risk is the variability in cash flows attributable to changes in a **contractually specified component** in a forecasted purchase or sale of a nonfinancial asset, identification of the contractually specified component.
 - viii. If the hedged risk is the variability in cash flows attributable to changes in a contractually specified interest rate for forecasted

interest receipts or payments on a variable-rate financial asset or liability, identification of the contractually specified interest rate.

In addition to the general documentation requirements discussed in section 6.9.10, there are incremental documentation requirements specific to **cash flow hedges**. These primarily relate to documentation around the specific identification of a forecasted transaction.

As discussed in section 9.3.30, a forecasted transaction needs to be described with sufficient specificity such that when the transaction occurs, it is clear whether that transaction is or is not the hedged transaction. Topic 815 requires an entity to formally document certain details around the specific identification of the forecasted transaction, including:

Timing	Timing of when the forecasted transaction is expected to occur (e.g. specific date or period). [815-20-25-3(d)(1)(i)] If a forecasted transaction is expected to occur within a timeframe, but the date within that timeframe is uncertain, an entity may document a range of time to comply with this requirement. For guidance around uncertainty of timing within a range, see section 9.3.40.
Nature	Specific nature of the asset or liability involved, or first cash flows received or paid to a specific amount in a particular period (without reference to the specific asset or liability). [815-20-25-3(d)(1)(ii)] For guidance around specifically identifying the single forecasted transaction (or group of forecasted transactions), see section 9.3.30.
Quantity	The hedged quantity (e.g. specific number of items or units of measure) for hedges of price risk, interest rate risk and/or credit risk. [815-20-25-3(d)(1)(ii)(02)]
Current market price	The current market price of the forecasted transaction, both at inception of the hedge and subsequently. [815-20-25-3(d)(1)(v)] This information is necessary to determine the change in expected cash flows. An entity should also document at inception how it will calculate the change in the cash flows of the hedged forecasted transaction attributable to the risk being hedged because how this is calculated affects the assessment of effectiveness.
Foreign currency amount	The expected currency amount for hedges of foreign currency risk. [815-20-25-3(d)(1)(iii)(01)]
Contractually specified component	The contractually specified component for hedges of exposure to changes in a contractually specified component related to forecasted transactions of nonfinancial assets or liabilities (see section 9.4.10). [815-20-25-3(d)(1)(vii)]
Contractually specified interest rate	The contractually specified interest rate for hedges of exposure to changes in a contractually specified interest rate related to forecasted transactions of financial assets or liabilities (see section 6.3.40). [815-20-25-3(d)(1)(viii)]

Price risk	For hedges of price risk, the hedged transaction should not be specified: [815-20-25-3(d)(1)(iv)] — solely in terms of expected currency amounts; or — as a percentage of sales or purchases during a period.

Examples

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

- Formal documentation for a cash flow hedge of a forecasted transaction (Example 6.9.40).
- Formal documentation for forecasted purchases of fuel when hedging price risk (Example 6.9.50).

Formal documentation required by certain private companies and NFPs is discussed in chapter 16.



Example 6.9.40

Formal documentation for a cash flow hedge of a forecasted transaction

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

ABC enters into a five-year interest rate swap with a notional amount of \$100,000,000 to receive interest at six-month LIBOR and pay interest at a fixed rate of 8.5% on January 15, Year 1. The debt obligation reprices and requires payments to be made on July 1 and January 1 of each year. The swap reprices and requires payments to be made or received on July 15 and January 15 of each year.

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

Hedging relationship and risk management objective and strategy

On January 1, Year 1, ABC issued a five-year, \$100,000,000 debt obligation. The interest rate on the debt obligation is variable at six-month LIBOR plus 1.5%. As a result, ABC is exposed to variability in cash flows related to changes in its forecasted interest payments as six-month LIBOR (the benchmark interest rate) changes.

ABC's risk management objective is to lock in the interest cash outflows on this debt obligation. ABC meets this objective by entering into a five-year interest rate swap with a notional amount of \$100,000,000 to receive interest at a variable rate equal to six-month LIBOR and to pay interest at a fixed rate of 8.5%. ABC designates the swap (the hedging instrument) as a cash flow hedge of the interest rate risk associated with the benchmark rate of six-month LIBOR attributable to the forecasted interest payments on its five-year, \$100,000,000 variable-rate debt obligation (the hedged forecasted transactions).

Hedging instrument

ABC identifies the following interest rate swap as the derivative hedging instrument.

- Date of Swap = January 15, Year 1
- Notional amount = \$100,000,000
- Premium paid = \$0
- Term = Five years maturing on January 14, Year 6
- Fixed leg = 8.5% per annum
- Fixed leg payer = ABC
- Floating leg = six-month LIBOR, repricing July 15 and January 15 of each year
- Floating leg payer = Bank A
- Settlement = net cash due in arrears on July 15 and January 15 of each year.

Hedged forecasted transaction

Forecasted interest payments are to be made on July 1 and January 1 of each year on its five-year \$100,000,000 debt obligation issued January 1, Year 1 and maturing on December 31, Year 6. The interest payments on the \$100,000,000 debt obligation are repriced on July 1 and January 1 of each year, with payments due in arrears. As interest expense is accrued on the debt obligation, amounts in AOCI related to that expense will be reclassified into earnings.

Hedge effectiveness at inception

Prospectively	ABC has designated the risk of changes in its interest cash flows on its five-year, \$100,000,000 debt obligation issued January 1, Year 1 attributable to changes in six-month LIBOR (the benchmark interest rate) as the hedged risk. Although the variable leg of the hedging instrument is equal to six-month LIBOR and ABC is hedging interest rate risk, ABC cannot automatically conclude that the hedging relationship would have been highly effective over the period equivalent to the designated hedging relationship. This is because the variable leg of the swap that is designated as the hedging instrument reprices at different dates from the variable leg of the debt obligation. As a result, the changes in the variable interest payments of the debt may not offset the changes in the cash flows of the swap. ABC concluded that the hypothetical derivative is a swap with terms that identically match the terms of the variable-rate debt obligation (i.e. would meet the criteria of the shortcut method) and is equivalent to the hedging instrument in this hedging relationship except that the variable leg of the swap would reprice and require payment or receipt on July 1 and January 1 of each year. As a result, ABC performed a regression analysis to compare the period-by-period change in the fair value of the hypothetical derivative to the change in fair value of the actual derivative on a quarterly basis for the preceding 20 years. Based on this analysis, ABC concluded that the hedging relationship would have been highly effective historically for the equivalent of at least four hedging periods.

Based on the regression analysis completed, it is expected that on an ongoing basis the hedging relationship will remain effective throughout the hedging relationship.

Hedge effectiveness testing method – documented at the inception of the hedging relationship

On a quarterly basis, ABC will assess effectiveness by updating the analysis performed coincident with the hedge designation (to reflect the most recent change in interest rates). It will consider the risk of default by the counterparty to the swap contract and its own nonperformance risk in this assessment.

Retrospectively	ABC will evaluate whether the hedging relationship has been highly effective during the quarter just ended by updating the regression analysis performed at the inception of the hedge. In performing that regression analysis, ABC will use the same number of data points used in the prospective analysis performed at inception, except that the earliest data points will be discarded and replaced with data points that have occurred after the inception of the hedge.
Prospectively	On a quarterly basis, ABC will determine whether it expects the hedging relationship to continue to be highly effective based on the updated analysis.

If certain criteria are met, ABC may elect to perform the quarterly effectiveness testing on a qualitative analysis basis. For further guidance on performing effectiveness testing on a qualitative basis, see section 13.5.



Example 6.9.50

Formal documentation of forecasted purchases of fuel when hedging price risk

This example illustrates the documentation of a hedging strategy for a group of similar forecasted purchases. In addition to documenting the overall hedging strategy, an entity needs to formally document (at inception) each individual hedging relationship that is designated using the hedging strategy. This could be a supplement to the documentation of the overall hedging strategy.

Risk management objective and strategy

Freight Co. (Freight) purchases fuel at various locations (e.g. New York Harbor, US Gulf Coast, Singapore) on an ongoing basis. Because its transport operations involve both air and ground transport, Freight regularly purchases both jet and diesel fuel.

Fuel costs make up a substantial part of Freight's total operating expenses. This exposes the overall profitability and operating cash flows to the variability in the market price for fuel. Freight's objective is to hedge this variability, which is limited to changes in prices at various locations. This is because fixed delivery costs from the locations have been negotiated.

Freight's strategy for achieving this objective is to use futures and purchased options with notional amounts and underlying indices that will be highly effective at hedging that variability.

Nature of the risk being hedged

The hedged risk is defined as the risk of overall changes in cash outflows (i.e. price risk) for the purchase of fuel. Freight's exposure to changes in the overall price of fuel will be affected by both the type of fuel expected to be purchased (e.g. jet fuel or diesel fuel) and the location.

As discussed above, the variability in the overall cash outflows for the purchase of fuel is limited to changes in spot prices at various locations because delivery costs are fixed. The hedge period for individual relationships is typically three months.

Hedging instrument

The individual hedging relationships associated with this overall strategy may link multiple derivative contracts in combination to either completely eliminate the variability in cash flows associated with the forecasted purchases of fuel or eliminate the variability in cash flows when the overall price exceeds a specified threshold.

Derivatives will be linked to groups of forecasted purchases based on their similarity to the overall price risk associated with the forecasted purchases. Similarity of overall price risk will be based on both the type and location of fuel expected to be purchased.

The hedging instruments will be futures or purchased options indexed to either:

- the NYMEX Heating Oil or NY Harbor No. 2 index (generally used for relationships involving forecasted purchases of jet fuel); or
- the NYMEX West Texas Intermediate Crude Oil index (generally used for relationships involving forecasted purchases of diesel fuel).

These indices generally exhibit high correlation with the changes in market prices for the hedged forecasted purchases. However, instruments with other underlying indices may be used if Freight is able to demonstrate high effectiveness.

A new hedging relationship will be designated each time a derivative is linked to a specified group of similar forecasted purchases.

Hedged forecasted transaction

The hedged forecasted transaction is defined as the first purchases of gallons of fuel over the 30-day period beginning on the first day of the month in which the derivative contract matures/settles that:

1. in aggregate represent the number of gallons (or equivalent barrels) equal to the notional amount of the hedging instrument; and
2. are not currently being hedged by another derivative instrument or were not previously identified in a relationship originally designated earlier in priority that has been terminated for which amounts remain in AOCI.

Individual relationships will link hedging instruments to a specified group of similar forecasted purchases.

Only those individual forecasted purchases that are considered to be *similar* with respect to the risk being hedged are included within the same hedging group of forecasted transactions.

Because the overall price of a gallon of fuel is significantly affected by both the type of fuel and the location of the purchase, Freight will identify groups of hedged forecasted transactions first by type and then more specifically by location. For example, each forecasted purchase within a particular group will be for the same type, either jet fuel or diesel fuel. However, there may be multiple groups of forecasted jet fuel purchases based on the location at which the jet fuel is expected to be purchased.

Similarity assessment

To demonstrate that each group is similar, Freight will perform a regression analysis to show that the changes in expected prices for the purchases of fuel at each location within the group are highly correlated with each other.

Example 9.3.30 continues this example, illustrating the similarity assessment.

Hedge effectiveness

For the forecasted transactions to qualify for hedge accounting, Freight needs to demonstrate that the hedging instrument is highly effective at hedging the overall price risk for each individual group. Example 13.6.20 continues this example, illustrating regression analysis to quantitatively assess effectiveness for a cash flow hedge of total price risk for a group of similar transactions.

6.10 Discontinuing hedge accounting – general guidance

6.10.10 Overview



Excerpt from ASC 815-20

55-56 This Subtopic permits a hedging relationship to be dedesignated (that is, discontinued) at any time. (See paragraphs 815-25-40-1(c) and 815-30-40-1(c).) If an entity wishes to change any of the critical terms of the hedging relationship (including the method designated for use in assessing hedge effectiveness), as documented at inception, the mechanism provided in this Subtopic to accomplish that change is the dedesignation of the original hedging relationship and the designation of a new hedging relationship that incorporates the desired changes. However, as discussed in paragraph 815-30-35-37A, a change to the hedged risk in a cash flow hedge of a forecasted transaction does not result in an automatic dedesignation of the hedging relationship if the hedging instrument continues to be highly effective at achieving offsetting cash flows associated with the hedged item attributable to the revised hedged risk. The dedesignation of an original hedging relationship and the designation of a new hedging relationship represents the application of this Subtopic and is not a change in accounting principle under Topic 250, even though the new hedging relationship may differ from the original hedging

relationship only with respect to the method designated for use in assessing the hedge effectiveness of that hedging relationship. Although paragraph 815-20-35-19 refers to discontinuing an existing hedging relationship and then designating and documenting a new hedging relationship using an improved method for assessing effectiveness, that reference was not meant to imply that the perceived improved method had to be justified as a preferable method of applying an accounting principle under Topic 250.



Excerpt from ASC 815-25

> Discontinuing Hedge Accounting

40-1 An entity shall discontinue prospectively the accounting specified in paragraphs 815-25-35-1 through 35-6 for an existing hedge if any one of the following occurs:

- Any criterion in Section 815-20-25 is no longer met.
- The **derivative instrument** expires or is sold, terminated, or exercised.
- The entity removes the designation of the **fair value hedge**.



Excerpt from ASC 815-30

> Discontinuing Hedge Accounting

40-1 An entity shall discontinue prospectively the accounting specified in paragraphs 815-30-35-3 and 815-30-35-38 through 35-41 for an existing hedge if any one of the following occurs:

- Any criterion in Section 815-30-25 is no longer met.
- The **derivative instrument** expires or is sold, terminated, or exercised.
- The entity removes the designation of the **cash flow hedge**.

Hedge accounting is elective and is permitted only for hedging relationships that meet all of the qualifying criteria. Therefore, if any eligibility criteria cease to be met the hedging relationship must be discontinued – i.e. hedge dedesignation.

An entity may also be required to dedesignate the hedging relationship if it decides to change any of the critical terms of the originally documented hedging relationship. As a result, it is important for an entity to properly document the hedging relationship at its inception, including documentation around the methods for assessing effectiveness (see **formal documentation** requirements in section 6.9).

The following table provides an overview of circumstances that would require an entity to discontinue or partially dedesignate a hedging relationship:

Change in eligibility or critical terms of hedged items or transactions (section 6.10.20)	— Hedged item or transaction no longer meets the eligibility criteria. [815-25-40-1(a), 815-30-40-1(a)] — Modification of hedged item or transaction such that critical terms of the original hedging relationship have changed. [815-20-55-56]
Change in eligibility or critical terms of hedging instrument (section 6.10.30)	— Hedging instrument no longer meets the eligibility criteria. [815-25-40-1(a), 815-30-40-1(a)] — Hedging instrument expires or is sold, terminated or exercised. [815-25-40-1(b), 815-30-40-1(b)] — Modification of hedging instrument such that critical terms of the original hedging relationship have changed. [815-20-55-56]
Change in hedged risk (section 6.10.40)	— Change in the hedged risk, with the exception of a cash flow hedge of a forecasted transaction in certain circumstances. [815-20-55-56]
Change in hedge effectiveness (section 6.10.50)	— Hedge is no longer highly effective on a retrospective and/or prospective basis, with certain exceptions (see Question 6.10.90). [815-25-40-1(a), 815-30-40-1(a)] — Change in quantitative method to assess hedge effectiveness, including whether a component of the hedging instrument is excluded from the assessment (see section 13.6.40). [815-20-55-56]
Elective dedesignation	An entity may elect to discontinue the hedging relationship. [815-25-40-1(c), 815-30-40-1(c)]

If an entity dedesignates a hedge, it could establish a new hedging relationship that involves the same item, transaction, risk and/or derivative instrument if all qualifying criteria are met for the new hedging relationship. See guidance on redesignating hedging relationships in section 6.10.70.

See the following sections for guidance on accounting for discontinued hedges:

- **Fair value hedges** (section 8.5);
- **Cash flow hedges** (section 10.5); and
- **Net investment hedges** (section 12.5.40).

For guidance on partially dedesignating hedging relationships, see section 6.10.60.

6.10.20 Change in eligibility or critical terms of hedged items or transactions

Hedge accounting must be discontinued when the hedged item or transaction no longer meets the qualifying criteria outlined in section 6.2.

- **Fair value hedge.** The hedged item must be specifically identified as either a specific portion of a single recognized asset or liability, a firm commitment

or a portfolio of similar assets or liabilities. Therefore, any unanticipated changes to the hedged item (or portfolio) impacting the originally documented hedging relationship would require full dedesignation or partial dedesignation.

- **Cash flow hedge.** Forecasted cash flows relating to existing or forecasted assets or liabilities are the hedged transactions in a cash flow hedge. A cash flow hedge should be discontinued when the forecasted transaction is no longer probable as described in the original hedge documentation.
- **Net investment hedges.** Net investment hedges of foreign operations include investments in incorporated and unincorporated foreign operations. Therefore, changes in ownership or changes in the net investment balance may require dedesignation.

The following table illustrates changes in the eligibility or critical terms of hedged items or transactions that would require full dedesignation or partial dedesignation.

Fair value hedge	Cash flow hedge	Net investment hedge
— Hedged item (or portions thereof) is sold or extinguished. — Adding to or deleting from a portion of a hedged item or portfolio of hedged items (Question 6.10.20). — Items in a hedged portfolio no longer pass the similarity test (section 7.3.40). — Hedged firm commitments are modified such that they no longer meet the definition of a firm commitment (Question 6.10.50). — For last-of-layer hedges, Question 6.10.40.	— Forecasted transaction is no longer probable (Question 6.10.10 and section 10.5.20). — Existing recognized asset or liability is sold or extinguished. — Entity is no longer exposed to variability in cash flows (i.e. forecasted transaction becomes a firm commitment) (Example 10.5.30). — Adding to or deleting from a portion of a forecasted transaction or group of hedged transactions (Question 6.10.20).	— Complete sale or substantial liquidation of foreign operation (section 12.5.20). — Other events leading to a loss of control of the investment in foreign entity (section 12.5.20). — Partial sale of investment in foreign operation (section 12.5.20). — Changes in the net investment balance should be monitored to determine whether the hedging relationship should be redesignated to reflect a revised balance (section 12.2.20).



Future developments#

The FASB has a project to provide potential Codification improvements related to an entity's ability to change the hedged risk and/or the hedged forecasted

transaction (see Question 9.4.90). This would include clarifying how broadly or narrowly the hedged transaction is defined and whether a change in the hedged risk constitutes a change in the hedged transaction. A proposed ASU was issued in November 2019. This project is ongoing and we expect a final ASU to be issued in 2021. [\[Proposed ASU\]](#)



Example 6.10.10

Discontinuance of hedging relationship when an unrelated party is acquired

Cash flow hedges

ABC Corp. applies hedge accounting to a forecasted transaction to purchase a nonfinancial asset from XYZ (a third party) for its exposure to price risk.

Later, ABC acquires a controlling interest in XYZ. Because XYZ is no longer a 'party external to the reporting entity', the forecasted transaction is not eligible for designation as a hedged transaction (see section 9.3.50).

Furthermore, intercompany transactions are not eligible for hedge accounting unless the hedged risk is variability due to changes in foreign currency exchange rates (see section 6.5.50).

Therefore, ABC is required to discontinue the hedging relationship.

Fair value hedges

Similarly, ABC would be required to discontinue a hedging relationship involving a firm commitment to purchase a nonfinancial asset from XYZ. To be eligible for hedge accounting, a firm commitment must be between two unrelated parties (see section 7.3.20).



Question 6.10.10

If an entity concludes that some (but not all) forecasted transactions are no longer probable, is it required to discontinue a cash flow hedging relationship?

Interpretive response: Yes. We believe the entity must discontinue cash flow hedge accounting for the specific forecasted transactions that are no longer probable, even if the entire hedging relationship is highly effective. If the conditions for a partial dedesignation are met (see Questions 6.10.100 and 6.10.110), the entity may choose to partially dedesignate the hedging relationship. Otherwise, we would generally expect the entity to fully dedesignate the hedging relationship, however there may be other acceptable approaches based on the specific facts and circumstances.

Scenario 1 of Example 6.10.40 illustrates a partial dedesignation when an entity concludes that some forecasted transactions in a group or series of forecasted transactions are no longer probable. In that example, the hedging instrument is

a forward contract. We believe the same general concepts in that example would apply when the hedging instrument is an option or an interest rate swap, although there may be additional complexities in those situations.



Question 6.10.20

Does adding to or deleting from a portion of a hedged item or transaction (or portfolio or group of hedged items or transactions) require dedesignation of the hedging relationship?

Interpretive response:

Fair value hedges

It depends. The following table summarizes when fair value hedging relationships should be dedesignated because of additions or deletions.

Change	Is dedesignation required?
Increase in hedged item or addition to a hedged portfolio	Yes. We would consider an increase to the portion of a hedged item or the addition of new items to a portfolio of hedged items as a change in the critical terms of the hedging relationship. This requires discontinuation of the hedging relationship. We believe reselling (reissuing) a portion of an entity's own debt is not considered an addition in this context (see Question 6.10.30).
Decrease in hedged item or deletion from a hedged portfolio	Yes. If there is a reduction in the balance of a hedged item or portfolio of hedged items, we believe this is a change to the critical terms of the original hedging relationship and would require full or partial dedesignation of the hedging relationship. We believe that scheduled loan amortizations of principal, prepayments or writeoffs are not considered deletions in this context. In addition, we believe repurchasing a portion of an entity's own debt is not a deletion in this context (see Question 6.10.30).

This response does not apply to hedges using the last-of-layer method (see Question 6.10.40).

Cash flow hedges

It depends on the method used to specifically identify the transaction (or group of transactions) in the original hedging relationship. The following table summarizes when cash flow hedging relationships should be dedesignated because of additions to or deletions from a portion of a hedged transaction or group of transactions.

Change / hedged transaction	Is dedesignation required?
Increase in hedged transaction or addition to a group of transactions	
Hedged transaction identified as relating	Yes. We believe that adding transactions to a specific item or group of items represents a change in a critical term of the

Change / hedged transaction	Is dedesignation required?
to a specific individual asset or liability (or group thereof)	original hedging relationship, which requires dedesignation of the original hedging relationship.
Hedged transaction identified as first cash flows received or paid up to a specific amount in a particular period (without reference to the specific asset or liability)	It depends. We believe an entity may continue the hedging relationship as long as it is probable that it will continue to receive (or pay) the specified cash flows. In other words, any changes to the composition of existing assets or liabilities generating the cash flows would not affect the designated hedging relationship. This assumes the total dollar amount of the forecasted transaction(s) has not changed.
Decrease in hedged transaction or deletion from a group of transactions	
Hedged transaction identified as relating to a specific individual asset or liability (or group thereof)	Yes. We believe that reducing a portion of a specific item or deleting from the composition of a specific group represents a change in the probability of the identified hedged forecasted transactions for the hedging relationships related to the reduced balance of an item or the individual item(s) removed from the group. Consequently, the hedging relationships for the forecasted transactions that are no longer probable must be discontinued. [815-20-55-99] We believe that in certain circumstances an entity would have the option of partially dedesignating a proportion of the hedging instrument if certain criteria are met (see section 6.10.60). Otherwise, we would generally expect the entity to fully dedesignate the hedging relationship, however there may be other acceptable approaches based on the specific facts and circumstances. Missed forecast. If it is probable that a portion of the forecasted transaction will <i>not</i> occur, we believe an entity must immediately reclassify into earnings related amounts in AOCI (unless the purchase will occur within an additional two-month period or extenuating circumstances apply) and also consider this missed forecast when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions. See section 10.5.20, including Question 10.5.110.
Hedged transaction identified as first cash flows received or paid up to a specific amount in a particular period (without reference to the specific asset or liability)	It depends. Any reductions to related assets or liabilities might not affect the designated hedging relationship. As long as an entity determines it is probable that it will continue to receive (or pay) the originally designated cash flows (e.g. first LIBOR-based interest payments received), the original hedging relationship can continue if it remains highly effective. [815-20-55-95] If an entity concludes it is not probable that it will receive (or pay) some of the originally designated cash flows, the entity must discontinue the hedging relationship for those forecasted transactions that are no longer probable.

Change / hedged transaction	Is dedesignation required?
	We believe that in certain circumstances an entity would have the option of partially dedesignating a proportion of the hedging instrument if certain criteria are met (see section 6.10.60). Otherwise, we would generally expect the entity to fully dedesignate the hedging relationship, however there may be other acceptable approaches based on the specific facts and circumstances. Missed forecast. If it is probable that a portion of the forecasted transaction will not occur, we believe an entity must immediately reclassify into earnings related amounts in AOCI (unless the purchase will occur within an additional two-month period or extenuating circumstances apply) and also consider this missed forecast when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions. See section 10.5.20, including Question 10.5.110.

The FASB has discussed updates that may extend an entity's ability to change the hedged risk to the hedged forecasted transaction (see Question 9.4.90). As a result, revisions to this interpretive response may be provided in a future edition.



Question 6.10.30

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

Background: In certain situations, an entity issues public debt and also acts as a market-maker for that debt. As a market-maker, the entity is expected to acquire and subsequently resell (reissue) some of the debt.

Interpretive response: It depends on whether the hedging relationship remains highly effective. We believe the entire debt issuance may be designated as the hedged item, rather than designating the individual debt certificates as a portfolio of hedged items.

This is consistent with:

- paragraph 470-60-15-4 regarding troubled debt restructurings, which states that a bond constitutes one payable even though there are many bondholders.
- paragraph 320-10-35-20 regarding investment securities, which states that securities of the same issuer bearing the same CUSIP number can be aggregated and treated as a single security when assessing and measuring impairment.

When the hedged item is designated as an individual debt issuance, acquisitions and resales (reissues) of a portion of the debt issuance result in the

outstanding principal balance of the designated hedged item fluctuating. In this instance, the balance of the designated hedged item is merely fluctuating and therefore this is not considered an additional item designated as the hedged item or portfolio in the context of Question 6.10.20 or a partial dedesignation (see section 6.10.60). In other words, it is not considered to be a change in the critical terms of the hedging relationship. These fluctuations will result in the hedging relationship not being perfectly effective.

This lack of perfect effectiveness will occur even if the hedged item is designated as a portion of the entire debt issuance (e.g. 90% of the entire issuance). In that situation, if an entity acquires a portion of the debt issuance, the hedged balance would be 90% of the new outstanding principal balance. In the initial and ongoing assessments of effectiveness, the entity is required to consider the effect of the market making activities. This may result in the entity concluding that the relationship will not be or has not been highly effective, which would require the hedging relationship to be fully or partially dedesignated.



Question 6.10.40

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

Background: Topic 815 permits an entity to designate a fixed amount of a closed portfolio of prepayable financial assets as the hedged item in a fair value hedge of interest rate risk if the entity expects that the designated amount will remain outstanding at the end of the hedge term – i.e. last of layer (see section 7.3.100). [815-20-25-12(b)(2), 25-12A]

An entity is required to support its expectation that the last of layer will remain outstanding at the end of the hedge term. In this analysis, the entity assumes that as prepayments, defaults and other events affecting the timing and amount of cash flows occur, they will first be applied to the portion of the closed portfolio that is not part of the designated last of layer (see Question 7.3.320). [815-20-25-12A]



Excerpt from ASC 815-25

>> Hedged Item Is Designated under the Last-of-Layer Method

40-8 For a hedging relationship designated under the last-of-layer method in accordance with paragraph 815-20-25-12A, an entity shall discontinue (or partially discontinue) hedge accounting in either of the following circumstances:

- a. If the entity cannot support on a subsequent testing date that the hedged item (that is, the designated last of layer) is anticipated to be outstanding in

- accordance with paragraph 815-25-35-7A, it shall at a minimum discontinue hedge accounting for the portion of the hedged item no longer expected to be outstanding at the hedged item's assumed maturity date.
- b. If on a subsequent testing date the outstanding amount of the closed portfolio of prepayable financial assets or one or more beneficial interests is less than the hedged item, the entity shall discontinue hedge accounting.

Interpretive response: There are two situations in which a hedging relationship designated using the last-of-layer method in a closed portfolio of prepayable financial assets is discontinued, as illustrated in the following diagram.

[815-25-40-8]

	Scenario 1: Partial discontinuation	Scenario 2: Full discontinuation
Occurs when:	Amount outstanding in portfolio on testing date exceeds last of layer (i.e. hedged item) but last of layer not expected to remain outstanding at end of hedge term	Amount outstanding in portfolio on testing date is less than the designated last of layer (i.e. hedged item)
Hedge accounting is discontinued for:	The portion of the last of layer no longer expected to remain outstanding at end of hedge term	The entire hedging relationship

By allowing partial dedesignation of a last-of-layer hedging relationship, an entity can reduce the amount of the hedged item based on updated estimates of the balance expected to remain outstanding at the end of the hedge term, assuming it is not less than the current balance of the portfolio.

The FASB acknowledged that estimating the balance expected to remain at the hedged item's assumed maturity date resembles a **cash flow hedging** concept. However, the tainting threshold for cash flow hedges in paragraph 815-30-40-5 should not be applied to the last-of-layer method. This means that a pattern of partially dedesignating a last-of-layer hedging relationship would *not* call into question an entity's ability to accurately predict the balance remaining at the end of the hedge term or the propriety of using the last-of-layer method in the future. [ASU 2017-12.BC119]

For guidance on partially and fully discontinuing hedge accounting for a last-of-layer hedge, see section 8.5.30.



Question 6.10.50

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



Excerpt from ASC 815-25

>> Hedged Item No Longer Meets Definition of Firm Commitment

40-5 If a fair value hedge of a **firm commitment** is discontinued because the hedged item no longer meets the definition of a firm commitment, the entity shall do both of the following:

- a. Derecognize any asset or liability previously recognized pursuant to paragraph 815-25-35-1(b) (because of an adjustment to the carrying amount for the firm commitment)
- b. Recognize a corresponding loss or gain currently in earnings.

40-6 A pattern of discontinuing hedge accounting and derecognizing firm commitments would call into question the firmness of future hedged firm commitments and the entity's accounting for future hedges of firm commitments.

If the hedged item in a fair value hedge is a firm commitment that later ceases to meet the definition of a firm commitment (e.g. because the counterparty terminated the agreement), the asset or liability previously recognized is recognized in earnings immediately. This is because the firm commitment no longer exists. [815-25-40-5]

Situations in which this occurs are expected to be rare. A pattern of discontinuing hedge accounting of firm commitments because the contracts ceased to meet the definition of a firm commitment may call into question whether future arrangements represent firm commitments and (as a result) the ability to apply hedge accounting for future firm commitments. [815-25-40-6]

6.10.30 Change in eligibility or critical terms of hedging instrument

Hedge accounting must be discontinued when the hedging instrument no longer meets the qualifying criteria outlined in section 6.6.

The following are examples of changes in the eligibility or critical terms of a hedging instrument that would require dedesignation:

- hedging instrument expires or is sold, terminated or exercised;
- hedging instrument is no longer highly effective at offsetting changes in fair value or cash flows of the hedged item or transaction (see section 6.10.50);

- a change in the creditworthiness of the counterparty or an entity's own nonperformance risk that causes the hedge to no longer be highly effective (see section 13.2.60);
- rebalancing a combination of hedging instruments (see Question 6.10.60);
- hedging instrument is dedesignated in its entirety; and
- changes to contractual terms (e.g. strike price, maturity dates, or embedded put or call options).

An entity may also elect to partially dedesignate a hedging relationship by partially dedesignating the hedging instrument (see section 6.10.60).



Question 6.10.60

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

Background: Some entities hedge portfolios of similar assets or liabilities using a combination of derivatives as hedging instruments. Additions or deletions (a rebalancing) to either the portfolio of derivatives or hedged items may be needed to achieve high effectiveness, such as in a delta-neutral dynamic hedging strategy or a dynamic hedging relationship involving a tailing strategy (see section 13.2.50). For guidance on designating a combination of derivatives as the hedging instrument, see section 6.6.40.

Interpretive response: Yes. Rebalancing a portfolio of derivatives changes the composition of the derivative hedging instruments specified in the original hedge documentation and therefore represents a change in the hedging relationship. As a result, an entity would be required to dedesignate the current hedging relationship and could redesignate a new hedging relationship.

Fair value hedges. For guidance on amortization of the basis adjustment when a portfolio of hedged items that is hedged by a combination of hedging instruments is rebalanced, see Question 8.5.10.



Question 6.10.70

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

Interpretive response: No. We believe that neither the modification of collateral requirements nor the addition of a new guarantor results in the existing derivative being viewed as terminated. This is because the substantive terms of the derivative (e.g. strike price or maturity date) did not change. As a result, we do not believe these changes cause discontinuation of any associated hedging relationship.

However, the fair value of the derivative instrument may be affected by these changes, which may affect hedge effectiveness.

Derivative novation



Excerpt from ASC 815-20

55-56A For the purposes of applying the guidance in paragraph 815-20-55-56, a change in the counterparty to a derivative instrument that has been designated as the hedging instrument in an existing hedging relationship would not, in and of itself, be considered a change in a critical term of the hedging relationship.



Excerpt from ASC 815-25

> Discontinuing Hedge Accounting

40-1A For the purposes of applying the guidance in paragraph 815-25-40-1, a change in the counterparty to a derivative instrument that has been designated as the hedging instrument in an existing hedging relationship would not, in and of itself, be considered a termination of the derivative instrument.



Excerpt from ASC 815-30

> Discontinuing Hedge Accounting

40-1A For the purposes of applying the guidance in paragraph 815-30-40-1, a change in the counterparty to a derivative instrument that has been designated as the hedging instrument in an existing hedging relationship would not, in and of itself, be considered a termination of the derivative instrument.

Novation refers to the replacement of one party to a derivative instrument with a new party, whereby the original party transfers all rights and obligations to the latter party. In some situations, the derivative instrument that is the subject of the novation might be designated as the hedging instrument in a hedging relationship.

A novation is not considered a termination of the hedging instrument, but rather is a change in the counterparty to a derivative instrument. Therefore, when a novation occurs an entity is typically not required to discontinue the hedging relationship.

However, if a derivative instrument novation involves a new counterparty with creditworthiness different from that of the old counterparty, the entity should consider that change in creditworthiness in determining whether the hedging relationship continues to be highly effective and qualifies for hedge accounting. Similarly, if a novation leads to changes in security or cash collateral posting requirements, those changes should also be incorporated into an entity's assessment of hedge effectiveness.



Question 6.10.80

Why would a derivative novation occur?

Interpretive response: Derivative novation may occur for a variety of reasons including but not limited to:

- in response to laws or regulatory requirements;
- when the derivative counterparty merges with and into a surviving entity that assumes the same rights and obligations that existed under a preexisting derivative instrument of the merged entities;
- when the derivative counterparty novates a derivative instrument to an entity under common control with the derivative counterparty;
- when the derivative counterparty decides to exit a particular derivative business or relationship; or
- for an over-the-counter (OTC) derivative entered into after applying the mandatory clearing requirement of the Dodd-Frank Act, when the counterparties agree in advance to clear the contract through a central counterparty according to standard market terms and conventions.

6.10.40 Change in hedged risk

Topic 815 requires an entity to discontinue hedge accounting when the critical terms of the original hedging relationship have changed, with the exception of changes to hedged risk when hedging forecasted transactions. [815-20-55-56]

- **Fair value hedges.** If there is a change to the hedged risk in a fair value hedge, this would be considered a change in the critical terms of the hedging relationship and an entity is required to dedesignate the hedging relationship.
- **Cash flow hedges.** If there is a change to the hedged risk in a cash flow hedge for a forecasted transaction, an entity is not required to automatically dedesignate the hedging relationship if the hedging relationship continues to be highly effective. See section 9.4.60 for guidance on changing the hedged risk when hedging forecasted transactions. [815-30-35-37A]
- **Net investment hedges.** A net investment hedge is a hedge of the exposure to foreign currency risk of a net investment in a foreign operation. If there is a change to the functional currency of the hedged net investment, an entity is required to dedesignate the hedging relationship. See paragraphs 4.021 to 4.033 in KPMG's Handbook, [Foreign Currency](#), for additional guidance on changing the functional currency of an entity.

6.10.50 Change in hedge effectiveness

Hedge accounting must be discontinued when the hedging relationship is no longer highly effective. The date at which hedge accounting must be

discontinued depends on whether the hedging relationship failed the prospective effectiveness test or the retrospective effectiveness test.

Failure to meet...	Discontinuance
Prospective effectiveness assessment	— Discontinue hedge accounting prospectively.
Retrospective effectiveness assessment	— Discontinue hedge accounting as of the last date on which effectiveness testing indicated relationship was highly effective, or date of a specific event or change in circumstance. [815-25-40-3 – 40-4] — Hedging relationship not eligible for partial dedesignation (see Question 6.10.100).

For additional guidance on hedging relationships that are no longer highly effective, see the following.

- **Fair value hedges.** For guidance on identifying the date hedge accounting should be discontinued, see section 8.5.20.
- **Cash flow hedges.** For guidance on identifying the date hedge accounting should be discontinued, including circumstances when a change in creditworthiness causes a hedge to cease being highly effective, see Questions 6.5.30 and 6.5.40.
- **Net investment hedges.** For guidance on discontinuing a hedging relationship that is no longer effective as an economic hedge, see section 12.5.40.

Changing quantitative methods for assessing effectiveness. A change in the quantitative method for assessing effectiveness – including whether a component of the hedging instrument is excluded from the assessment of effectiveness – is considered a change in the hedging relationship that requires an entity to dedesignate and redesignate the hedging relationship. For guidance on requirements when an entity changes its quantitative method for assessing effectiveness, see section 13.6.40.



Question 6.10.90

If a hedging relationship has not been highly effective retrospectively, but *is* expected to be prospectively, is hedge accounting required to be discontinued prospectively?

Interpretive response: Not necessarily. Generally, if an entity determines that a hedging relationship has not been retrospectively highly effective at the current assessment date, it does not apply hedge accounting for the period between the previous assessment date and the current assessment date. This means that the change in fair value of the hedged item (for **fair value hedges**) is not recognized as a basis adjustment or the change in fair value of the hedging instrument (for **cash flow hedges**) is recognized in earnings (rather

than OCI) for the assessment period. The entity may discontinue the current hedging relationship and designate the derivative in a new hedging relationship (see section 6.10.70).

However, if the hedging relationship is expected to be prospectively highly effective, the hedging relationship is not required to be discontinued prospectively. We believe these circumstances should be limited. For example, if an entity can provide sufficient evidence to support its conclusion that the hedging relationship was not highly effective in a previous effectiveness assessment period due to an unusual, discrete event that is not expected to occur in future effectiveness assessment periods, we believe the hedging relationship is not required to be discontinued prospectively.



Example 6.10.20

Hedge discontinuation because the hedging relationship is no longer highly effective

ABC has 20,000 barrels of West Texas Grade A crude oil in its inventory. To hedge the fair value of this oil, ABC enters into a six-month futures contract on 20,000 barrels of West Texas Grade B crude oil.

ABC has entered into a futures contract on West Texas Grade B (rather than Grade A) crude oil because it is more economical and futures contracts on West Texas Grade B crude oil historically have been highly effective in achieving offsetting changes in fair value of West Texas Grade A crude oil inventory.

During the first three months of the futures contract, ABC determined that the hedging relationship was highly effective. However, at the end of the fourth month, ABC's management determined that the hedging relationship is no longer highly effective on a prospective basis; this is because of a major fire (during the fourth month of the hedging relationship) in one of the oil wells that produces West Texas Grade B crude oil.

ABC is required to stop applying hedge accounting as of the latest date that it can be demonstrated that the hedging relationship was highly effective, which would be the date of the fire. For guidance on applying hedge accounting through the date that an event or change in circumstance resulted in the hedge no longer being highly effective, see section 8.5.20 (**fair value hedges**) and Question 10.5.30 (**cash flow hedges**).

However, ABC could later redesignate the futures contract in a fair value hedging relationship with its West Texas Grade A crude oil inventory (i.e. a new hedging relationship) if it concluded that the hedging relationship was expected to be effective in the future and all the other hedge criteria are met.

6.10.60 Partially dedesignating a hedging relationship



Question 6.10.100

Under what conditions may an entity partially dedesignate a hedging relationship?

Background: We believe an entity may partially dedesignate a hedging relationship for a variety of reasons, including but not limited to:

- a decrease in the balance of a hedged item or deletion from a hedged portfolio (see Question 6.10.20);
- a portion of the forecasted transaction or group of transactions is no longer probable (see Questions 6.10.10 and 6.10.20); or
- the entity elects to partially dedesignate the hedging relationship.

Interpretive response: We believe an entity may partially dedesignate a hedging relationship if all of the following conditions are met:

- **The entity concurrently modifies the original hedge documentation** to reflect updated proportions of the hedging instrument and/or hedged item or forecasted transaction. This is based on the requirement for an entity to prepare hedge documentation concurrent with the hedge designation (see section 6.9.40). [815-20-25-3]
- **The original hedging relationship has been highly effective on a retrospective basis.** This assessment is based on the hedged item(s) or forecasted transaction(s) as designated in the original formal hedge documentation (as opposed to the formal hedge documentation as updated to reflect the partial dedesignation). Changes to the hedged items or transactions subsequent to hedge inception would be factored into the assessment – i.e. specific forecasted transactions that are not probable would be excluded from the effectiveness assessment for a cash flow hedge.
- **The partially dedesignated hedging instrument is expected to be prospectively highly effective** at offsetting changes in the fair value or cash flows of the hedged item or transaction. This assessment is based on the hedged item(s) or forecasted transaction(s) as designated in the formal hedge documentation after it had been updated to reflect the partial designation.
- **Hedge ratio.** When partially dedesignating a hedging relationship, we believe the same hedge ratio – i.e. the ratio of the amount of the hedged item or transaction to the notional amount of the hedging instrument – that was included in the original hedging relationship needs to be maintained in the partially dedesignated hedging relationship.

This response does not apply to **fair value hedges** using the last-of-layer method (see Question 6.10.40).



Question 6.10.110

How does an entity partially dedesignate a hedging instrument?

Interpretive response: If the criteria to partially designate the hedging relationship are met (see Question 6.10.100), we believe a decrease to the notional amount of a derivative designated as the hedging instrument can be achieved in either of the following ways.

- **Decreasing the proportion of the derivative designated as the hedging instrument.** An entity can modify the hedge documentation to reduce the proportion of the derivative instrument designated in the hedging relationship. The proportion of the derivative instrument no longer designated as part of the hedging relationship is eligible to be designated in a new hedging relationship. This is illustrated in Examples 6.10.30 (**fair value hedge**) and 6.10.40 (**cash flow hedge**).
- **Partially terminating the derivative hedging instrument.** We believe the hedging instrument can be partially terminated such that the notional of the hedging instrument is decreased. In this situation, the originally documented proportion of the hedging instrument continues to be the designated proportion, although of a smaller notional amount. To partially terminate a hedging instrument without dedesignating and redesignating the entire hedging relationship, the only change in the terms of the hedging instrument should relate to the reduction in the notional amount. There can be no other changes to the critical terms of the original agreement. This is illustrated in Example 6.10.50.



Example 6.10.30

Partial decrease of hedged item in a fair value hedge

ABC entered into an interest rate swap to hedge exposure to interest rate risk on \$60 million of \$100 million outstanding debt. ABC documents the hedged item as 60% of the principal amount of \$100 million.

The original hedging relationship includes the following.

- Principal amount of debt: 60% of the outstanding debt balance (the initial hedged item is therefore \$60 million)
- Swap notional amount: 100% of the interest rate swap notional amount

Because both amounts are initially \$60 million, the initial hedge ratio is 1:1.

Scenario 1: Partial repayment of principal and partial dedesignation

ABC subsequently repays \$10 million principal of the outstanding debt (i.e. 10%). This is not a scheduled principal payment. Since the hedged item is 60% of the outstanding debt balance, and the outstanding debt has been reduced to \$90 million, the hedged item is reduced to \$54 million.

ABC wishes to partially dedesignate 10% (or \$6 million) of the notional amount of the interest rate swap to align it with the remaining amount of the hedged item.

ABC performs retrospective and prospective hedge effectiveness assessments.

Retrospective – original hedging relationship	100% of the interest rate swap (\$60 million notional) is determined to be highly effective retrospectively at hedging exposure to interest rate risk on the remaining amount of the hedged item (\$90 million principal outstanding $\times$ 60% = \$54 million principal).
Prospective – original hedging relationship	90% of the interest rate swap (\$60 million notional $\times$ 90% = \$54 million notional) is determined to be highly effective prospectively at hedging exposure to interest rate risk on the remaining amount of the hedged item (\$90 million principal outstanding $\times$ 60% = \$54 million principal).

In addition, the hedge ratio of the partially dedesignated hedging relationship remains 1:1 – i.e. \$54 million remaining amount of hedged item to \$54 million notional amount of the hedging instrument.

Therefore, ABC may partially dedesignate the hedging relationship.

ABC elects to partially dedesignate 10% (or \$6 million) of the notional amount of the interest rate swap. Concurrently, ABC modifies the hedge documentation to reflect the reduced amounts of the hedged item and hedging instrument.

Updated hedging relationship	Accounting considerations
60% designated portion of outstanding portion of debt balance: \$54 million¹ principal 90% designated proportion of swap: \$54 million² notional	Subsequent changes in the fair value of the proportion of the swap no longer designated as part of the hedging relationship (i.e. \$6 million notional) are recognized in earnings. This proportion of the hedging instrument is eligible to be designated in a new hedging relationship. [815-25-40-2] The cumulative basis adjustment recognized at the date of prepayment is part of the amortized cost basis used to determine the gain or loss related to the prepayment. For additional guidance on partially discontinuing fair value hedge accounting, see Question 8.5.20.
Notes: 1. \$90 million principal outstanding $\times$ 60% = \$54 million principal. 2. \$60 million total notional of the swap $\times$ 90% = \$54 million notional.	

Alternatively, ABC could partially dedesignate the hedging relationship by terminating a proportion of the interest rate swap (see Example 6.10.50).

Scenario 2: Partial repayment of principal and full dedesignation

ABC subsequently repurchases \$25 million on its outstanding debt (i.e. 25%). This is not a scheduled principal payment.

ABC wishes to partially dedesignate 25% (or \$15 million) of the notional amount of the interest rate swap to align it with the remaining amount of the hedged item.

ABC performs a retrospective effectiveness assessment.

Retrospective – original hedging relationship	100% of the interest rate swap (\$60 million notional) is determined to be <i>not</i> highly effective retrospectively at hedging exposure to interest rate risk on the remaining amount of the hedged item (\$75 million principal outstanding $\times$ 60% = \$45 million principal).

Because the original hedging relationship is not highly effective retrospectively, ABC cannot partially dedesignate the hedging relationship. Instead, ABC must fully dedesignate the hedging relationship.



Example 6.10.40

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

ABC Corp. is a car manufacturer. On January 1, Year 1, ABC forecasts it will purchase 100,000 tons of steel on December 31, Year 1. ABC's contracts to purchase steel are typically at a price based on the NYSE American Steel Index.

ABC enters into a forward derivative contract indexed to the NYSE American Steel Index to purchase 100,000 tons of steel that will mature on December 31, Year 1.

ABC documents as the hedged risk the variability in cash flows attributable to changes in the contractually specified NYSE American Steel Index in the not-yet-existing purchase contract. Assume all criteria are met to qualify for hedge accounting.

The hedge ratio is 1:1 – i.e. forecasted purchase of 100,000 tons to a hedging instrument with a notional of 100,000 tons.

Scenario 1: It is probable that 10% of the original forecasted transaction will not occur

On July 1, Year 1, ABC determines it is probable that the purchase of 10,000 tons of steel will not occur. ABC concludes it is probable that it will continue to purchase 90,000 tons of steel on December 31, Year 1.

ABC wishes to partially dedesignate 10% (or 10,000 tons) of the notional amount of the forward contract to align it with the amount of steel purchases that remain probable (i.e. 90,000 tons).

ABC performs retrospective and prospective hedge effectiveness assessments.

Retrospective – original hedging relationship	100% of the forward contract (100,000 tons notional) is determined to be highly effective retrospectively at hedging exposure to the contractually specified NYSE American Steel Index on the remaining amount of the hedged forecasted transaction (90,000 tons).
Prospective – original hedging relationship	90% of the forward contract (100,000 tons notional $\times$ 90% = 90,000 tons) is highly effective prospectively at hedging exposure to the contractually specified NYSE American Steel Index on the remaining amount of the hedged forecasted transaction (90,000 tons).

In addition, the hedge ratio of the partially dedesignated hedging relationship remains 1:1 – i.e. forecasted purchase of 90,000 tons to a hedging instrument with a notional of 90,000 tons.

Therefore, ABC may partially dedesignate the hedging relationship.

ABC partially dedesignates 10,000 tons of the notional amount of the forward contract. Concurrently, ABC modifies the hedge documentation to reflect the reduced amounts of the hedged transaction and hedging instrument.

Updated hedging relationship	Accounting considerations
Forecasted transaction: 90,000 tons of steel 90% designated proportion of forward contract: 90,000 tons of steel ¹	Subsequent changes in the fair value of the proportion of the forward contract no longer designated as part of the hedging relationship (i.e. 10,000 tons of notional) are recognized in earnings, rather than AOCI. This proportion of the hedging instrument is eligible to be designated in a new hedging relationship. Amounts in AOCI at the date of partial dedesignation are allocated between the forecasted transactions that remain in the hedging relationship and those that were dedesignated. Because it is probable that the purchase of 10,000 tons will <i>not</i> occur, the amount of AOCI allocated to the purchase of 10,000 tons is immediately reclassified into earnings unless the purchase will occur within an additional two-month period or extenuating circumstances apply. For additional guidance on partially discontinuing cash flow hedge accounting, see Question 10.5.20.
Note: 1. Total notional amount of forward contract (i.e. 100,000 tons of steel) × 90% = 90,000 tons of steel.	

Because it is probable that a portion of the originally forecasted transactions will not occur, ABC is required to consider this as a missed forecast when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions (see Question 10.5.110).

Scenario 2: Probable 25% of the forecasted transaction will not occur and full dedesignation

On July 1, Year 1, ABC determines it is probable that the purchase of 25,000 tons of steel will not occur. ABC concludes it is probable that it will continue to purchase 75,000 tons of steel on December 31, Year 1.

ABC wishes to partially dedesignate 25% (or 25,000 tons) of the notional amount of the forward contract to align it with the amount of steel purchases that remain probable (i.e. 75,000 tons).

ABC performs a retrospective hedge effectiveness assessment.

Retrospective – original hedging relationship	100% of the forward contract (100,000 tons notional) is <i>not</i> highly effective retrospectively at hedging exposure to the contractually specified NYSE American Steel Index on the remaining amount of the hedged forecasted transaction (75,000 tons).

Because the original hedging relationship is not highly effective retrospectively, ABC cannot partially dedesignate the hedging relationship. Instead, ABC must fully dedesignate the hedging relationship.

Because it is probable that the purchase of 25,000 tons of steel will *not* occur, ABC is required to immediately reclassify related amounts from AOCI into earnings unless the purchase will occur within an additional two-month period or extenuating circumstances apply (see section 10.5.20). Additionally, ABC is required to consider this as a missed forecast when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions (see Question 10.5.110).



Example 6.10.50

Partial termination of a hedging instrument

Assume the same facts and circumstances as in Example 6.10.30 (Scenario 1: Partial repayment of principal and partial dedesignation), except that ABC partially terminates the interest rate swap.

After paying down \$10 million on its outstanding debt balance (originally \$60 million principal), ABC negotiates with the counterparty of the interest rate swap to reduce the notional amount from \$60 million to \$54 million. ABC settles the fair value of the interest rate swap related to the \$6 million reduced notional with the counterparty. The swap agreement is amended to reflect the reduced notional amount of \$54 million. No other critical terms or conditions are changed.

The hedge ratio of the partially dedesignated hedging relationship remains 1:1 – i.e. \$54 million hedged item to \$54 million hedging instrument. Hedge accounting continues to be applied to the reduced notional amount of the interest rate swap. Concurrently, ABC modifies the hedge documentation to reflect the reduced amounts of the hedged transaction and hedging instrument.

6.10.70 Redesignating a hedging relationship



Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15A This Topic places no limitations on an entity's ability to prospectively designate, dedesignate, and redesignate a qualifying hedge of the same forecasted transaction.



Excerpt from ASC 815-25

> Discontinuing Hedge Accounting

40-2 In the circumstances discussed in paragraph 815-25-40-1, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in (a) and (c) in paragraph 815-25-40-1, a different hedged item or a hedged **transaction** if the hedging relationship meets the criteria specified in Section 815-20-25 for a fair value hedge or a **cash flow hedge**.



Excerpt from ASC 815-30

> Discontinuing Hedge Accounting

40-3 Furthermore, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in paragraph 815-30-40-1(a) and 815-30-40-1(c), a different hedged **transaction** or a hedged item if the hedging relationship meets the applicable criteria for a cash flow hedge or a **fair value hedge**.

An entity may redesignate a new hedging relationship that involves either: [815-25-40-2, 815-30-40-3]

- the same hedged item or transaction and a different (or modified) hedging instrument;
- the same hedging instrument with a different (or modified) hedged item or transaction; or
- the same hedged item or transaction and the same hedging instrument.

The redesignated hedging relationship must meet all of the qualifying criteria and be formally documented.

The dedesignation and redesignation of a new hedging relationship is not a change in accounting principle under Topic 250 (accounting changes and errors). Hedge accounting is applied prospectively at inception of the redesignated hedging relationship. [815-20-55-56, 815-25-40-2, 815-30-40-3]

Net investment hedges. Entities are required to periodically assess whether a net investment hedge needs to be dedesignated and redesignated based on changes in the net investment balance. For further discussion, see section 12.2.20.



Question 6.10.120

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

Background: If an entity redesignates an existing derivative instrument in a new hedging relationship, the derivative will typically have a fair value other than zero because of changes in market conditions since inception of the hedging instrument. In other words, the derivative will be off-market at redesignation.

Interpretive response: These off-market terms should be considered when determining whether the new relationship is expected to be highly effective and can qualify for hedge accounting.

There are additional considerations for the following.

- **Cash flow hedges** involving derivative hedging instruments with multiple cash flows or periodic cash settlements (e.g. interest rate swaps). For these hedging relationships, amounts in AOCI that are related to the initial fair value are required to be reclassified into earnings on a systematic and rational basis over the periods during which the hedged forecasted transactions affect earnings (see section 10.3.20). [815-30-35-41A]
- **Net investment hedges.** When an entity changes from the forward to the spot method for assessing effectiveness of a net investment hedge, a non-zero fair value of the derivative instrument creates some complexity when determining the value of the excluded component at the time of redesignation. In a February 2018 FASB meeting, the Board discussed methodologies for amortizing the excluded component, including the off-market element of a derivative instrument that could occur at the time of redesignation. For further discussion, see Question 8.4.100.



Question 6.10.130

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

Interpretive response: No. Topic 815 does not limit the frequency of dedesignating and redesignating hedging relationships. There are hedging strategies that require frequent dedesignation and redesignation – i.e. dynamic hedging strategies (see Question 6.10.60 and section 13.2.50).

However, a pattern of dedesignating hedging relationships in certain circumstances may limit an entity's ability to designate similar hedging relationships in the future:

- **Cash flow hedges.** A pattern of dedesignating hedging relationships when it is probable that a forecasted transaction will not occur calls into question an entity's ability to accurately predict forecasted transactions and use hedge accounting in the future for similar forecasted transactions. See Question 16.5.110 regarding factors that are considered when evaluating whether missed forecasts represent a pattern. [815-30-40-5]
- **Fair value hedges.** A pattern of dedesignating hedging relationships because a contract no longer meets the definition of a firm commitment calls into question whether contracts entered into in the future are firm commitments that are eligible for hedge accounting (see Question 6.10.50). [815-25-40-6]

7. Qualifying criteria for fair value hedges

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New item added in this edition: **
Item significantly updated in this edition: #

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- 7.3.280 Is an entity permitted to hedge the risk of changes in the fair value of an embedded call option in an HTM security that is prepayable?
- 7.3.290 Can an entity hedge the fair value exposure of options embedded in contracts that qualify as firm commitments?
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7.4 Eligibility of hedged risks

7.4.10 Interest rate risk hedges of prepayable financial instruments

7.4.20 Limitations on price risk for nonfinancial items

Questions

7.4.10 Why would an entity elect to consider only the effect of changes in the benchmark interest rate on the decision to prepay the financial instrument?

7.4.20 Is an entity *required* to consider only how changes in the benchmark interest rate affect the decision to prepay?

7.4.30 What instruments are considered prepayable under paragraph 815-20-25-6B?

7.4.40 How does paragraph 815-20-25-6B apply to nonconvertible debt with an embedded contingent call or put option?

7.4.50 Does paragraph 815-20-25-6B apply to interest rate risk hedges related to debt conversion options?

7.4.60 Does the election to consider only how changes in the benchmark interest rate affect the decision to prepay a debt instrument have to be applied to all prepayable hedged items?

Examples

7.4.10 Applying paragraph 815-20-25-6B to a callable bond

7.4.20 Applying paragraph 815-20-25-6B to a nonconvertible bond with an embedded contingent put

7.4.30 Fair value hedge of gold watch inventory with a gold futures contract

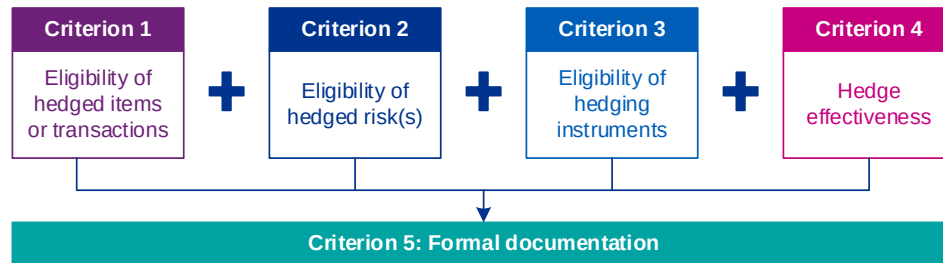
7.5 Hedging instruments in fair value hedges

7.5.10 Overview

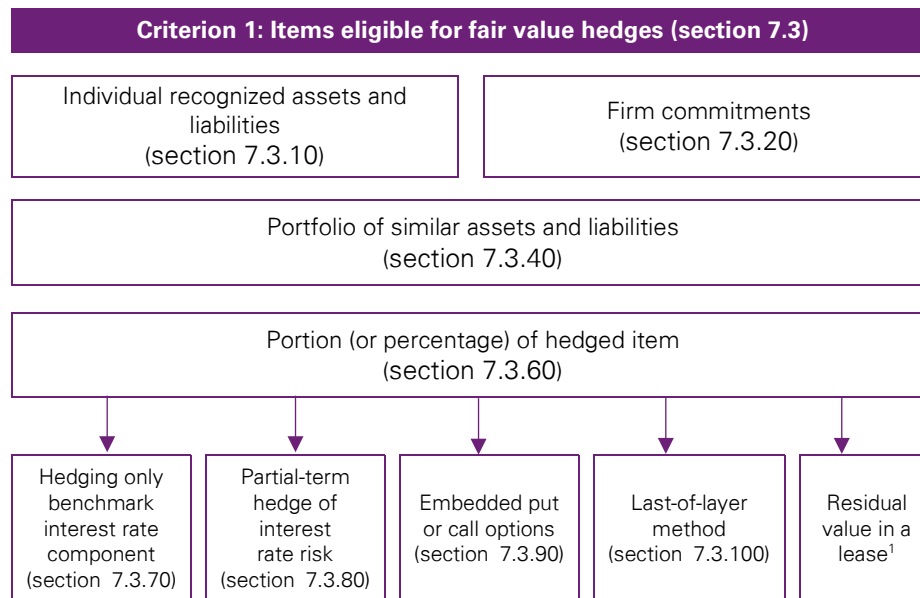
7.1 How the standard works

The objective of a **fair value hedge** is to reduce or eliminate the exposure to a change in fair value that is associated with an item due to its fixed price or rate.

Topic 815 requires that certain criteria be met for a hedging relationship to qualify for fair value hedge accounting.



Topic 815 specifies certain items that are eligible for designation as a hedged item in a fair value hedge.



Note:

1. Paragraph 815-20-25-12(b)(2)(iv).

Additionally, the risk(s) associated with the hedged item needs to qualify for hedge accounting. The risks eligible to be designated in a fair value hedge are different for financial and nonfinancial items.

Criterion 2: Risks eligible for fair value hedges		
	Financial items (section 6.3)	Nonfinancial items (section 6.4)
 Interest rate risk	— Changes in the benchmark interest rate for recognized fixed-rate financial instruments.	Not applicable.
 Credit risk	Includes: — changes in the obligor's creditworthiness; and — changes in the credit spread over the benchmark interest rate.	Not applicable.
 Foreign currency risk	— Changes in the related foreign currency exchange rates.	— Changes in the related foreign currency exchange rates if the firm commitment is denominated in a foreign currency.
 Price risk	— Total change in the fair value.	— Total change in the fair value.

Section 7.4 provides detail around the eligibility criteria for hedged risks that are specific to fair value hedges, including:

- interest rate risk on prepayable financial instruments; and
- limitations on price risk for nonfinancial items.

 **Foreign currency risk.** For further guidance on hedging foreign currency risk, see chapter 11.

Criterion 3: Hedging instruments eligible for fair value hedges	
General criteria for all hedging instruments (section 6.6)	General limitations on all hedging instruments (section 6.7)

Chapter 6 discusses the general criteria and limitations on hedging instruments for all hedges. There are no additional eligibility criteria or limitations specific to fair value hedges, other than fair value hedges involving foreign currency risk (see section 11.6.20).

Criterion 4: Hedge effectiveness (chapter 13)

A derivative hedging instrument can qualify as a hedging instrument only if the entity expects the changes in fair value of the instrument to be – and the

changes in fair value of the instrument actually are – effective at offsetting changes in fair value of the hedged item.

Criterion 5: Formal documentation for fair value hedges

Formal documentation requirements
for all hedges
(section 6.9)

Formal documentation requirements
specific to fair value hedges
(section 6.9.50)



Observation**

Optional expedients available in Topic 848

The guidance in this chapter does not consider the optional expedients that may be available in Topic 848 (reference rate reform) for hedging relationships that reference LIBOR or a reference rate that is expected to be discontinued. See 'Optional expedients available in Topic 848' in chapter 6 for discussion of expedients to hedge accounting that are not specific to a particular type of hedging relationship.

The key provisions of the optional expedients in Topic 848 that are specifically related to fair value hedges that an entity may elect to apply are summarized below.

- Change the designated benchmark interest rate from one that is expected to be discontinued due to reference rate reform to another eligible benchmark rate without terminating the hedging relationship. This expedient can only be applied if the referenced interest rate index of the **hedging instrument** changes (or two derivative instruments are combined) and the revised hedging relationship is expected to be highly effective prospectively. [848-40-25-2]
- Change the proportion of a designated hedged item or derivative hedging instrument that is designated in a fair value hedging relationship. [848-30-25-9(a)]

See 'Optional expedients available in Topic 848' in chapter 13 for discussion of expedients related to assessing hedge effectiveness for fair value hedges.

7.2 Objective of a fair value hedge

Fair value hedges are structured to reduce or eliminate the exposure resulting from a hedged item's fixed price or rate. Common examples of transactions that create such exposure are:

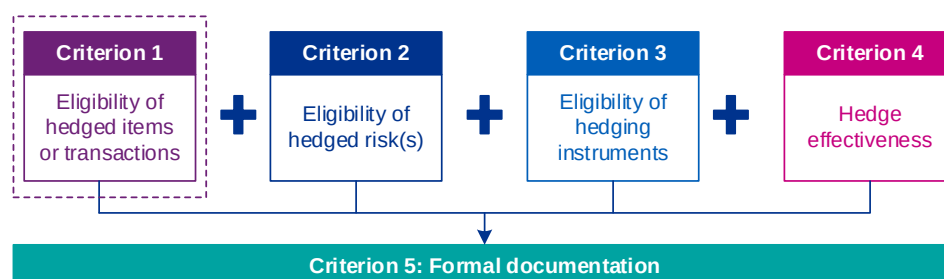
- lending money at fixed-rates;
- purchasing fixed-rate debt securities;
- issuing fixed-rate debt obligations; and
- making certain fixed-price commitments to purchase or sell assets and incur liabilities.

Such transactions expose an entity to changes in the fair value of the item. For example, when an entity holds a fixed-rate security, the entity bears the risk of a change in the market price of the security through the date on which it matures or is sold.

The following table includes common examples of fair value exposures and hedging strategies.

Hedged item	Fair value exposure	Hedging strategy
Recognized assets and liabilities		
Fixed-rate assets	Interest rate risk	Convert the interest received to variable by entering into an interest rate swap. Terms of the swap call for receipt of interest at a variable rate and payment of interest at a fixed rate.
	Price risk	Lock in a minimum value by purchasing a put option to sell the asset at a specified price.
Fixed-rate liabilities	Interest rate risk	Convert the interest paid to variable by entering into an interest rate swap. Terms of the swap call for receipt of interest at a fixed rate and payment of interest at a variable rate.
	Price risk	Lock in a maximum value by purchasing an interest rate floor option.
Firm commitments		
Commitment to issue a fixed-rate debt obligation	Changes in fair value due to changes in market interest rates to date of issuance	Participate in changes in market interest rates from the commitment date through the date of issuance by entering into an interest rate futures contract to purchase US Treasury securities.
Commitment to purchase inventory	Changes in fair value due to changes in market prices to date of purchase	Participate in changes in the fair value of the inventory to date of purchase by entering into a forward contract to sell inventory.
Commitment to sell inventory	Changes in fair value due to changes in market prices to date of sale	Participate in changes in the fair value of the inventory to date of sale by entering into a forward contract to purchase inventory.

7.3 Eligibility of hedged items



Section 7.3 discusses the criteria that must be met for items to be eligible for fair value hedge accounting. Topic 815 also prohibits certain items from hedge accounting, which are discussed in section 6.5.



Foreign currency risk. For guidance on the eligibility of hedged items in a fair value hedge of foreign currency risk, see section 11.4.10.

7.3.10 Basic requirements



Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-11 An entity may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof (hedged item) that is attributable to a particular risk if all applicable criteria in this Section are met.

25-12 An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following additional criteria are met:

- a. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment.

Only recognized assets or liabilities, or unrecognized firm commitments, are eligible to be designated as the hedged item in a fair value hedge. [\[815-20-25-12\]](#)



Question 7.3.10

Can unrecognized assets or liabilities ever be hedged items in a fair value hedge?

Interpretive response: Yes, but only if they embody a firm commitment. The FASB decided that an unrecognized asset or liability that does not embody a firm commitment should not be eligible for designation as a hedged item. This is because fair value hedge accounting for an unrecognized asset or liability (e.g. an internally developed core deposit intangible) would result in recognizing a portion of it. [\[FAS 133.BC437\]](#)

For example, a contingent liability should only be recorded if the contingency is probable and the amount of the liability can be reasonably estimated under Topic 450 (contingencies). It should not be recognized earlier through the application of hedge accounting.

However, an entity is permitted to designate unrecognized firm commitments, including one that is embodied in an unrecognized asset or liability (e.g. mortgage servicing rights), as the hedged item in a fair value hedge. [\[815-20-55-11\]](#)



Question 7.3.20

When hedging an unrecognized firm commitment, is the risk related to changes in forward or spot prices?

Interpretive response: Either. A firm commitment is subject to exposures that are similar to those of an existing asset or liability because they embody certain rights to benefits or obligations to make sacrifices. When the hedged item is an unrecognized firm commitment, entities are required to estimate its fair value. In doing so, entities may base their estimate of fair value on forward prices (because a firm commitment relates to rights or obligations that will be realized in the future) or on spot prices.

Therefore, when hedging changes in the fair value of a firm commitment attributable to changes in prices (i.e. price risk or foreign currency risk), entities may designate the risk being hedged as either changes in forward prices or changes in spot prices.

7.3.20 Firm commitments: Definition and identification



Excerpt from ASC 815-20

20 Glossary

Firm Commitment – An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

- a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield. The binding provisions of an agreement are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject. A price that varies with the market price of the item that is the subject of the firm commitment cannot qualify as a fixed price. For example, a price that is specified in terms of ounces of gold would not be a fixed price if the market price of the item to be purchased or sold under the firm commitment varied with the price of gold.
- b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment.

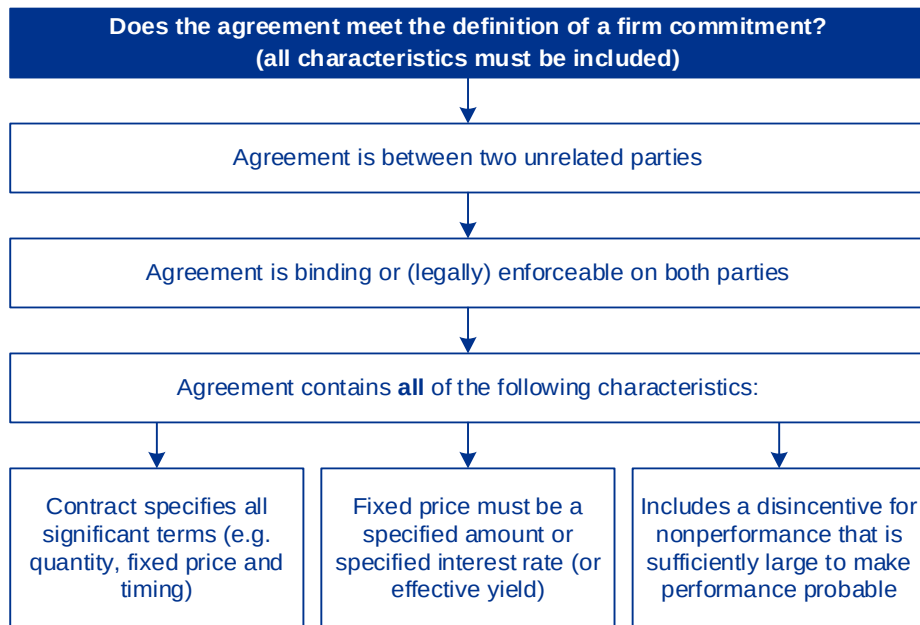
>>>> Application of the Definition of a Firm Commitment

55-10 This implementation guidance discusses whether certain items meet the definition of a **firm commitment** for purposes of paragraph 815-20-25-12.

55-11 A firm commitment that represents an asset or liability that a specific accounting standard prohibits recognizing (such as a lessor's noncancellable operating lease or an unrecognized mortgage servicing right) may nevertheless be designated as the hedged item in a **fair value hedge**.

55-12 A mortgage banker's unrecognized interest rate lock commitment does not qualify as a firm commitment (because as an option it does not obligate both parties) and thus is not eligible for fair value hedge accounting as the hedged item. (However, a mortgage banker's forward sale commitments, which are **derivative instruments** that lock in the prices at which the mortgage loans will be sold to investors, may qualify as hedging instruments in **cash flow hedges** of the forecasted sales of mortgage loans.)

The hedged item in a fair value hedging relationship can be an unrecognized firm commitment. Topic 815 defines a firm commitment by specifying certain characteristics that must be present, which are summarized below. [\[815-20 Glossary\]](#)



Examples of firm commitments that could be eligible for designation as hedged items include:

- an agreement to purchase a specified quantity of assets at a specified price and date;
- an agreement to purchase a particular machine in one year at a specified price; and
- a royalty agreement that provides for fixed periodic payments at specific time intervals; if no minimum amount is specified, the agreement would not meet the definition of a firm commitment because the quantity to be exchanged would be unknown.

Agreement is between two unrelated parties

A firm commitment must be between two unrelated parties. As a result, transactions with parties such as equity method investees, affiliates, unconsolidated joint ventures, consolidated entities, shareholders and directors are excluded from being firm commitments.

Agreement is binding or (legally) enforceable on both parties

To meet the definition of a firm commitment, the agreement must be binding on both parties.

The FASB noted that an agreement that is binding on one party but not the other is an option rather than a firm commitment. They believe the fundamental nature of a financial instrument should not be ignored. [FAS 133.BC441]

Firm commitments that meet the definition of a derivative (e.g. options) are not eligible to be designated in a fair value hedge. See discussion of this limitation in section 7.3.30.

**Example 7.3.10****Letter of intent to purchase steel**

ABC Corp. is a manufacturing entity. A major component of ABC's manufacturing (steel) is purchased from Metal Inc., an unrelated supplier. Steel is readily available from a number of suppliers and there is little cost associated with switching suppliers.

To ensure availability of steel, ABC has signed a letter of intent with Metal that specifies the likely requirements. The letter of intent is not legally binding and includes a fixed price. ABC is not required to pay a penalty if the letter of intent is cancelled.

Does the letter of intent with Metal meet the definition of a firm commitment?

No. The definition of a firm commitment requires a legally binding agreement.

Among other things, this agreement also lacks a sufficiently large economic disincentive restricting ABC from changing suppliers. ABC is not required to pay a penalty for cancelling the contract, steel is readily available from other suppliers and there is little cost to ABC for switching suppliers.

**Question 7.3.30****Do loan commitments or interest rate locks meet the definition of a firm commitment?**

Background: Loan commitments and interest rate lock commitments are legally binding commitments to extend credit to a counterparty under certain

pre-specified terms and conditions, with the interest rate and the maximum loan amounts set before funding. [815-10 Glossary]

Interpretive response: Neither a commitment to originate a loan nor an interest rate lock commitment obligate the potential borrower. Therefore, they do not meet the definition of a firm commitment and cannot be the hedged item in a fair value hedge. [815-20-55-12]

Characteristics of significant terms (including fixed price and disincentive for nonperformance)

The significant terms an agreement needs to specify include:

- the quantity to be exchanged;
- the fixed price; and
- the timing of the transaction.

The definition of a firm commitment requires that the fixed price be specified in terms of a currency (or an interest rate) rather than an index, or in terms of the price or a number of units of an asset other than a currency (e.g. ounces of gold).

In addition, the agreement must include a disincentive for nonperformance that is sufficiently large to make performance probable. The determination of whether a sufficiently large disincentive for nonperformance exists requires judgment based on the facts and circumstances of each contract.



Question 7.3.40

Can a price that varies with the market price of a fixed quantity of an item qualify as a fixed price?

Interpretive response: No. The definition of a firm commitment explicitly states that a price that varies with the market price of an item that is the subject of the firm commitment cannot qualify as a fixed price.

For example, an agreement to purchase a gold ring in one year would not be a firm commitment if payment were based on a fixed quantity of gold. This is because the price of gold is not fixed. The price of the fixed quantity of gold varies with the market price of the gold.

However, a contract with a price that varies with the market price of an item may qualify as a hedged item in a **cash flow hedge** of a forecasted transaction.



Example 7.3.20

Contract based on fair value at future date

ABC Corp. enters into a contract to sell in one month 100,000 bushels of wheat to XYZ at the then fair value. If ABC cancels this contract, it will be required to pay a \$50,000 penalty to XYZ.

Does the contract meet the definition of a firm commitment?

No. Because this contract provides for the sale of wheat to XYZ at fair value as opposed to a fixed price, it does not qualify as a firm commitment.



Question 7.3.50

Can a price specified in a foreign currency be a fixed price?

Interpretive response: Yes. A fixed price may be expressed as a specific amount of an entity's functional currency or of a foreign currency.

The price of a foreign currency denominated firm commitment is not fixed in terms of the entity's functional currency. However, Topic 815 explicitly allows foreign currency denominated firm commitments to be designated in fair value hedges of **foreign currency risk** (see section 11.4.50).

A firm commitment in a currency other than the entity's functional currency also exposes the entity to variability in cash flows due to changes in foreign currency exchange rates. Therefore, such commitments are also eligible to be designated in **cash flow hedges** of foreign currency risk (see section 11.6.40).



Example 7.3.30

Contract with fixed price specified in a currency other than the entity's functional currency

ABC Corp. is a manufacturing entity with a functional currency of the US Dollar. A major component in its manufacturing process (CPUs) comes from Asia Corp., an unrelated Japanese supplier. No other supplier has a product that meets ABC's specifications.

To ensure CPU availability, ABC enters into a contract with Asia to purchase a minimum of 1,000 CPUs each month for the next 12 months. The cost of each CPU is 10,000 yen. There are significant penalties if the contract is broken.

Does the contract meet the definition of a firm commitment?

Yes. The definition of a firm commitment requires a fixed price and quantity, that the timing of the transaction be known, and that the agreement include a sufficiently large disincentive for nonperformance to make performance probable. ABC's commitment has all of these features.

The fixed price may be expressed as a specific amount of an entity's functional currency or of a foreign currency (see Question 7.3.50). The fixed price has been specified in yen, a currency other than ABC's functional currency.

Therefore, this foreign currency denominated firm commitment is eligible for designation in a fair value foreign currency hedge if all other criteria are met (see sections 11.3 and 11.4).

Example 7.3.60 continues this example, illustrating the designation of a specific portion of a foreign currency denominated firm commitment as the hedged item.

Cash flow hedges. Because this foreign currency denominated firm commitment also exposes ABC to variability in cash flows due to changes in currency rates, it is also eligible to be a hedged transaction in a cash flow hedge of foreign currency risk (see sections 11.3 and 11.6).



Example 7.3.40

Payments made pursuant to royalty agreements

ABC Corp. pays royalties on each of the two products it sells. ABC's functional currency is the US Dollar.

For one of its products, ABC pays King Corp. royalties of 10% of its revenue on all US sales. The royalty payments are made on January 15 and July 15 each year in US Dollars. ABC has a very stable sales history and has consistently achieved its stated budgets. It expects to make royalty payments of \$5,000,000 on each of January 15 and July 15.

For its second product, ABC pays Queen PLC royalties on all sales in the UK of a product licensed from Queen. The royalties are paid in pounds sterling (£) and equal to £200,000 per quarter plus 2% of the quarterly revenue in excess of £5,000,000. The royalties are due 10 business days after the quarter-end. ABC expects to pay Queen £300,000 per quarter.

In both instances, ABC is subject to an enforceable contract with a third party and can estimate the quantity/price and timing of the payments with a high level of precision.

Does the agreement with King meet the definition of a firm commitment?

No. The definition of a firm commitment requires that the commitment have a fixed price and quantity to be exchanged. The royalty payments due under this contract depend solely on sales levels.

Those sales levels are not determinable in advance and the royalty agreement does not include contractual minimums. Therefore, the fixed price and quantity requirements for a firm commitment have not been satisfied.

Cash flow hedges. However, this contract may qualify as a hedged transaction in a cash flow hedge because the anticipated payments due under the contract may qualify as forecasted transactions.

Does the agreement with Queen meet the definition of a firm commitment?

Yes, because there is a £200,000 minimum contractual payment. That amount is not variable and is due to Queen regardless of revenue. The remaining amounts (i.e. any royalty payable over £200,000) should be considered in the same manner as the agreement with King.

Therefore, this foreign currency denominated firm commitment is eligible for designation in a fair value foreign currency hedge if all other criteria are met (see sections 11.3 and 11.4).



Question 7.3.60

Is there a requirement for the economic disincentive to be explicitly stated in a contract?



Excerpt from ASC 815-25

>> Example 13: Definition of Firm Commitment

55-84 This Example illustrates a circumstance in which statutory remedies for default constitute a disincentive for nonperformance in applying the definition of a firm commitment. Entity A enters into an agreement to purchase 4,000 barrels of a common solvent from a chemical entity at \$200 per barrel on June 1, 2000. The provisions of the agreement do not include a specific disincentive for nonperformance that is sufficiently large to make performance probable. However, the laws of the legal jurisdiction to which the agreement is subject provide a disincentive for nonperformance if Entity A does not take delivery of the barrels pursuant to the agreement. The solvent is not **readily convertible to cash**. Therefore, because the governing legal jurisdiction provides statutory rights to pursue remedies for default equivalent to the damages suffered, the agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable for purposes of applying the definition of a firm commitment.

Interpretive response: A sufficiently large disincentive for nonperformance is required for a contract to be a firm commitment. This penalty does not need to be explicitly contained in the contract.

This requirement would be met if the legal jurisdiction that governs the agreement provides statutory remedies for default equivalent to the damages suffered by the non-defaulting party, even though the agreement itself does not include an explicit monetary penalty for nonperformance. [815-20-55-84]

In other words, the sufficiently large disincentive for nonperformance criterion can be met if the counterparty to a transaction may initiate legal remedies that constitute a sufficiently large disincentive. [815-20 Glossary]

This is illustrated in Subtopic 815-25's FASB Example 13 above.



Question 7.3.70

Can the disincentive for nonperformance be in the form of opportunity cost?

Background: A manufacturer enters into a commitment to purchase certain raw materials from one supplier. The transaction is considered probable

because to purchase the same raw materials from other suppliers would be significantly more expensive.

Interpretive response: A disincentive for nonperformance cannot be in the form of opportunity costs. Such a disincentive is not included in an agreement, nor is it part of the legal rights or obligations codified in the laws to which such agreements are subject. Therefore, an agreement with a disincentive based solely on opportunity cost does not qualify as a firm commitment.



Question 7.3.80

Can the disincentive for nonperformance be in the form of a potential writeoff?

Background: A significant amount of capitalized assets related to an in-process project may be considered worthless if certain materials needed to complete a project are not purchased from a particular supplier.

Interpretive response: A disincentive for nonperformance cannot be in the form of a potential writeoff. Such a disincentive is not included in an agreement, nor is it part of the legal rights or obligations codified in the laws to which such agreements are subject. Therefore, an agreement with a disincentive based solely on a potential write-off does not qualify as a firm commitment.

7.3.30 Firm commitments: Limitation on contracts that meet the definition of a derivative



Excerpt from ASC 815-20

>>> Normal Purchases and Normal Sales as Hedged Items or Transactions

25-7 A contract that is not subject to the requirements of Subtopic 815-10 because it qualifies for the normal purchases and normal sales scope exception may be designated as a hedged item in a fair value hedge, if the provisions of this Section are met. As the hedged item, the contract would be accounted for under fair value hedge accounting. Similarly, the purchase under that contract may be the hedged transaction in a cash flow hedge, if the provisions of paragraph 815-20-25-15 are met. For cash flow hedges, the special accounting applies to the hedging instrument, not to the purchase contract that is related to the hedged forecasted transaction.

25-8 In emphasizing the conditions in the definition of a **derivative instrument** in paragraphs 815-10-15-83 through 15-139, paragraphs 815-10-15-13 through 15-82 essentially exempt contracts that meet the definition of a derivative instrument from the requirements of Subtopic 815-10 applicable to derivative instruments. However, paragraphs 815-10-15-13 through 15-82 are not

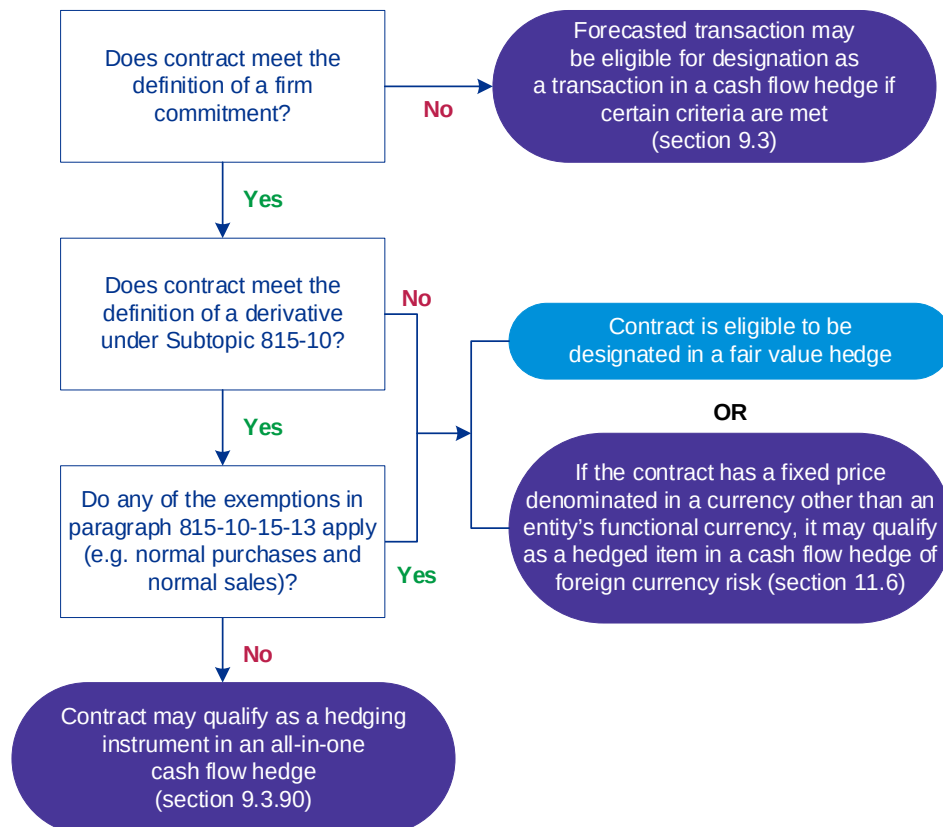
intended to preclude such contracts from being subject to the requirements of Subtopic 815-10 applicable to the hedged item in a fair value hedge.

25-9 A contract that qualifies for the normal purchases and normal sales exception will typically satisfy the criteria for a firm commitment and will not be recognized on an entity's financial statements because of the exclusion from recognition under Subtopic 815-10 or other Topics. The transaction under a contract that qualifies for the normal purchases and normal sales exception but does not satisfy the criteria for a firm commitment because the contract does not contain a fixed price may be the hedged transaction in a cash flow hedge.

If a firm commitment is also a derivative instrument in the scope of Subtopic 815-10, it cannot be designated as a hedged item in a fair value hedge. Rather, it is accounted for as a derivative instrument.

A firm commitment is not in the scope of Topic 815 if it meets the NPNS scope exception (or any other scope exception in that Subtopic); see chapter 2 for guidance about scope exceptions, including section 2.4 about the NPNS scope exception. Therefore, a firm commitment that is a derivative instrument but that qualifies for this exception and is not accounted for as a derivative can be a hedged item in a fair value hedge. [815-20-25-7]

The following decision tree provides an overview of the considerations to determine whether a firm commitment is eligible to be designated as a hedged item in a fair value, cash flow or foreign currency hedge.





Question 7.3.90

Can a firm commitment that is accounted for as a derivative ever qualify as a hedging instrument?

Interpretive response: Yes. If a firm commitment does not meet any of the scope exceptions in paragraph 815-10-15-13 (e.g. NPNS scope exception), it is treated as a derivative and may be used as the **hedging instrument** in a hedging relationship. For example, it may qualify as a hedging instrument for the forecasted purchase or sale that will result from the firm commitment. This is referred to as an 'all-in-one' **cash flow hedge** (see section 9.3.90).



Example 7.3.50

Firm commitment to purchase silver with a forward contract

ABC Corp. produces silver platters for sale to department stores. The sales price of the silver platters depends in large part on the market price of silver at the date of sale. ABC has a contract to purchase 100,000 ounces of silver from DEF at \$4.99 per ounce on December 31, Year 1.

If ABC does not purchase the silver from DEF, it will be required to pay DEF a substantial penalty of \$300,000. ABC is not required to make an up-front cash payment. There is no net settlement provision in the contract. Further, the quantities of silver delivered under the contract are expected to be used by ABC over a reasonable period in the normal course of business.

ABC is concerned about fluctuations in the price of silver during the commitment period. This would cause the inventory to be recorded at prices other than the market price at the date of purchase. Therefore, ABC wishes to enter into a transaction to hedge the risk of changes in the fair value of the forward contract due to changes in the market price of silver.

Does the forward contract meet the definition of a firm commitment?

Yes. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price and the timing of the transaction. The agreement also includes a disincentive for nonperformance that is sufficiently large to make performance probable. Therefore, the forward contract meets the definition of a firm commitment.

Does the contract meet the definition of a derivative under Subtopic 815-10?

Yes. The contract meets the definition of a derivative under Subtopic 815-10 because: [\[815-10-15-83\]](#)

- it has an underlying and a notional amount – i.e. price of silver, and 100,000 ounces of silver;
- no initial investment is required; and
- the contract provides for delivery of an asset (i.e. silver) that is readily convertible to cash.

Do any of the exemptions in paragraph 815-10-15-13 apply (e.g. NPNS scope exception)?

Yes. Although the contract meets the definition of a derivative, it qualifies for the NPNS scope exception based on the following.

- The quantities of silver delivered under the contract are expected to be used over a reasonable period in the normal course of business. [815-10-15-27]
- The contract does not include a price adjustment. Therefore, ABC is not required to assess whether the underlying is clearly and closely related to the asset being purchased. [815-10-15-30]
- ABC documents the designation of the contract as a normal purchase or a normal sale.

Does the forward contract qualify to be designated as a hedged item?

Yes. The forward contract may present an earnings exposure to ABC because as the market price of silver changes, the amount at which ABC can sell the silver platters will also change. As a result, ABC can hedge the exposure related to the forward contract assuming all other eligibility criteria are met.

Example 8.3.40 continues this example, illustrating the accounting for a fair value hedge of a firm commitment to purchase silver with a forward contract.

7.3.40 Portfolio of similar assets or liabilities**Excerpt from ASC 815-20****>> Hedged Item Criteria Applicable to Fair Value Hedges Only**

25-12(b)(1) If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities shall share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio shall be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. See the discussion beginning in paragraph 815-20-55-14 for related implementation guidance. An entity may use different stratification criteria for the purposes of impairment testing and for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge.

>>>> Determining Whether Risk Exposure is Shared within a Portfolio

55-14 This implementation guidance discusses the application of the guidance in paragraph 815-20-25-12(b)(1) that the individual assets or individual liabilities within a portfolio hedged in a fair value hedge shall share the risk exposure for which they are designated as being hedged. If the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in

the portfolio would range from 7 percent to 13 percent would be inconsistent with the requirement in that paragraph.

For assets or liabilities to be aggregated and hedged as a portfolio, at the inception of the hedging relationship and on an ongoing basis, each asset or liability *individually* needs to: [\[815-20-25-12\(b\)\(1\)\]](#)

- share the same risk exposure as the risk designated as being hedged; and
- be expected to respond proportionately to the total change in fair value of the hedged portfolio attributable to the hedged risk.



Question 7.3.100

Are there acceptable ranges when evaluating shared risk exposure?

Interpretive response: Topic 815 provides an example illustrating an acceptable range of changes in fair value.

If the change in the fair value of a hedged portfolio attributable to the hedged risk were 10%, then the change in fair values attributable to the hedged risk for *each* item in the portfolio should be within a relatively narrow range, such as 9%–11% (i.e. 90%–110% of the change in fair value of the hedged portfolio attributable to the hedged risk of 10%). The example further illustrates that a range of 7%–13% (i.e. 70%–130% of the change in fair value of the hedged portfolio attributable to the hedged risk of 10%) would indicate the items are not similar. [\[815-20-55-14\]](#)

Based on this example, we believe that items in a portfolio are similar if the change in fair value of each individual item in the portfolio attributable to the risk being hedged is expected to move in the same direction within 80%–120% of the percentage change in the fair value of the aggregate hedged portfolio attributable to the hedged risk.

Therefore, if the change in the fair value of a hedged portfolio is 5%, the acceptable range for each individual item in the portfolio would be 4%–6% – i.e. 80%–120% of the 5% change in total fair value of portfolio.

However, in certain circumstances we believe an entity could perform a qualitative assessment when evaluating shared risk exposure. See Questions 7.3.120 and 7.3.150.



Question 7.3.110

How often should the evaluation of the similarity of items hedged in a portfolio be performed?

Interpretive response: To continue applying hedge accounting, hedged items in the portfolio must continue to be similar. Therefore, the similarity test should

be performed prospectively on a recurring basis. We believe the evaluation of 'similar' should be performed each period that hedge effectiveness is assessed.

For example, if it were expected over the course of the next hedge assessment period that the portfolio would not continue to be similar as a consequence of changes in market factors, an entity cannot continue applying hedge accounting.

However, there is an exception for hedges applying the last-of-layer method, whereby an entity is permitted to perform this assessment only at hedge inception (see Question 7.3.310).



Question 7.3.120

Are periodic similarity tests required to be performed on a quantitative basis?

Interpretive response: Not necessarily. Instead of performing a quantitative assessment each period, we believe an entity could perform a qualitative assessment in certain circumstances. This will require judgment and should be based on a variety of factors, including the extent of the quantitative analysis performed at inception of the hedge and the nature of the items being hedged.

For example, an entity could perform detailed stress testing around changes in market factors to develop a range based on impact to the similarity of items in a portfolio. In other words, whether changes in market factors would cause items to be outside the acceptable range for concluding that each individual item shares similar risk exposure. Any subsequent similarity assessments could be limited to monitoring whether hedged items are trending within the range originally expected and confirming that market factors did not change in a way that wasn't originally considered in the stress testing.

If facts and circumstances regarding the portfolio change, or changes are not within the range originally expected, the entity should perform a quantitative assessment to determine whether the items continue to be similar.



Question 7.3.130

Should the similarity assessment for servicing rights use the same risk characteristics as those used in the impairment assessment under Topic 860?



Excerpt from ASC 815-20

>>>> Servicing Rights as a Hedged Item

55-16 Paragraph 815-20-25-12(b)(1) provides criteria under which similar assets or similar liabilities may be aggregated and hedged as a portfolio under a fair value hedge, requiring, in part, that the individual assets or individual liabilities

share the risk exposure for which they are designated as being hedged. Servicers of financial assets that designate a hedged portfolio by aggregating servicing rights within one or more risk strata used under paragraph 860-50-35-9 would not necessarily comply with the requirement in paragraph 815-20-25-12(b)(1) for portfolios of similar assets because the risk strata under paragraph 860-50-35-9 can be based on any predominant risk characteristic, including date of origination or geographic location.

Interpretive response: An entity is required by Topic 860 (transfers and servicing) to aggregate servicing rights for purposes of assessing impairment. This includes stratifying servicing assets within a class based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type, size, interest rate, date of origination, term and geographic location. For mortgage loans, financial asset type refers to the various conventional or government guaranteed or insured mortgage loans and adjustable-rate or fixed-rate mortgage loans. [\[860-50-35-9\]](#)

When considering the similarity of the individual items to determine whether they can be hedged as a portfolio, an entity is not required to aggregate servicing rights in the same manner as when assessing impairment. That is because the risk strata used for impairment testing may not be sufficient to satisfy the similarity requirements for portfolio hedging. [\[815-20-55-16\]](#)



Question 7.3.140

Can a first cash flows received (paid) approach be used in a fair value hedge?

Background: For a **cash flow hedge**, the hedged transaction can be identified as the first cash flows received or paid to a specific amount in a particular period (without reference to the specific asset or liability) when hedging a group of transactions (see section 9.3.30).

Interpretive response: No. A first cash flows received (paid) approach does not require an entity to specifically identify the asset or liability for which the forecasted transaction relates. In general, Topic 815 requires fair value hedge accounting to be applied to individual assets or liabilities or portions of individual assets or liabilities, including those hedged in a portfolio (see section 8.3.30 for guidance on portfolio-level basis adjustments). Therefore, we believe an entity needs to specifically identify the individual assets or liabilities (or portions thereof) within the portfolio as the hedged item, with the exception of the last-of-layer method. [\[FAS 133.432, ASU-2017.BC109\]](#)

Under the last-of-layer method, the hedged item can be designated as a stated amount remaining in a closed portfolio of prepayable assets (see section 7.3.100). The designation of the hedged item under this method is effectively the inverse of how the hedged item is designated when a first cash flows received (or paid) approach is used for a cash flow hedge. [\[815-20-25-12A, ASU2017.BC109–BC110\]](#)

7.3.50 Hedging portfolios: Assessing similar risks for a portfolio of loans



Excerpt from ASC 815-20

>>>> Determining Whether Risk Exposure is Shared within a Portfolio

55-15 In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate:

- a. Loan type
- b. Loan size
- c. Nature and location of collateral
- d. Interest rate type (fixed or variable)
- e. Coupon interest rate or the benchmark rate component of the contractual coupon cash flows (if fixed)
- f. Scheduled maturity or the assumed maturity if the hedged item is measured in accordance with paragraph 815-25-35-13B
- g. Prepayment history of the loans (if seasoned)
- h. Expected prepayment performance in varying interest rate scenarios.

Topic 815 provides characteristics to be considered when assessing similarity in a portfolio of loans, including the type of loan and its scheduled maturity. [815-20-55-15]

For individual loans to be considered similar and aggregated in a portfolio, there must be an expectation that the change in fair value attributable to the hedged risk for each individual loan responds in a generally proportionate manner to the overall change in fair value of the portfolio attributable to the hedged risk – i.e. changes in interest rates, which may also require consideration of prepayment risk.



Question 7.3.150

Which key characteristics of a loan are considered when evaluating whether individual loans share similar risk exposure?

Interpretive response: It depends. By defining the portfolio of loans in a restrictive manner (e.g. similar settlement terms, collateralized by property in the same geographic region, similar scheduled maturities and similar interest rates), each loan in a portfolio may be expected to meet the similarity test. That is, each loan may be considered to have the same exposure to prepayment risk since each loan has a similar prepayment option. [815-20-55-176]

However, there are some fair value hedging strategies that provide opportunities for an entity to designate the hedged components of financial instruments within a portfolio in a manner that will result in those items sharing the same maturity and/or coupon rate (solely for hedge accounting purposes).

Benchmark rate component (section 7.3.70)	Fixed-rate financial instruments can have the same benchmark rate component designated as the hedged item.
Partial-term hedges (section 7.3.80)	Maturities of financial instruments can be defined as the same partial term.
Last-of-layer method (section 7.3.100)	Assumes all prepayable financial assets in a closed portfolio have the same maturity and benchmark coupon rate.

An entity may designate the hedged item and the benchmark rate component (e.g. LIBOR) to be the same.

For example, assume an entity wants to aggregate and hedge a portfolio of five loans.

	Contractual terms of loans		Hedge using partial-term and benchmark rate components	
	Remaining maturity	Interest rate	Remaining maturity	Interest rate
Loan 1	24 months	6%	17 months	LIBOR component
Loan 2	17 months	5%	17 months	LIBOR component
Loan 3	21 months	7%	17 months	LIBOR component
Loan 4	26 months	5%	17 months	LIBOR component
Loan 5	28 months	6%	17 months	LIBOR component

If the entity hedges the portfolio using the benchmark interest rate component and/or the partial-term guidance, it may be more likely that it could assess similarity qualitatively (see Question 7.3.120). In the example above, applying these approaches in combination would allow the entity to assume all five loans have the identical coupon rate (i.e. the LIBOR component of the fixed interest coupons) and mature on the identical date (i.e. in 17 months).

However, depending on the type of hedge, an entity may still need to consider items such as loan type, collateral, prepayment expectations, etc. For example, a more complex similarity test is required if the entity aggregates loans based on contractual terms. This is illustrated in Subtopic 815-20's Example 19 below.

FASB Example: Hedging a portfolio of fixed-rate financial assets



Excerpt from ASC 815-20

>> Example 19: Hedging a Portfolio of Fixed-Rate Financial Assets

55-173 This Example illustrates the application of paragraphs 815-20-25-12(b)(1) and 815-20-25-75 to a hedge of a portfolio of fixed-rate financial assets.

55-174 Entity A has a portfolio of seasoned, one to four family, fixed-rate mortgages that it wishes to designate as the hedged item in a fair value hedge of the benchmark interest rate (LIBOR). Each loan within the portfolio has similar settlement terms, is collateralized by property in the same geographic region, and has similar scheduled maturities. The loans are all within a specified interest rate band and are prepayable at par; each of the loans contained in the portfolio is expected to react in a generally proportionate manner to changes in the benchmark interest rate based on calculations performed by Entity A.

55-175 Entity A enters into a pay-fixed, receive-LIBOR interest rate swap with a fair value of zero at the inception of the hedging relationship. The stated maturity of the interest rate swap is consistent with the stated maturities of the loans. The notional amount of the interest rate swap amortizes based on a schedule that is expected to approximate the principal repayments of the loans (excluding prepayments). There is no optionality included in the interest rate swap. As part of its documented risk management strategy associated with this hedging relationship, on a quarterly basis, Entity A intends to do both of the following:

- a. Assess effectiveness of the existing hedging relationship on a quantitative basis for the past three-month period
- b. Consider possible changes in value of the hedging derivative and the hedged item over the next three months in deciding whether it has an expectation that the hedging relationship will continue to be highly effective at achieving offsetting changes in fair value.

55-176 Entity A's portfolio of loans satisfies the requirements of paragraph 815-20-25-12(b)(1) regarding the grouping of similar assets because the portfolio of loans has been defined in a restrictive manner and Entity A determined, by calculation, that each of the loans contained in the portfolio is expected to react in a generally proportionate manner to changes in the benchmark interest rate. Even though certain of the loans may prepay, each loan still may be considered to have the same exposure to prepayment risk because each loan has a similar prepayment option. When aggregating loans in a portfolio, an entity is permitted to consider among other things prepayment history of the loans (if seasoned) and expected prepayment performance in varying interest rate scenarios.

55-177 Entity A's documented hedging strategy meets the requirements of paragraph 815-20-25-75 for a prospective assessment of effectiveness provided the entity established that the hedging relationship is expected to be

highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated.

55-178 Paragraph 815-20-25-79(a) explains that a probable future change in fair value will be more heavily weighted than a reasonably possible future change. For example, Entity A could assign a probability weighting to each possible future change in value of the hedged portfolio. Depending on the level of market interest rates and the expected prepayment rates for the types of loans in the hedged portfolio, Entity A may reach a conclusion that the change in fair value of the swap will be highly effective at offsetting the change in the value of the portfolio of loans, inclusive of the prepayment option. As a result of this analysis, management would conclude that hedge accounting is permitted for the hedging relationship for the next three-month period. Management is required to assess the effectiveness of the existing hedging relationship for the past three-month period. If necessary, the notional amount of the swap in excess of the portfolio balance at the end of each three-month period must be dedesignated to allow high effectiveness to continue in the future.

7.3.60 Portion (or percentage) of a hedged item



Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable for Fair Value Hedges Only

25-12(b)(2) If the hedged item is a specific portion of an asset or liability (or of a portfolio of similar assets or a portfolio of similar liabilities), the hedged item is one of the following:

- i. A percentage of the entire asset or liability (or of the entire portfolio). An entity shall not express the hedged item as multiple percentages of a recognized asset or liability and then retroactively determine the hedged item based on an independent matrix of those multiple percentages and the actual scenario that occurred during the period for which hedge effectiveness is being assessed.
- ii. One or more selected contractual cash flows, including one or more individual interest payments during a selected portion of the term of a debt instrument (such as the portion of the asset or liability representing the present value of the interest payments in any consecutive two years of a four-year debt instrument). Paragraph 815-25-35-13B discusses the measurement of the change in fair value of the hedged item in partial-term hedges of **interest rate risk** using an assumed term.
- iii. A put option or call option (including an interest rate cap or price cap or an interest rate floor or price floor) embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 815-15-25-1.
- iv. The residual value in a lessor's net investment in a direct financing or sales-type lease.

>> Example 2: Portions and Portfolios of Individual Items as Hedged Item

55-81 This Example illustrates the application of paragraph 815-20-25-12.

55-82 An entity that issues \$100 million of fixed-rate debt may wish to hedge 50 percent of its fair value exposure to interest rate risk, as permitted by paragraph 815-20-25-12(b)(2). To accomplish that, the entity could enter into an interest rate swap with a notional amount of \$50 million. The paragraph 815-20-25-104(a) criterion is satisfied because the entity has designated as a fair value hedge 50 percent of the contractual principal amount as the hedged item and has entered into an interest rate swap with a notional amount that matches the hedged principal amount.

55-83 If \$100 million of fixed-rate debt were issued in increments of \$1,000 individual bonds, the entity could aggregate 50,000 of those individual bonds as a portfolio to equal the notional amount of the swap, as permitted by paragraph 815-20-25-12(b)(1) (for the purposes of this Example, it is assumed that the hedge satisfies the portfolio requirements of that paragraph).

An entity can hedge a portion or percentage of an asset, liability or firm commitment. However, the specific portion (or percentage) must be identified.

For example, an entity could hedge 70% of its exposure to interest rate risk related to a specified debt obligation by designating 70% of the principal amount of the debt as the hedged item, and entering into an interest rate swap with a notional amount equal to the portion of the debt designated as the hedged item.

%↑ Interest rate risk. Topic 815 also provides an entity with additional choices when designating the hedged item in a fair value hedge of interest rate risk, which include both of the following.

Benchmark rate component (section 7.3.70)	Benchmark rate component of fixed-coupon interest cash flows.
Partial-term hedges (section 7.3.80)	Selected contractual cash flows, including one or more selected consecutive interest payments, for part of the financial instrument's remaining term.

**Question 7.3.160**

Can an entity designate a portion or percentage of a nonfinancial item as the hedged item?

Interpretive response: It depends. If a nonfinancial asset or liability (other than a recognized loan servicing right or a nonfinancial firm commitment with financial components) is the hedged item, the designated risk being hedged is the risk of changes in the fair value of the entire hedged asset or liability (i.e. price risk). [815-20-25-12(e)]

Therefore, an entity is unable to designate only a portion or percentage of the nonfinancial asset or liability as the hedged item. For guidance on limitations when hedging price risk for nonfinancial assets and liabilities in a fair value hedge, see section 7.4.20.

 **Foreign currency risk.** However, if the hedged item is a foreign currency denominated firm commitment to purchase a nonfinancial asset in a fair value hedge of foreign currency risk, we believe an entity can designate a specific portion as the hedged item when hedging foreign currency risk. For guidance on hedging foreign currency denominated firm commitments, see section 11.4.50.

Cash flow hedges. The restriction on hedging a specific component of a nonfinancial item differs from guidance for cash flow hedges, which allows an entity to hedge a contractually specified component.



Example 7.3.60

Specific portion of a foreign currency denominated firm commitment

This example uses the same facts and circumstances as Example 7.3.30. For ease of reference, they are summarized below.

ABC Corp. is a manufacturing entity with a functional currency of the US Dollar. A major component in its manufacturing process (CPUs) comes from Asia Corp., an unrelated Japanese supplier. No other supplier has a product that meets ABC's specifications. To ensure CPU availability, ABC enters into a contract with Asia to purchase a minimum of 1,000 CPUs each month for the next 12 months. The cost of each CPU is 10,000 yen. There are significant penalties if the contract is broken.

Assume the contract meets the definition of a firm commitment and all other eligibility criteria are met.

Foreign currency risk

ABC wishes to hedge foreign currency risk associated with the first 500 units being acquired each month. In this instance, ABC has identified a specific portion of the firm commitment because there is no uncertainty as to which units are being hedged. Therefore, the first 500 units being acquired each month can be designated as the hedged item. For guidance on fair value hedges of foreign currency risk, see section 11.4.

However, ABC cannot designate the hedged item as being the foreign currency exposure associated with *any* 500 units being acquired each month. Because the hedged item could be any 500 units acquired during the month, ABC has not identified a specific portion as the hedged item. This portion of the firm commitment would not be eligible for hedge accounting.

Price risk

ABC cannot hedge price risk associated with a portion of the firm commitment to purchase CPUs. For limitations on price risk for nonfinancial items, see section 7.4.20.

Prohibition of preset hedge coverage ratios for servicing right assets



Excerpt from ASC 815-20

>>> Prohibition of Preset Hedge Coverage Ratios

55-63 Subtopic 860-50 requires that if an entity subsequently measures servicing assets and servicing liabilities using the amortization method, any impairment of servicing assets, which is the amount by which the carrying amount of the servicing assets for an individual stratum exceeds their fair value, be recognized in current earnings. However, an increase in the fair value above the carrying amount of servicing assets for an individual stratum may not be recognized in current earnings.

55-64 Entities that service certain types of financial assets may wish to designate as the hedged item in a fair value hedge a prespecified percentage of the total change in fair value of those servicing rights (attributable to the hedged risk) that varies based on changes in a specified independent variable. Because the prespecified percentage for each specified independent variable can be presented in a rectangular array, that method of determining the hedged item retroactively based on the actual independent variable is sometimes referred to as the matrix method. Under that approach, at the end of the hedge assessment period, the entity would determine the hedged item and assess hedge effectiveness by determining retrospectively which hedge coverage ratio would be applied to the servicing right asset to identify the hedged item for that period. That approach is in contrast to designating the hedged item at the inception of the hedge by specifying a single percentage of that recognized servicing right asset as the hedged item.

55-65 In a fair value hedge of a portion of a recognized servicing right asset subsequently measured using the amortization method and its related impairment analysis, an entity may not designate the hedged item at the inception of the hedge by initially specifying a series of possible percentages of the servicing right asset (that is, preset hedge coverage ratios) and then determining at the end of the assessment period what specific percentage of the servicing right asset is the actual hedged item for that period based on the change in a specified independent variable during that period. Such a matrix method would not be a valid application of the provisions of this Subtopic.

55-66 Paragraph 815-20-25-12(b)(2)(i) precludes an entity from expressing the hedged item as multiple percentages of a recognized asset or liability and then retroactively determining the hedged item based on an independent matrix of those multiple percentages and the actual scenario that occurred during the period for which hedge effectiveness is being assessed.

55-67 There is a limited exception under paragraph 815-20-25-10 in which a collar that is comprised of one purchased option and one written option that have different notional amounts is designated as the hedging instrument, and the hedged item is specified as two different proportions of the same asset based on the upper and lower rate or price range of the asset referenced in those two options.

An entity may designate a specific percentage of a recognized servicing asset as the hedged item at inception. However, an entity may *not* designate a series of possible percentages of servicing right assets (referred to as preset hedge coverage ratios) that each correspond to a specified independent variable (e.g. an interest rate). [815-20-55-65]

Under this approach, at the end of the hedge assessment period, an entity would determine the hedged item and measure hedge effectiveness by determining retrospectively which hedge coverage ratio would be applied when designating the hedged item for that period. In other words, the percentage of assets being hedged changes after hedge inception and is not determinable until the end of the hedge period.

This is different from designating a specific percentage of the recognized servicing right asset as the hedged item at inception.

There is one exception to the general concept that a single percentage of the entire asset or liability (or portfolio) must be designated at inception of the hedge as the hedged item. This strategy incorporates a collar that has different notional amounts for the purchased and written option components (see Question 13.2.290).

7.3.70 Hedging portions of financial items: Benchmark interest rate component



Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-12 An asset or liability is eligible for designation as a hedged item in a fair value hedge if all of the following additional criteria are met: ...

- f. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is any of the following: ...
 2. The risk of changes in its fair value attributable to changes in the designated benchmark interest rate (referred to as interest rate risk)



Excerpt from ASC 815-25

>> Changes Involving Interest Rate Risk

35-13 In calculating the change in the hedged item's fair value attributable to changes in the **benchmark interest rate** (see paragraph 815-20-25-12(f)(2)), the estimated coupon cash flows used in calculating fair value shall be based on either the full contractual coupon cash flows or the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception.

 **Interest rate risk.** Topic 815 provides an entity with a choice of measuring the change in a hedged item's fair value attributable to the changes in the benchmark interest rate based on either the hedged item's: [\[815-25-35-13\]](#)

- entire contractual coupon cash flows; or
- the benchmark rate component of the contractual coupon cash flows determined at inception of the hedging relationship.

This election affects an entity's assessment of **hedge effectiveness** and fair value hedge accounting because of its effect on the measurement of the hedged item. [\[815-25-35-13A\]](#)

Section 8.3.20 provides detailed guidance on using either the hedged item's entire contractual coupon cash flows or using the benchmark rate component of the contractual coupon cash flows to measure the change in the hedged item's fair value.



Question 7.3.170

Which benchmark interest rate may be used for measurement purposes when hedging only the benchmark rate component?

Interpretive response: Topic 815 uses the term 'benchmark rate' component of the contractual coupon cash flows. We believe 'benchmark rate' refers to the Benchmark Interest Rate as defined in the Master Glossary.

An entity may use any rate that meets the Master Glossary definition of a Benchmark Interest Rate to measure the change in the hedged item's fair value attributable to interest rate risk. In the United States, the interest rates on direct Treasury obligations of the US government, the LIBOR swap rate, the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate) and the SIFMA Municipal Swap Rate are considered to be benchmark interest rates. For more information on benchmark interest rates, see section 6.3.30.

[\[815-20-25-6A, 815-20 Glossary\]](#)



Question 7.3.180

May an entity separately designate the fixed rate subject to inflation adjustments as a benchmark rate component?

Interpretive response: No. At a September 2018 Board meeting, the FASB noted an entity could not separately designate the benchmark interest rate component of an otherwise fixed interest rate as the hedged item in a fair value hedge if the fixed interest rate was subject to inflation adjustments. This is because the overall rate is considered to be a variable rate, as opposed to a fixed rate, and interest rate components of variable rate instruments can only be the hedged risk when they are contractually specified. [\[FASB meeting 09-18\]](#)

For example, an entity owns fixed-rate debt instruments with an inflation-adjusted principal that fluctuates based on an inflation index. Interest payments are calculated based on the fixed rate and the inflation-adjusted principal balance. Because of the inflation adjustment, the rate is not considered to be a fixed-rate. As a result, the entity would not be able to hedge a benchmark component in a fair value hedge.

Because these are considered variable-rate instruments, the entity may hedge the variability in cash flows using a **cash flow hedge**.



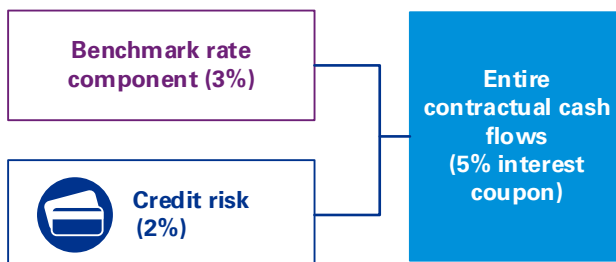
Question 7.3.190

Why would an entity designate only the benchmark rate component?

Interpretive response: For hedge accounting purposes, using only the benchmark rate component of the contractual coupon cash flows of a financial instrument can provide a better offset between the changes in the fair values of the hedging instrument (e.g. an interest rate swap) and hedged item attributable to interest rate risk. Therefore, we expect that many entities will use the benchmark rate component.

Certain hedging relationships could even be perfectly effective; see Case B of Subtopic 815-25's Example 9 in section 8.3.20. [\[815-25-55-61C\]](#)

In addition, using the benchmark rate component for hedge accounting may better reflect how entities manage interest rate risk. For example, assume a bond has a 5% interest coupon. If the benchmark rate component is 3%, the additional 2% could be viewed as a reflection of credit risk.



Using the entire contractual coupon cash flows to assess hedge effectiveness incorporates credit risk into the hedge effectiveness assessment. If an entity's risk management strategy is to hedge only the changes in the benchmark interest rate without hedging credit spreads, applying hedge accounting to the total contractual coupon results in misalignment between the risk management strategy and hedge accounting.



Question 7.3.200

If an entity uses the benchmark rate component to measure the change in fair value of a hedged item, must it do so for all similar hedging relationships?

Interpretive response: No. For fair value hedges, the election to use either the entire contractual coupon or the benchmark rate component cash flows to measure the change in the hedged item's fair value attributable to interest rate risk is made on a hedge-by-hedge basis. [ASU 2017-12.BC129]

7.3.80 Hedging portions of prepayable financial instruments: Partial-term hedges of interest rate risk#



Excerpt from ASC 815-25

>>> Measuring the Change in Fair Value of the Hedged Item in Partial-Term Hedges of Interest Rate Risk Using an Assumed Term

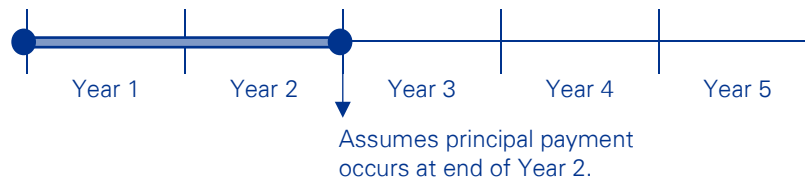
35-13B For a fair value hedge of interest rate risk in which the hedged item is designated as selected contractual cash flows in accordance with paragraph 815-20-25-12(b)(2)(ii), an entity may measure the change in the fair value of the hedged item attributable to interest rate risk using an assumed term that begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable. The assumed issuance of the hedged item occurs on the date that the first hedged cash flow begins to accrue. The assumed maturity of the hedged item occurs on the date in which the last hedged cash flow is due and payable. An entity may measure the change in fair value of the hedged item attributable to interest rate risk in accordance with this paragraph when the entity is designating the hedged item in a hedge of both interest rate risk and foreign exchange risk. In that hedging relationship the change in carrying value of the hedged item attributable to foreign exchange risk shall be measured on the basis of changes in the foreign currency spot rate in accordance with paragraph 815-25-35-18. Additionally, an entity may have one or more separately designated partial-term hedging relationships outstanding at the same time for the same debt instrument (for example 2 outstanding hedging relationships for consecutive interest cash flows in Years 1—3 and consecutive interest cash flows in Years 5—7 of a 10-year debt instrument).

%† Topic 815 provides an entity with a choice of designating the hedged item in a fair value hedge of **interest rate risk** as either: [\[815-20-25-12\(b\)\(2\)\(ii\)\]](#)

- the entire financial instrument (or a percentage of it) for its entire remaining term; or
- selected consecutive interest payments with the assumption that the principal payment occurs at the end of the hedge term (partial-term hedge).

For example, an entity issues a noncallable, five-year fixed-rate debt instrument. The entity could designate a fair value hedge of interest rate risk for the entire term or designate a partial-term hedge for the first two years of its term (see Example 7.3.70). [\[815-25-55-95\]](#)

The following illustrates a partial-term hedge.



For partial-term hedges, an entity measures the change in the hedged item's fair value attributable to interest rate risk using an assumed term that reflects only the designated cash flows and assumes that the principal payment occurs at the end of the hedge term. [\[815-25-35-13B\]](#)



Question 7.3.210

When will a partial-term hedge improve effectiveness?

Interpretive response: A partial-term hedge may enable an entity to better align hedge accounting with its interest rate risk management strategies.

Assume an entity uses a two-year interest rate swap to hedge the first two years of fixed-rate interest payments on a noncallable, five-year fixed-rate bond. The entity could consider the bond's entire contractual term when assessing hedge effectiveness and measuring the change in the bond's fair value attributable to interest rate risk. However, the changes in the fair value of a two-year interest rate swap would generally not be expected to offset the changes in the fair value of a noncallable, five-year fixed-rate bond. Therefore, the entity would likely be unable to conclude that the hedging relationship would be highly effective.

Instead, an entity may designate a partial-term hedge. In this case, the principal repayment of the hedged item is assumed to occur at the end of the hedge term. This results in more favorable assessment of hedge effectiveness and measurement of the hedged item. [\[815-25-35-13B\]](#)



Question 7.3.220

Can an entity designate a partial-term hedge using an assumed term that ends on or before the initial date a financial instrument can be prepaid?

Interpretive response: Yes. An entity could designate the partial term such that it ends before (or on) the initial date on which a financial instrument can be prepaid – e.g. the first day a bond can be called. Therefore, the hedged item is not prepayable during the hedge term. In such cases, an entity does not consider prepayment risk when assessing hedge effectiveness and measuring the change in the hedged item's fair value attributable to interest rate risk. [ASU 2017-12.BC106]

For further discussion of hedging prepayable financial instruments, see sections 7.4.10 and 7.3.100 (last-of-layer method).



Question 7.3.230

Can the partial-term hedge guidance and the guidance for hedging only the benchmark rate component be applied to the same hedging relationship?

Interpretive response: Yes. An entity may:

- designate only part of the remaining term of a financial instrument as the hedged item in a fair value hedge of interest rate risk; and [815-25-35-13B]
- elect to measure the change in the hedged item's fair value using only the benchmark rate component of the contractual coupon cash flows. [815-25-35-13]



Question 7.3.240#

Must specific conditions be met to apply partial-term hedging in a fair value hedge of interest rate risk?

Interpretive response: Yes. The interest payments being hedged must be consecutive interest payments. For example, an entity may designate the first five years of interest payments of a 10-year bond as a hedged item. [815-20-25-12(b)(2)(ii), 815-25-35-13B]

The partial term may begin after inception of the financial instrument. For example, an entity may designate the interest payments in Years 4–6 of the bond as the hedged item, along with an appropriate hedging instrument (e.g. a forward-starting three-year interest rate swap) as a fair value hedge. The issuance of the hedged item is assumed to occur on the date on which the first hedged cash flow begins to accrue. [815-25-35-13B]



Question 7.3.250

Can an entity apply hedge accounting to more than one partial term of a single instrument?

Background: An entity may wish to designate two or more partial terms from a single financial instrument as separate hedged items in separate hedging relationships. For example, the first five years of interest payments of a bond as a hedged item in a fair value hedge, and the next five years of interest payments of the same bond as a hedged item in a separate fair value hedge.

Interpretive response: Yes, the partial-term hedging guidance can be applied simultaneously to multiple partial-term hedging relationships for a single debt instrument. In other words, an entity is permitted to designate more than one partial term of a financial instrument as separate hedged items. [815-25-35-13B]



Question 7.3.260

When multiple partial terms are hedged in separate hedging relationships, do the terms need to be consecutive?

Interpretive response: No. There is no requirement for the terms of multiple partial-term hedges to be consecutive. For example, an entity may simultaneously designate consecutive interest cash flows in Years 1–3 and consecutive interest cash flows in Years 5–7 of a 10-year bond. [815-25-35-13B]



Example 7.3.70

Designating a fair value hedge of interest rate risk using the partial-term approach

The following example is adapted from the facts outlined in the Example 15 in Subtopic 815-25 (reproduced in section 8.3.20).

On January 1, Year 1, ABC Corp. issues a noncallable, five-year, \$100 million debt instrument with a 3% semiannual interest coupon. On the same date, ABC also enters into a two-year interest rate swap with a notional amount of \$100 million.

ABC elects to apply partial-term hedging guidance by:

- designating the cash flows associated with the first two years of the debt issuance as the hedged item; and
- identifying interest rate risk as the hedged risk.

The assumed term of the hedged item is two years – i.e. the same term as the interest rate swap.

Partial-term begins after inception

The partial term may begin after inception of the financial instrument. For example, ABC could designate the cash flows associated with Years 2–4 as the

hedged item. The hedging instrument would be a forward-starting three-year interest rate swap.

Multiple partial-term hedges

ABC could designate multiple partial-term hedges. For example, in addition to designating the cash flows associated with Years 1–2 of the issued debt, ABC could also designate cash flows associated with Years 4–5.

The hedging instruments would be two interest rate swaps: one associated with the first two years of the debt instrument, and the second a forward-starting two-year interest rate swap that aligns with the cash flows for Years 4–5.



Question 7.3.270#

Can an entity hedge risks other than interest rate risk when applying partial-term hedging guidance?

Interpretive response: The guidance for partial-term hedges focuses on fair value hedges of interest rate risk. However, an entity can also apply the partial-term hedging guidance to a single fair value hedge of both interest rate risk and foreign currency risk. In this situation, the entity first measures the change in fair value of the hedged item attributable to interest rate risk using an assumed term, and then remeasures it for changes in foreign exchange risk based on changes in the foreign currency spot rate (see Example 7.3.80). [815-25-35-13B, ASU 2019-04.BC60–BC61]

Although the scope of the guidance for partial-term hedges includes only hedges of interest rate risk, in practice some entities hedge foreign currency risk over a partial term when excluding the spot-forward difference or the cross-currency basis spread when assessing hedge effectiveness (see section 13.2.70). Subtopic 815-25 acknowledges this practice by clarifying that an entity can designate the hedged risks in a partial-term hedge as both interest rate and foreign currency risk, and specifying how to measure the change in fair value of the hedged item in this situation. [ASU 2019-04.BC60–BC61]

We do not believe the partial-term guidance should be applied to hedges of other risks (e.g. credit risk, price risk).



Example 7.3.80#

Hedging interest rate risk and foreign currency risk in a partial-term hedge

On January 1, Year 1, ABC Corp. issues a noncallable, five-year, €100 million debt instrument with a 3% semiannual interest coupon denominated in euros. ABC's functional currency is the US Dollar.

On the same date, ABC also enters into a two-year cross-currency interest rate swap with a notional amount of €100 million.

ABC may elect to apply partial-term hedging guidance by:

- designating the cash flows associated with the first two years of the euro-denominated debt issuance as the hedged item;
- identifying both the interest rate risk and foreign currency risk as the hedged risks; and
- excluding the portion of the change in fair value of the currency swap attributable to the cross-currency basis spread when assessing effectiveness (see section 13.2.70).

ABC measures the change in fair value of the hedged item (i.e. the basis adjustment) by:

- using an assumed term of two years – i.e. the same term as the cross-currency interest rate swap – when measuring the change in fair value of the hedged item attributable to interest rate risk; and
- remeasuring the hedged item for changes in foreign currency risk based on changes in the foreign currency spot rate.

Section 11.5.10 discusses adjusting the basis of the hedged item when hedging the changes in both the benchmark interest rate and foreign currency exchange rate.

For guidance on hedging a combination of foreign currency risk and other risks, see section 11.3.40 (hedging multiple risks).

7.3.90 Hedging portions of items: Embedded put or call options



Excerpts from ASC 815-20

>> Hedged Item Criteria Applicable for Fair Value Hedges Only

25-12(b)(2) If the hedged item is a specific portion of an asset or liability (or of a portfolio of similar assets or a portfolio of similar liabilities), the hedged item is one of the following: ...

- iii. A put option or call option (including an interest rate cap or price cap or an interest rate floor or price floor) embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 815-15-25-1.

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

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

- c. With respect to fair value hedges only:
 - 1. If the entire asset or liability is an instrument with variable cash flows, an implicit fixed-to-variable swap (or similar instrument) perceived to be embedded in a host contract with fixed cash flows.

...

7. A component of an embedded derivative in a hybrid instrument—for example, embedded options in a **hybrid instrument** that are required to be considered a single forward contract under paragraph 815-10-25-10 cannot be designated as items hedged individually in a fair value hedge in which the hedging instrument is a separate, unrelated freestanding option.

On a stand-alone basis, derivatives cannot be designated as hedged items. However, Topic 815 specifically allows embedded put or call options that are not separated to be hedged items in a fair value hedge, with some limitations. [\[815-20-25-12\(b\)\(2\)\(iii\)\]](#)

The following table summarizes the embedded put or call options that are explicitly prohibited from being designated as the hedged item.

Re-characterization of a financial instrument	An entity is prohibited from re-characterizing a variable-rate financial instrument as a fixed-rate financial instrument with an embedded interest rate swap in an effort to achieve fair value hedging. The FASB did not intend for an entity to be able to hedge a contractual provision that creates variability in future cash flows as a fair value hedge rather than a cash flow hedge. [815-20-25-43(c)(1), FAS 133.BC435]
Component of an embedded derivative	An entity is prohibited from hedging a component of an embedded derivative in a hybrid instrument. For example, assume the combination of two embedded options (e.g. a purchased put option and a written put option) in a single hybrid instrument is viewed as a single forward contract. An entity cannot separately designate either the purchased put option or the written put option as the hedged item. [815-10-25-10, 815-20-25-43(c)(7)]

If an entity does not separately identify an embedded derivative as the hedged item in a fair value hedge of interest rate risk, and the hedge is not designated using the last-of-layer method, it must consider the effect of the embedded derivative of the same risk class when designating a hedge of an individual risk, if that embedded derivative is exercisable during the hedge period. For example, the effect of an embedded prepayment option must be considered in designating a hedge of interest rate risk (see section 7.4.10). [\[815-20-25-6\]](#)



Question 7.3.280

Is an entity permitted to hedge the risk of changes in the fair value of an embedded call option in an HTM security that is prepayable?

Interpretive response: Yes. Interest rate risk and price risk are not eligible to be designated as hedged risks for a debt security that is classified as HTM. However, Topic 815 allows an entity to hedge the risk of changes in the fair value of an embedded call option in a HTM debt security that is prepayable. [\[815-20-25-12\(d\)\]](#)

For example, an entity purchased a five-year callable debt security and classified it as HTM. The callable feature of the security represents a call option held by the issuer of the security. The entity may purchase a put option to hedge the written call option component (i.e. prepayment feature) of the HTM debt security and designate it as a hedge of the changes in fair value of the call option.



Question 7.3.290

Can an entity hedge the fair value exposure of options embedded in contracts that qualify as firm commitments?



Excerpt from ASC 815-20

>>>> Application of the Definition of Firm Commitment

55-13 A supply contract for which the contract price is fixed only in certain circumstances (such as if the selling price is above an embedded price cap or below an embedded price floor) meets the definition of a firm commitment for purposes of designating the hedged item in a fair value hedge. Provided the embedded price cap or floor is considered clearly and closely related to the host contract and therefore is not accounted for separately under paragraph 815-15-25-1, either party to the supply contract can hedge the fair value exposure arising from the cap or floor.

Background: The term 'fixed price' as it relates to a firm commitment encompasses: [\[815-20 Glossary, 815-20-55-13\]](#)

- situations in which the price is always fixed; and
- situations in which the price is fixed through the existence of an embedded option that is not separated from the host contract – e.g. price caps or floors in a long-term supply or purchase contract.

Interpretive response: The fair value exposure of the cap or the floor in supply contracts is eligible for fair value hedge accounting. The embedded caps and floors typically are not required to be separated from the host contracts because their economic characteristics and risks are clearly and closely related to the economic characteristics and risks of the host contract. [\[815-20-55-13\]](#)

For example, an entity enters into a long-term supply contract with a customer to sell a specified amount of a certain material with a selling price equal to the monthly average list price for the month for the quantity delivered, not to exceed \$15 per pound (requiring physical delivery). [\[815-20-55-85\]](#)

The entity could purchase a cash-settled call option with a strike price of \$15 per pound and a notional amount equal to the quantity specified in the supply contract. It could then designate it as a fair value hedge of the risk of changes in the fair value of the embedded written price cap in the supply contract, provided the other criteria for a fair value hedge are met. [\[815-20-55-87\]](#)

An option embedded in a nonderivative contract may be a purchased option that an entity hedges with a written option in an effort to monetize the value of the purchased option (see Example 3 in Subtopic 815-20 below).

FASB Example: Firm commitment with embedded price caps or floors



Excerpt from ASC 815-20

>> Example 3: Firm Commitment as Hedged Item in Relation to Long-Term Supply Contracts with Embedded Price Caps or Floors

55-84 This Example illustrates the application of paragraph 815-20-25-12 and the definition of firm commitment in relation to long-term supply contracts with embedded price caps or floors.

55-85 Entity A enters into a long-term supply contract with a customer to sell a specified amount of a certain material. The selling price is the current monthly average list price for the quantity delivered each month but not to exceed \$15 per pound. The current list price at the contract signing date is \$12 per pound. The contract can be settled only by physical delivery. The contract also includes a penalty provision that is sufficiently large to make performance probable. The customer is not required to make an up-front cash payment for the written option (that is, the price cap) in the supply contract. Consequently, the supply contract is neither a recognized asset nor a recognized liability at inception.

55-86 The supply contract in its entirety does not meet the definition of a derivative instrument due to the absence of a net settlement characteristic—that is, the contract does not permit or require net settlement (see guidance beginning in paragraph 815-10-15-100), there is no market mechanism (see guidance beginning in paragraph 815-10-15-110), and it does not require delivery of an asset that is **readily convertible to cash** (see guidance beginning in paragraph 815-10-15-119). Pursuant to the guidance in paragraph 815-15-25-19, the embedded cap on the selling price is an option that does not warrant separate accounting under Subtopic 815-15 because it is clearly and closely related to the host supply contract. In addition, because the supply contract is not remeasured with changes in fair value reported currently in earnings, it meets the criteria in paragraph 815-20-25-43(c)(3) to qualify as a hedged item in a fair value hedge.

55-87 Entity A wishes to enter into a transaction to hedge the risk of changes in the fair value of the embedded written price cap in the supply contract. Accordingly, it purchases a cash-settled call option with a strike price of \$15 per pound and a notional amount equal to the quantity specified in the supply contract. In accordance with the guidance in paragraph 815-20-25-12, a supply contract for which the contract price is fixed only under certain circumstances (such as when market prices are above an embedded price cap) meets the definition of a firm commitment for purposes of designating the

hedged item in a fair value hedge. Therefore, if the selling price in a supply contract is subject to a cap, a floor, or both, either party to the contract is eligible to apply fair value hedge accounting in a hedging relationship to hedge the fair value exposure of the cap or floor. For the range of monthly average list prices above \$15 per pound, the contract has a fixed \$15 per pound price. Thus, Entity A may designate the written cap embedded in the supply contract as the hedged item in a fair value hedging relationship provided the other criteria for a fair value hedge are met. The embedded written cap in this Example is a specific portion of the contract that is subject to the risk of changes in fair value due to changes in the list price of the underlying materials. Because it is not accounted for separately from the supply contract, the embedded written cap may be designated as the hedged item in a fair value hedge. Paragraph 815-20-25-12 allows a nonbifurcated call option that is embedded in a supply contract to be the hedged item in a fair value hedge regardless of whether that supply contract is a recognized asset or liability or an unrecognized firm commitment.

7.3.100 Last-of-layer method



Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-12A For a closed portfolio of **prepayable** financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments, an entity may designate as the hedged item a stated amount of the asset or assets that are not expected to be affected by prepayments, defaults, and other factors affecting the timing and amount of cash flows if the designation is made in conjunction with the partial-term hedging election in paragraph 815-20-25-12(b)(2)(ii) (this designation is referred to throughout Topic 815 as the “last-of-layer method”).

- a. As part of the initial hedge documentation, an analysis shall be completed and documented to support the entity’s expectation that the hedged item (that is, the designated last of layer) is anticipated to be outstanding as of the hedged item’s assumed maturity date in accordance with the entity’s partial-term hedge election. That analysis shall incorporate the entity’s current expectations of prepayments, defaults, and other events affecting the timing and amount of cash flows associated with the closed portfolio of prepayable financial assets or beneficial interest(s) secured by a portfolio of prepayable financial instruments.
- b. For purposes of its analysis, the entity may assume that as prepayments, defaults, and other events affecting the timing and amount of cash flows occur, they first will be applied to the portion of the closed portfolio of prepayable financial assets or one or more beneficial interests that is not part of the hedged item (that is, the designated last of layer).

>>>> Determining Whether Risk Exposure Is Shared Within a Portfolio

55-14 This implementation guidance discusses the application of the guidance in paragraph 815-20-25-12(b)(1) that the individual assets or individual liabilities within a portfolio hedged in a fair value hedge shall share the risk exposure for which they are designated as being hedged. If the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7 percent to 13 percent would be inconsistent with the requirement in that paragraph.

55-14A If both of the following conditions exist, the quantitative test described in paragraph 815-20-55-14 may be performed qualitatively and only at hedge inception:

- a. The hedged item is a closed portfolio of prepayable financial assets or one or more beneficial interests designated in accordance with paragraph 815-20-25-12A.
- b. An entity measures the change in fair value of the hedged item based on the benchmark rate component of the contractual coupon cash flows in accordance with paragraph 815-25-35-13.

Using the benchmark rate component of the contractual coupon cash flows when all assets have the same assumed maturity date and prepayment risk does not affect the measurement of the hedged item results in all hedged items having the same benchmark rate component coupon cash flows.

>>> Consideration of Prepayment Risk Using the Last-of-Layer Method

25-118A In a fair value hedge of interest rate risk designated under the last-of-layer method in accordance with paragraph 815-20-25-12A, an entity may exclude prepayment risk when measuring the change in fair value of the hedged item attributable to interest rate risk.

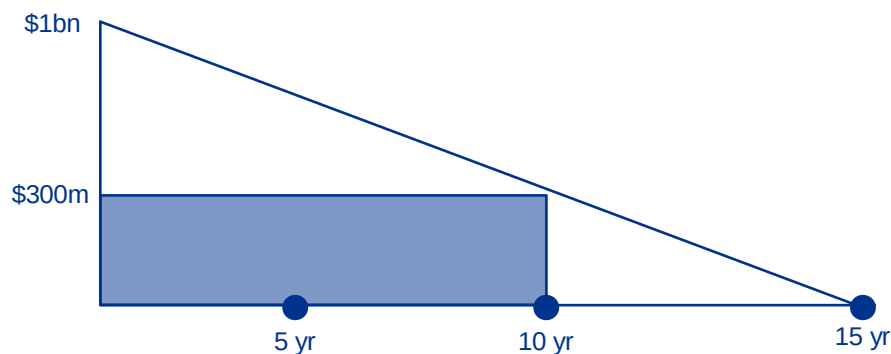
**Excerpt from ASC 815-25****> Estimating the Remaining Balance under the Last-of-Layer Method**

35-7A When the hedged item is designated and accounted for under the last-of-layer method in accordance with paragraph 815-20-25-12A, an entity shall perform and document at each effectiveness assessment date an analysis that supports the entity's expectation that the hedged item (that is, the designated last of layer) is still anticipated to be outstanding as of the hedged item's assumed maturity date. That analysis shall incorporate the entity's current expectations of prepayments, defaults, and other events affecting the timing and amount of cash flows using a method consistent with the method used to perform the analysis in paragraph 815-20-25-12A(a).

%I Topic 815 permits an entity to designate a fixed amount of a closed portfolio of prepayable financial assets as the hedged item in a fair value hedge of **interest rate risk** if the entity expects that the designated amount will remain outstanding at the end of the hedge term (i.e. last of layer). One or more beneficial interests secured by a portfolio of prepayable financial instruments may also be designated as a last of layer. [815-20-25-12A]

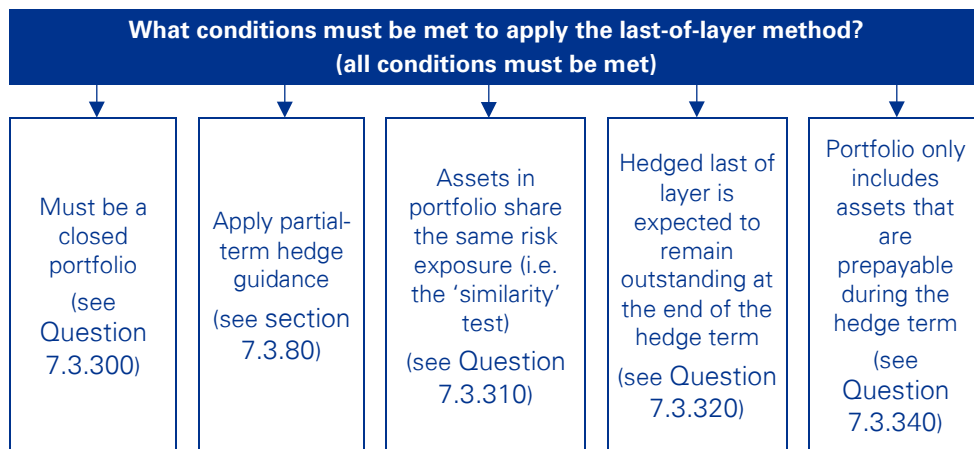
If an entity uses the last-of-layer method, it does not consider prepayment risk for assessing hedge effectiveness and measuring the change in fair value of the hedged item attributable to interest rate risk. For example, an entity has a \$1 billion closed portfolio of 15-year prepayable mortgage loans. It expects that \$300 million will remain outstanding at the end of 10 years. The entity may designate the \$300 million portion of the mortgage portfolio as the hedged item in a fair value hedge of interest rate risk for 10 years. [815-20-25-12(b)(2), 25-12A, 25-118A, ASU 2017-12.BC113]

This example is illustrated below.



The entity then treats the last of layer as a nonprepayable item for hedge effectiveness assessment and measurement purposes. Consequently, it can designate a 10-year \$300 million plain vanilla interest rate swap as the hedging instrument. [815-20-25-118A, ASU 2017-12.BC113]

To apply the last-of-layer method to a portfolio of prepayable financial assets, certain conditions must be met.



Formal documentation. There are additional requirements related to the initial hedge documentation. Specifically, an entity needs to document its analysis supporting its expectation that the designated last of layer (i.e. the hedged item) will remain outstanding at the end of the hedge term. This analysis must be performed and documented at each effectiveness assessment date. [\[815-20-25-3\(c\)\(2\)\]](#)



Future developments#

The FASB has an ongoing project on the last-of-layer method to address issues related to accounting for basis adjustments and whether entities should be able to hedge multiple layers of a single closed portfolio using this method. This project is ongoing and we expect a final ASU to be issued in 2021.



Question 7.3.300

What is a 'closed portfolio'?

Interpretive response: To apply the last-of-layer method, the portfolio must be a closed portfolio. That is, a portfolio of financial assets to which no other financial assets will be added during the hedge term and for which the assets are not designated in any other interest rate hedging relationship. [\[815-20-25-12A\]](#)

Current guidance is not clear as to whether an entity would be able to remove assets from a closed portfolio on a discretionary basis. At a September 2018 meeting, the FASB clarified that financial assets could be sold or voluntarily transferred from the closed portfolio, but cannot be added or replaced. [\[FASB meeting 09-18\]](#)

This means that an entity can remove financial assets from the closed portfolio in a last-of-layer hedge without dedesignating the hedging relationship. This is because the hedged item, which is only the last-of-layer portion of the portfolio, was not changed.



Question 7.3.310

What conditions must be met for a last-of-layer hedge to pass the similarity test qualitatively?

Interpretive response: To apply the last-of-layer method, the prepayable financial assets in the closed portfolio should share the same risk exposure for the risk being hedged – i.e. the same benchmark interest rate risk. In other words, they must pass the similarity test. [\[815-20-25-12A, 55-14\]](#)

An entity is permitted to assess similarity qualitatively, and is permitted to perform this assessment only at hedge inception, only when it: [\[815-20-25-12A, 55-14A, ASU 2017-12.BC112\]](#)

- applies the partial-term hedge guidance (see section 7.3.80); and
- elects to hedge only the benchmark rate component of the contractual coupon cash flows (see section 7.3.70).

When an entity applies the partial-term hedge guidance, it assumes that the maturities of all assets in the closed portfolio are identical. [\[ASU 2017-12.BC112\]](#)

Further, using the benchmark rate component when all assets have the same assumed maturity (partial-term) has the same effect as all of the assets in the closed portfolio having the same benchmark rate coupon. [\[ASU 2017-12.BC112\]](#)

The assets that comprise the closed portfolio will likely have different coupon payment dates. We believe an entity is not required to consider differences in coupon payment dates when performing its qualitative assessment because coupon payment dates are not one of the criteria in performing the similarity test qualitatively. [\[815-20-55-14A, ASU 2017-12.BC112\]](#)



Question 7.3.320

What is needed to support the entity's expectation that the last of layer will remain outstanding at the end of the hedge term?

Interpretive response: An entity is required to perform and document an analysis supporting its expectation that the last of layer (i.e. the hedged item) will remain outstanding at the end of the hedge term. This is done as part of the initial hedge documentation and on each effectiveness assessment date. [\[815-20-25-12A, 815-25-35-7A, ASU 2017-12.BC113\]](#)

The analysis should incorporate the entity's current expectations of prepayments, defaults and other events affecting the timing and amount of cash flows associated with the closed portfolio of prepayable financial assets (or beneficial interests secured by a portfolio of prepayable financial assets). We believe these expectations should be consistent with the entity's expectations and estimates prepared for other purposes (e.g. the allowance for credit losses). [\[815-20-25-12A, 815-25-35-7A, ASU 2017-12.BC113\]](#)

In this analysis, the entity assumes that as prepayments, defaults and other events affecting the timing and amount of cash flows occur, they will first be applied to the portion of the closed portfolio (or one or more beneficial interests) that is not part of the designated last of layer. [\[815-20-25-12A\]](#)

**Question 7.3.330**

Must an entity assert it is 'probable' that the balance of the last of layer will remain outstanding at the end of the hedge term?

Interpretive response: No. An entity need not assert that it is 'probable' that the last of layer (i.e. the hedged item) will remain outstanding at the end of the hedge term. [\[ASU 2017-12.BC115\]](#)

Instead, the entity only needs to have an expectation that the last of layer will remain outstanding at the end of the hedge term and should support that expectation (see Question 7.3.320). We believe the FASB intended this to be a lower threshold than probable.

**Question 7.3.340**

What financial instruments can be included in the portfolio under the last-of-layer method?

Interpretive response: The financial instruments in the portfolio from which the last of layer is derived are comprised solely of assets that are prepayable (e.g. mortgage loans) during the hedge term and that would be eligible as a hedged item in a fair value hedge. At its February 2018 Board meeting, the FASB clarified that financial instruments considered prepayable for the purpose of applying paragraph 815-20-25-6B would also be considered to be prepayable for the purpose of applying the last-of-layer method. [\[Staff interpretation\]](#)

For a discussion of what is considered prepayable for the purpose of applying paragraph 815-20-25-6B, see Question 7.4.30.

The last-of-layer method can also be applied to a beneficial interest, or a portfolio of beneficial interests collateralized by prepayable financial instruments. The FASB decided to allow the last-of-layer method to be applied to these types of beneficial interests because their cash flows are generated from a portfolio of prepayable financial instruments. Therefore, the economic substance of their cash flows is the same as that of a portfolio of prepayable financial assets. [\[ASU 2017-12.BC124\]](#)

**Question 7.3.350**

Can the last-of-layer method be applied to a portfolio of financial liabilities?

Interpretive response: No. The FASB did not extend the last-of-layer method to financial liabilities.

An important part of the FASB's rationale for providing the last-of-layer method was the high degree of uncertainty about which individual assets would prepay. For financial assets, this uncertainty exists because the borrower controls the decision of whether to prepay the asset – not the entity looking to hedge. For

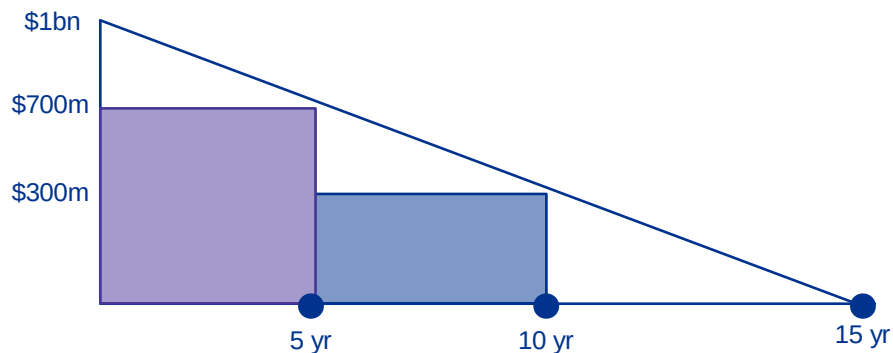
financial liabilities, there is less uncertainty about prepayments because the entity looking to hedge the liability controls the decision to prepay. [ASU 2017-12.BC126]



Question 7.3.360

Can an entity hedge multiple layers under the last-of-layer method?

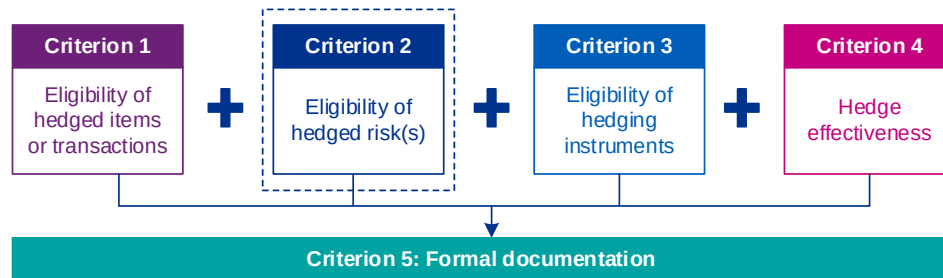
Background: An entity may wish to designate multiple layers under the last-of-layer method. For example, assume an entity has a \$1 billion closed portfolio of 15-year prepayable mortgage loans. The entity may wish to designate \$300 million of the portfolio expected to be outstanding at the end of ten years and \$700 million of the portfolio expected to be outstanding at the end of five years.



Interpretive response: At a March 2018 meeting, the FASB stated that entities should not apply a multiple-layer hedging strategy under the last-of-layer method.

The FASB is undertaking a narrow-scope project to determine whether hedging multiple layers should be permitted. A final ASU is expected to be issued in 2021 (see 'Future developments' above). As a result, revisions to this interpretive response may be provided in a future edition.

7.4 Eligibility of hedged risks



Sections 6.3 and 6.4 provide an overview of the eligible hedged risks for both financial and nonfinancial items, including limitations on certain risks for hedged items.

This section provides detail around the eligibility criteria of hedged risks that are specific to fair value hedges, including:

- interest rate risk on prepayable financial instruments (section 7.4.10); and
- limitations on price risk for nonfinancial items (section 7.4.20).

 **Foreign currency risk.** For further guidance on foreign currency risk as it relates to fair value hedges, see chapter 11.

7.4.10 Interest rate risk hedges of prepayable financial instruments



Excerpt from ASC 815-20

>>> Hedged Items Involving Interest Rate Risk

25-6 Hedges involving a **benchmark interest rate** are addressed in paragraphs 815-20-25-12(f) and 815-20-25-12A (for fair value hedges) and paragraph 815-20-25-15(j) (for cash flow hedges). Hedges involving a contractually specified interest rate are addressed in paragraph 815-20-25-15(j) (for cash flow hedges). The benchmark interest rate or the contractually specified interest rate being hedged in a hedge of **interest rate risk** shall be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Paragraphs 815-20-25-19A through 25-19B provide guidance on the interest rate risk designation of hedges of forecasted issuances or purchases of debt instruments. An entity shall not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a **prepayable** instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the overall fair value of that prepayment option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an **embedded derivative** of the same risk class shall be considered in designating a hedge of

an individual risk. For example, the effect of an embedded prepayment option shall be considered in designating a hedge of interest rate risk.

>>>> Fair Value Hedges of Interest Rate Risk in Which the Hedged Item Can Be Settled before Its Scheduled Maturity

25-6B An entity may designate a fair value hedge of interest rate risk in which the hedged item is a prepayable instrument in accordance with paragraph 815-20-25-6. The entity may consider only how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity (for example, an entity may consider only how changes in the benchmark interest rate affect an obligor's decision to call a debt instrument when it has the right to do so). The entity need not consider other factors that would affect this decision (for example, credit risk) when assessing hedge effectiveness. Paragraph 815-25-35-13A discusses the measurement of the hedged item.



Excerpt from ASC 815-25

>>> Measuring the Fair Value of a Prepayable Instrument in Hedges of Interest Rate Risk

35-13A In a hedge of interest rate risk in which the hedged item is a **prepayable** instrument in accordance with paragraph 815-20-25-6, the factors incorporated for the purpose of adjusting the carrying amount of the hedged item shall be the same factors that the entity incorporated for the purpose of assessing hedge effectiveness in accordance with paragraph 815-20-25-6B. For example, if an entity considers only how changes in the benchmark interest rate affect an obligor's decision to prepay a debt instrument when assessing hedge effectiveness, it shall consider only that factor when adjusting the carrying amount of the hedged item. The election to consider only how changes in the benchmark interest rate affect an obligor's decision to prepay a debt instrument does not affect an entity's election to use either the full contractual coupon cash flows or the benchmark rate component of the contractual coupon cash flows determined at hedge inception for purposes of measuring the change in fair value of the hedged item in accordance with paragraph 815-25-35-13.



Interest rate risk. When the hedged risk is changes in interest rates on a financial instrument with a prepayment option, an entity considers the prepayment option when measuring the change in the hedged item's fair value attributable to interest rate risk unless the hedged item is not prepayable during the hedge term. For example, partial-term hedges using an assumed term that ends before (or on) the initial date a financial instrument can be prepaid (see Question 7.3.220).

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

The factors that an entity uses to measure the change in the hedged item's fair value are the same factors that it uses for assessing hedge effectiveness. [815-25-35-13A]



Question 7.4.10

Why would an entity elect to consider only the effect of changes in the benchmark interest rate on the decision to prepay the financial instrument?

Interpretive response: Electing this alternative will make achieving hedge accounting more likely and provide a better accounting offset between the hedging instrument and the hedged item when hedge accounting is achieved.

In a fair value hedge, an entity measures the change in the hedged item's fair value attributable to interest rate risk. If the hedged item is or will become prepayable during the hedge term, the entity incorporates the effect of the prepayment option into this measurement. [815-20-25-6]

One way to incorporate the effect of the prepayment option is to measure the change in the hedged item's fair value without the prepayment option, and then add the change (positive or negative) in the fair value of the prepayment option.

When determining the change in the fair value of the prepayment option, an entity may elect to consider only the effect that changes in the benchmark interest rate have on the decision to prepay the hedged instrument. This approach helps align an entity's hedge accounting and risk management activities, and it more accurately reflects the change in the fair value of the hedged item attributable to interest rate risk. [ASU 2017-12.BC99]



Question 7.4.20

Is an entity *required* to consider only how changes in the benchmark interest rate affect the decision to prepay?

Interpretive response: No. This is an election for each hedging relationship. An entity can also continue to consider all factors (e.g. credit risk, liquidity, interest rates) when measuring the change in the fair value of the option to prepay. [815-20-25-6B]



Question 7.4.30

What instruments are considered prepayable under paragraph 815-20-25-6B?

Interpretive response: The term 'prepayable' is defined in the Master Glossary as "able to be settled by either party before its scheduled maturity." [815-25 Glossary]

At the February 2018 Board meeting, the FASB noted that it intended for paragraph 815-20-25-6B to apply to financial instruments that are prepayable according to the Master Glossary definition, except for instruments that are only prepayable before maturity upon the occurrence of an event related to the debtor's credit risk. [\[Staff interpretation\]](#)

In addition, the FASB clarified that the following financial instruments are considered prepayable for purposes of paragraph 815-20-25-6B:

- nonconvertible debt with currently exercisable embedded non-contingent call or put options;
- nonconvertible debt with embedded options that are exercisable during the hedge term solely based on the passage of time;
- nonconvertible debt with embedded contingent call or put options; and
- debt that is convertible into the issuer's shares during the hedge term.

However, certain instruments that are considered prepayable for purposes of paragraph 815-20-25-6B may not be considered prepayable for other purposes. For example, the following debt instruments would be considered prepayable for purposes of paragraph 815-20-25-6B, but are not considered prepayable for purposes of applying the shortcut method (see section 13.3):

- fixed-rate debt that is callable at its then fair value;
- fixed-rate debt that includes a make-whole provision; and
- debt that includes a contingent acceleration clause that permits the issuer to accelerate the debt's maturity only upon the occurrence of a specified event that (1) is not probable at the time the debt was issued; (2) is unrelated to changes in any market variable, including benchmark interest rates; and (3) is related to regulatory or legislative actions, or other similar events that are beyond the control of the debt issuer or holder.

For the application of paragraph 815-20-25-6B to nonconvertible debt with embedded contingent call or put options and convertible debt, see [Questions 7.4.40 and 7.4.50](#), respectively.



Example 7.4.10

Applying paragraph 815-20-25-6B to a callable bond

ABC Corp. issues a 10-year fixed-rate bond that is callable any time starting after Year 5. ABC designates the entire term of the bond as the hedged item and designates a 10-year receive-fixed, pay-variable interest rate swap as the hedging instrument in a fair value hedge of interest rate risk.

ABC elects to assess hedge effectiveness considering only changes in the benchmark interest rate when evaluating whether it will call the debt before its scheduled maturity – i.e. it does not consider other factors that could affect the exercise of the call option.

If ABC did not make this election, it would have considered all factors (e.g. credit risk, liquidity, interest rates) that could result in calling the bond before its maturity when measuring the change in fair value of the call option – e.g. ABC would have considered changes in its own creditworthiness because such changes could affect its decision to refinance the bond.



Question 7.4.40

How does paragraph 815-20-25-6B apply to nonconvertible debt with an embedded contingent call or put option?

Interpretive response: Contingent calls and puts are options that become exercisable upon the occurrence of an event.

If the call or put option is exercisable contingent on an event that is not explicitly linked to interest rates (e.g. it is linked to a change in control or an initial public offering by the issuer) and the contingency is substantive, the entity can ignore the option until the contingent event occurs. Once the contingent event occurs, the call or put option is currently exercisable and the entity considers only how changes in the benchmark interest rate affect the decision to settle the debt instrument before its scheduled maturity.

If the call or put option is exercisable contingent on an event explicitly linked to the benchmark interest rate (e.g. callable if LIBOR exceeds 2.0%), an entity should measure the hedged item's fair value attributable to interest rate risk considering:

- fluctuations in interest rates that would cause the occurrence of the contingent event; and
- the probability of exercise given the interest rate scenario (only considering the effect of the benchmark interest rate).



Example 7.4.20

Applying paragraph 815-20-25-6B to a nonconvertible bond with an embedded contingent put

ABC Corp. issues a nonconvertible bond. If ABC sells a substantial asset, the bond holder can put the bond back to ABC any time after the sale.

ABC designates the bond as a hedged item in a fair value hedge. Because the put option is not currently exercisable and its exercisability is contingent on an event that is not explicitly linked to interest rates, ABC does not consider the put option for purposes of assessing hedge effectiveness and measuring the change in fair value of the bond attributable to interest rate risk until ABC sells a substantial asset.

If ABC sells a substantial asset, the option would become non-contingent and ABC would then consider how changes in the designated benchmark interest rate would affect the holder's decision to exercise the put option for assessment and measurement purposes.



Question 7.4.50

Does paragraph 815-20-25-6B apply to interest rate risk hedges related to debt conversion options?

Background: A debt instrument that is convertible into a fixed number of the issuer's equity shares may have an interest rate significantly less than the interest rate on a similar debt instrument that is not convertible.

Therefore, changes in interest rates generally do not significantly affect the decision to exercise a call or put option embedded in a convertible debt instrument. Instead, that decision is typically based on the issuer's or holder's view of the current and future expectations of the:

- underlying equity instrument's price;
- volatility of the equity instrument's price; and
- dividend yield on the equity instrument.

Interpretive response: Yes. At the February 2018 Board meeting, the FASB concluded that an entity may apply the guidance in paragraph 815-20-25-6B for interest rate risk hedges related to convertible debt. Equity price changes typically have a significant effect on the conversion option's fair value. However, if an entity applies the guidance in paragraph 815-20-25-6B, it ignores how changes in equity prices affect the holder's decision to exercise the conversion option when assessing hedge effectiveness and measuring the change in the hedged item's fair value attributable to interest rate risk. [[Staff interpretation](#)]



Question 7.4.60

Does the election to consider only how changes in the benchmark interest rate affect the decision to prepay a debt instrument have to be applied to all prepayable hedged items?

Interpretive response: No. For fair value hedges, the election to consider only how changes in the benchmark interest rate affect the decision to prepay the hedged item when measuring its change in fair value attributable to interest rate risk is made on a hedge-by-hedge basis. [[ASU 2017-12.BC129](#)]

7.4.20 Limitations on price risk for nonfinancial items



Price risk. Fair value hedge accounting is permitted for nonfinancial assets and liabilities (other than a recognized loan servicing right or nonfinancial firm commitment with financial components) when the designated hedged risk is the risk of changes in the fair value of the *entire* asset or liability (i.e. price risk). [[815-20-25-12\(e\)](#)]

Therefore, an entity is prohibited from disaggregating the risk profile of a nonfinancial asset or liability and designating one component of the profile as

the hedged risk. This is because changes in the fair value of an ingredient or component of a nonfinancial asset or liability generally do not have a predictable and separately measurable effect on the fair value of the item that is comparable to the effect of, for example, the change in the market interest rates on the price of a bond. [FAS 133.BC416]

However, an entity could hedge its exposure to total price risk and achieve results similar to hedging a component of a nonfinancial asset (or liability). Topic 815 permits a derivative instrument with the price of a component as its underlying to hedge changes in the fair value of the entire nonfinancial asset (or liability). To qualify for hedge accounting, the derivative instrument (based on the underlying component) must be highly effective at offsetting changes in fair value of the entire asset (or liability).



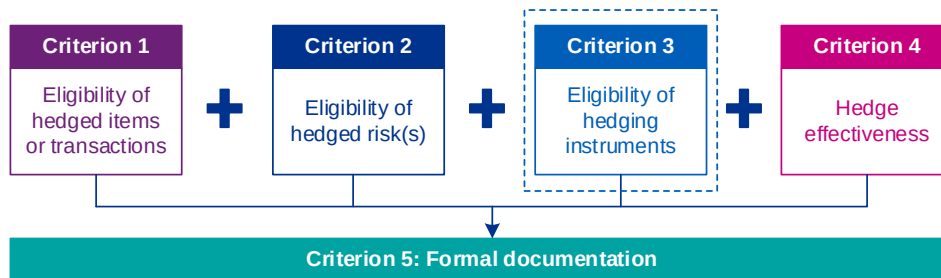
Example 7.4.30

Fair value hedge of gold watch inventory with a gold futures contract

Goldco, a gold watch manufacturer, would not qualify for fair value hedge accounting if it used a gold futures contract to hedge the gold component of its gold watch inventory.

However, Goldco would be able to qualify for fair value hedge accounting if it used a gold futures contract to hedge the fair value risk of its gold watch inventory provided it can demonstrate that the gold futures contract is highly effective in offsetting the changes in fair value associated with the inventory of gold watches (i.e. total price risk).

7.5 Hedging instruments in fair value hedges



Topic 815 specifies certain criteria that must be met for financial instruments to be eligible for designation as hedging instruments, the primary requirement being that the instrument meets the definition of a derivative. Topic 815 also specifically prohibits certain instruments and outlines limitations involving written options. These concepts are discussed in sections 6.6 and 6.7.

7.5.10 Overview

There is no additional guidance specific to fair value hedges regarding the eligibility of hedging instruments, other than fair value hedges involving foreign currency risk.

 **Foreign currency risk.** For guidance on the eligibility of hedging instruments in a fair value hedge of foreign currency risk, see section 11.4.10.

8. Accounting for fair value hedges

Detailed contents

Item significantly updated in this chapter: #

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- 8.3.10 Fair value hedge of inventory after initial recognition
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- 8.5.10 Accounting for the termination of an interest rate swap hedging fixed-rate debt
- 8.5.20 Identifying the date a hedging relationship ceased to be highly effective
- 8.5.30 Discontinuation of a last-of-layer method hedge

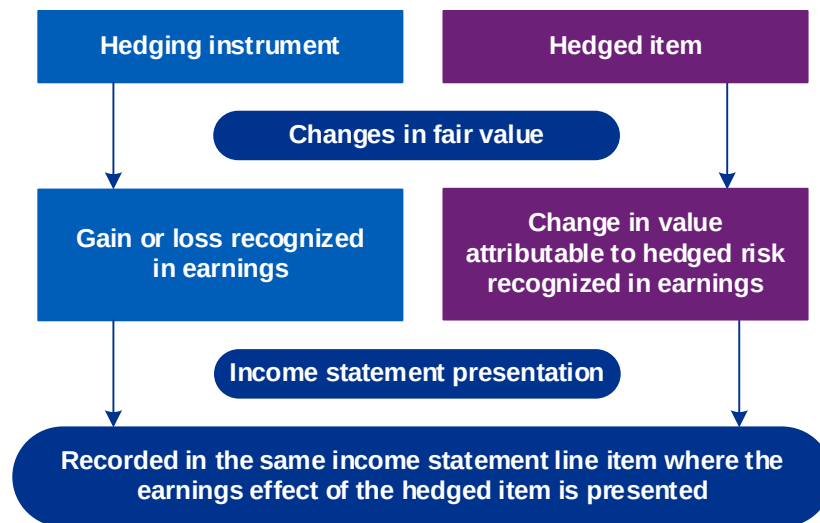
8.1 How the standard works

A fair value hedge is a hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to a particular risk.

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

Hedging instrument	Hedged item
A derivative hedging instrument is recognized at fair value on the balance sheet with changes in fair value recognized in earnings, other than amounts related to excluded components that are recognized through an amortization approach.	Changes in the fair value of the hedged item that are attributable to the hedged risk are recognized on the balance sheet as an adjustment to the amortized cost basis of the hedged item. The offsetting entry is a gain or loss that is recognized in earnings.

The following diagram shows the general accounting and presentation for a highly effective fair value hedge (not including excluded components).



The effect is to offset gains or losses on the hedging instrument with gains or losses on the hedged item that are attributable to the hedged risk within one line item in the income statement.

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

8.2 Fair value hedge accounting model

8.2.10 Overview



Excerpts from Subtopic 815-20

35-1 Paragraph 815-10-35-2 states that the accounting for subsequent changes in the **fair value** (that is, gains or losses) of a **derivative instrument** depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Specifically, subsequent gains and losses on derivative instruments shall be accounted for as follows:

...

- b. **Fair value hedge.** The gain or loss on a derivative instrument designated and qualifying as a fair value hedging instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk shall be recognized currently in earnings in the same accounting period, as provided in paragraphs 815-25-35-1 through 35-6. The gain or loss on the hedging derivative or nonderivative instrument in a hedge of a foreign-currency-denominated **firm commitment** and the offsetting loss or gain on the hedged firm commitment shall be recognized currently in earnings in the same accounting period, as provided in paragraphs 815-20-25-58 through 25-59. The gain or loss on the hedging derivative instrument in a hedge of an available-for-sale debt security and the offsetting loss or gain on the hedged available-for-sale debt security shall be recognized currently in earnings in the same accounting period.



Excerpt from ASC 815-25

> Changes in Fair Value in General

35-1 Gains and losses on a qualifying **fair value hedge** shall be accounted for as follows:

- a. The gain or loss on the hedging instrument shall be recognized currently in earnings, except for amounts excluded from the assessment of effectiveness that are recognized in earnings through an amortization approach in accordance with paragraph 815-20-25-83A. All amounts recognized in earnings shall be presented in the same income statement line item as the earnings effect of the hedged item.
- b. The gain or loss (that is, the change in **fair value**) on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized currently in earnings.

35-4 Although a hedging relationship must comply with an entity's established policy range of what is considered highly effective pursuant to paragraphs 815-20-25-75 through 25-85 for that relationship to qualify for hedge accounting,

that compliance does not assure perfect offset between the gain or loss on the hedging instrument and the hedged item attributable to the hedged risk. Any gain or loss on the hedging instrument that does not offset the gain or loss on the hedged item attributable to the hedged risk is recognized in earnings in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

35-6 If a hedged item is otherwise measured at fair value with changes in fair value reported in **other comprehensive income** (such as an available-for-sale debt security), the adjustment of the hedged item's carrying amount discussed in paragraph 815-25-35-1(b) shall be recognized in earnings rather than in other comprehensive income to offset the gain or loss on the hedging instrument.

In general, the fair value hedge accounting model has two main elements.
[815-25-35-1]

- **Hedging instrument.** A derivative hedging instrument is recognized at fair value on the balance sheet with changes in fair value recognized in earnings, other than amounts related to excluded components that are recognized through an amortization approach (see section 8.2.20).
- **Hedged item.** Changes in the fair value of the hedged item that are attributable to the hedged risk are recognized on the balance sheet as an adjustment to the amortized cost basis of the hedged item. The offsetting entry is a gain or loss that is recognized in the same income statement line item as the gain or loss on the hedging instrument (see section 8.3).

The effect of the fair value hedge accounting model is to offset gains or losses on the hedging instrument with gains or losses on the hedged item within one line item of the income statement. If the hedging relationship is: [815-25-35-4]

- **Perfectly effective.** These amounts exactly offset each other.
- **Not perfectly effective.** The extent to which these changes do not perfectly offset is reflected in a single line item of the income statement.

When the earnings effect of the hedged item is presented in more than one line item, the change in the fair value of the hedging instrument is allocated to the different line items. [815-20-55-79Z – 55-79AD]

For entities that do not report earnings, amounts that would normally be reported in earnings are reported in the change in net assets; see further discussion in section 16.4.



Question 8.2.10

Are changes in the fair value of a hedged AFS debt security recognized in earnings?

Interpretive response: Yes, to the extent that the changes in fair value are attributable to the hedged risk. When the hedged item is measured at fair value with the changes in fair value reported in OCI (e.g. AFS debt securities),

changes in the hedged item's fair value attributable to the risk being hedged are recognized in earnings rather than OCI. However, the unrealized gain or loss that arose between the time the hedged item was initially recognized and the time it was designated in a hedging relationship (if any) continues to be recognized in AOCI. Additionally, changes in fair value after inception of the hedging relationship that are not attributable to the hedged risk are recognized in AOCI. See also Question 8.3.40. [815-25-35-6]

Hedged item (basis adjustments)

The adjustment to the amortized cost basis of the **hedged item** from applying fair value hedge accounting is referred to as a basis adjustment.

Hedged items continue to be subject to other applicable US GAAP, including for assessing impairment (see section 8.4.30). Basis adjustments are accounted for in the same manner as other components of the amortized cost basis of the hedged item. Topic 815 provides additional guidance regarding how basis adjustments are considered when applying other applicable GAAP for interest-bearing financial instruments (see section 8.4.20).

When a fair value hedge is discontinued, the basis adjustment generally is not recognized immediately in earnings. Instead, it remains part of the amortized cost basis of the hedged item and continues to be accounted for in the same manner as other components of the amortized cost basis. The basis adjustment is included in the gain or loss calculation if the hedged item is derecognized (see section 8.5.10).

Hedging instruments

As discussed in section 8.2.20, Topic 815 permits an entity to exclude certain components of a hedging instrument from the assessment of a fair value hedge's effectiveness. The following table summarizes the timing and presentation for recognizing in earnings changes in a derivative hedging instrument's fair value that arise during the hedging relationship, depending on whether the change in fair value relates to a component that is included or excluded from the effectiveness assessment.

Component	Timing of earnings recognition for changes in fair value	Presentation in income statement (see also section 14.3.10)
Changes in fair value that are included in the assessment of hedge effectiveness	Recognized in earnings immediately	Same line item as the effect of hedged item
Initial value of the excluded component and the subsequent changes in its fair value	Depends on the approach elected (see section 8.2.20): — Amortization approach. The initial fair value of an excluded component is recognized in earnings using	Same line item as the effect of hedged item

Component	Timing of earnings recognition for changes in fair value	Presentation in income statement (see also section 14.3.10)
	a systematic and rational method. Any difference between the change in the fair value of the excluded component and the amounts recognized in income are included in OCI. — Mark-to-market approach. Changes in fair value are recognized in earnings immediately – i.e. as the changes occur.	

Examples

The following examples demonstrate the fair value hedge accounting model:

- Accounting for a hedge that lacks perfect offset (Example 8.2.10).
- Income statement presentation of hedging instruments (FASB paragraphs 815-20-55-79W – 55-79Y, reproduced in section 14.3.10).



Example 8.2.10

Accounting for a hedge that lacks perfect offset

On January 1, Year 1, ABC Corp. designates a derivative as the hedging instrument in a fair value hedge of interest rate risk on a recognized fixed-rate debt obligation. On that date, ABC formally documents that the hedging relationship is expected to be highly effective – i.e. the derivative hedging instrument is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk (interest rate risk) during the period that the hedge is designated. ABC also documents that its established policy for the range of the extent of that offset that is considered highly effective is 80%–125%.

During the three months ended March 31, Year 1, changes in the fair values of the derivative hedging instrument and the hedged debt attributable to the hedged risk are as follows.

	Fair value increase (decrease)
Derivative hedging instrument	\$(50,000)
Hedged debt attributable to the hedged risk (interest rate risk)	45,000
Hedge effectiveness ¹	111%
Note:	
1. $\$50,000 \div \$45,000$.	

Because the hedging relationship was highly effective during the three months ended March 31, Year 1 in achieving offsetting changes in fair value attributable to the hedged risk, ABC applies fair value hedge accounting for the period.

ABC records the following journal entry.

	Debit	Credit
Interest expense	50,000	
Derivative hedging instrument		50,000
<i>To record change in fair value of derivative hedging instrument.</i>		
Debt	45,000	
Interest expense		45,000
<i>To record change in fair value of hedged item attributable to hedged risk.</i>		

Although the hedging relationship is highly effective, ABC's net income reflects the \$5,000 loss on the derivative hedging instrument that exceeds the gain on the hedged item. This amount reflects the extent to which the hedging relationship is not perfectly effective.

8.2.20 Excluded components

Topic 815 permits an entity to exclude certain components of a **hedging instrument** – for example, the time value of an option – from the assessment of **hedge effectiveness** (see section 13.2.70).

An entity can recognize the initial value of the excluded components in earnings using either of the following approaches. [815-20-25-83A – 25-83B]

- **Amortization approach.** A systematic and rational method over the life of the hedging instrument.
- **Mark-to-market approach.** A method that recognizes all fair value changes of the excluded components currently in earnings, consistent with legacy US GAAP.

An entity presents amounts related to excluded components that are recognized in earnings in the same income statement line item that is used to present the earnings effect of the hedged item. [815-20-45-1A]

When using the amortization approach, any difference between the change in the fair value of the excluded component and the amounts recognized in income are included in OCI each period. Net gains or losses on derivative hedging instruments that are included in AOCI are displayed as a separate classification within AOCI. [815-20-25-83A, 45-3]

The tax effect of amounts recorded in OCI also should be charged or credited directly to OCI. See KPMG Handbook, [Accounting for Income Taxes](#), including paragraphs 9.043 and 9.050, for further information.

Any amounts associated with the excluded component remaining in AOCI when a fair value hedge is discontinued are recorded in earnings in the same manner as other components of the amortized cost basis of the hedged asset or liability when the hedged item continues to exist (see section 8.5.10).

Entities that do not report earnings are not permitted to elect an amortization approach for excluded components; see further discussion in section 16.4.

Examples

The following FASB example describes approaches for assessing effectiveness in a fair value hedge of a recognized asset (US Treasury bond) with a purchased option when time value is excluded – i.e. time value is an excluded component. As discussed in section 13.4.20 (and consistent with paragraph 815-20-35-16 and the discussion in section 13.2.60). We believe the critical terms match method is precluded for fair value hedging relationships in the vast majority of circumstances.

The FASB example is followed by a KPMG example that illustrates assessing effectiveness in the fair value hedge described in the FASB example when the recognized asset is classified as an available for sale security. It includes two scenarios, illustrating and comparing the mark-to-market and amortization approaches for recognizing the excluded component.



Excerpt from ASC 815-25

>> Example 5: Fair Value Hedge of U.S. Treasury Bond with Put Options

55-23 This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value hedge of a U.S. Treasury bond with put options. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

55-24 Entity E owns a U.S. Treasury bond and wants to protect itself against the fair value exposure to declines in the price of the bond. Entity E purchases an at-the-money put option on a U.S. Treasury security with the same terms (remaining maturity, notional amount, and interest rate) as the U.S. Treasury bond held and designates the option as a hedge of the fair value exposure of the U.S. Treasury bond. Entity E plans to hold the put option until it expires.

55-25 Because Entity E plans to hold the put option (a static hedge) rather than manage the position with a delta-neutral strategy, it could assess whether it expects the hedge to be highly effective at achieving offsetting changes in fair value by calculating and comparing the changes in the intrinsic value of the option and changes in the price (fair value) of the U.S. Treasury bond for different possible market prices. In assessing the expectation of effectiveness on an ongoing basis, Entity E also must consider the actual changes in the fair value of the U.S. Treasury bond and in the intrinsic value of the option during the hedge period.

55-26 However, because the pertinent critical terms of the option and the bond are the same in this Example, Entity E could expect the changes in value of the bond attributable to changes in interest rates and changes in the intrinsic value of the option to offset completely during the period that the option is in the money. That is, the hedging relationship will be perfectly effective because Entity E has chosen to exclude changes in the option's time value from the assessment of hedge effectiveness. Entity E may elect to account for changes in the time value of the option through an amortization approach in accordance with paragraph 815-20-25-83A or through a mark-to-market approach in accordance with paragraph 815-20-25-83B. Under either of those approaches, it should present the portion of excluded components recognized in earnings in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.



Example 8.2.20#

Comparison of approaches to recognize excluded component (time value) for a hedge of an AFS debt security with a put option

ABC Corp. purchases at par a US Treasury bond with a face value of \$15,000,000 that it classifies as AFS.

On January 1, Year 1, the fair value of the US Treasury bond is \$18,500,000 and ABC wants to protect itself against the fair value exposure to declines in the price of the bond. Therefore, ABC purchases an at-the-money put option on a US Treasury security with the same terms (remaining maturity, notional amount, and interest rate) as the US Treasury bond it holds. ABC pays a premium of \$200,000.

ABC designates the put option as the hedging instrument in a hedge of the changes in fair value of the US Treasury bond. ABC plans to hold the put option until it expires.

The following additional facts are relevant.

- All criteria for hedge accounting have been met.
- ABC will assess hedge effectiveness by comparing changes in the intrinsic value of the put option with changes in the fair value of the US Treasury bond. Because the option provides only one-sided protection, effectiveness is required to be assessed during only those periods in which the put option has an intrinsic value.
- The hedging relationship is expected to be perfectly effective.
 - At inception, ABC concluded that the changes in the intrinsic value of the option will be highly (100%) effective at offsetting the changes in the fair value of its investment in the US Treasury bond.
 - On an ongoing basis, ABC will ascertain and document that the hedging relationship has been, and will continue to be, highly (100%) effective.

- The changes in fair values of both the US Treasury bond and the put option that are attributable to credit risk are nominal and are disregarded for purposes of this example.
 - The put option is fully collateralized
 - Credit risk associated with the US Treasury bond is considered to be nominal.
- ABC elects to exclude changes in the time value of the option from the assessment of hedge effectiveness.
- The debt security's fair value is as shown in the following table.

Date	Fair value
January 1, Year 1	\$18,500,000
March 31, Year 1	19,000,000
June 30, Year 1	18,300,000
September 30, Year 1	18,000,000
December 31, Year 1	17,750,000

- The fair value, intrinsic value and time value of the put option are as follows.

Date	Fair value	Intrinsic value	Time value ¹
January 1, Year 1	\$200,000	\$ -	\$200,000
March 31, Year 1	180,000	-	180,000
June 30, Year 1	350,000	200,000	150,000
September 30, Year 1	550,000	500,000	50,000
December 31, Year 1	750,000	750,000	-
Note:			
1. Fair value less intrinsic value.			

For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
- ABC prepares financial reports at the end of every quarter.
- ABC settles the put option through delivery of the US Treasury bond on December 31, Year 1.

Scenario 1: Mark-to-market approach

Journal entries – January 1, Year 1

ABC records the following journal entry at January 1, Year 1.

	Debit	Credit
Put option	200,000	
Cash		200,000
<i>To record purchase of put option.</i>		

There would also be a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship.

Journal entries – March 31, Year 1

ABC records the following journal entries.

	Debit	Credit
Gains (losses) on AFS debt securities	20,000	
Put option		20,000
<i>To record change in time value of put option.</i>		
US Treasury bond – AFS	500,000	
OCI – Gains on AFS debt securities ¹		500,000
<i>To record change in fair value of US Treasury bond.</i>		
Note:		
1. The entire change in fair value of the US Treasury bond is recorded in OCI, because there was no change in the intrinsic value of the put option.		

Journal entries – June 30, Year 1

ABC records the following journal entries.

	Debit	Credit
Gains (losses) on AFS debt securities	30,000	
Put option		30,000
<i>To record change in time value of put option.</i>		
Put option	200,000	
Gains (losses) on AFS debt securities		200,000
<i>To record change in intrinsic value of put option.</i>		
OCI – Gains on AFS debt securities ¹	500,000	
Gains (losses) on AFS debt securities ¹	200,000	
US Treasury bond – AFS		700,000
<i>To record change in fair value of investment in US Treasury bond.</i>		
Note:		
1. The loss on the investment that is recognized in earnings is limited to the change in the put option's intrinsic value (i.e. the hedged risk). The remainder of the change in fair value is recorded in OCI.		

Journal entries – September 30, Year 1

ABC records the following journal entries.

	Debit	Credit
Gains (losses) on AFS debt securities	100,000	
Put option		100,000
<i>To record change in time value of put option.</i>		
Put option	300,000	
Gains (losses) on AFS debt securities		300,000
<i>To record change in intrinsic value of put option.</i>		
Gains (losses) on AFS debt securities ¹	300,000	
US Treasury bond – AFS		300,000
<i>To record change in fair value of investment in US Treasury bond.</i>		
Note:		
1. The entire loss on this investment is recognized in earnings because it is equal to the change in the put option's intrinsic value (i.e. the hedged risk).		

Journal entries – December 31, Year 1

ABC records the following journal entries.

	Debit	Credit
Gains (losses) on AFS debt securities	50,000	
Put option		50,000
<i>To record change in time value of the put option.</i>		
Put option	250,000	
Gains (losses) on AFS debt securities		250,000
<i>To record change in intrinsic value of put option.</i>		
Gains (losses) on AFS debt securities ¹	250,000	
US Treasury bond – AFS		250,000
<i>To record change in fair value of investment in US Treasury bond.</i>		
Cash	18,500,000	
US Treasury bond – AFS		17,750,000
Put option		750,000
<i>To record settlement of put option through delivery of US Treasury bond.</i>		
AOCI – Gains on AFS debt securities	3,500,000	
Gains (losses) on AFS debt securities		3,500,000

To record realized gain on sale of investment in US Treasury bond.

Note:

1. The entire loss on this investment is recognized in earnings because it is equal to the change in the put option's intrinsic value (i.e. the hedged risk).

Financial statement excerpts

At the end of each period, ABC's financial statements reflect the following related to this hedging relationship.

Account	3 months ended Mar 31	6 months ended Jun 30	9 months ended Sep 30	Year ended Dec 31
Balance sheet – assets				
Debt securities AFS	\$19,000,000	\$18,300,000	\$18,000,000	-
Put option	180,000	350,000	550,000	-
Balance sheet – equity				
AOCI – Gains (losses) on AFS debt securities	\$4,000,000	\$3,500,000	\$3,500,000	-
Income statement				
Gains (losses) on AFS debt securities	\$(20,000)	\$(50,000)	\$(150,000)	\$3,300,000
Disclosures under subparagraphs 815-10-50-4EE(a) – 50-4EE(c)				
Amortized cost of AFS debt securities on the balance sheet that are designated as hedged items in fair value hedges ¹ [815-10-50-4EE(a), 50-4EE(c)]	15,000,000	14,800,000	14,500,000	-
Increase (decrease) in fair value of hedged AFS debt securities recognized in earnings due to fair value hedge accounting ² [815-10-50-4EE(b)]	-	(200,000)	(500,000)	-
Notes:				
1. Amortized cost at January 1, Year 1 (\$15,000,000, which equals the purchase price since there were no premiums or discounts) + Increase (decrease) in fair value of hedged AFS debt securities recognized in earnings due to fair value hedge accounting (see Note 2). 2. Fair value at that date - fair value at January 1, Year 1. This amount represents the cumulative basis adjustment (i.e. amount of fair value hedge adjustments) included in the amortized cost at that date. This equals the intrinsic value of the put option because the hedging relationship was perfectly effective.				

The \$3,300,000 gain on AFS debt securities for the year ended December 31, Year 1 represents the following.

- **\$3,500,000 unrealized gain in AOCI as of the date of inception of the hedging relationship.** Although the US Treasury bond's fair value fell to \$17,750,000, ABC was able to lock in a \$18,500,000 sale price as a result of entering into the put option. Therefore, it was able to realize the gain of \$3,500,000 (less the premium paid for the option).
Because the intrinsic value of the put option was perfectly effective at offsetting changes in the fair value of the US Treasury bond, each change in the intrinsic value of the put option recognized in earnings was offset by an equal amount that represents the change in the fair value of the US Treasury bond.
- **\$200,000 premium paid for the put option.** This was recognized in earnings as the fair value of the time value portion of the put option changed over time.

Scenario 2: Amortization approach – straight-line method

The following table shows the effect on earnings and AOCI of the time value using the straight-line method:

Date	Total change in time value (A)	Recognized in earnings – amortization of initial time value (B)	Recognized in AOCI (A) - (B)
March 31, Year 1	\$ 20,000	\$ 50,000	\$(30,000)
June 30, Year 1	30,000	50,000	(20,000)
September 30, Year 1	100,000	50,000	50,000
December 31, Year 1	50,000	50,000	-
		\$200,000	

Journal entries – January 1, Year 1

ABC records the following journal entry at January 1, Year 1.

	Debit	Credit
Put option	200,000	
Cash		200,000
<i>To record purchase of put option.</i>		

There would also be a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship.

Journal entries – March 31, Year 1

ABC records the following journal entries.

	Debit	Credit
OCI – Fair value hedge excluded component Put option <i>To record change in fair value of excluded component (time value).</i>	20,000	20,000
Gains (losses) on AFS debt securities OCI – Gains on AFS debt securities <i>To record amortization of excluded component (time value).</i>	50,000	50,000
US Treasury bond – AFS OCI – Gains on AFS debt securities ¹ <i>To record change in fair value of US Treasury bond.</i>	500,000	500,000
Note: 1. There was no change in the intrinsic value of the purchased put option. As a result, amortization of the excluded component is recognized but there are no other changes in the fair value of the option to recognize.		

Journal entries – June 30, Year 1

ABC records the following journal entries.

	Debit	Credit
OCI – Fair value hedge excluded component Put option <i>To record change in fair value of excluded component (time value).</i>	30,000	30,000
Gains (losses) on AFS debt securities OCI – Gains on AFS debt securities <i>To record amortization of excluded component (time value).</i>	50,000	50,000
Put option Gains (losses) on AFS debt securities <i>To record change in intrinsic value of put option.</i>	200,000	200,000
OCI – Gain on AFS debt securities ¹ Gains (losses) on AFS debt securities ¹ US Treasury bond – AFS <i>To record change in fair value of investment in US Treasury bond.</i>	500,000 200,000	700,000

Note:

1. The loss on this investment that is recognized in earnings is limited to the change in the put option's intrinsic value (i.e. the hedged risk). The remainder of the change in fair value of the investment is recorded in OCI.

Journal entries – September 30, Year 1

ABC records the following journal entries.

	Debit	Credit
OCI – Fair value hedge excluded component	100,000	
Put option		100,000
<i>To record change in fair value of excluded component (time value).</i>		
Gains (losses) on AFS debt securities	50,000	
OCI – Gains on AFS debt securities		50,000
<i>To record amortization of excluded component (time value).</i>		
Put option	300,000	
Gains (losses) on AFS debt securities		300,000
<i>To record change in intrinsic value of put option.</i>		
Gains (losses) on AFS debt securities ¹	300,000	
US Treasury bond – AFS		300,000
<i>To record change in fair value of US Treasury bond.</i>		
Note:		
1. The entire loss on this investment is recognized in earnings because it is equal to the change in the put option's intrinsic value (i.e. the hedged risk).		

Journal entries – December 31, Year 1

ABC records the following journal entries.

	Debit	Credit
OCI – Fair value hedge excluded component	50,000	
Put option		50,000
<i>To record change in fair value of excluded component (time value).</i>		
Gains (losses) on AFS debt securities	50,000	
OCI – Gains on AFS debt securities		50,000
<i>To record amortization of excluded component (time value).</i>		
Put option	250,000	
Gains (losses) on AFS debt securities		250,000

<i>To record change in intrinsic value of put option.</i>	
Gains (losses) on AFS debt securities ¹	250,000
US Treasury bond – AFS	250,000
<i>To record change in fair value of US Treasury bond.</i>	
Cash	18,500,000
US Treasury bond – AFS	17,750,000
Put option	750,000
<i>To record settlement of put option through delivery of US Treasury bond.</i>	
AOCI – Gains on AFS debt securities	3,500,000
Gains (losses) on AFS debt securities	3,500,000
<i>To record realized gain on sale of investment in US Treasury bond.</i>	
Note:	
1. The entire loss on this investment is recognized in earnings because it is equal to the change in the put option's intrinsic value (i.e. the hedged risk).	

Financial statement excerpts

At the end of each period, ABC's financial statements reflect the following related to this hedging relationship.

Account	3 months ended Mar 31	6 months ended Jun 30	9 months ended Sep 30	Year ended Dec 31
Balance sheet – assets				
AFS debt securities	\$19,000,000	\$18,300,000	\$18,000,000	-
Put option	180,000	350,000	550,000	-
Balance sheet – equity				
AOCI – Gains (losses) on AFS debt securities	\$4,000,000	\$3,500,000	\$3,500,000	-
AOCI – Fair value hedge excluded component	(30,000)	(50,000)	-	-
Income statement				
Gains (losses) on AFS debt securities	\$(50,000)	\$ (100,000)	\$(150,000)	\$3,300,000

Account	3 months ended Mar 31	6 months ended Jun 30	9 months ended Sep 30	Year ended Dec 31
Disclosures under subparagraphs 815-10-50-4EE(a) – 50-4EE(c)				
Amortized cost of AFS debt securities on the balance sheet that are designated as hedged items in fair value hedges ¹ [815-10-50-4EE(a), 50-4EE(c)]	15,000,000	14,800,000	14,500,000	-
Increase (decrease) in fair value of hedged AFS debt securities recognized in earnings due to fair value hedge accounting ² [815-10-50-4EE(b)]	-	(200,000)	(500,000)	-
Notes: 1. Amortized cost at January 1, Year 1 (\$15,000,000, which equals the purchase price since there were no premiums or discounts) + Increase (decrease) in fair value of hedged AFS debt securities recognized in earnings due to fair value hedge accounting. 2. Fair value at that date - fair value at January 1, Year 1. This amount represents the cumulative basis adjustment (i.e. amount of fair value hedge adjustments) included in the amortized cost at that date. This equals the intrinsic value of the put option because the hedging relationship was perfectly effective.				

The \$3,300,000 gain on AFS securities for the year ended December 31, Year 1 represents the following.

- **\$3,500,000 unrealized gain in AOCI as of the date of inception of the hedging relationship.** Although the US Treasury bond's fair value fell to \$17,750,000, ABC was able to lock in a \$18,500,000 sale price as a result of entering into the put option. Therefore, it was able to realize the gain of \$3,500,000 (less the premium paid for the option).
Because the intrinsic value of the put option was perfectly effective at offsetting changes in the fair value of the US Treasury bond, each change in the intrinsic value of the put option recognized in earnings was offset by an equal amount that represents the change in the fair value of the US Treasury bond.
- **\$200,000 premium paid for the put option.** This was recognized in earnings evenly over the term of the put option using an amortization approach (i.e. straight-line method).

The following table compares the earnings effect of the excluded component under each method.

Approach	3 months ended				Total
	March 31	June 30	September 30	December 31	
Mark-to-market (Scenario 1)	\$20,000	\$30,000	\$50,000	\$100,000	\$200,000
Amortization (Scenario 2)	50,000	50,000	50,000	50,000	200,000
Difference	\$(30,000)	\$(20,000)	\$ -	\$ 50,000	\$ -

8.3 Measuring the hedged item (basis adjustments)

8.3.10 Overview

The amortized cost basis of a **hedged item** in a fair value hedge (i.e. the hedged asset, liability or firm commitment) is adjusted for its change in fair value that is attributable to the risk being hedged. This adjustment is referred to as a basis adjustment. [815-25-35-1]

Additional considerations apply when:

- the hedged risk is **interest rate risk** (section 8.3.20); and
- basis adjustments are determined at a portfolio level (section 8.3.30).



Question 8.3.10

May a basis adjustment be measured using a method different from that used to assess effectiveness?

Interpretive response: No. A basis adjustment is measured consistently with the entity's risk management strategy and the method used to assess the hedging relationship's effectiveness.

For example, in a fair value hedge of a firm commitment, an entity assesses hedge effectiveness based on the entire gain or loss on the derivative hedging instrument – i.e. including the time value component. In this situation, the basis adjustment is also based on the total change in its fair value – i.e. including the time value component.

In contrast, if the hedged item is a recognized asset or liability, its fair value is measured based on current prices – e.g. spot prices for a commodity. As a result, the entity's risk management strategy and assessment of effectiveness likely considers only changes in spot prices of the hedging derivative instrument – i.e. time value of an option contract is an excluded component (see section 13.2.70). In this situation, the basis adjustment is limited to changes in the fair value of the hedged item attributable to changes based on spot prices.

See also Example 8.3.50 regarding the benchmark rate component for effectiveness assessment and basis adjustment measurement.



Question 8.3.20

Is it appropriate to use the change in fair value of the hedging instrument to measure the basis adjustment?

Interpretive response: It depends. When the shortcut method is used (see section 13.3), the change in fair value of the hedging instrument is used as a proxy to measure the change in fair value of the hedged item with no effect on net income – i.e. the income statement reflects perfect effectiveness of the hedging relationship.

This approach for measuring the hedged item's fair value is not appropriate when the shortcut method is not used. As a result, differences may arise between measurement of the hedging instrument and the basis adjustment, resulting in the hedge not being perfectly effective and creating volatility in earnings.

For example, such a difference may result when the discount rate used to measure the fair value of a derivative hedging instrument is not the same as the benchmark interest rate designated as the hedged risk.



Question 8.3.30

Do the principles of Topic 820 apply when measuring a basis adjustment?

Interpretive response: Yes. Although the hedged item may not be measured at fair value (see Question 8.3.40), we believe the measurement of changes in the fair value of the hedged item attributable to the hedged risk(s) should follow the principles of Topic 820 (fair value measurement).

See also KPMG Handbook, [Fair value measurement](#), including Question B70 and Section O, *Application issues: Derivatives and hedging*.



Question 8.3.40

Does a basis adjustment result in the hedged item being measured at its fair value?

Interpretive response: Not necessarily. A basis adjustment is measured based on changes in the fair value that are attributable to the hedged risk that occurred since the hedged item was designated in the hedging relationship. As a result, the hedged item's measurement may not be fair value on the balance

sheet unless it is required to be measured at fair value under other applicable US GAAP (e.g. an AFS debt security).

The following two situations demonstrate when a hedged item's amortized cost basis (including the basis adjustment) does not represent the hedged item's fair value.

- **Hedge designated after initial recognition of the hedged item carried at amortized cost.** If an asset or liability is not designated in a hedging relationship until after it is initially recognized, any unrealized gain or loss that arose between initial recognition and the time it was designated in a hedging relationship is not recognized.
- **Hedged risk is a specific risk rather than total changes in fair value.** If the hedged risk is changes in fair value attributable to only a specific risk, the basis adjustment is measured based only on changes in fair value attributable to the specific risk rather than all changes in fair value of the hedged item. For example, if the hedged risk for a fixed-rate debt obligation relates to the benchmark interest rate, only changes in fair value attributable to changes in the benchmark interest rate are recognized and changes due to other factors (e.g. credit risk) are not.



Question 8.3.50

When the hedged risk is overall changes in fair value, can any of the contractual cash flows be excluded from the basis adjustment measurement?

Interpretive response: No. When the hedged risk is overall changes in fair value, *all* contractual cash flows of the hedged item are considered when measuring the basis adjustment.

Examples

The following examples demonstrate measuring the basis adjustment.

- Fair value hedge of inventory after initial recognition (Example 8.3.10).
- Accounting for the hedge of long-term debt with an interest rate swap (shortcut method) (Example 8.3.20).
- Accounting for a fair value hedge of the LIBOR swap rate in a fixed-rate noncallable note (Example 8.3.30).
- Accounting for a hedge of a firm commitment to purchase silver with a forward contract (Example 8.3.40).



Example 8.3.10

Fair value hedge of inventory after initial recognition

ABC Corp. purchased 10,000 units of widget inventory three months ago for \$100,000. Since that time, the widgets have increased in value to \$150,000.

Because ABC carries its inventory at the lower of cost or net realizable value, ABC has not recognized the \$50,000 appreciation in this inventory.

To hedge the fair value of this inventory, ABC purchases a put option to sell 10,000 widgets at a price of \$15 each. ABC assesses effectiveness using the option's intrinsic value – i.e. ABC excludes time value from its assessment of effectiveness. ABC elects to use the mark-to-market approach for recognizing changes in the fair value of the excluded component (time value).

At the next reporting date, the intrinsic value of the option and fair value of the inventory have changed as reflected in the following table.

	Intrinsic value increase (decrease)
Put option	\$20,000
Inventory	(20,000)

ABC records the following journal entry.

	Debit	Credit
Put option	20,000	
Cost of goods sold		20,000
<i>To record change in intrinsic value of put option (hedging instrument).</i>		
Cost of goods sold	20,000	
Inventory		20,000
<i>To record change in fair value of inventory attributable to hedged risk.</i>		

In addition, ABC would record a journal entry to recognize the change in the fair value of the excluded component (i.e. time value of option) as cost of goods sold.

After the above journal entry is recognized, the inventory's cost basis is \$80,000, which represents the carrying amount of the inventory at inception of the hedge (\$100,000) less the change in its fair value during the hedge period (\$20,000).

The preexisting gain on the inventory at inception of the hedge is not recognized on the balance sheet. As a result, even though the fair value of the hedged inventory is \$130,000, applying the fair value hedge accounting requirements results in it being carried at an amount below its fair value. In essence, if the hedge is effective, the fair value hedge accounting approach has the effect of locking in the \$50,000 gain that existed at the beginning of the hedge. This excludes the cost of the option (time value) – which is excluded from the assessment of effectiveness and is recognized as cost of goods sold during the hedging relationship.

If the inventory's fair value was equal to \$130,000 at the date it was sold and the put option also settled on that date, ABC would record the following journal entry (other than related to the cost of the excluded component).

	Debit	Credit
Cash	130,000	
Cost of goods sold	80,000	
Sales revenue		130,000
Inventory		80,000
<i>To record revenue from sale of inventory with related cost of goods sold.</i>		
Cash	20,000	
Put option		20,000
<i>To record settlement of the put option.</i>		



Example 8.3.20

Accounting for the hedge of long-term debt with an interest rate swap (shortcut method)

On January 1, Year 1, ABC Corp. issues a three-year \$1,000,000 debt obligation bearing a fixed interest rate of 10%. ABC simultaneously enters into a three-year interest rate swap with a notional amount of \$1,000,000 to receive interest at a fixed rate of 9.5% and pay interest at a variable rate equal to six-month LIBOR. The combination of the interest rate swap and debt obligation results in ABC effectively paying an interest rate equal to six-month LIBOR plus 50 bps.

Both the debt obligation and interest rate swap require payments to be made or received on June 30 and December 31 of each year. The variable rate on the interest rate swap resets on January 1 and July 1 of each year. No premium is paid or received for the interest rate swap.

ABC designates the interest rate swap as a fair value hedge of the changes in fair value of the fixed-rate debt obligation attributable to changes in the benchmark interest rate – i.e. six-month LIBOR.

The following additional facts are relevant.

- All criteria for hedge accounting using the shortcut method have been met (see section 13.3). There have been no changes in creditworthiness that would alter the effectiveness of the hedging relationship.
- The six-month LIBOR rates on the annual interest rate swap reset dates are as follows.

Date	6-month LIBOR
January 1, Year 1	9.5%
January 1, Year 2	8.5%
January 1, Year 3	10.5%

- Payments made (received) are as follows.

	December 31		
	Year 1	Year 2	Year 3
Fixed-rate debt obligation ¹	\$100,000	\$100,000	\$100,000
Interest rate swap ²	-	(10,000)	10,000
Net effect	\$100,000	\$90,000	\$110,000
Notes:			
1. Principal amount of the debt obligation \$1,000,000 × the fixed interest rate of 10%.			
2. Notional amount of the interest rate swap \$1,000,000 × (6-month LIBOR at the beginning of the year less 9.5%).			

- Assumed fair value amounts (after cash settlements, which is referred to as 'clean' pricing) are as follows.

	December 31		
	Year 1	Year 2	Year 3
Asset (liability)			
Interest rate swap	\$ 150,000	\$ 90,000	\$ -
Fixed-rate debt obligation (due solely to changes in the benchmark interest rate) ¹	1,150,000	1,090,000	-
Change in fair value – gain (loss)			
Interest rate swap	150,000	(60,000)	(90,000)
Fixed-rate debt obligation ¹	\$(150,000)	\$60,000	\$90,000
Note:			
1. Under the shortcut method, the change in fair value of the interest rate swap (hedging instrument) is used as a proxy to measure the change in the fair value of the fixed-rate debt obligation (hedged item).			

For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
- It is based on annual periods; normally the assessment of effectiveness and fair value adjustments of the hedged item and derivative would be done at least quarterly.
- Journal entries are demonstrated for annual periods although payments are made on June 30 and December 31 of each year and the interest rate swap resets on January 1 and July 1 of each year.
- Journal entries (for all years) are presented gross for illustrative purposes but could be combined.

Journal entries – January 1, Year 1

	Debit	Credit
Cash	1,000,000	
Fixed-rate debt obligation		1,000,000
<i>To record issuance of fixed-rate debt obligation.</i>		

A memorandum entry is also made on January 1, Year 1 documenting the existence of this hedging relationship. The financial records of ABC are not otherwise affected as of this date because the interest rate swap had a fair value of zero at inception.

Journal entries – December 31, Year 1

ABC records the following journal entries.

	Debit	Credit
Interest expense	100,000	
Cash		100,000
<i>To record interest expense on fixed-rate debt obligation.</i>		
Interest rate swap	150,000	
Interest expense		150,000
<i>To record change in fair value of interest rate swap (hedging instrument).</i>		
Interest expense	150,000	
Fixed-rate debt obligation		150,000
<i>To record change in fair value of fixed-rate debt obligation due to changes in interest rates.</i>		

Journal entries – December 31, Year 2

ABC records the following journal entries.

	Debit	Credit
Interest expense	100,000	
Cash		100,000
<i>To record interest expense on fixed-rate debt obligation.</i>		
Interest expense	60,000	
Interest rate swap		60,000
<i>To record change in fair value of interest rate swap (hedging instrument).</i>		

	Debit	Credit
Fixed-rate debt obligation	60,000	
Interest expense		60,000
<i>To record change in fair value of fixed-rate debt obligation due to changes in interest rates.</i>		
Cash	10,000	
Interest expense		10,000
<i>To record net interest cash receipt on interest rate swap as a decrease in interest expense.</i>		

Journal entries – December 31, Year 3

ABC records the following journal entries.

	Debit	Credit
Interest expense	100,000	
Cash		100,000
<i>To record interest expense on fixed-rate debt obligation.</i>		
Interest expense	90,000	
Interest rate swap		90,000
<i>To record change in fair value of interest rate swap (hedging instrument).</i>		
Fixed-rate debt obligation	90,000	
Interest expense		90,000
<i>To record change in fair value of fixed-rate debt obligation due to changes in interest rates.</i>		
Interest expense	10,000	
Cash		10,000
<i>To record net interest cash payment on interest rate swap as an increase in interest expense.</i>		
Fixed-rate debt obligation	1,000,000	
Cash		1,000,000
<i>To record cash paid by the borrower on maturity of the fixed-rate debt obligation.</i>		

Financial statement excerpts

At the end of Years 1–3, ABC’s financial statements reflect the following.

Account	Year 1	Year 2	Year 3
Balance sheet – assets			
Interest rate swap	\$150,000	\$90,000	-
Balance sheet – liabilities			
Debt obligation	\$1,150,000	\$1,090,000	-
Income statement			
Interest expense	\$100,000 ¹	\$90,000 ²	\$110,000 ³
Disclosures under 815-10-55-4EE			
Carrying amount of debt obligations on the balance sheet that are hedged liabilities [815-10-50-4EE(a), 50-4EE(c)]	\$1,150,000	\$1,090,000	-
Cumulative amount of fair value hedge adjustments included in the carrying amount of hedged debt obligations [815-10-50-4EE(b)]	\$150,000	\$90,000	-
Notes:			
1. For Year 1, this can be computed as (9.5% LIBOR at the beginning of the year + 0.50%) × \$1,000,000 = \$100,000.			
2. For Year 2, this can be computed as (8.5% LIBOR at the beginning of the year + 0.50%) × \$1,000,000 = \$90,000.			
3. For Year 3, this can be computed as (10.5% LIBOR at the beginning of the year + 0.50%) × \$1,000,000 = \$110,000.			

Under the shortcut method, the hedging relationship is assumed to be perfectly effective. As a result, recording both the changes in fair value of the interest rate swap (derivative hedging instrument) and the changes in fair value of the fixed-rate debt obligation (hedged item) due to changes in 6-month LIBOR (benchmark interest rate) have the effect of converting the interest expense on the 10% fixed-rate debt obligation to six-month LIBOR plus 50 bps.



Example 8.3.30

Accounting for a fair value hedge of the LIBOR swap rate in a fixed-rate noncallable note

On January 1, Year 1, ABC Corp. issues at par a \$100,000 BBB-rated, two-year noncallable note at a fixed rate of 10%. Interest is paid annually on December 31.

Also on January 1, Year 1, ABC enters into a two-year interest rate swap based on the 12-month LIBOR swap rate. Under the terms of the swap, ABC will receive fixed interest at 7% and pay variable interest at 12-month LIBOR. The variable leg of the swap resets each year on December 31 for the payments due the following year. The shortcut method cannot be used because the

interest rate swap resets annually and the shortcut method requires the frequency of repricing generally to be three to six months. [815-20-25-105(c)]

On January 1, Year 1, ABC designates the interest rate swap as the hedging instrument in a fair value hedge. The hedge objective and strategy is to hedge the change in the fair value of the \$100,000 BBB-rated, two-year debt obligation due to changes in the benchmark interest rate (12-month LIBOR) with a two-year \$100,000 interest rate swap to receive 7% and pay 12-month LIBOR. Through the interest rate swap, ABC effectively converts its fixed-rate obligation to a 12-month LIBOR-based variable-rate obligation. This results in an effective variable rate of approximately 12-month LIBOR plus 3% because the receiving leg of the swap is fixed at 7% compared to the debt obligation's 10%.

The assessment of hedge effectiveness is made by comparing the cumulative change in the fair value of the hedged item attributable to changes in the benchmark interest rate with the cumulative changes in the fair value of the interest rate swap.

The change in the fair value of the debt obligation attributable to interest rate risk is calculated based on the full contractual cash flows of the debt obligation. Further, it is based on:

- the note's coupon rate (i.e. its market interest rate at inception) adjusted for changes in the benchmark interest rate from inception to the beginning of the period for which the change in fair value is being calculated; and
- the note's coupon rate adjusted for changes in the benchmark interest rate from inception to the end of that period.

This example has been simplified by assuming that the interest rate applicable to all payments is the same – i.e. the yield curve is flat.

The following additional facts are relevant.

- All criteria for hedge accounting have been met (see chapters 6 and 7).
- The 12-month LIBOR swap rates reset as follows.

Date	12-month LIBOR
January 1, Year 1	7.0%
December 31, Year 1	7.5%

- Payments made (received) are as follows.

	December 31, Year 1	December 31, Year 2
Debt obligation ¹	\$10,000	\$10,000
Interest rate swap ²	-	500
Net effect	\$10,000	\$10,500

Notes:

1. Principal amount of the debt obligation \$100,000 × the fixed interest rate of 10%.
2. Notional amount of the interest rate swap \$100,000 × (12-month LIBOR at the beginning of the year less 7.0% received on the fixed leg).

- Changes in the fair value of the debt obligation attributable to interest rate risk (12-month LIBOR) are as follows (after settlement of interest).

December 31, Year 1	
Principal and interest payment due at end of Year 2	\$110,000
Market rate at inception of hedge adjusted for changes in LIBOR, at beginning of Year 1	10.00%
Present value based on market rate as adjusted, beginning of period	\$100,000
Market rate at inception of hedge adjusted for changes in LIBOR, at end of period	10.50%
Present value based on market rate as adjusted, end of period ¹	\$99,548
Change in fair value attributable to changes in LIBOR	\$(452)
Note:	
1. Final principal and interest amounts of the debt obligation of \$110,000 (\$100,000 + \$10,000) discounted at 10.50%.	
December 31, Year 2	
Principal payment due at end of Year 2 (equals present value because it is due immediately)	\$100,000
Change in fair value attributable to changes in LIBOR	\$452

- Fair value amounts of the interest rate swap are as follows (assumed).

	December 31, Year 1 asset (liability)	December 31, Year 2 asset (liability)
Interest rate swap (liability) <i>before</i> settlement	(465) ¹	(500) ²
Interest rate swap (liability) <i>after</i> settlement	(465)	-
Notes:		
1. Because the yield curve is assumed to be flat, the fair value of \$465 represents the present value of the assumed net settlement of \$500 in one year's time based on 7.5% LIBOR rate at December 31, Year 1.		
2. The increase of \$35 is due to the passage of time (note that the benchmark rate did not change) and is calculated as the \$465 fair value at December 31, Year 1 × 7.5%.		

- Hedge effectiveness at December 31, Year 1 is as follows.

Change in fair value of the interest rate swap	\$465
Change in fair value of the debt obligation attributable to interest rate risk	452
Hedge effectiveness ¹	102.9%
Extent to which hedge is not perfectly effective ²	\$13
Notes:	
1. $\$465 \div \$452$.	
2. $\$465 - \$452$.	

For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
- It is based on annual periods; normally the assessment of effectiveness and fair value adjustments of the hedged item and derivative is done at least quarterly.
- Journal entries (for all years) are presented gross for illustrative purposes but could be combined.

Journal entries – January 1, Year 1

	<i>Debit</i>	<i>Credit</i>
Cash	100,000	
Debt obligation		100,000
<i>To record issuance of \$100,000, 2-year debt obligation.</i>		

There would also be a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship. The financial records of ABC would not otherwise be affected as of this date because the interest rate swap had a fair value of zero at inception.

Journal entries – December 31, Year 1

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	10,000	
Cash		10,000
<i>To record interest expense on debt obligation.</i>		
Debt obligation	452	
Interest expense		452
<i>To record change in fair value of debt obligation due to changes in interest rates.</i>		
Interest expense	465	
Interest rate swap		465
<i>To record change in fair value of interest rate swap (hedging instrument).</i>		

Journal entries – December 31, Year 2

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	10,000	
Cash		10,000
<i>To record interest expense on debt obligation.</i>		

	Debit	Credit
Interest expense	452	
Debt obligation		452
<i>To record change in fair value of debt obligation due to changes in interest rates.</i>		
Interest expense	35	
Interest rate swap		35
<i>To record change in fair value of interest rate swap (hedging instrument).</i>		
Interest rate swap	500	
Cash		500
<i>To record net interest cash payment of interest rate swap (hedging instrument).</i>		
Debt obligation	100,000	
Cash		100,000
<i>To record settlement of debt obligation.</i>		

Financial statement excerpts

At the end of Years 1–2, ABC’s financial statements reflect the following.

Account	Year 1	Year 2
Balance sheet – liabilities		
Debt obligation	\$99,548	-
Interest rate swap	465	-
Income statement		
Interest expense	\$10,013 ¹	\$10,487 ²
Disclosures under 815-10-55-4EE		
Carrying amount of debt obligations on the balance sheet that are hedged liabilities [815-10-50-4EE(a), 50-4EE(c)]	\$99,548	-
Cumulative amount of fair value hedge adjustments included in the carrying amount of hedged debt obligations [815-10-50-4EE(b)]	452	-
Notes:		
- For Year 1, interest expense reflects the following. - Effective interest of 12-month LIBOR at the most recent reset date (7%) + the fixed spread (3%) = 10% (\$10,000). - The extent to which the hedging relationship is not perfectly effective (\$13). - For Year 2, interest expense reflects the following. - Effective interest of 12-month LIBOR at the most recent reset date (7.5%) + the fixed spread (3%) = 10.5% (\$10,500).		

- The slight difference in the expected effective rate of 10.5% and the actual rate of 10.49% ($\$10,487 \div 100,000$) is due to the fact that the hedging relationship was not perfectly effective.

Through the interest rate swap, ABC converted its fixed-rate obligation to a 12-month LIBOR-based variable-rate obligation. This results in an effective variable rate of approximately 12-month LIBOR plus 3% because the receiving leg of the swap is fixed at 7% compared to the debt obligation's 10%.



Example 8.3.40

Accounting for a hedge of a firm commitment to purchase silver with a forward contract

This example continues from Example 7.3.50; for ease of reference, this example includes the full fact pattern.

ABC Corp. produces silver platters for sale to department stores. The sales price of the silver platters depends in large part on the market price of silver as of the date of sale. ABC has a contract to purchase 100,000 ounces of silver from DEF at \$4.99 per ounce on December 31, Year 1. This transaction is considered a normal purchase as defined by Topic 815; therefore, the forward contract is not recognized and measured as a derivative.

If ABC does not purchase the silver from DEF, it will be required to pay DEF a substantial penalty of \$300,000 – i.e. ABC's contract with DEF is a firm commitment. ABC is not required to make an up-front cash payment.

ABC is concerned that – as a result of fluctuations in the price of silver during the commitment period – the inventory would be recorded at other than market price at the date of purchase. Therefore, to hedge against the fluctuations in fair value of its firm commitment due to changes in the market price of silver, ABC enters into an over-the-counter silver forward contract on July 1, Year 1 that settles in cash on a net basis on December 31, Year 1. The forward contract requires ABC to sell 100,000 ounces of silver at \$4.99 per ounce.

The forward contract is designated as a fair value hedge of ABC's firm commitment to purchase 100,000 ounces of silver from DEF in six months.

The following additional facts are relevant.

- The relationship is expected to be highly effective. ABC will assess hedge effectiveness based on the changes in the forward price of silver.
 - At inception, ABC concludes and documents that the hedging relationship is expected to be highly effective.
 - On an ongoing basis, ABC will ascertain and document that the hedging relationship has been, and will continue to be, highly effective.
 - Credit risk (and changes in credit risk) are assumed to be nominal.
- The basis adjustment recognized in earnings related to the firm commitment will equal the changes in the fair value of the forward contract.
- All criteria for hedge accounting have been met (see chapters 6 and 7).

- The forward contract is at market rates; therefore, no cash is exchanged at inception of the contract.
- The spot and forward price of silver, and the fair value of the forward contract, are as follows.

	Spot price	Forward price	Fair value ¹ asset (liability)	Change in fair value
July 1, Year 1	\$5.00	\$4.99	\$ -	N/A
September 1, Year 1	4.98	4.95	3,960	\$ 3,960
December 31, Year 1	5.10	N/A	(11,000)	(14,960)
Note:				
1. Measured using the change in forward rates, discounted at an appropriate discount rate				

- The forward contract settles on December 31, Year 1 with ABC paying $\$11,000 = \$100,000 \times (\$4.99 - \$5.10)$.

For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
- ABC's silver purchase contract is considered a normal purchase (see section 7.3.30).
- The hedging relationship is perfectly effective.

Journal entries – July 1, Year 1

A memorandum entry is made on July 1, Year 1 documenting the existence of this hedging relationship. ABC's financial records are otherwise not affected as of this date because the forward contract is at market rates.

Journal entries – September 30, Year 1

ABC records the following journal entries.

	Debit	Credit
Forward contract to sell silver	3,960	
Cost of goods sold		3,960
<i>To record change in fair value of forward contract attributable to discounted change in forward rate.</i>		
Cost of goods sold	3,960	
Firm commitment to purchase silver		3,960
<i>To record change in fair value of firm commitment to purchase silver.</i>		

At September 1, Year 1, ABC's financial statements reflect the following.

Account	Amount
Balance sheet – assets	
Forward contract to sell silver	\$3,960
Balance sheet – liabilities	
Firm commitment to purchase silver	3,960
Income statement	
Cost of goods sold	-

Journal entries – December 31, Year 1

ABC records the following journal entries.

	Debit	Credit
Cost of goods sold	14,960	
Forward contract to sell silver		14,960
<i>To record change in fair value of forward contract attributable to discounted change in forward rate.</i>		
Firm commitment to purchase silver	14,960	
Cost of goods sold		14,960
<i>To record change in fair value of firm commitment to purchase silver.</i>		
Forward contract to sell silver	11,000	
Cash		11,000
<i>To record settlement of forward contract at December 31, Year 1.</i>		
Silver inventory	510,000	
Firm commitment to purchase silver		11,000
Cash		499,000
<i>To record purchase of 100,000 ounces of silver at \$4.99 per ounce pursuant to contract with DEF.</i>		

At December 31, Year 1, ABC's financial statements reflect the following.

Account	Amount
Balance sheet – assets	
Silver inventory	\$510,000
Income statement	
Cost of goods sold	-

ABC enters into this hedging transaction because of concerns that changes in silver prices would cause fluctuations in the fair value of the firm commitment

to purchase silver. The silver inventory includes the realized gain on the firm commitment of \$11,000. Since silver prices increased, ABC realized a gain of \$11,000 on the firm commitment to purchase silver from DEF. This gain is offset by an \$11,000 loss on the forward contract to sell silver. Therefore, even though ABC pays \$499,000 for the silver inventory (i.e. the contract price), the inventory is recorded at the current market price of \$510,000 (i.e. the purchase price plus the fair value of the firm commitment).

8.3.20 Hedges involving interest rate risk



Excerpt from ASC 815-25

>> Changes Involving Interest Rate Risk

35-13 In calculating the change in the hedged item's fair value attributable to changes in the **benchmark interest rate** (see paragraph 815-20-25-12(f)(2)), the estimated coupon cash flows used in calculating fair value shall be based on either the full contractual coupon cash flows or the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception.

>>> Measuring the Fair Value of a Prepayable Instrument in Hedges of Interest Rate Risk

35-13A In a hedge of interest rate risk in which the hedged item is a **prepayable** instrument in accordance with paragraph 815-20-25-6, the factors incorporated for the purpose of adjusting the carrying amount of the hedged item shall be the same factors that the entity incorporated for the purpose of assessing hedge effectiveness in accordance with paragraph 815-20-25-6B. For example, if an entity considers only how changes in the benchmark interest rate affect an obligor's decision to prepay a debt instrument when assessing hedge effectiveness, it shall consider only that factor when adjusting the carrying amount of the hedged item. The election to consider only how changes in the benchmark interest rate affect an obligor's decision to prepay a debt instrument does not affect an entity's election to use either the full contractual coupon cash flows or the benchmark rate component of the contractual coupon cash flows determined at hedge inception for purposes of measuring the change in fair value of the hedged item in accordance with paragraph 815-25-35-13.

>>> Partial-Term Hedges of Interest Rate Risk

35-13B For a fair value hedge of interest rate risk in which the hedged item is designated as selected contractual cash flows in accordance with paragraph 815-20-25-12(b)(2)(ii), an entity may measure the change in the fair value of the hedged item attributable to interest rate risk using an assumed term that begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable. The assumed maturity of the hedged item occurs on the date in which the last hedged cash flow is due and payable.

%I Interest rate risk. When the risk being hedged is the benchmark interest rate, an entity may choose to measure the change in the hedged item's fair value attributable to the changes in the benchmark interest rate based on either (see section 7.3.70): [\[815-25-35-13\]](#)

- the entire contractual coupon cash flows of the hedged item; or
- the benchmark rate component of the contractual coupon cash flows of the hedged item determined at inception of the hedging relationship.

When the hedged item is a prepayable financial instrument, the entity is required to consider the prepayment option when measuring the basis adjustment. An entity can elect either of the following two approaches (see section 7.4.10): [\[815-20-25-6B, 815-25-35-13A\]](#)

- consider only the effect of changes in the benchmark interest rate on the decision to prepay a financial instrument; or
- consider all factors (e.g. credit risk, liquidity, interest rates) when measuring the change in fair value of the call option.

As discussed in Question 8.3.10, a basis adjustment is measured consistently with the method an entity uses to assess the hedging relationship's effectiveness. As a result, the approaches elected with respect to assessing hedge effectiveness also affect the measurement of the basis adjustment when the hedged risk is the benchmark interest rate and/or when hedging interest rate risk of a prepayable financial instrument. [\[815-25-35-13A\]](#)

For partial-term hedges of interest rate risk (see section 7.3.80), the basis adjustment is measured assuming the hedged item has a term that reflects only the designated cash flows and assumes that the principal payment occurs at the end of the hedge term. [\[815-25-35-13B\]](#)



Question 8.3.60

What discount rate should be applied when calculating the change in fair value of the hedged item attributable to changes in the benchmark rate?

Interpretive response: Subtopic 815-25 does not specify the discount rate to use to calculate the change in the fair value of the hedged item. [\[815-25-55-56A\]](#)

For purposes of determining the change in fair value attributable to changes in the benchmark interest rate, we believe the discount rate can be either:

- the benchmark interest rate designated as being hedged; or
- the market interest rate of the hedged item at inception of the hedge, adjusted for changes in the benchmark interest rate being hedged.

See also Example 8.3.60, which illustrates this response.



Question 8.3.70

When the hedged risk is the benchmark interest rate, are changes in sector credit spreads, issuer credit risk or liquidity spreads included in the measurement of the basis adjustment?

Interpretive response: No. These components of an interest rate do not represent components of the benchmark interest rate. As a result, when the hedged risk is changes in fair value attributable to changes in the benchmark interest rate, changes in these components are excluded.



Question 8.3.80

What is the benchmark rate component if the hedged item is a nonprepayable financial instrument?

Interpretive response: We believe the benchmark rate component of the contractual coupon cash flows is the swap rate (i.e. the fixed leg) on an interest rate swap that at hedge inception has a fair value of zero and has no spread on its floating leg.

See also Example 8.3.50, which illustrates this response.



Question 8.3.90

What is the benchmark rate component if the hedged item is a prepayable financial instrument?

Interpretive response: In addition to the factors described in Question 8.3.80, we believe an entity would also have to consider the prepayment option in the financial instrument when determining the benchmark rate component of the contractual coupon cash flows. For example, an entity issues a 10-year fixed-rate bond that is prepayable after Year 7. The entity hedges the debt by entering into a 10-year interest rate swap that may be cancelled without penalty after Year 7 whereby it receives 2.75% and pays three-month LIBOR. The benchmark rate component is the swap rate on a cancellable swap – i.e. 2.75%. It would not be the swap rate on a similar but non-cancellable swap.



Question 8.3.100

What is the benchmark rate component if the hedged item has a premium or discount at hedge inception?

Interpretive response: We believe the benchmark rate component of the contractual coupon cash flows of a financial instrument issued or acquired at a premium or discount is the same as if the instrument was issued or acquired at par at hedge inception. This is the case regardless of whether the financial instrument is acquired or issued before hedge inception (a late hedge). We view the premium or discount as a source of incremental spread that is not part of the benchmark rate component.



Question 8.3.110

Can the benchmark rate component of the contractual coupon be used if it is greater than the entire coupon?

Interpretive response: Yes. An entity may measure the change in the hedged item's fair value attributable to interest rate risk using the benchmark rate component of its contractual coupon cash flows even when the benchmark rate component is greater than the contractual coupon rate (a sub-benchmark rate). [\[ASU 2017-12.BC95\]](#)

The benchmark rate component of a fixed-rate asset or liability could be greater than the asset's or liability's contractual coupon rate. This can happen if an entity issues or acquires a debt instrument, and subsequently designates it as a hedged item (a late hedge) and interest rates have changed between the date the entity recognized the instrument and the date it designated the hedge. [\[ASU 2017-12.BC92\]](#)

This can also happen if, for example, an entity issues a bond with a 3% coupon at a time when similar bonds are being issued with a 5% coupon. In this case, the bond is issued at a discount. The benchmark rate component, determined as explained in Example 8.3.50, could be 4%, which is higher than the contractual coupon of 3%.



Question 8.3.120

Does Topic 815 prescribe a method to be used for measuring the basis adjustment when the benchmark interest rate is hedged?

Interpretive response: No. Topic 815 provides examples of how to measure the basis adjustment when the hedged risk is changes in fair value due to changes in the benchmark interest rate but does not prescribe the particular method.

The following table summarizes two methods illustrated in Topic 815.

FASB Example	Description	Comments
Example 9 [815-25-55-53 – 55-61C] <i>Reproduced below</i>	In this example, the change in fair value of the hedged item due to changes in the benchmark interest rate is measured by comparing the present values of the remaining cash flows¹ at the <i>end</i> of the period when discounted by the benchmark rate²: — at the <i>beginning</i> of the period; versus — at the <i>end</i> of the period.	— Because the method in Example 9 measures the periodic change in the fair value of the hedged item (i.e. the periodic basis adjustment) using the cash flows at the end of the period only, it does not capture changes in fair value due to the passage of time. — As a result, a basis adjustment for time value will remain at the end of the hedge term even if the hedge term coincides with maturity of the hedged item. To avoid this, entities may want to consider amortizing the basis adjustment during the hedge term (see section 8.4.20).
Example 11 [815-25-55-72 – 55-77] and Example 16 [815-25-55-100 – 55-108] <i>Both reproduced below</i>	Under these examples, the change in fair value of the hedged item due to changes in the benchmark interest rate is measured by comparing the present value of the remaining cash flows¹: — at the <i>beginning</i> of the period discounted by the benchmark rate² at the <i>beginning</i> of the period; versus — at the <i>end</i> of the period discounted by the benchmark rate² at the <i>end</i> of the period.	— If the method in Examples 11 and 16 is used, the periodic basis adjustment captures the change in fair value due to the passage of time because it compares the present value of the cash flows at the end of the period with the present value of the cash flows at the beginning of the period. — However, under this method, a basis adjustment may remain unless an entity elects to begin amortizing it during the hedge term when the entity elects to use all contractual cash flows rather than the benchmark component of contractual cash flows. This occurs because the instrument's coupon rate typically includes a credit spread over the benchmark rate. As a result, the present value of cash flows at inception of the hedge when discounted at the benchmark rate will differ from the instrument's par amount.

FASB Example	Description	Comments
Notes:		
- The remaining cash flows may be either the benchmark component of contractual cash flows or all contractual cash flows. - As an alternative to using the applicable benchmark rate at the beginning and end of the period, the discount rates used may be, respectively: - the market rate at inception of the hedge as adjusted for changes in the benchmark rate through the <i>beginning</i> of the period; and - the market rate at inception of the hedge as adjusted for changes in the benchmark rate through the <i>end</i> of the period. See Question 8.3.60 and Example 8.3.60.		

To avoid a basis adjustment remaining at the end of the hedge term, we anticipate that many entities will elect to use the method described in Examples 11 and 16 and to use the benchmark rate component (rather than full contractual cash flows) to measure the basis adjustment.

Examples

The following KPMG and FASB examples demonstrate fair value hedges involving interest rate risk.

- Benchmark rate component for assessment and measurement (Example 8.3.50).
- Fair value hedge of the LIBOR swap rate in a \$100,000 BBB-Quality 5-Year Fixed-Rate Noncallable Note (Subtopic 815-25's Example 9).
- Change in fair value attributable to changes in LIBOR – all contractual cash flows included (Example 8.3.60).
- Fair value hedge of the LIBOR swap rate in a \$100 million A1-quality 5-year fixed-rate noncallable debt (Subtopic 815-25's Example 11).
- Fair value hedge of interest rate risk using the partial-term approach (Subtopic 815-25's Example 15).
- Fair value hedge of the LIBOR swap rate in a \$100 million A1-quality 5-year fixed-rate noncallable debt (Subtopic 815-25's Example 16).



Example 8.3.50

Benchmark rate component for assessment and measurement

This example illustrates the response in Question 8.3.80.

ABC Corp. issues a 10-year bond with a 5% coupon at par. On the same day, ABC enters into a 10-year interest rate swap whereby it receives 3% and pays the three-month LIBOR rate. ABC designates the bond as the hedged item and the interest rate swap as the hedging instrument in a fair value hedge of interest rate risk.

ABC does not apply the shortcut method and elects to use the benchmark rate component of the bond's contractual coupon cash flows to measure the change in the bond's fair value attributable to changes in the benchmark interest rates.

At hedge inception, the fair value of the swap is zero and there is no spread on the floating leg of the swap. Therefore, ABC uses 3% (i.e. the fixed leg of the swap, which is referred to as the swap rate in the 10-year interest rate swap) as the benchmark rate component to measure the change in the bond's fair value attributable to interest rate risk.



Excerpt from ASC 815-25

>> Example 9: Fair Value Hedge of the LIBOR Swap Rate in a \$100,000 BBB-Quality 5-Year Fixed-Rate Noncallable Note

55-53 This Example illustrates one method that could be used pursuant to paragraph 815-20-25-12(f)(2) in determining the hedged item's change in fair value attributable to changes in the benchmark interest rate. Other methods could be used in determining the hedged item's change in fair value attributable to changes in the benchmark interest rate as long as those methods meet the criteria in that paragraph. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-54 On January 1, 20X0, Entity GHI issues at par a \$100,000 BBB-quality 5-year fixed-rate noncallable debt instrument with an annual 10 percent interest coupon. On that date, Entity GHI enters into a 5-year interest rate swap based on the LIBOR swap rate and designates it as the hedging instrument in a fair value hedge of the \$100,000 liability. Under the terms of the interest rate swap, Entity GHI will receive fixed interest at 7 percent and pay variable interest at LIBOR. The variable leg of the interest rate swap resets each year on December 31 for the payments due the following year. This Example has been simplified by assuming that the interest rate applicable to a payment due at any future date is the same as the rate for a payment at any other date (that is, the yield curve is flat). During the hedge period, the gain or loss on the interest rate swap will be recorded in earnings. The Example assumes that immediately before the interest rate on the variable leg resets on December 31, 20X0, the LIBOR swap rate increased by 50 basis points to 7.50 percent, and the change in fair value of the interest rate swap for the period from January 1 to December 31, 20X0, is a loss in value of \$1,675.

55-55 Under this method, the change in a hedged item's fair value attributable to changes in the benchmark interest rate for a specific period is determined as the difference between two present value calculations that use the remaining cash flows as of the end of the period and reflect in the discount rate the effect of the changes in the benchmark interest rate during the period.

55-56 Both present value calculations are computed using the estimated future cash flows for the hedged item, which would be either its remaining contractual coupon cash flows or the LIBOR benchmark rate component of the remaining contractual coupon cash flows determined at hedge inception as illustrated by the following Cases:

- a. Using the full contractual coupon cash flows (Case A)
- b. Using the LIBOR benchmark rate component of the contractual coupon cash flows (Case B).

55-56A This Example illustrates two approaches for computing the change in fair value of the hedged item attributable to changes in the benchmark interest rate. This Subtopic does not specify the discount rate that must be used to calculate the change in fair value of the hedged item.

55-56B In Cases A and B in this Example, Entity GHI presents the total change in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same income statement line item (in this case, interest expense) that is used by Entity GHI to present the earnings effect of the hedged item before applying hedge accounting in accordance with paragraph 815-20-45-1A.

>>> Case A: Using the Full Contractual Coupon Cash Flows

55-57 In this Case, assume Entity GHI elected to calculate the change in the fair value of the hedged item attributable to interest rate risk on the basis of the full contractual coupon cash flows of the hedged item. Accordingly, both present value calculations in accordance with paragraph 815-25-55-55 are computed using the remaining contractual coupon cash flows as of the end of the period and the discount rate that reflects the change in the designated benchmark interest rate during the period. The method chosen by Entity GHI in this Case requires that the discount rate be based on the market interest rate for the hedged item at the inception of the hedging relationship. The discount rates used for those present value calculations would be, respectively:

- a. The discount rate equal to the market interest rate for that hedged item at the inception of the hedge adjusted (up or down) for changes in the benchmark rate (designated as the interest rate risk being hedged) from the inception of the hedge to the beginning date of the period for which the change in fair value is being calculated
- b. The discount rate equal to the market interest rate for that hedged item at the inception of the hedge adjusted (up or down) for changes in the designated benchmark rate from the inception of the hedge to the ending date of the period for which the change in fair value is being calculated.

55-58 Entity GHI elected to subsequently assess hedge effectiveness on a quantitative basis. In Entity GHI's quarterly assessments of hedge effectiveness for each of the first three quarters of year 20X0 in this Example, there was zero change in the hedged item's fair value attributable to changes in the benchmark interest rate because there was no change in the LIBOR swap rate. However, in the assessment for the fourth quarter 20X0, the discount rate for the beginning of the period is 10 percent (the hedged item's original market interest rate with an adjustment of zero), and the discount rate for the end of the period is 10.50 percent (the hedged item's original market interest rate adjusted for the change during the period in the LIBOR swap rate [+ 0.50 percent]).

December 31, 20X0

Calculate the present value using the beginning-of-period discount rate of 10 percent:

\$10,000pmt, 10%i, 4n, PV =	\$ 31,699 (interest payments)
\$100,000fv, 10%i, 4n, PV =	\$ 68,301 (principal payment)
Total present value	<u>\$100,000</u>

55-59 Calculate the present value using the end-of-period discount rate of 10.50 percent (that is, the beginning-of-period discount rate adjusted for the change during the period in the LIBOR swap rate of 50 basis points).

\$10,000pmt, 10.50%i, 4n, PV =	\$ 31,359 (interest payments)
\$100,000fv, 10.50%i, 4n, PV =	\$ 67,073 (principal payment)
Total present value	<u>\$ 98,432</u>

55-60 The change in fair value of the hedged item attributable to the change in the benchmark interest rate is $\$100,000 - \$98,432 = \$1,568$ (the fair value decrease in the liability is a gain on debt).

55-61 When the change in fair value of the hedged item (\$1,568 gain) attributable to the risk being hedged is compared with the change in fair value of the hedging instrument (\$1,675 loss), a mismatch of \$107 results that will be reported in earnings, because both changes in fair value are recorded in earnings. The change in the fair value of the hedging instrument will be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

>>> Case B: Using the LIBOR Benchmark Rate Component of the Contractual Coupon Cash Flows

55-61A In this Case, assume Entity GHI elected to calculate the change in the fair value of the hedged item attributable to interest rate risk on the basis of the benchmark rate component of the contractual coupon cash flows determined at hedge inception. Accordingly, both present value calculations in accordance with paragraph 815-25-55-55 are computed using the remaining benchmark rate component of contractual coupon cash flows as of the end period and the discount rate that reflects the change in the designated benchmark rate during the period. The discount rates used by Entity GHI in this Case would be, respectively:

- The benchmark rate (designated as the interest rate risk being hedged) as of the beginning date of the period for which the change in fair value is being calculated
- The designated benchmark rate as of the ending date of the period for which the change in fair value is being calculated.

55-61B Entity GHI elected to subsequently assess hedge effectiveness on a quantitative basis. In Entity GHI's quarterly assessments of hedge effectiveness for each of the first three quarters of year 20X0, there was no change in the hedged item's fair value attributable to changes in the benchmark interest rate because there was no change in the LIBOR swap rate. However, in the assessment for the fourth quarter 20X0, the discount rate for the beginning of the period is 7 percent, and the discount rate for the end of the period is 7.50 percent reflecting the change during the period in the LIBOR swap rate. The change in fair value of the hedged item attributable to the

change in the benchmark interest risk for the period January 1, 20X0, to December 31, 20X0, is a gain of \$1,675, calculated as follows.

December 31, 20X0

Calculate the present value using the beginning-of-period benchmark interest rate:

\$7,000pmt, 7%i, 4n, PV =	\$ 23,710	(benchmark component of coupon payments)
\$100,000fv, 7%i, 4n, PV =	\$ 76,290	(principal payment)
Total present value	<u>\$100,000</u>	

Calculate the present value using the end-of-period benchmark interest rate:

\$7,000pmt, 7.50%i, 4n, PV =	\$ 23,445	(benchmark component of coupon payments)
\$100,000fv, 7.50%i, 4n, PV =	\$ 74,880	(principal payment)
Total present value	<u>\$ 98,325</u>	
Change in value	<u>\$ 1,675</u>	

55-61C Because the change in fair value of the hedged item (\$1,675 gain) attributable to the risk being hedged is the same as the change in fair value of the hedging instrument (\$1,675 loss), there is perfect offset and, therefore, a zero net earnings effect.



Example 8.3.60

Change in fair value attributable to changes in LIBOR – all contractual cash flows included

As discussed in Question 8.3.60, Subtopic 815-25 does not specify the discount rate that must be used to calculate the change in the fair value of the hedged item. We believe there are two acceptable discount rates that may be used, which are illustrated in this example as follows.

- **Scenario 1:** the discount rate is the designated benchmark interest rate (LIBOR).
- **Scenario 2:** the discount rate is the market interest rate of the hedged item at inception of the hedge, adjusted for changes in the designated benchmark interest rate (LIBOR).

Borrower hedges the changes in fair value attributable to changes in LIBOR (a Benchmark Interest Rate) of a \$1 million, five-year, 4% fixed-rate debt obligation issued at par on January 1, Year 1. Interest is paid quarterly. The hedge is designated at inception of the debt obligation (i.e. January 1, Year 1).

Borrower elects to calculate the change in the fair value of the debt obligation that is due to interest rate risk on the basis of the full contractual coupon cash flows of the debt obligation. Therefore, the cash flows being discounted at each date are the remaining contractual cash flows:

- interest of \$10,000 at the end of each quarter; and
- principal of \$1 million due on maturity of the debt.

LIBOR is as follows.

Date	LIBOR
January 1, Year 1	2.50%
March 31, Year 1	3.00%
June 30, Year 1	3.25%

The quarterly interest payments were made before determining the change in fair value.

Scenario 1: Discount rate is LIBOR

If the discount rate is LIBOR, the change in fair value of the total contractual cash flows that is attributable to changes in LIBOR is calculated at March 31, Year 1 as follows.

Quarterly interest payments, for 19 remaining quarters	\$ 190,000
Principal payment at end of 19 remaining quarters	1,000,000
Total	\$1,190,000
LIBOR at beginning of period	2.50%
Present value based on LIBOR at beginning of period	\$775,317
LIBOR at end of period	3.00%
Present value based on LIBOR at end of period	\$713,524
Change in fair value attributable to changes in LIBOR	\$(61,793)

Similarly, the change in fair value of the total contractual cash flows that is attributable to changes in LIBOR is calculated at June 30, Year 1 as follows.

Quarterly interest payments, for 18 remaining quarters	\$ 180,000
Principal payment at end of 18 remaining quarters	1,000,000
Total	\$1,180,000
LIBOR at beginning of period	3.00%
Present value based on LIBOR at beginning of period	\$724,930
LIBOR at end of period	3.25%
Present value based on LIBOR at end of period	\$696,987
Change in fair value attributable to changes in LIBOR	\$(27,943)

Scenario 2: Discount rate is the market interest rate at inception of the hedge as adjusted for changes in LIBOR

If the discount rate is the market interest rate at inception of the hedge as adjusted for changes in LIBOR, the change in fair value of the total contractual cash flows that is attributable to changes in LIBOR is calculated at March 31, Year 1 as follows.

Quarterly interest payments, for 19 remaining quarters	\$ 190,000
Principal payment at end of 19 remaining quarters	1,000,000
Total	\$1,190,000
Market rate at inception of hedge adjusted for changes in LIBOR, at beginning of period	4.00%
Present value based on market rate as adjusted, beginning of period	\$605,982
Market rate at inception of hedge adjusted for changes in LIBOR, at end of period	4.50%
Present value based on market rate as adjusted, end of period	\$559,235
Change in fair value attributable to changes in LIBOR	\$(46,747)

Similarly, the change in fair value of the total contractual cash flows that is attributable to changes in LIBOR is calculated at June 30, Year 1 as follows.

Quarterly interest payments, for 18 remaining quarters	\$ 180,000
Principal payment at end of 18 remaining quarters	1,000,000
Total	\$1,180,000
Market rate at inception of hedge adjusted for changes in LIBOR, at beginning of period	4.50%
Present value based on market rate as adjusted, beginning of period	\$574,400
Market rate at inception of hedge adjusted for changes in LIBOR, at end of period	4.75%
Present value based on market rate as adjusted, end of period	\$552,951
Change in fair value attributable to changes in LIBOR	\$(21,449)



Excerpt from ASC 815-25

>> Example 11: Fair Value Hedge of the LIBOR Swap Rate in a \$100 Million A1-Quality 5-Year Fixed-Rate Noncallable Debt

55-72 This Example illustrates application of the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 to a fair value hedge of the LIBOR swap rate in a \$100 million A1-quality 5-year fixed-rate noncallable debt. Assume that an entity elected to calculate the change in the fair value of the hedged item attributable to LIBOR interest rate risk using the full contractual coupon cash flows of the hedged item.

55-73 On April 3, 20X0, Global Tech issues at par a \$100 million A1-quality 5-year fixed-rate noncallable debt instrument with an annual 8 percent interest coupon payable semiannually. On that date, Global Tech enters into a 5-year interest rate swap based on the LIBOR swap rate and designates it as the hedging instrument in a fair value hedge of the \$100 million liability. Under the

terms of the interest rate swap, Global Tech will receive a fixed interest rate at 8 percent and pay variable interest at LIBOR plus 78.5 basis points (current LIBOR 6.29 percent) on a notional amount of \$101,970,000 (semiannual settlement and interest reset dates). A duration-weighted hedge ratio was used to calculate the notional amount of the interest rate swap necessary to offset the debt's fair value changes attributable to changes in the LIBOR swap rate.

55-74 This Example has the following assumptions:

- PV01 debt = 4.14
- PV01 interest rate swap = 4.06
- Hedge ratio = PV01 debt / PV01 interest rate swap = $4.14/4.06 = 1.0197$
- Interest rate swap notional = $1.0197 \times \$100 \text{ million} = \$101,970,000$.
- For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-75 The Example assumes that the LIBOR swap rate increased 100 basis points to 7.29 percent on June 30, 20X0. The change in fair value of the interest rate swap for the period from April 3 to June 30, 20X0, is a loss of \$4,016,000. The change in fair value of the debt attributable to changes in the benchmark interest rate for the period April 3 to June 30, 20X0, is calculated as follows.

Period	Principal Balance	Coupon Rate	Cash Flow – Interest	Cash Flow – Principal	Present Value
0.5	\$ 100,000,000	0.08	2,000,000	-	1,956,464
1.5	\$ 100,000,000	0.08	4,000,000	-	3,744,429
2.5	\$ 100,000,000	0.08	4,000,000	-	3,583,185
3.5	\$ 100,000,000	0.08	4,000,000	-	3,428,885
4.5	\$ 100,000,000	0.08	4,000,000	-	3,281,230
5.5	\$ 100,000,000	0.08	4,000,000	-	3,139,933
6.5	\$ 100,000,000	0.08	4,000,000	-	3,004,721
7.5	\$ 100,000,000	0.08	4,000,000	-	2,875,331
8.5	\$ 100,000,000	0.08	4,000,000	-	2,751,513
9.5	\$ 100,000,000	0.08	4,000,000	100,000,000	68,458,689
Present value					<u>96,224,380</u>

55-76 As of June 30, 20X0, 9.5 periods remain and the cash flows are discounted at 9 percent, determined as the initial 8-percent yield plus a 100 basis point increase attributable to the 100 basis point increase in the LIBOR swap rate. The accrual for the first quarter interest was excluded. The following journal entries illustrate the interest rate swap and debt fair value changes, attributable to changes in the LIBOR swap rate, excluding accruals.

	Debit	Credit
Debt	\$ 3,775,620	
Interest expense		\$ 3,775,620

Interest expense	\$ 4,016,000	
Swap liability		\$ 4,016,000

55-77 The net earnings effect of the hedging relationship was \$240,380 because of the mismatch between the change in the fair value of the hedging instrument and the change in fair value of the hedged item. In accordance with paragraph 815-20-45-1A, Global Tech presents the entire change in the fair value of the hedging instrument (including interest accruals and all other changes in fair value) in the same income statement line item (in this case, interest expense) that is used by Global Tech to present the earnings effect of the hedged item before applying hedge accounting.



Excerpt from ASC 815-25

>> Example 15: Fair Value Hedge of Interest Rate Risk Using the Partial-Term Approach

55-94 This Example illustrates the application of paragraphs 815-20-25-12(b)(2)(ii) and 815-25-35-13B to the designation and measurement of a hedged item as a portion of the term of a financial instrument in a hedge of interest rate risk. Assume that Entity S elected to calculate fair value changes in the hedged item attributable to interest rate risk on the basis of the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception.

55-95 On January 1, 20X1, Entity S issues a noncallable, 5-year, \$100 million debt instrument with a 3 percent semiannual interest coupon. On that date, the issuer also enters into a 2-year interest rate swap with a notional amount of \$100 million. Entity S designates the swap as a fair value hedge of the fixed-rate debt attributable to interest rate risk for the first two years of its term in accordance with the guidance in paragraph 815-20-25-12(b)(2)(ii). The swap pays LIBOR and receives a fixed rate of 2 percent, with semiannual payments. The swap has a fair value of zero at inception. The designated benchmark interest rate is the LIBOR swap rate. For ease of calculation, the yield curve is assumed to be flat at the level of the current benchmark interest rate. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-96 This Example assumes that the LIBOR swap rate increased by 50 basis points to 2.5 percent on June 30, 20X1. The change in fair value of the interest rate swap for the period January 1, 20X1, to June 30, 20X1, is a loss in value of \$731,633.

55-97 In calculating the change in fair value of the debt attributable to changes in the benchmark interest rate in accordance with paragraph 815-25-35-13B, Entity S determines that the assumed term of the hedged item is two years

because it is hedging only the cash flows associated with the first two years of its debt issuance. The change in fair value of the debt attributable to changes in the benchmark interest rate for the period January 1, 20X1, to June 30, 20X1, is a gain of \$731,633, calculated as follows.

January 1, 20X1—beginning balance

\$1,000,000pmt, 1.00%i, 4n, 100,000,000fv, PV =	\$ 100,000,000

June 30, 20X1—ending balance

\$1,000,000pmt, 1.25%i, 3n, 100,000,000fv, PV =	99,268,367

Change in value	\$ 731,633

55-98 As of June 30, 20X1, the change in fair value of the debt attributable to the benchmark interest rate is calculated by discounting the benchmark rate component of the contractual coupon cash flows using the benchmark interest rate at June 30, 20X1 (2.5 percent annual rate and 1.25 percent for each semiannual period). The change in fair value of the debt and the change in fair value of the swap result in perfect offset in current-period earnings. In accordance with paragraph 815-20-45-1A, Entity S presents the total change in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same income statement line item (in this case, interest expense) that is used by Entity S to present the earnings effect of the hedged item before applying hedge accounting.

55-99 Although this Example illustrates the hedged item as the first two years of interest payments associated with an existing debt instrument, paragraph 815-20-25-12(b)(2)(ii) permits one interest payment or any consecutive interest payments associated with an existing debt instrument to be designated as the hedged item. An entity also may have one or more separately designated partial term hedging relationships outstanding at the same time for the same debt instrument. For example, an entity may have 2 outstanding hedging relationships for consecutive interest cash flows in Year 1 and 2 and consecutive interest cash flows in Years 4 and 5 of the 5-year debt instrument.



Excerpt from ASC 815-25

>> Example 16: Fair Value Hedge of the LIBOR Swap Rate in a \$100 Million A1-Quality 5-Year Fixed-Rate Noncallable Debt

55-100 The following Cases illustrate application of the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 to a fair value hedge of the LIBOR swap rate in a \$100 million A1-quality 5-year fixed-rate noncallable debt:

- Using the full contractual coupon cash flows (Case A)
- Using the benchmark rate component of the contractual coupon cash flows (Case B).

55-101 On July 2, 20X0, Entity XYZ issues at par a \$100 million A1-quality 5-year fixed-rate noncallable debt instrument with an annual 8 percent interest coupon payable semiannually. On that date, Entity XYZ enters into a 5-year interest rate swap based on the LIBOR swap rate and designates it as the hedging instrument in a fair value hedge of interest rate risk of the \$100 million liability. Under the terms of the interest rate swap, Entity XYZ will receive a fixed interest rate at 8 percent and pay variable interest at LIBOR plus 200 basis points (current LIBOR 6 percent) on a notional amount of \$100 million (semiannual settlement and interest reset dates). For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship. The Example also assumes that the yield curve is flat and that the LIBOR swap rate increased 100 basis points to 7 percent on December 31, 20X0. The change in fair value of the interest rate swap for the period from July 2, 20X0, to December 31, 20X0, is a loss of \$3,803,843.

55-102 In both Cases A and B in this Example, Entity XYZ presents the total change in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same income statement line item (in this case, interest expense) that is used by Entity XYZ to present the earnings effect of the hedged item before applying hedge accounting in accordance with paragraph 815-20-45-1A.

>>> Case A: Using the Full Contractual Coupon Cash Flows

55-103 In this Case, assume that Entity XYZ elected to calculate fair value changes in the hedged item attributable to interest rate risk using the full contractual coupon cash flows of the hedged item. The change in fair value of the debt attributable to changes in the benchmark interest rate for the period July 2, 20X0, to December 31, 20X0, is a gain of \$3,634,395, calculated as follows.

July 2, 20X0—beginning balance

\$4,000,000pmt, 4.0%i, 10n, 100,000,000fv, PV =	\$ 100,000,000

December 31, 20X0—ending balance

\$4,000,000pmt, 4.5%i, 9n, 100,000,000fv, PV =	96,365,605

Change in value	\$ 3,634,395

55-104 As of December 31, 20X0, the fair value of the debt attributable to interest rate risk is calculated by discounting the full contractual coupon cash flows at the debt's original market rate with a 100 basis point adjustment related to the increase in the LIBOR swap rate (50 basis point adjustment on a semiannual basis). The following journal entries illustrate the interest rate swap and debt fair value changes attributable to changes in the LIBOR swap rate.

Debt	\$ 3,634,395	
Interest expense		\$ 3,634,395
Interest expense	3,803,843	
Swap liability		3,803,843

55-105 The net earnings effect of the hedge is \$169,448 due to the mismatch between the changes in fair value of the hedging instrument and the hedged item attributable to the changes in the benchmark interest rate.

>>> Case B: Using the Benchmark Rate Component of the Contractual Coupon Cash Flows

55-106 In this Case, assume that Entity XYZ elected to calculate fair value changes in the hedged item attributable to interest rate risk using the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception. The change in fair value of the debt attributable to changes in the benchmark interest rate for the period July 2, 20X0, to December 31, 20X0, is a gain of \$3,803,843, calculated as follows.

<i>July 2, 20X0—beginning balance</i>	
\$3,000,000pmt, 3.0%i, 10n, 100,000,000fv, PV =	\$ 100,000,000
<i>December 31, 20X0—ending balance</i>	
\$3,000,000pmt, 3.5%i, 9n, 100,000,000fv, PV =	96,196,157
Change in value	<u>\$ 3,803,843</u>

55-107 As of December 31, 20X0, the fair value of the debt attributable to interest rate risk is calculated by discounting the benchmark rate component of the contractual coupon cash flows using the benchmark interest rate at December 31, 20X0 (7 percent annual rate; 3.5 percent for each semiannual period). The following journal entries illustrate the interest rate swap and debt fair value changes attributable to changes in the LIBOR swap rate.

Debt	\$ 3,803,843	
Interest expense		\$ 3,803,843
Interest expense	3,803,843	
Swap liability		3,803,843

55-108 The net earnings effect of the hedge is zero due to the perfect offset in fair value changes between the hedging instrument and the hedged item attributable to the changes in the benchmark interest rate.

8.3.30 Portfolio-level basis adjustments

When the **hedged item** is a portfolio of similar assets or liabilities (see section 7.3.40), the basis adjustment is measured at the portfolio level.

Generally, a portfolio-level basis adjustment is allocated to the individual items in the portfolio. This allocation generally is necessary to determine the amortized cost basis for the items in the portfolio for purposes of complying with other applicable US GAAP, both during and after the hedging relationship, such as:

- applying impairment guidance (see section 8.4.30)
- preparing disclosures;

- measuring the gain or loss when an item in the portfolio is sold or otherwise disposed of; and
- determining amortization when the hedged item is a financial instrument for which interest rate risk was hedged (see section 8.4.20).

A systematic and rational method is used to allocate the portfolio-level basis adjustment to the individual items in the portfolio.



Question 8.3.130

When the last-of-layer method is used, is it necessary to allocate the basis adjustment?



Excerpt from ASC 815-10

> Basis Adjustment Considerations under the Last-of-Layer Method

50-5B For hedging relationships designated under the last-of-layer method, an entity may need to allocate the outstanding basis adjustment to meet the objectives of disclosure requirements in other Topics. For purposes of those disclosure requirements, the entity may allocate the basis adjustment on an individual asset basis or on a portfolio basis using a systematic and rational method.

Interpretive response: In a portfolio hedge that is other than a last-of-layer hedge, all individual items in the portfolio are hedged items. However, in a last-of-layer hedge, only the items that constitute the last of layer that is treated as a nonprepayable item are being hedged (see section 7.3.100). The individual items in that layer are not known during the hedge term. This is because the individual items that may prepay, default or be sold are unknown before the actual event occurs. As a result, it is not clear to which items in the closed portfolio the basis adjustment relates – nor consequently to which items the basis adjustment should be allocated.

For disclosures, Topic 815 provides guidance that the portfolio-level basis adjustment may be allocated on an individual asset basis or on a portfolio basis using a systematic and rational method. However, Topic 815 does not provide guidance for whether or how to allocate the outstanding portfolio-level basis adjustment during the hedge term for any other purpose. [815-10-50-5B]

At its March 28, 2018 meeting, the FASB added a narrow-scope project to its agenda to address when and how an entity is permitted or required to allocate a last-of-layer basis adjustment to the individual assets in the closed portfolio. In conjunction with that project, at its October 16, 2019 meeting, the FASB tentatively decided that an entity should not be permitted to allocate the fair value hedge basis adjustment to the assets in the closed portfolio during an outstanding last-of-layer hedge. This project is ongoing and a final ASU is expected to be issued in 2021. As a result, revisions to this interpretive response may be provided in a future edition.



Question 8.3.140

When assets in the portfolio from which the last of layer is derived are sold during the hedge term, is the related basis adjustment allocated to individual assets?

Interpretive response: It depends on whether the balance remaining in the portfolio exceeds the designated last of layer.

- If an entity sells an asset from the closed portfolio and the balance remaining in the portfolio after the sale exceeds the designated last of layer, the entity does not need to allocate any of the remaining basis adjustment to the asset that was sold as it would not be part of the last-of-layer. See Question 8.3.130 regarding the FASB's narrow-scope project on the allocation of basis adjustments. [ASU 2017-12.BC121(a)]
- If the sale of the asset causes the remaining balance in the portfolio to be less than the last of layer, the entity discontinues the entire hedging relationship and follows Steps 1 to 3 in Question 8.5.30 as part of full discontinuation. See also Example 8.5.30 (Scenario 2). [815-25-40-8(b)]

8.4 Subsequent accounting for basis adjustments

8.4.10 Overview



Excerpt from ASC 815-25

> Changes in Fair Value of Hedged Item

35-8 The adjustment of the carrying amount of a hedged asset or liability required by paragraph 815-25-35-1(b) shall be accounted for in the same manner as other components of the carrying amount of that asset or liability. For example, an adjustment of the carrying amount of a hedged asset held for sale (such as inventory) would remain part of the carrying amount of that asset until the asset is sold, at which point the entire carrying amount of the hedged asset would be recognized as the cost of the item sold in determining earnings.

Basis adjustments generally are accounted for in the same manner as other components of the **hedged item's** amortized cost basis. Basis adjustments related to interest-bearing financial instruments are amortized to earnings over a period that depends on when amortization commences (see section 8.4.20). [815-25-35-8 – 35-9A]

The following table provides examples of the subsequent accounting for the basis adjustment, including the timing and method for its recognition in earnings.

Hedged item	Timing and method of recognizing the basis adjustment in earnings
Asset held for sale (e.g. inventory)	The basis adjustment remains part of the asset's amortized cost basis until the asset is sold. When the asset is sold, its entire carrying amount (including the basis adjustment) is recognized as the cost of the item sold in determining earnings. [815-25-35-8]
Interest-bearing financial instrument (e.g. long-term borrowing)	The basis adjustment is amortized to earnings. Amortization is required to begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged (see section 8.4.20). [815-25-35-9 – 35-9A]
Firm commitments	We expect the entity to account for the firm commitment in the same manner as it will account for the related asset or liability once it is recognized (see Question 8.4.10).

Formal documentation. If the hedged item is a firm commitment, the initial hedge documentation is required to include the method (which must be reasonable) for recognizing in earnings the asset or liability that represents the gain or loss on the hedged firm commitment (see section 6.9.50). [815-20-25-3(c)(1)]



Question 8.4.10

For firm commitments, what is the subsequent accounting for assets (liabilities) recognized due to applying fair value hedge accounting?

Interpretive response: In a hedge of a firm commitment (rather than of a recognized asset or liability), adjustments of the hedged item (firm commitment) result in the recognition of assets or liabilities.

For firm commitments to purchase inventory we expect those earnings adjustments will follow the entity's existing inventory accounting policies. Specifically, the asset (or liability) recognized due to applying fair value hedge accounting will be included in the cost of inventory when the inventory is purchased (i.e. when the firm commitment is settled). As a result, it will be recognized in earnings when the related inventory is sold; this includes consideration of the inventory method, e.g. FIFO, LIFO, average cost.

For firm commitments that relate to assets or liabilities that are prohibited from being recognized – such as those embodied in a lessor's non-cancellable operating lease or an unrecognized mortgage servicing right – an entity will need to develop a policy for the earnings adjustments.

FASB Example: Fair value hedge of a commodity inventory



Excerpt from ASC 815-25

>> Example 7: Fair Value Hedge of a Commodity Inventory

55-30 The following Cases illustrate application of the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 to a fair value hedge of a commodity inventory:

- a. The terms of the hedging derivative have been negotiated such that the hedging relationship is perfectly effective (Case A).
- b. The hedging relationship is not perfectly effective (Case B).

55-31 To simplify the illustration and focus on basic concepts, the derivative instrument in Cases A and B is assumed to have no time value. In practice, a derivative instrument used for a fair value hedge of a commodity would have a time value that would change over the term of the hedging relationship. The changes in that time value may be accounted for through an amortization approach in accordance with paragraph 815-20-25-83A or a mark-to-market approach in accordance with paragraph 815-20-25-83B. Under either of those approaches, the portion of excluded components recognized in earnings should be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

55-32 Other Examples in this Section illustrate accounting for the time value component of a derivative instrument.

55-33 For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-34 Cases A and B share all of the following assumptions:

- a. Entity ABC decides to hedge the risk of changes during the period in the overall fair value of its entire inventory of Commodity A by entering into a derivative instrument, Derivative Z.
- b. On the first day of Period 1, Entity ABC enters into Derivative Z and neither receives nor pays a premium (that is, the fair value at inception is zero).
- c. Entity ABC designates the derivative instrument as a hedge of the changes in fair value of the inventory due to changes in the price of Commodity A during Period 1.
- d. The hedging relationship qualifies for fair value hedge accounting. Entity ABC will assess effectiveness on a quantitative basis both initially and subsequently by comparing the entire change in fair value of Derivative Z with the change in the market price of the hedged commodity inventory.

>>> Case A: Perfect Effectiveness in the Hedging Relationship

55-35 In this Case, Entity ABC expects the hedge to be perfectly effective because both of the following conditions exist:

- a. The notional amount of Derivative Z matches the amount of the hedged inventory (that is, Derivative Z is based on the same number of bushels as the number of bushels of the commodity that Entity ABC designated as hedged).
- b. The underlying of Derivative Z is the price of the same variety and grade of Commodity A as the inventory at the same location.

55-36 At inception of the hedge, Derivative Z has a fair value of zero and the hedged inventory has a carrying amount of \$1,000,000 and a fair value of \$1,100,000. On the last day of Period 1, the fair value of Derivative Z has increased by \$25,000, and the fair value of the inventory has decreased by \$25,000. The inventory is sold, and Derivative Z is settled on the last day of Period 1. The following table illustrates the accounting for the situation described in this Case.

	Debit (Credit)			
	Cash	Derivative	Inventory	Earnings ^(a)
Period 1				
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	25,000	(25,000)		
Total	\$ 1,100,000	\$ -	\$ (1,000,000)	\$ (100,000)

- a. For presentation purposes, the change in the fair value of the hedging instrument is in the same income statement line item as the hedged item.

55-37 If Entity ABC had sold the hedged inventory at the inception of the hedge, its gross profit on that sale would have been \$100,000. This Case illustrates that, by hedging the risk of changes in the overall fair value of its inventory, Entity ABC recognized the same gross profit at the end of the hedge period even though the fair value of its inventory decreased by \$25,000.

>>> Case B: Hedging Relationship Is Not Perfectly Effective

55-38 The hedge in Case A was perfectly effective because the gain on Derivative Z exactly offsets the loss on the inventory. However, in this Case, assume the terms of Derivative Z do not perfectly match the inventory and its fair value has increased by \$22,500 as compared with the decline in fair value of the inventory of \$25,000. The mismatch of \$2,500 has to be recognized in earnings and presented in the same income statement line item as the earnings effect of the hedged item. The following table illustrates the accounting for the situation described in this Case.

	Debit (Credit)			
	Cash	Derivative	Inventory	Earnings ^(a)
Period 1				
Recognize change in fair value of derivative		\$ 22,500		\$ (22,500)
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	22,500	(22,500)		
Total	\$ 1,097,500	\$ -	\$ (1,000,000)	\$ (97,500)
a. For presentation purposes, the change in the fair value of the hedging instrument is in the same income statement line item as the hedged item.				
55-39 The difference between the effect on earnings in Case B and the effect on earnings in Case A is \$2,500.				

8.4.20 Interest-bearing financial instruments



Excerpt from ASC 815-25

> Changes in Fair Value of Hedged Item

35-9 An adjustment of the carrying amount of a hedged interest-bearing **financial instrument** shall be amortized to earnings. Amortization shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

35-9A If, as permitted by paragraph 815-25-35-9, an entity amortizes the adjustment to the carrying amount of the hedged item during an outstanding partial-term hedge of an interest-bearing financial instrument, the entity shall fully amortize that adjustment by the hedged item's assumed maturity date in accordance with 815-25-35-13B. For a discontinued hedging relationship, all remaining adjustments to the carrying amount of the hedged item shall be amortized over a period that is consistent with the amortization of other discounts or premiums associated with the hedged item in accordance with other Topics (for example, Subtopic 310-20 on receivables—nonrefundable fees and other costs).



Question 8.4.20

When is amortization of the basis adjustment for interest-bearing financial instruments required to begin?

Interpretive response: Amortization is required to begin no later than when the interest-bearing financial instrument (hedged item) ceases to be adjusted for changes in its fair value attributable to the risk being hedged. However, an entity may begin amortization earlier depending on its accounting policy.

[815-25-35-9]

See comments about the FASB examples in Question 8.3.120 for a situation in which an entity may wish to begin amortization before the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.



Question 8.4.30

Over what period are basis adjustments of interest-bearing financial instruments amortized?

Interpretive response: It depends on whether amortization begins during the hedging relationship or after the hedging relationship has been discontinued, as shown in the following table. [815-25-35-9A]

When amortization begins	Amortization period
During the hedging relationship	The remaining life of the hedging relationship, unless the hedging relationship is discontinued. For a partial-term hedge, amortization is therefore over the partial term.
After the hedging relationship is discontinued – hedge is discontinued for reasons other than derecognition of the hedged item	A period that is consistent with the amortization of other discounts or premiums associated with the hedged item under other applicable US GAAP – e.g. Subtopic 310-20 (receivables – nonrefundable fees and other costs). Because the amortization period during the hedging relationship is different from the amortization period after the hedging relationship is discontinued, a hedge discontinuation may result in a change to the amortization period if amortization was started during the hedging relationship (e.g. for a partial-term hedge).
After the hedging relationship is discontinued – hedged item is derecognized	The basis adjustment is derecognized together with the hedged item (i.e. immediately).



Question 8.4.40

Do basis adjustments for interest-bearing borrowings affect the capitalization of interest?



Excerpt from ASC 815-25

>> Interaction with Capitalization Rate for Assets under Construction

35-14 Amounts recorded in an entity's income statement as interest costs shall be reflected in the capitalization rate under Subtopic 835-20. Those amounts could include amortization of the adjustments of the carrying amount of the hedged liability, under paragraphs 815-25-35-9 through 35-9A, if an entity elects to begin amortization of those adjustments during the period in which interest is eligible for capitalization.

Background: Subtopic 835-20 (capitalization of interest) requires capitalizing interest cost as part of the historical cost of acquiring certain assets. The amount capitalized in a period is based on applying a capitalization rate to the average amount of accumulated expenditures for a qualifying asset during the period. The capitalization rate to be used is based on rates for borrowings outstanding during the period. [835-20-05-1, 30-3]

Interpretive response: Whether basis adjustments for interest-bearing borrowings affect the capitalization rate depends on whether the basis adjustments are being amortized during the period for which interest costs are capitalized.

Only amounts recorded in an entity's income statement as interest costs that are included in the assessment of effectiveness are included in the capitalization rate that is used to determine capitalized interest. Those amounts include amortization of basis adjustments recognized during the period for interest-bearing borrowings. [815-25-35-14]

FASB Example: Fair value hedge of fixed-rate interest-bearing debt



Excerpt from ASC 815-25

>> Example 8: Fair Value Hedge of Fixed-Rate Interest-Bearing Debt

55-40 This Example demonstrates the guidance in Subtopic 815-20 and this Subtopic as applied to the mechanics of reporting an interest rate swap used as a fair value hedge of an interest-bearing liability. It is not intended to demonstrate how to compute the fair value of an interest rate swap or an interest-bearing liability. This Example has been simplified by assuming that the

interest rate applicable to a payment due at any future date is the same as the rate for a payment due at any other date (that is, the yield curve is flat). Although that is an unrealistic assumption, it makes the amounts used easier to understand without detracting from the purpose of the Example. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-41 The fair values of the interest rate swap in this Example are determined using the **zero-coupon method**. The zero-coupon method is not the only acceptable method. Explanations of other acceptable methods of determining the fair value of an interest rate swap can be obtained from various published sources. Fair values also may be available from dealers in interest rate swaps and other derivative instruments.

55-42 In this Example, the term and notional amount of the interest rate swap match the term and principal amount of the interest-bearing liability being hedged. The fixed and variable interest rates used to determine the net settlements on the interest rate swap match the current yield curve, and the sum of the present values of the expected net settlements is zero at inception. Thus, paragraphs 815-20-25-102 through 25-106 permit the reporting entity to assume perfect effectiveness. Assessment of effectiveness at one of the interest rate swap's repricing dates would confirm the validity of that assumption.

55-43 A shortcut method (see paragraphs 815-20-25-102 through 25-106) can be used to produce the same reporting results as the method illustrated in this Example. This shortcut is only appropriate for a fair value hedge of a fixed-rate asset or liability using an interest rate swap and only if the assumption of perfect effectiveness is appropriate. The steps in the shortcut method are as follows:

- a. Determine the difference between the fixed rate to be received on the interest rate swap and the fixed rate to be paid on the bonds.
- b. Combine that difference with the variable rate to be paid on the interest rate swap.
- c. Compute and recognize interest expense using that combined rate and the fixed-rate liability's principal amount. (Amortization of any purchase premium or discount on the liability also must be considered, although that complication is not incorporated in this Example.)
- d. Determine the fair value of the interest rate swap.
- e. Adjust the carrying amount of the interest rate swap to its fair value and adjust the carrying amount of the liability by an offsetting amount.

55-44 Amounts determined using the shortcut method and the facts in this Example will match the amounts in paragraph 815-25-55-48 even though the shortcut does not involve explicitly amortizing the hedge accounting adjustments on the debt. That is, the quarterly adjustments of the debt and explicit amortization of previous adjustments will have the same net effect on earnings as the shortcut method.

55-45 A slightly different shortcut method for interest rate swaps used as cash flow hedges is illustrated in Example 6 (see paragraph 815-30-55-24).

55-46 On July 1, 20X1, Entity ABC borrows \$1,000,000 to be repaid on June 30, 20X3. On that same date, Entity ABC also enters into a two-year receive-fixed, pay-variable interest rate swap. Entity ABC designates the interest rate swap as a hedge of the changes in the fair value of the fixed-rate debt attributable to changes in the designated **benchmark interest rate**. Entity ABC designates changes in **London Interbank Offered Rate (LIBOR) swap rates** as the benchmark interest rate in hedging interest rate risk. The terms of the interest rate swap and the debt are as follows.

	Interest Rate Swap	Fixed-Rate Debt
Trade date and borrowing date ^(a)	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 ^(a)	6.41%	6.41%
Variable interest rate	3-month USD LIBOR	Not applicable
Settlement dates and interest payment dates ^(a)	End of each calendar quarter	End of each calendar quarter
Reset dates	End of each calendar quarter through March 31, 20X3	Not applicable

a. These terms need not match for the assumption of perfect effectiveness to be appropriate. (See paragraphs 815-20-25-102 through 25-110.)

55-47 The USD LIBOR rates that are in effect at inception of the hedging relationship and at each of the quarterly reset dates are assumed to be as follows.

Reset date	3-Month LIBOR Rate
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%

55-48 The following table summarizes the fair values of the debt and the interest rate swap at each quarter end, the details of the changes in the fair values during each quarter (including accrual and payment of interest, the effect of changes in rates, and level-yield amortization of hedge accounting adjustments), the expense for each quarter, and the net cash payments for each quarter. The calculations of fair value of both the debt and the interest rate swap are made using LIBOR. (A discussion of the appropriate discount rate appears in paragraph 815-20-25-111.)

	Fixed-Rate Debt	Interest Rate Swap	Expense	Net Payment
July 1, 20X1	\$ (1,000,000)	\$ -		

8. Accounting for fair value hedges

Interest accrued			\$	(16,025)	
	(16,025)	-		5)	
Payments (receipts)	16,025	-			\$ 16,025
Effect of change in rates	1,149	(1,149)		-	
September 30, 20X1	(998,851)	(1,149)	\$	(16,025)	\$ 16,025
Interest accrued	(16,025)	(19)	\$	(16,044)	
Payments (receipts)	16,025	175			\$ 16,200
Amortization of basis adjustments	(156)	-	\$	(156)	
Effect of changes in rates	(993)	993		-	
December 31, 20X1	(1,000,000)	-	\$	(16,200)	\$ 16,200
Interest accrued	(16,025)	-	\$	(16,025)	
Payments (receipts)	16,025	-			\$ 16,025
Amortization of basis adjustments	-	-		-	
Effect of changes in rates	(1,074)	1,074		-	
March 31, 20X2	(1,001,074)	1,074	\$	(16,025)	\$ 16,025
Interest accrued	(16,025)	17	\$	(16,008)	
Payments (receipts)	16,025	(225)			\$ 15,800
Amortization of basis adjustments	208	-		208	
Effect of changes in rates	12,221	(12,221)		-	\$ 15,800
June 30, 20X2	(988,645)	(11,355)	\$	(15,800)	\$ 15,800
Interest accrued	(16,025)	(216)	\$	(16,241)	
Payments (receipts)	16,025	2,975			\$ 19,000
Amortization of basis adjustments	(2,759)	-		(2,759)	
Effect of changes in rates	789	(789)		-	
September 30, 20X2	(990,615)	(9,385)	\$	(19,000)	\$ 19,000
Interest accrued	(16,025)	(181)	\$	(16,206)	
Payments (receipts)	16,025	3,250			\$ 19,275
Amortization of basis adjustments	(3,069)	-		(3,069)	
Effect of changes in rates	532	(532)		-	
December 31, 20X2	(993,152)	(6,848)	\$	(19,275)	\$ 19,275
Interest accrued	(16,025)	(134)	\$	(16,159)	
Payments (receipts)	16,025	3,525			\$ 19,550
Amortization of basis adjustments	(3,391)	-		(3,391)	
Effect of changes in rates	(978)	978		-	
March 31, 20X3	(997,521)	(2,479)	\$	(19,550)	\$ 19,550
	Fixed-Rate Debt	Interest Rate Swap	Expense	Net Payment	
Interest accrued	(16,025)	(46)	\$	(16,071)	
Payments (receipts)	1,016,025	2,525			\$ 1,018,550
Amortization of basis adjustments	(2,479)	-		(2,479)	
June 30, 20X3	\$ -	\$ -	\$	(18,550)	\$ 1,018,550

55-49 The preceding table demonstrates two important points that explain why the shortcut method described in paragraphs 815-25-55-43 through 55-45

produces the same results as the computation in the preceding table if the hedging relationship is perfectly effective:

- In every quarter, the effect of changes in rates on the interest rate swap completely offsets the effect of changes in rates on the debt. That is as expected because the hedge is perfectly effective.
- In every quarter except the last when the principal is repaid, the expense equals the cash payment.

55-50 The following table illustrates the computation of interest expense using the shortcut method described in paragraphs 815-25-55-43 through 55-45. The results are the same as the results computed in the preceding table.

Quarter Ended	(a) Difference between Fixed Rates	(b) Variable Rate on Swap	(c) Sum (a) + (b)	(d) Debt's Principal Amount	(e) Interest Expense [(c) x (d)] ÷ 4
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

55-51 As stated in the introduction to this Example, a flat yield curve is assumed for simplicity. An upward-sloping yield curve would have made the computations more complex. Paragraph 815-25-55-47 would have shown different interest rates for each quarterly repricing date, and the present value of each future payment would have been computed using a different rate (as described in paragraph 815-25-55-41). However, the basic principles are the same. As long as the hedging relationship meets the criteria for the shortcut method, perfect effectiveness can be assumed.

55-52 In this Example of a fair value hedge of fixed-rate interest-bearing debt, it is assumed that Entity ABC elects to immediately begin amortizing the adjustments of the carrying amount of the fixed-rate debt while the hedge is still in place. Because the change in fair value of the interest rate swap attributable to the passage of time is recognized as interest expense by Entity ABC, the amounts recorded as expenses in the table in paragraph 815-25-55-48 would be eligible for capitalization under Subtopic 835-20.

8.4.30 Measuring impairment or credit losses#



Excerpt from Subtopic 326-20

>> Effect of a Fair Value Hedge on the Discount Rate When Using a Discounted Cash Flow Model

55-9 Section 815-25-35 implicitly affects the measurement of credit losses under this Topic by requiring the present value of expected future cash flows to be discounted by the new **effective interest rate** based on the adjusted **amortized cost basis** in a hedged **loan**. When the amortized cost basis of a

loan has been adjusted under fair value hedge accounting, the effective interest rate is the discount rate that equates the present value of the loan's future cash flows with that adjusted amortized cost basis. The adjustment under fair value hedge accounting of the loan's carrying amount for changes in fair value attributable to the hedged risk under Section 815-25-35 shall be considered to be an adjustment of the loan's amortized cost basis. Paragraph 815-25-35-11 explains that the loan's original effective interest rate becomes irrelevant once the recorded amount of the loan is adjusted for any changes in its fair value.



Excerpt from ASC 815-25

>> Impairment or Credit Losses of Hedged Item

35-10 An asset or liability that has been designated as being hedged and accounted for pursuant to this Section remains subject to the applicable requirements in generally accepted accounting principles (GAAP) for assessing impairment or credit losses for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment or credit loss requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 815-25-35-1(b). Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment or credit loss requirements to the hedged asset or liability.

>>> Interaction with Measurement of Credit Losses

35-11 This Subtopic implicitly affects the measurement of credit losses under Subtopic 326-20 on financial instruments measured at amortized cost by requiring the present value of expected future cash flows to be discounted by the new effective rate based on the adjusted amortized cost basis in a hedged loan. Paragraph 326-20-55-9 requires that, when the amortized cost basis of a loan has been adjusted under fair value hedge accounting, the effective rate is the discount rate that equates the present value of the loan's future cash flows with that adjusted amortized cost basis. That paragraph states that the adjustment under fair value hedge accounting for changes in fair value attributable to the hedged risk under this Subtopic shall be considered to be an adjustment of the loan's amortized cost basis. As discussed in that paragraph, the loan's original effective interest rate becomes irrelevant once the recorded amount of the loan is adjusted for any changes in its fair value. Because paragraph 815-25-35-10 requires that the loan's amortized cost basis be adjusted for hedge accounting before the requirements of Subtopic 326-20 are applied, this Subtopic implicitly supports using the new effective rate and the adjusted amortized cost basis.

35-12 This guidance applies to all entities applying Subtopic 326-20 to financial assets that are hedged items in a fair value hedge, regardless of whether those entities have delayed amortizing to earnings the adjustments of the loan's amortized cost basis arising from fair value hedge accounting until the hedging

relationship is dedesignated. The guidance on recalculating the effective rate is not intended to be applied to all other circumstances that result in an adjustment of a loan's amortized cost basis.

The **hedged item** in a fair value hedge remains subject to other applicable US GAAP for assessing impairment. Impairment guidance generally is applied *after* fair value hedge accounting is applied to the hedged item – i.e. after any basis adjustment is recognized. [815-25-35-10]

When assessing impairment or credit losses, the fair value or cash flows of the derivative hedging instrument generally do not affect the determination of whether the hedged item is impaired or has a credit loss. To do so would be inconsistent with the fact that the derivative is a separate asset or liability. However, see Question 10.4.10 regarding application of the full cost method of accounting for entities with oil and gas producing activities.

Subtopic 326-20 (credit losses) does not prescribe a specific method that must be used to estimate the allowance for credit losses. Subtopic 326-20 distinguishes between a discounted cash flow method and other methods. [326-20-30-3, 55-6 – 55-7]

- **Non-discounted cash flow methods.** In estimating expected credit losses of the amortized cost basis for an asset (or group of assets) using a method *other* than a discounted cash flow method, the estimate needs to reflect the expected loss of principal and the effect of unamortized premiums and discounts, including fair value hedge accounting adjustments. [326-20-30-5]
- **Discounted cash flow methods.** When a discounted cash flow method is used, additional guidance is provided. Because a basis adjustment changes the amortized cost basis of a loan, the loan's original effective interest rate becomes irrelevant. As a result, the relevant effective interest rate is the new effective rate implicit in the adjusted amortized cost basis of the hedged loan – i.e. the amortized cost basis including basis adjustments. [815-25-35-11, 326-20-55-9]

In this situation, the effective rate is the discount rate that equates the present value of the loan's future contractual cash flows with the adjusted amortized cost basis. This guidance applies even if the basis adjustments are not being amortized because the entity has elected to delay amortizing basis adjustments until the hedging relationship is dedesignated. [815-25-35-11 – 35-12, 326-20-55-9]

See KPMG Handbook, [Credit impairment](#), for additional guidance on estimating the allowance for credit losses.

FASB Example: Interaction with loan impairment



Excerpt from ASC 815-25

>> Example 14: Interaction with Measurement of Credit Losses

55-85 This Example illustrates the application of paragraph 815-25-35-11 involving the interaction of hedge accounting and measurement of credit losses in Subtopic 326-20 on financial instruments measured at amortized cost. The following Cases also illustrate the effect of the two approaches to calculate the change in the fair value of the hedged item attributable to interest rate risk discussed in paragraph 815-25-35-13 on that interaction, as follows:

- a. Using the full contractual coupon cash flows (Case A)
- b. Using the benchmark rate component of the contractual coupon cash flows (Case B).

55-86 Entity A formally documents a qualifying fair value hedge (for fair value changes attributable to changes in the designated benchmark interest rate) between a fixed-rate loan receivable from Entity B and an interest rate swap. The 5-year, fixed-rate loan to Entity B has a principal amount of \$1,000,000 payable at maturity and interest payable annually at a 10 percent rate. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-87 One year after inception of the hedging relationship, the following conditions exist:

- a. Subparagraph superseded by Accounting Standards Update No. 2017-12.
- b. There has been an adverse change to Entity B's creditworthiness.
- c. The LIBOR swap rate (the designated benchmark interest rate) has decreased from 6 percent to 5.5 percent.

55-88 Assume that the repayment of the loan is not dependent on the underlying collateral. In applying the requirements of Subtopic 326-20 ~~310-10~~ to the loan, Entity A evaluates the loan for credit losses on an individual basis because it does not have similar risk characteristics with other loans in the portfolio and uses a discounted cash flow approach. Entity A determines that the present value of expected future cash flows discounted at the loan's effective interest rate at inception of the loan is \$930,000. (See row C in the table in paragraph 815-25-55-90, which presents calculations—at the end of the first year of the loan's term—of the net present value of current estimates of expected future cash flows based on the loan's original effective interest rate.)

>>> Case A: Using the Full Contractual Coupon Cash Flows

55-88A In this Case, assume that the entity elected to calculate fair value changes in the hedged item attributable to interest rate risk using the full contractual coupon cash flows of the hedged item. One year after inception of the hedging relationship, the change in the hedged item's fair value attributable to changes in the LIBOR swap rate (the designated benchmark interest rate) is

a gain of \$16,022. (See row B in the table in paragraph 815-25-55-90, which presents calculations—at the end of the first year of the loan's term—of the net present value of contractual cash flows based on the loan's original effective interest rate adjusted for a 50 basis point decrease in the LIBOR swap rate.)

55-89 After adjusting the amortized cost basis of the hedged loan by \$16,022 (pursuant to paragraph 815-25-35-1(b)) for the increase in the hedged item's fair value attributable to changes in the benchmark interest rate, Entity A should apply the guidance in Subtopic 326-20 by doing both of the following:

- Comparing the amortized cost basis of the loan after the effect of the fair value hedge, or \$1,016,022, to the \$944,901 present value of expected future cash flows discounted using the rate that reflects the rate of return implicit in the loan after adjusting the amortized cost basis of the hedged loan pursuant to paragraph 815-25-35-1(b) (that is, 9.5 percent)
- Recording an allowance for credit losses (with the offsetting entry charged to expense) for the difference of \$71,121 (\$1,016,022 – \$944,901).

55-90 Following are calculations (at the end of the first year of the loan's term) of the net present value of the contractual cash flows and the creditor's best estimate of expected future cash flows based on the loan's original effective interest rate and the new implicit rate.

	Rate	Net Present Value at End of Year 1	Assumed Cash Flow in Year			
			2	3	4	5
A. Original cash flows and original effective rate	10.0%	\$ 1,000,000	\$ 100,000	\$100,000	\$100,000	\$1,100,000
B. Original cash flows and new implicit rate	9.5%	\$ 1,016,022	\$100,000	\$100,000	\$100,000	\$1,100,000
C. Expected future cash flows and original effective rate	10.0%	\$ 930,000	\$ 93,000	\$ 93,000	\$ 93,000	\$1,023,000
D. Expected future cash flows and new implicit rate	9.5%	\$ 944,901	\$ 93,000	\$ 93,000	\$ 93,000	\$1,023,000

>>> Case B: Using the Benchmark Rate Component of the Contractual Coupon Cash Flows

55-91 In this Case, assume that Entity A elected to calculate fair value changes in the hedged item attributable to interest rate risk using the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception. One year after inception of the hedging relationship, the change in the hedged item's fair value attributable to changes in the LIBOR swap rate (the designated benchmark interest rate) is a gain of \$17,526, which is calculated as follows.

At the beginning of the loan's term

$$\$60,000\text{pmt}, 6\%i, 5n, 1,000,000\text{fv}, \text{PV} = \$ 1,000,000$$

<i>At the end of the first year of the loan's term</i>	
\$60,000pmt, 5.5%i, 4n, 1,000,000fv, PV =	\$ 1,017,526
Change in value	\$ (17,526)

55-92 After adjusting the amortized cost basis of the hedged loan by \$17,526 (in accordance with paragraph 815-25-35-1(b)) for the increase in the hedged item's fair value attributable to changes in the benchmark interest rate, Entity A should apply the guidance in Subtopic 326-20 by doing both of the following:

- Comparing the amortized cost basis of the loan after the effect of the fair value hedge, or \$1,017,526, to the \$946,299 present value of expected future cash flows discounted using the rate that reflects the rate of return implicit in the loan after adjusting the amortized cost basis of the hedged loan in accordance with paragraph 815-25-35-1(b) (that is, 9.45 percent that equates the adjusted amortized cost basis of the loan with the present value of the contractual cash flows of the loan)
- Recognizing an allowance for credit losses (with the offsetting entry charged to expense) for the difference of \$71,227 (\$1,017,526 – \$946,299).

55-93 Following are calculations (at the end of the first year of the loan's term) of the net present value of the benchmark rate component of the contractual cash flows and the creditor's best estimate of expected future cash flows based on the loan's original effective interest rate and the new implicit rate. In row B, the net present value at the end of the first year is equal to the net present value of the benchmark rate component of the contractual coupon cash flows discounted at the 5.5 percent benchmark rate.

	Rate	Net Present Value at End of Year 1	Assumed Cash Flow in Year			
			2	3	4	5
A. Original cash flows and original effective rate	10.0%	\$ 1,000,000	\$ 100,000	\$ 100,000	\$ 100,000	\$1,100,000
B. Original cash flows and new implicit rate	9.45%	\$ 1,017,526	\$ 100,000	\$ 100,000	\$ 100,000	\$1,100,000
C. Expected future cash flows and original effective rate	10.0%	\$ 930,000	\$ 93,000	\$ 93,000	\$ 93,000	\$1,023,000
D. Expected future cash flows and new implicit rate impairment	9.45%	\$ 946,299	\$ 93,000	\$ 93,000	\$ 93,000	\$1,023,000

8.5 Discontinuing hedge accounting

8.5.10 Overview



Excerpt from ASC 815-25

> Discontinuing Hedge Accounting

>> Amounts Excluded from the Assessment of Effectiveness under an Amortization Approach

40-7 When applying the guidance in paragraph 815-20-25-83A, any amounts remaining in accumulated other comprehensive income associated with amounts excluded from the assessment of effectiveness shall be recorded in earnings in the current period if the hedged item is derecognized. For all other discontinued fair value hedges, any amounts associated with the excluded component remaining in accumulated other comprehensive income shall be recorded in earnings in the same manner as other components of the carrying amount of the hedged asset or liability in accordance with paragraphs 815-25-35-8 through 35-9A.

The following table provides an overview of circumstances that would require an entity to discontinue or partially dedesignate a hedging relationship.

Change in eligibility or critical terms of hedged items or transactions (section 6.10.20)	— Hedged item no longer meets the eligibility criteria [815-25-40-1(a)] — Hedged firm commitments are modified such that they no longer meet the definition of a firm commitment (see Question 6.10.50) — Modification of hedged item or transaction such that critical terms of the original hedging relationship have changed [815-20-55-56]
Change in eligibility or critical terms of hedging instrument (section 6.10.30)	— Hedging instrument no longer meets the eligibility criteria [815-25-40-1(a)] — Hedging instrument expires or is sold, terminated or exercised [815-25-40-1(b)] — Modification of hedging instrument such that critical terms of the original hedging relationship have changed [815-20-55-56]
Change in hedged risk (section 6.10.40)	— Change in the hedged risk [815-20-55-56]
Change in hedge effectiveness (section 6.10.50)	— Hedge is no longer highly effective on a retrospective and/or prospective basis, with certain exceptions (see Question 6.10.90) [815-25-40-1(a), 815-30-40-1(a)]

	— Change in quantitative method to assess hedge effectiveness, including whether a component of the hedging instrument is excluded from the assessment (see section 13.6.40) [815-25-55-56]
Elective dedesignation	An entity may elect to discontinue the hedging relationship. [815-30-40-1(c)]

Treatment of hedging instruments. When hedge accounting is discontinued, if the derivative instrument has not expired and has not been sold, terminated or exercised, it may be used as the hedging instrument in a new hedging relationship as long as the hedge criteria are met for the new relationship. Unless it is designated as the hedging instrument in a new cash flow or net investment hedging relationship, the derivative instrument continues to be recorded on the balance sheet at fair value and all changes in fair value (including changes related to the previously excluded components) are reflected in earnings. [815-25-40-2]

Treatment of hedged items. When hedge accounting is discontinued, the entity may designate prospectively the previously hedged item in a new hedging relationship with a different hedging instrument as long as the hedge criteria are met for the new relationship. Otherwise, changes in the fair value are no longer recognized as basis adjustments.

The following diagram illustrates how to account for the hedged item and hedging instrument after hedge accounting is discontinued. [815-25-40-7]

Accounting for discontinued hedging relationships (if not designated in new hedging relationship)		
	Hedged item	Hedging instrument, including excluded components
At date of discontinuance:	Basis adjustment remains in hedged item's amortized cost basis	Amount in AOCI associated with previously excluded component remains in AOCI
When fair value subsequently changes:	Do not record change in earnings	Recorded in earnings, including changes in fair value of previously excluded component
When hedged item is derecognized:	Include basis adjustment remaining in amortized cost basis in gain/loss computation	Record amount remaining in AOCI associated with previously excluded component in earnings

The following table provides examples of how a basis adjustment (and any amount that remains in AOCI associated with excluded components) is accounted for after a hedge is discontinued.

Hedged item	Timing and method of recognizing the basis adjustment (and amount remaining in AOCI associated with excluded components) in earnings
Inventory	The basis adjustment remains part of the hedged inventory's cost basis until it is sold (subject to ongoing impairment tests). When the asset is sold, its entire cost basis (including the basis adjustment) is recognized as part of the cost of the item sold. [815-25-35-8] Similarly, the amount remaining in AOCI associated with an excluded component (if any) remains in AOCI until the inventory is sold, at which time it is recognized in earnings immediately. [815-25-40-7]
Long-term loan receivable with a \$100,000 basis adjustment that increased its amortized cost basis (i.e. an interest-bearing financial instrument)	The basis adjustment is treated like a premium or discount and is amortized as interest income using the effective yield method. The amortization period after the hedge is discontinued is a period that is consistent with the amortization of other discounts or premiums associated with the hedged item under other applicable US GAAP – e.g. Subtopic 310-20. [815-25-35-9, 35-9A] Similarly, the amount remaining in AOCI associated with an excluded component (if any) when the hedge is discontinued is amortized as interest income over a period that is consistent with other premiums and discounts associated with the hedged item. [815-25-40-7]



Question 8.5.10

Does amortization begin if a portfolio of hedged items that is hedged by a combination of derivatives is rebalanced?

Background: Some entities hedge portfolios of similar assets or liabilities using a combination of derivatives as hedging instruments (see section 6.6.40). Additions or deletions (a rebalancing) to either the portfolio of hedged items or derivative hedging instruments require a discontinuation of the hedging relationship (see Question 6.10.60). An entity that is required to discontinue a hedging relationship upon a rebalancing may decide to redesignate the portfolio of hedged items in a new hedging relationship.

Interpretive response: If a hedging relationship is discontinued and the original hedged items are redesignated in a relationship hedging the same risks with a rebalanced combination of derivatives, we do not believe amortization of the basis adjustment is required to begin. This is because the hedged items continue to be hedged for changes in fair value attributable to the same risk.

Similarly, if the original hedged items are redesignated with additional items added to the portfolio of hedged items in a relationship hedging the same risks, we do not believe amortization is required to begin. However, if the original

hedged items are redesignated in a relationship specifically hedging a *different* risk, amortization should begin.

This response does not relate to hedges using the last-of-layer method (see section 8.5.30).



Example 8.5.10

Accounting for the termination of an interest rate swap hedging fixed-rate debt

On January 1, Year 1, ABC Corp. issues a five-year, \$10,000,000 debt obligation. The debt obligation requires annual interest payments at a fixed rate of 10% with principal payable at maturity.

Simultaneously, ABC enters into a five-year interest rate swap with a notional amount of \$10,000,000 to receive interest at a fixed rate of 10% and pay interest at a variable rate equal to three-month LIBOR.

The interest rate swap is designated and is effective as a hedge of changes in the fair value of the debt obligation due to changes in three-month LIBOR, the designated benchmark interest rate.

On December 31, Year 3, ABC terminates the interest rate swap and discontinues hedge accounting. It pays \$1,000,000 to the counterparty, which is the interest rate swap's fair value at the date of termination. As a result of ABC having applied hedge accounting, the carrying amount of the fixed-rate debt obligation is \$9,000,000 at December 31, Year 3.

ABC accounts for the \$1,000,000 basis adjustment on the fixed-rate debt obligation as a discount on the debt obligation and accretes that amount as interest expense over the remaining life of the debt obligation using the effective yield method.

The following table summarizes the remaining payments on December 31, Year 3 and the new effective rate for the debt obligation. The new effective rate is the rate that equates the adjusted amortized cost basis of the debt obligation with the present value of future cash flows.

Annual interest payments for remaining 2 years	\$ 2,000,000
Principal payment at end of 2 remaining years	10,000,000
Total	\$12,000,000
Original effective rate	10.00%
Present value at original effective rate	\$10,000,000
Amortized cost basis (with basis adjustment)	\$9,000,000
New effective rate based on adjusted amortized cost basis (rounded)	16.25%

For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.

- It is based on annual periods; normally the assessment of effectiveness and fair value adjustments of the hedged item and derivative would be done at least quarterly.

The following journal entries are required to be made for Year 4 and Year 5.

Journal entries – December 31, Year 4

ABC records the following journal entries.

	Debit	Credit
Interest expense	1,000,000	
Cash		1,000,000
<i>To record interest payment on debt obligation.</i>		
Interest expense	462,500	
Fixed-rate debt obligation		462,500
<i>To accrete basis adjustment on fixed-rate debt obligation using effective yield method.¹</i>		
Note:		
1. (\$9,000,000 beginning amortized cost basis (with basis adjustment) × 16.25% effective rate) - \$1,000,000 cash interest expense.		

Journal entries – December 31, Year 5

ABC records the following journal entries.

	Debit	Credit
Interest expense	1,000,000	
Cash		1,000,000
<i>To record interest payment on debt obligation.</i>		
Interest expense	537,500	
Fixed-rate debt obligation		537,500
<i>To amortize basis adjustment on fixed-rate debt obligation using effective yield method.¹</i>		
Fixed-rate debt obligation	10,000,000	
Cash		10,000,000
<i>To record repayment of fixed-rate debt obligation on December 31, Year 5.</i>		
Note:		
1. (\$9,462,500 beginning amortized cost basis (with basis adjustment) × 16.25% effective rate) - \$1,000,000 cash interest expense (rounded).		

Financial statement excerpts

At the end of Years 4 and 5, ABC's financial statements reflect the following.

Account	Year 4	Year 5
Balance sheet – liabilities		
Debt obligation	\$9,462,500 ¹	-
Income statement		
Interest expense	\$1,462,500 ²	\$1,537,500 ³
Disclosures under 815-10-55-4EE		
Carrying amount of debt obligations on the balance sheet that are hedged liabilities [815-10-50-4EE(a), 50-4EE(c)]	\$9,462,500	-
Cumulative amount of fair value hedge adjustments included in the carrying amount of hedged debt obligations [815-10-50-4EE(b)]	537,500 ⁴	-
Cumulative amount of fair value hedge adjustments remaining for hedged debt obligations for which hedge accounting has been discontinued [815-10-50-4EE(d)]	537,500 ⁴	-
Notes:		
1. \$9,000,000 beginning amortized cost basis (with basis adjustment) + \$462,500 amortization of the basis adjustment.		
2. \$9,000,000 beginning amortized cost basis (with basis adjustment) × 16.25% effective rate.		
3. \$9,462,500 beginning amortized cost basis (with basis adjustment) × 16.25% effective rate (rounded).		
4. \$1,000,000 basis adjustment - \$462,500 amortized during Year 4.		



Question 8.5.20

What is the accounting for a partially dedesignated fair value hedging relationship?

Interpretive response: We believe it is acceptable to partially dedesignate a fair value hedging relationship under certain circumstances (see section 6.10.60). When an entity partially dedesignates a fair value hedging relationship, hedge accounting should be partially discontinued as follows.

- **Treatment of dedesignated portion of hedging instrument.** Unless it is designated as the hedging instrument in a new cash flow or net investment hedging relationship, the dedesignated portion of the derivative instrument continues to be recorded on the balance sheet at fair value and all changes in fair value (including changes related to the previously excluded components) are reflected in earnings.
- **Treatment of hedged item (basis adjustment).** The cumulative basis adjustment is part of the amortized cost basis of a hedged item. If an entity partially dedesignates a hedging relationship, it is necessary to allocate the

basis adjustment between the portion of the hedged item that continues to be hedged versus the portion that is not; also, it may be necessary to allocate a portfolio level basis adjustment to individual items in the portfolio (see section 8.3.30). This is because the basis adjustment recognized through the date of the partial dedesignation relates (in part) to the items that have been partially dedesignated while further changes to the cumulative basis adjustment will relate only to items that continue to be hedged.

Subsequent accounting for the portion of the basis adjustment allocated to the previously hedged item depends on whether it continues to be recognized and on the nature of the hedged item. For example, if a portion of the originally designated hedged item has been derecognized, the basis adjustment is part of the amortized cost basis used to determine the gain or loss recorded on derecognition. As another example, if the dedesignated hedged item is a portion of a financial instrument that has not been derecognized, the entity is required to amortize the related basis adjustment over a period that is consistent with the amortization of other discounts or premiums associated with the hedged item under other applicable US GAAP. For guidance on accounting for basis adjustments, see section 8.4.

This response does not relate to hedges using the last-of-layer method (see section 8.5.30).

8.5.20 Hedge relationship is no longer highly effective



Excerpt from ASC 815-25

>> Noncompliance with Effectiveness Criterion

40-3 In general, if a periodic assessment indicates noncompliance with the effectiveness criterion in paragraphs 815-20-25-75 through 25-80, an entity shall not recognize the adjustment of the carrying amount of the hedged item described in paragraphs 815-25-35-1 through 35-6 after the last date on which compliance with the effectiveness criterion was established.

40-4 However, if the event or change in circumstances that caused the hedging relationship to fail the effectiveness criterion can be identified, the entity shall recognize in earnings the changes in the hedged item's fair value attributable to the risk being hedged that occurred before that event or change in circumstances.

A quarterly hedge effectiveness assessment may indicate that a hedging relationship is no longer highly effective and the hedge relationship is discontinued as a result. In that case, generally no changes in the fair value of the hedged item attributable to the hedged risk are recorded after the last date on which effectiveness testing indicated the relationship was highly effective. This date is presumably the date of the immediately preceding quarterly effectiveness assessment. [\[815-25-40-3\]](#)

However, if an event or change in circumstances caused the relationship to fail to be highly effective, the change in fair value of the hedged item attributable to the hedged risk is recognized through the date on which the entity can demonstrate that the hedging relationship was highly effective. [815-25-40-4]

Additionally, if a hedging relationship had not been highly effective retrospectively, but is expected to be highly effective prospectively, hedge accounting is not required to be discontinued prospectively (see Question 6.10.90).



Example 8.5.20

Identifying the date a hedging relationship ceased to be highly effective

On January 1, Year 1, ABC Corp. designated a forward contract for which the underlying is a soybean meal index as the hedging instrument in a hedge of changes in fair value of its cottonseed meal inventory. ABC performs its quarterly hedge effectiveness assessments using the period-by-period dollar-offset approach.

When ABC performs its quarterly hedge effectiveness assessment for the quarterly period ended December 31, Year 1, ABC identifies that the hedging relationship was not highly effective in the period being assessed.

ABC identifies that the cause of the relationship ceasing to be highly effective was a storm that damaged the soybean harvest on December 1, Year 1. The storm caused a shortage in soybean meal and an increase in the soybean meal index, but did not affect the fair value of cottonseed meal inventory. ABC determines that the hedging relationship was highly effective through November 30, Year 1. Accordingly, ABC applies hedge accounting through November 30, Year 1, then discontinues hedge accounting.

If ABC had been unable to identify an event or change in circumstances that caused the relationship to fail to be highly effective, ABC would not apply hedge accounting for the quarterly period ended December 31, Year 1 – i.e. hedge accounting would be applied only through September 30, Year 1. Additionally, ABC would discontinue the hedging relationship unless the hedging relationship is expected to be highly effective prospectively.

8.5.30 Last-of-layer hedging relationships



Excerpt from ASC 815-25

>> Hedged Item Is Designated under the Last-of-Layer Method

40-9 If a last-of-layer method hedging relationship is discontinued (or partially discontinued), the outstanding basis adjustment (or portion thereof) as of the discontinuation date shall be allocated to the individual assets in the closed portfolio using a systematic and rational method. An entity shall amortize those amounts over a period that is consistent with the amortization of other

discounts or premiums associated with the respective assets in accordance with other Topics (for example, Subtopic 310-20 on receivables–nonrefundable fees and other costs).

As discussed in section 7.3.100, Topic 815 permits an entity to designate a fixed amount of a closed portfolio of prepayable financial assets as the hedged item in a fair value hedge of interest rate risk if the entity expects the designated amount will remain outstanding at the end of the hedge term (i.e. last of layer).

There are two situations in which a hedging relationship designated using the last-of-layer method in a closed portfolio of prepayable financial assets is discontinued, as illustrated in the following diagram (see Question 6.10.40). [815-25-40-8]

	Scenario 1: Partial discontinuation	Scenario 2: Full discontinuation
Occurs when:	Amount outstanding in portfolio on testing date exceeds last of layer (i.e. hedged item) but last of layer not expected to remain outstanding at end of hedge term	Amount outstanding in portfolio on testing date is less than the designated last of layer (i.e. hedged item)
Hedge accounting is discontinued for:	The portion of the last of layer no longer expected to remain outstanding at end of hedge term	The entire hedging relationship

Under a partial discontinuation, the entity allocates the portion of the cumulative basis adjustment related to the discontinued portion to the individual assets in the portfolio at the date of partial discontinuation using a systematic and rational method. It also uses a method to amortize those amounts over a period that is consistent with the amortization of other discounts or premiums associated with the respective assets. [815-25-40-9]



Question 8.5.30

How is the outstanding basis adjustment allocated to the individual items in a portfolio on a full discontinuation?

Interpretive response: The following table indicates the steps we believe an entity should take when it is required to discontinue the entire hedging relationship as a result of the outstanding amounts in the portfolio falling below the last-of-layer amount on the testing date.

Step 1	We believe an entity should recognize in earnings the portion of the cumulative basis adjustment related to the difference between the full amount of the last of layer and the current outstanding amount of the portfolio.
Step 2	Allocate the remaining portion of the basis adjustment to the individual assets in the closed portfolio.
Step 3	Amortize the amounts allocated to the individual assets in the closed portfolio over a period that is consistent with the amortization of other discounts or premiums associated with the respective assets.

Given the consequences of full discontinuation, an entity may want to forecast conservatively. In addition, it may want to closely monitor the portfolio balance, and if necessary, proactively make a partial discontinuation.



Example 8.5.30

Discontinuation of a last-of-layer method hedge

ABC Corp. has a closed portfolio of \$1 billion of prepayable fixed-rate assets. It designates a hedging relationship comprising a last of layer of \$300 million from the closed portfolio as the hedged item and a \$300 million plain-vanilla interest rate swap under which ABC pays a fixed rate and receives the 3-month LIBOR rate.

Scenario 1: Partial discontinuation

At a subsequent testing date, ABC has \$500 million in prepayable fixed-rate assets remaining in the closed portfolio and its current expectation has changed such that it now expects only \$250 million of the portfolio to remain outstanding at the end of the hedge term. Therefore, ABC discontinues hedge accounting related to $1/6^{\text{th}}$ ($(\$300 \text{ million} - \$250 \text{ million}) \div \$300 \text{ million}$) of the last of layer. However, it may continue hedge accounting on the remaining $5/6^{\text{th}}$ of the last of layer.

ABC allocates the portion of the cumulative basis adjustment related to the discontinued portion (i.e. $1/6^{\text{th}}$ of the cumulative basis adjustment) to the remaining individual assets in the portfolio (i.e. the \$500 million) using a systematic and rational method. ABC then amortizes those amounts using a method that is consistent with the amortization of other discounts or premiums associated with the respective assets.

Scenario 2: Full discontinuation

Assume the same facts as in Scenario 1, except that ABC never changed its expectation and therefore never made a partial discontinuation. Rather, on a subsequent testing date, it determines that the current outstanding amount of the closed portfolio of prepayable financial assets is \$270 million. The current outstanding amount of the portfolio is less than the designated last of layer (\$300 million).

Therefore, ABC is required to discontinue the hedging relationship entirely and performs the following steps.

Step 1	ABC recognizes in earnings 1/10 th $((\$300 \text{ million} - \$270 \text{ million}) \div \$300 \text{ million})$ of the cumulative basis adjustment related to the difference between the full amount of the designated last of layer and the current outstanding amount of the portfolio.
Step 2	ABC allocates the remaining portion of the basis adjustment to the individual assets in the closed portfolio (\$270 million).
Step 3	ABC amortizes the remaining portion of the basis adjustment as calculated in Step 2 using a method that is consistent with the amortization of other discounts or premiums associated with the respective assets.

9. Qualifying criteria for cash flow hedges

Detailed contents

New item added in this edition: **

Item significantly updated in this edition: #

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- 9.3.80 Hedging a group of transactions: Layering with first-payments-received (paid) approach
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Future developments #

Future developments #

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- 9.5.60 Can basis swaps other than those involving interest rates be designated as a hedging instrument?

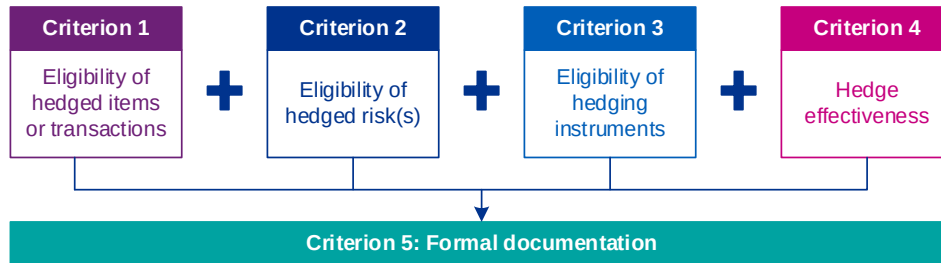
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- 9.5.10 Basis swap that qualifies for cash flow hedge accounting
- 9.5.20 Basis swap that does not qualify for cash flow hedge accounting
- 9.5.30 First-payments-received (paid) approach with basis swap as the hedging instrument

9.1 How the standard works

The objective of a **cash flow hedge** is to reduce or eliminate exposure to variability in expected future cash flows that affect earnings.

Topic 815 requires that certain criteria be met for a hedging relationship to qualify for cash flow hedge accounting. The criteria are organized as follows.



Topic 815 specifies certain items and transactions that are eligible for designation as a hedged transaction in a cash flow hedge.

Criterion 1: Transactions eligible for cash flow hedges (section 9.3)	
Cash flows from existing recognized assets and liabilities (section 9.3.10)	Forecasted transactions – e.g. forecasted purchases or sales (section 9.3.20)
Group of similar forecasted transactions (section 9.3.60)	All-in-one hedge (section 9.3.90)

Additionally, the risk(s) associated with the hedged transaction also needs to qualify for hedge accounting. The risks eligible to be designated in a cash flow hedge are different for financial and nonfinancial assets and liabilities.

Criterion 2: Risks eligible for cash flow hedges		
	Financial assets and liabilities (section 6.3)	Nonfinancial assets and liabilities (section 6.4)
 Interest rate risk	Either: changes in a contractually specified interest rate for variable-rate financial instruments or forecasted issuances or purchases of variable-rate financial instruments; or	Not applicable.

	— changes in the benchmark interest rate for forecasted issuances or purchases of fixed-rate financial instruments.	
 Credit risk	Includes: — risk of default; — changes in the obligor's creditworthiness; and — changes in the credit spread over the contractually specified interest rate or the benchmark interest rate.	Not applicable.
 Foreign currency risk	— Changes in the related foreign currency exchange rates.	— Changes in the related foreign currency exchange rates of foreign currency denominated forecasted transactions or firm commitments.
 Price risk	— Total change in the cash flows related to the asset or liability – e.g. all changes in the purchase price or sales price.	Either: — all changes in the purchase price or sales price of the asset – i.e. price risk; or — changes in a contractually specified component – i.e. a component of price risk.

Section 9.4 discusses the eligibility criteria for hedged risks that are specific to cash flow hedges, including:

- contractually specified component price risk for nonfinancial items;
- interest rate risk on the forecasted issuance or purchase of debt instruments; and
- changing the hedged risk.

 **Foreign currency risk.** For further guidance on hedging foreign currency risk, see chapter 11.

Criterion 3: Hedging instruments eligible for cash flow hedges

General criteria for all hedging instruments (section 6.6)	General limitations on all hedging instruments (section 6.7)	Eligibility criteria specific to cash flow hedges (section 9.5)

Section 9.5 discusses the eligibility criteria of hedging instruments that are specific to cash flow hedges, including:

- special rule for basis swaps; and
- limitations on mixed-attribute derivative commodity contracts.

Criterion 4: Hedge effectiveness (chapter 13)

A derivative hedging instrument can qualify as a hedging instrument only if the entity expects the instrument to be (and the instrument actually is) effective at offsetting changes in cash flows of the hedged transaction.

Criterion 5: Formal documentation for cash flow hedges

Formal documentation requirements for all hedges (section 6.9)

Formal documentation requirements specific to cash flow hedges (section 6.9.60)



Observation**

Optional expedients available in Topic 848

The guidance in this chapter does not consider the optional expedients that may be available in Topic 848 (reference rate reform) for hedging relationships that reference LIBOR or a reference rate that is expected to be discontinued. See 'Optional expedients available in Topic 848' in chapter 6 for discussion of expedients to hedge accounting that are not specific to a particular type of hedging relationship.

The key provisions of the optional expedients that are specifically related to cash flow hedges that an entity may elect to apply are summarized below.

- If the designated hedged interest rate risk in a cash flow hedge of a forecasted transaction is a reference rate in the scope of Topic 848, disregard a modification or potential modification of terms when asserting whether the forecasted transaction remains probable. [848-50-25-2]
- Change the designated hedged interest rate risk and continue to apply hedge accounting. To apply this expedient, an entity is required to assess whether the revised hedging relationship is highly effective; however, it may also apply other optional expedients when performing this assessment. [848-50-25-3]
- For hedges of portfolios of forecasted transactions in which one or more of the individual forecasted transactions reference a rate in the scope of Topic 848, disregard the guidance that requires a group of individual transactions to share the same risk exposure. However, the requirement that prohibits forecasted sale and forecasted purchase transactions from being included in the same group continues to apply. [848-50-25-13 – 25-14]

See 'Optional expedients available in Topic 848' in chapter 13 for discussion of expedients related to hedge effectiveness for cash flow hedges.

9.2 Objective of a cash flow hedge

Cash flow hedges are structured to reduce or eliminate variability in expected future cash flows due to changes in variable rates or prices. A cash flow hedge is designed to ensure that the amount and timing of those cash flows are either fixed or will change in a single direction (i.e. only increase or decrease).

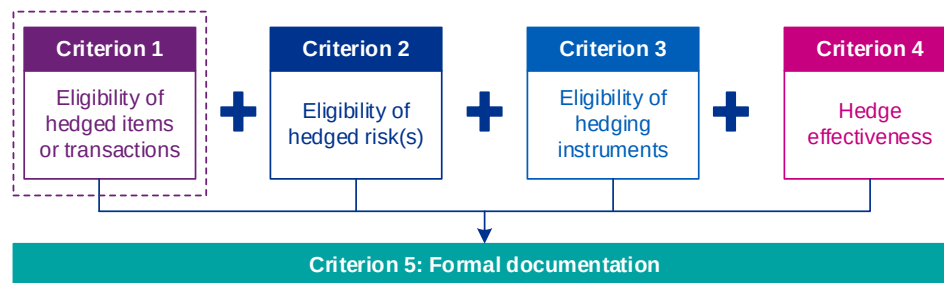
For example, an entity may wish to eliminate all fluctuations in the cash flows associated with variable-rate debt, or may seek to reduce only the exposure to increases in the variable interest rate.

The following are common examples of cash flow exposures and hedging strategies.

Hedged transaction	Cash flow exposure / hedged risk	Hedging strategy
Recognized assets and liabilities		
Variable-rate assets	Exposure to variability in interest receipts.	— Convert the interest received to fixed by entering into an interest rate swap for receipt of interest at a fixed rate and payment of interest at a variable rate. — Lock in a minimum yield by purchasing an interest rate floor option.
Variable-rate liabilities	Exposure to variability in interest payments.	— Convert the interest paid to fixed by entering into an interest rate swap for receipt of interest at a variable rate and payment of interest at a fixed rate. — Lock in a maximum cost of funds by purchasing an interest rate cap option.
Forecasted transactions		
Forecasted sale of a mortgage loan	Exposure to variability in market prices to date of sale.	Lock in a minimum price on the forecasted sale of a mortgage loan by purchasing a put option.
Forecasted issuance of a fixed-rate debt	Exposure to variability in market interest rates to date of issuance.	Fix the interest rate on the forecasted issuance of debt by entering into an interest rate lock agreement or forward-starting interest rate swap.
Forecasted issuance of a variable-rate debt	Exposure to variability in contractually specified interest rates to date of issuance.	Fix the interest rate on the forecasted issuance of debt by entering into an interest rate lock agreement or forward-starting interest rate swap.

Hedged transaction	Cash flow exposure / hedged risk	Hedging strategy
Forecasted purchase of inventory	— Exposure to variability in market prices to date of purchase. — Exposure to variability in market prices of a contractually specified component to date of purchase.	Lock in the cost of a forecasted purchase price of inventory, or a contractually specified component, by entering into a forward contract to purchase inventory or the specific component.
Forecasted sale of inventory	— Exposure to variability in market prices to date of sale. — Exposure to variability in market prices of a contractually specified component to date of sale.	Lock in the sales price of inventory, or a contractually specified component, by entering into a forward contract to sell inventory or the specific component.

9.3 Eligibility of hedged transactions



This section discusses the criteria for transactions to be eligible for cash flow hedge accounting. Topic 815 also prohibits certain transactions from being hedged, which are discussed in section 6.5.

 **Foreign currency risk.** For guidance on the eligibility of hedged transactions in a cash flow hedge of foreign currency risk, see section 11.6.10.

9.3.10 Basic requirements



Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-13 An entity may designate a derivative instrument as hedging the exposure to variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with either of the following:

- a. An existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt)
- b. A forecasted transaction (such as a forecasted purchase or sale).

Note that the glossary definition of **transaction** is intended to clearly distinguish a transaction from an internal cost allocation or an event that happens within an entity.

25-14 For purposes of this Subtopic and Subtopic 815-30, the individual cash flows related to a recognized asset or liability and the cash flows related to a forecasted transaction are both referred to as a forecasted transaction or hedged transaction.

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

In Topic 815 and throughout this publication, both the cash flows related to a recognized asset or liability and the cash flows related to a forecasted transaction are referred to as the forecasted transaction or the hedged transaction.

9.3.20 Forecasted transactions: Definition



Excerpt from ASC 815-20

20 Glossary

Forecasted Transaction – A transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15 A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

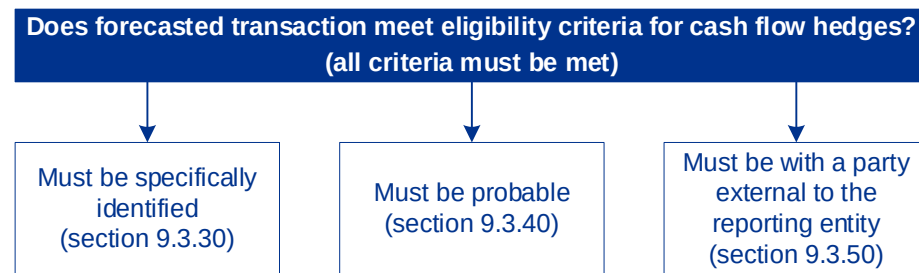
- a. The forecasted transaction is specifically identified as either of the following:
 - 1. A single transaction
 - 2. A group of individual transactions that share the same risk exposure for which they are designated as being hedged. A forecasted purchase and a forecasted sale shall not both be included in the same group of individual transactions that constitute the hedged transaction.
- b. The occurrence of the forecasted transaction is **probable**.
- c. The forecasted transaction meets both of the following conditions:
 - 1. It is a transaction with a party external to the reporting entity (except as permitted by paragraphs 815-20-25-30 and 815-20-25-38 through 25-40).

2. It presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

A forecasted transaction is essentially a future transaction that is probable and does not meet the definition of a firm commitment. A firm commitment is a (legally) binding agreement between unrelated parties that specifies all significant terms (e.g. quantity, fixed price) and includes a disincentive for nonperformance that is sufficiently large to make performance probable (see section 7.3.20). [815-20 Glossary]

Forecasted transactions are eligible only for cash flow hedge accounting, while firm commitments are generally eligible only for fair value hedge accounting.

Certain criteria must be met for a forecasted transaction to be eligible for designation as a hedged transaction.



Question 9.3.10

Can a contract that qualifies for the NPNS scope exception qualify as a hedged transaction?



Excerpt from ASC 815-20

>>> Normal Purchases and Normal Sales as Hedged Items or Transactions

25-7 A contract that is not subject to the requirements of Subtopic 815-10 because it qualifies for the normal purchases and normal sales scope exception may be designated as a hedged item in a fair value hedge, if the provisions of this Section are met. As the hedged item, the contract would be accounted for under fair value hedge accounting. Similarly, the purchase under that contract may be the hedged transaction in a cash flow hedge, if the provisions of paragraph 815-20-25-15 are met. For cash flow hedges, the special accounting applies to the hedging instrument, not to the purchase contract that is related to the hedged forecasted transaction.

Interpretive response: Yes. A contract that meets the definition of a derivative but qualifies for the NPNS scope exception (or any other scope exception) is eligible to be designated as a hedged transaction; see chapter 2

for guidance about scope exceptions, including section 2.4 about the NPNS scope exception.

In contrast, if the contract meets the definition of a derivative and does not meet any of the scope exceptions in Subtopic 815-10, it cannot be designated as a hedged transaction. Rather, it is accounted for as a derivative instrument.

The purchase or sale under a variable-price contract that qualifies for the normal purchases and normal sales exception may be designated as the hedged transaction in a cash flow hedge for the forecasted purchase or sale of the asset underlying the contract.

For an example of a contract not accounted for as derivative because the normal purchases and normal sales scope exception is met, see Example 9.4.30.

9.3.30 Forecasted transactions: Specific identification



Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

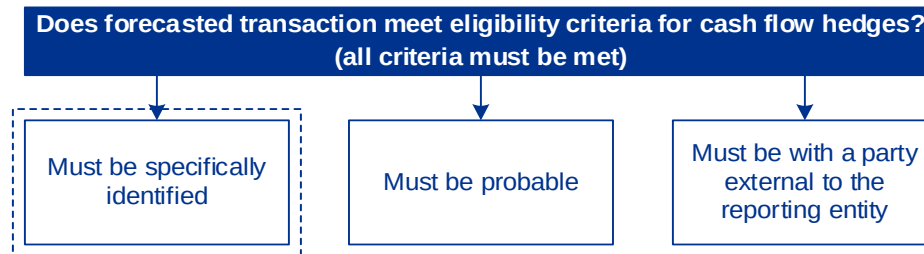
25-15(a) The forecasted transaction is specifically identified as either of the following:

1. A single transaction
2. A group of individual transactions that share the same risk exposure for which they are designated as being hedged. A forecasted purchase and a forecasted sale shall not both be included in the same group of individual transactions that constitute the hedged transaction.

>> Example 1: Designation and Documentation of Hedged Forecasted Transaction

55-80 This Example illustrates the requirement in paragraph 815-20-25-3(d)(1) for specific identification of the hedged transaction. Entity A determines with a high degree of probability that it will issue \$5,000,000 of fixed-rate bonds with a 5-year maturity sometime during the next 6 months, but it cannot predict exactly when the debt issuance will occur. That situation might occur, for example, if the funds from the debt issuance are needed to finance a major project to which Entity A is already committed but the precise timing of which has not yet been determined. To qualify for cash flow hedge accounting, Entity A might identify the hedged forecasted transaction as, for example, the first issuance of five-year, fixed-rate bonds that occurs during the next six months.

To qualify for cash flow hedge accounting, an entity must specifically identify the single forecasted transaction (or group of transactions) that gives rise to the cash flow exposure that is being hedged. [\[815-20-25-15\(a\)\]](#)



The specifically identified transaction may be: [\[815-20-25-3\(d\)\(1\), 25-15\(a\)\]](#)

- the specific asset or liability for which the forecasted transaction relates; or
- the first cash flows received or paid to a specific amount in a particular period (without reference to the specific asset or liability) when hedging a group of similar forecasted transactions (see sections 9.3.60 and 9.3.70).

The key is that the designation is specific enough so that when the transaction occurs, it is clear whether that transaction is or is not the hedged transaction. [\[815-20-25-3\(d\)\(1\)\]](#)

Formal documentation. Topic 815 requires an entity to formally document certain details around the specifically identified forecasted transaction, including: [\[815-20-25-3\(d\)\(1\)\]](#)

- timing of when the forecasted transaction is expected to occur;
- specific asset or liability involved (if applicable); and
- the expected currency amount and/or the physical quantity (e.g. number of items or unit of measure).

For further guidance on the formal documentation requirements when hedging a forecasted transaction, see section 6.9.60.

 **Foreign currency risk.** If the hedged forecasted transaction is denominated in a foreign currency, an entity needs to specify the exact amount of foreign currency being hedged. Hedges of foreign currency exposures are discussed in detail in section 11.6.30.



Future developments#

The FASB has a project to provide potential Codification improvements related to an entity's ability to change the hedged risk without terminating the hedging relationship. This project is expected to clarify how broadly or narrowly the hedged transaction is defined and whether (or when) a change in the hedged risk constitutes a change in the hedged transaction. This project is ongoing and we expect a final ASU to be issued in 2021.

9.3.40 Forecasted transactions: Probability



Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15 A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met: ...

- b. The occurrence of the forecasted transaction is **probable**.

>>> Timing and Probability of the Hedged Forecasted Transaction

25-16 Example 4 (see paragraph 815-20-55-88) illustrates that how the hedged forecasted transaction is designated and documented in a cash flow hedge is critically important in determining whether it is probable that the hedged forecasted transaction will occur. The following guidance expands on the timing and probability criteria in paragraphs 815-20-25-3 and 815-20-25-15(b): ...

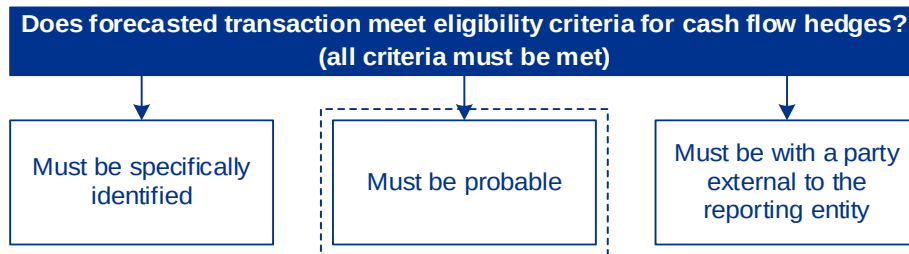
- e. The term *probable* requires a significantly greater likelihood of occurrence than the phrase *more likely than not*.
- f. The cash flow hedging model does not require that it be probable that any variability in the hedged transaction will actually occur—that is, in a cash flow hedge, the variability in future cash flows must be a possibility, but not necessarily a probability. However, the hedging derivative must be highly effective at achieving offsetting cash flows whenever that variability in future interest does occur.

>>>> Probability of a Forecasted Transaction

55-24 An assessment of the likelihood that a forecasted transaction will take place (see paragraph 815-20-25-15(b)) should not be based solely on management's intent because intent is not verifiable. The transaction's probability should be supported by observable facts and the attendant circumstances. Consideration should be given to the following circumstances in assessing the likelihood that a transaction will occur.

- a. The frequency of similar past transactions
- b. The financial and operational ability of the entity to carry out the transaction
- c. Substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity)
- d. The extent of loss or disruption of operations that could result if the transaction does not occur
- e. The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to a common stock offering).

To qualify for cash flow hedge accounting, a forecasted transaction needs to be probable. [\[815-20-25-15\(b\)\]](#)



Topic 815 defines probable as ‘the future event or events are likely to occur.’ The term ‘probable’ requires a significantly greater likelihood of occurrence than the phrase ‘more likely than not’. [\[815-20-25-16\(e\)\]](#)

The assessment of the likelihood that a transaction will occur is not based solely on management’s intent, but rather is supported by observable facts and circumstances. This is illustrated in Example 9.3.10. [\[815-20-55-24\]](#)

In addition to the considerations in paragraph 815-20-55-24, Topic 815 provides guidance to consider when assessing the timing and probability of forecasted transactions: [\[815-20-25-16\]](#)

- time until forecasted transaction is expected to occur;
- quantity of forecasted transaction;
- effect of counterparty creditworthiness;
- probability of forecasted acquisition of a marketable debt security; and
- uncertainty of timing within a range.

Each of these topics is discussed in the subsections that follow.

Formal documentation. In its formal hedge documentation, an entity should specify the circumstances that were considered in concluding that a transaction is probable. For further guidance on the formal documentation requirements when hedging a forecasted transaction, see section 6.9.60.



Question 9.3.20

Does a change in the probability assessment of a hedged transaction affect the ability to apply hedge accounting?

Interpretive response: Yes. A change in the probability of the forecasted transaction may affect whether the hedging relationship remains eligible for hedge accounting. For further discussion, see Questions 6.10.10 and 10.5.20.

If an entity has a pattern of determining that it is probable that hedged forecasted transactions will *not* occur, the appropriateness of management’s previous assertions and its ability to make future assertions regarding forecasted transactions may be called into question. [\[815-30-40-5\]](#)



Example 9.3.10

Probability of transaction to purchase steel

ABC Corp. produces consumer goods called widgets.

The CEO recently decided to expand its operations to include the manufacturing of the equipment used to produce widgets. This will require Board approval for the change in business strategy.

This change will require ABC to purchase steel to manufacture the equipment. ABC has not purchased steel before, but has several possible suppliers. It expects to purchase steel from Steelco within six months but does not have a firm commitment with Steelco. ABC wants to lock in the purchase price of the steel.

Can ABC designate the overall changes in cash flows related to the forecasted purchase of steel as a hedged transaction?

It depends. ABC needs verifiable evidence to conclude the transaction is probable before it is eligible to be designated as a hedged transaction.

There are certain facts that could make it difficult to assert that the transaction is probable, including:

- there are no past purchases of steel;
- if the Board doesn't approve the strategy change, ABC will not be able to carry out the transaction; and
- ABC could decide to purchase the equipment instead of manufacturing it in-house.

However, ABC may be able to provide other observable information to support its assertion that the forecasted purchase of steel is probable.

Time until transaction occurs and quantity of transaction



Excerpt from ASC 815-20

>>>> Probability of a Forecasted Transaction

55-25 Both the length of time until a forecasted transaction is projected to occur and the quantity of the forecasted transaction are considerations in determining probability. Other factors being equal, the more distant a forecasted transaction is or the greater the physical quantity or future value of a forecasted transaction, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be required to support an assertion that it is probable.

Both the length of time until a forecasted transaction is projected to occur and the quantity of the forecasted transaction is considered in determining probability. [\[815-20-55-25\]](#)

For example, a forecasted sale of manufactured goods projected to occur in five years may be less likely than a forecasted transaction expected to occur in one year. Or for an entity whose historical sales volumes are closer to 1,000 units per month, forecasted sales of 1,000 units in a particular month may be more likely than forecasted sales of 2,500 units in that month.

Effect of counterparty creditworthiness on probability



Excerpt from ASC 815-20

>>> Timing and Probability of the Hedged Forecasted Transaction

25-16(a) Effect of counterparty creditworthiness on probability. An entity using a cash flow hedge shall assess the creditworthiness of the counterparty to the hedged forecasted transaction in determining whether the forecasted transaction is probable, particularly if the hedged transaction involves payments pursuant to a contractual obligation of the counterparty.

When assessing the probability that a transaction will occur, an entity should also consider the effect of counterparty creditworthiness. A counterparty to a transaction may fail to comply with the contractual terms of an agreement because of credit problems or other reasons. [815-20-25-16(a)]

An entity should assess the likelihood that the counterparty will make the contractual payments or deliveries.

Hedge effectiveness. In addition, an entity's own creditworthiness and risk of nonperformance is relevant in its hedge effectiveness assessments. For further discussion of how counterparty credit risk and the entity's own nonperformance risk may affect the effectiveness of a hedging relationship, see section 13.2.60.

Probability of forecasted acquisition of a marketable debt security



Excerpt from ASC 815-20

>>> Timing and Probability of the Hedged Forecasted Transaction

25-16(b) Probability of forecasted acquisition of a marketable debt security. To qualify for cash flow hedge accounting for an option designated as a hedge of the forecasted acquisition of a marketable debt security, an entity must be able to establish at the inception of the hedging relationship that the acquisition of the marketable debt security is probable, without regard to the means of acquiring it. In documenting the hedging relationship, the entity shall specify the date on or period within which the forecasted acquisition of the security will occur. The evaluation of whether the forecasted acquisition of a marketable debt security is probable of occurring shall be independent of the terms and nature of the derivative instrument designated as the hedging

instrument. Specifically, in determining whether an option designated as a hedge of the forecasted acquisition of a marketable debt security may qualify for cash flow hedge accounting, the probability of the forecasted transaction being consummated shall be evaluated without consideration of whether the option designated as the hedging instrument has an intrinsic value other than zero.

>>>> Forecasted Acquisition of a Marketable Debt Security

55-27 This discussion provides additional information on the forecasted acquisition of a marketable debt security as a hedged item (see paragraph 815-20-25-16(b)).

55-28 An entity seeking to reduce the variability of the price at which it will acquire a marketable debt security in the future might use a forward contract to fix the price today.

55-29 With a forward contract, the typical settlement is the delivery of the marketable debt security at a later date at the pre-fixed price.

55-30 With a purchased option, the typical settlement might be the delivery of the marketable debt security at the ceiling price, or the holder may allow the purchased option to expire unexercised.

55-31 Therefore, to qualify for cash flow hedge accounting in this circumstance, the entity shall be able to establish that it is probable that it will acquire the marketable debt security by any of the following means:

- a. Exercising the option designated as the hedging instrument if it is in the money
- b. Purchasing the security in the marketplace at its prevailing market price if the option is out of the money.

55-32 If the entity expects to acquire the marketable debt security only by exercising the option and only if the option were in the money, a cash flow hedging relationship typically would not be designated because acquisition of the security is contingent and thus would not be considered probable.

An entity may designate a purchased option or warrant as the hedging instrument in a cash flow hedge of the forecasted acquisition of the marketable security to which the option or warrant relates (i.e. the forecasted transaction).

To qualify for cash flow hedge accounting, the forecasted transaction needs to be probable. The evaluation of whether the forecasted acquisition of the marketable security is probable must be independent of the hedging instrument. Specifically, an entity needs to assert that the marketable debt security will be purchased regardless of whether the option or warrant is in the money. [815-20-25-16(b), 55-32]

**Example 9.3.20****Assessing the probability of the forecasted acquisition of a marketable debt security**

ABC Corp. purchases an option contract that gives it the right to purchase a marketable debt security at a fixed price. ABC would like to designate the option as a cash flow hedge of the variability in cash flows associated with the forecasted purchase of the marketable debt security.

ABC establishes it is probable that it will acquire the security by either:
[815-20-55-31]

- exercising the option designated as the hedging instrument if it is in the money; or
- purchasing the security at its prevailing market price if the option is out of the money.

Therefore, the forecasted acquisition of the marketable debt security is considered probable and eligible for cash flow hedge accounting.

Alternatively, if ABC determines the marketable debt security would be acquired only on exercise of the option (i.e. option is in the money), it is probable the forecasted acquisition will *not* occur and therefore the transaction is not eligible for cash flow hedge accounting. This is because the acquisition of the security is contingent on the market price of the security.

Uncertainty of timing within a range**Excerpt from ASC 815-20****>>> Timing and Probability of the Hedged Forecasted Transaction**

25-16(c) Uncertainty of timing within a range. For forecasted transactions whose timing involves some uncertainty within a range, that range could be documented as the originally specified time period if the hedged forecasted transaction is described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. As long as it remains probable that a forecasted transaction will occur by the end of the originally specified time period, cash flow hedge accounting for that hedging relationship would continue. See paragraph 815-30-40-4 for related guidance and Example 5 (see paragraph 815-20-55-100), which illustrates the application of this paragraph.

25-16(d) Importance of timing in both documentation and hedge effectiveness. Although documenting only the period within which the forecasted transaction will occur is sufficient to comply with the requirements of paragraph 815-20-25-3, compliance with Section 815-20-35 and paragraph 815-20-25-75(b) requires that the best estimate of the forecasted transaction's timing be both documented and used in assessing hedge effectiveness. As explained in paragraphs 815-20-25-84 and 815-20-25-120 through 25-121, the time value of money is likely to be important in the assessment of cash flow hedge

effectiveness, especially if the entity plans to use a rollover or tailing strategy to hedge its forecasted transaction. The use of time value of money requires information about the timing of cash flows.

>>>> Specificity to Timing of a Forecasted Transaction

55-26 Paragraph 815-20-25-3(d)(1)(vi) requires an entity to identify the hedged forecasted transaction with sufficient specificity to make it clear whether a particular transaction is a hedged transaction when it occurs. Paragraph 815-20-25-3(d)(1)(i) requires that an entity document the date on or period within which the forecasted transaction is expected to occur. An entity should not be able to choose when to reclassify into earnings a gain or loss on a hedging instrument in accumulated other comprehensive income after the gain or loss has occurred by asserting that the instrument hedges a transaction that has or has not yet occurred. However, this Subtopic does not require that an entity be able to specify at the time of entering into a hedge the date on which the hedged forecasted transaction will occur.

Topic 815 requires an entity to specify and document the date or period within which the forecasted transaction is expected to occur. If a forecasted transaction is expected to occur within a timeframe, but the date within that timeframe is uncertain, an entity may document a range of time to comply with this requirement. [\[815-20-25-3\(d\)\(1\), 25-16\(c\)\]](#)

This flexibility allows some forecasted transactions with uncertain timing to be considered probable within a range. For example, an entity could document that a hedged forecasted transaction is a foreign currency denominated payment to a subcontractor to be paid within a five-year contract period for a construction project. As long as it remains probable that the forecasted transaction will occur by the end of the originally projected five-year period, cash flow hedge accounting could continue assuming all other eligibility criteria are met.

[\[815-20-55-102\]](#)

Hedge effectiveness. More precision is likely required to assess effectiveness of a forecasted transaction when using an estimated period. This is because the time value of money is likely to be important in the assessment of cash flow hedge effectiveness (see section 13.2.110), especially if an entity plans to use a rollover or tailing strategy. In those analyses, cash flow estimates need to involve estimating points in time when those cash flows will occur. [\[815-20-25-16\(d\)\]](#)

However, an entity may elect to exclude the forward points/time value component of a derivative from the effectiveness assessment. For guidance on excluding certain components of a hedging instrument's cash flows from the effectiveness assessment, see section 13.2.70.



Question 9.3.30

Does a change in the expected timing of a forecasted transaction affect the ability to apply hedge accounting?

Interpretive response: It depends. If the expected timing of a forecasted transaction changes, but is still within the range originally documented, an entity will need to assess effectiveness based on a newly revised best estimate of the cash flows. If it is no longer probable that the forecasted transaction will occur within the originally specified time period, the transaction no longer qualifies for hedge accounting (see Question 6.10.10 and section 10.5.20).

Hedge effectiveness. An entity must document and use its best estimate of timing of the forecasted transaction, which needs to be more specific than the period used to support the probability that the forecasted transaction will occur. This could lead to situations where – at some point during the hedge period – it remains probable that the forecasted transaction will occur within the specified time range, but the hedge is no longer highly effective due to changes in the expected timing of the forecasted transaction. Additionally, circumstances may change over time causing the expected timing used in effectiveness assessments to change, even though the revised expected timing would still be within the original range. The entity would have to consider that change because the change would likely affect the assessment of effectiveness.

FASB Example: Hedged forecasted transaction when timing involves some uncertainty within a range

The FASB example below illustrates a hedged forecasted transaction that has uncertainty of timing within a range.



Excerpt from ASC 815-20

>> Example 5: Hedged Forecasted Transaction When Timing Involves Some Uncertainty within a Range

55-100 This Example Illustrates the application of paragraph 815-20-25-16(c).

55-101 A general contractor enters into a long-term contract to build a power plant. The long-term contract is to be completed within five years. As part of the construction project, the general contractor expects to subcontract a portion of the construction to a foreign entity with a functional currency different from its own. Because the subcontractor will be paid in its functional currency, the general contractor will have a foreign currency exposure that it desires to hedge. At the start of the project, the general contractor concludes it is probable that the subcontract work will be completed and paid for at the end of Year 2. However, the general contractor knows that the timing of a subcontractor's work, and thus the foreign-currency-denominated payment for its work, may possibly be delayed by a period of more than two months, even

though it is probable that the overall project will remain on schedule in meeting the ultimate completion date. The contractor intends to hedge the exposure by using a forward contract with a maturity date that coincides with the current expected date of payment (that is, a two-year foreign currency forward) and the expected notional amount of the forecasted transaction.

55-102 The general contractor could document (as required by paragraph 815-20-25-3(d)(1)) that the hedged forecasted transaction is the foreign-currency-denominated payment to the foreign subcontractor to be paid within the five-year contract period of the overall project (which is the originally specified time period referred to in paragraphs 815-30-40-4 through 40-5). In accordance with paragraph 815-20-25-16(c), as long as it remains probable that the forecasted transaction will occur by the end of the originally projected five-year period of the overall project, cash flow hedge accounting for that hedging relationship would continue. Consequently, if the subcontractor's payment is delayed by more than two months, but less than three years and two months, then the forecasted transaction would still be considered probable of occurrence within the originally specified time period.

55-103 If the expected timing of the forecasted transaction changes, the contractor must first apply the requirements of paragraph 815-30-35-3 using its originally documented hedging strategy and the newly revised best estimate of the cash flows, and then reevaluate whether continuing hedge accounting is appropriate, pursuant to the requirements of paragraphs 815-30-40-1 through 40-3. If hedge accounting is discontinued prospectively, the derivative instrument's gains or losses in other comprehensive income should be accounted for pursuant to paragraphs 815-30-35-38 through 35-41 (unless paragraphs 815-30-40-4 through 40-5 require reclassification into earnings).

55-104 If a quantitative assessment of hedge effectiveness is applied and the assessment of effectiveness is based on changes in forward rates, the most recent best estimate would be based on the current forward rate for the hedged transaction relevant for the probable date that the transaction will occur. If the assessment of effectiveness is based on changes in spot rates, the best estimate would be based on the current spot rate.

9.3.50 Forecasted transactions: Party external to the reporting entity



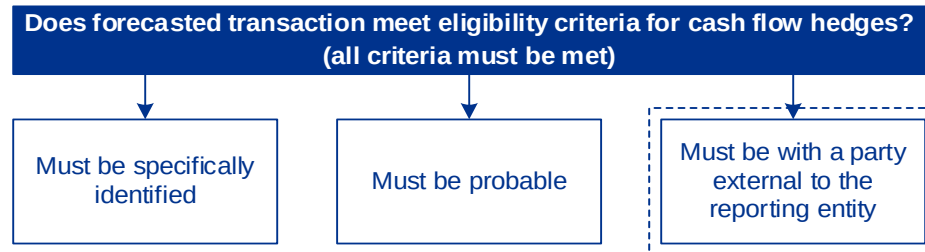
Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15(c) The forecasted transaction meets both of the following conditions:

1. It is a transaction with a party external to the reporting entity (except as permitted by paragraphs 815-20-25-30 and 815-20-25-38 through 25-40).
2. It presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

For a forecasted transaction to qualify as a hedged transaction, it generally needs to be a transaction with a party external to the reporting entity. [815-20-25-15(c)(1)]



Therefore, transactions between a parent and its consolidated subsidiaries do not qualify for hedge accounting at the consolidated level.

Foreign currency risk. Topic 815 provides an exception allowing cash flow hedges of foreign currency risk to hedge forecasted intercompany foreign currency denominated transactions (see section 11.3.40). [815-20-25-43(b)(4)]

However, a subsidiary may apply cash flow hedge accounting to a forecasted transaction in its stand-alone financial statements if the transaction is with a 'party external to the reporting entity' in the stand-alone financial statements.



Question 9.3.40

What is the difference between a 'party external to the reporting entity' and an 'unrelated party'?

Interpretive response: To qualify as a hedged transaction, a forecasted transaction needs to be with a 'party external to the reporting entity'. [815-20 Glossary, 815-20-25-15(c)(1)]

We believe using the term 'party external to the reporting entity' limits the prohibition on hedging forecasted transactions only to transactions with entities that are consolidated by the reporting entity.

As a result, we believe transactions with parties such as equity method investees, affiliates, unconsolidated joint ventures, shareholders and directors are *not* excluded from being forecasted transactions in a cash flow hedge. This assumes the effects of the forecasted transaction will not be eliminated or the forecasted transaction is not specifically prohibited (e.g. forecasted sale of an equity method investment) and all other criteria are met.

Firm commitments. In contrast, a firm commitment needs to be between two 'unrelated parties'. [815-20 Glossary]

Topic 815 does not define an 'unrelated party.' However, we believe the term 'related party' generally includes all parties specified in Topic 850 (related parties).

As a result, we believe transactions with parties such as equity method investees, affiliates, unconsolidated joint ventures, shareholders and directors are precluded from being firm commitments.

9.3.60 Group of similar forecasted transactions



Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

25-15(a) The forecasted transaction is specifically identified as either of the following:

1. A single transaction
2. A group of individual transactions that share the same risk exposure for which they are designated as being hedged. A forecasted purchase and a forecasted sale shall not both be included in the same group of individual transactions that constitute the hedged transaction.

>>>> Grouping Individual Transactions

55-20 It sometimes will be impractical (perhaps impossible) and not cost-effective for an entity to identify each individual transaction that is being hedged. An example is a group of sales or purchases over a period of time to or from one or more parties. This Subtopic permits an entity to aggregate individual forecasted transactions for hedging purposes in some circumstances. As it does for a hedge of a single forecasted transaction, paragraph 815-20-25-3(d)(1)(vi) requires that an entity identify the hedged transactions with sufficient specificity that it is possible to determine which transactions are hedged transactions when they occur.

55-21 For example, an entity that expects to sell at least 300,000 units of a particular product in its next fiscal quarter might designate the sales of the first 300,000 units as the hedged transactions. Alternatively, it might designate the first 100,000 sales in each month as the hedged transactions. It could not, however, simply designate any sales of 300,000 units during the quarter as the hedged transaction because it then would be impossible to determine whether the first sales transaction of the quarter was a hedged transaction. Similarly, an entity could not designate the last 300,000 sales of the quarter as the hedged transaction because it would not be possible to determine whether sales early in the quarter were hedged or not.

55-22 Under the guidance in this Subtopic, a single derivative instrument of appropriate size could be designated as hedging a given amount of aggregated forecasted transactions, such as any of the following:

- a. Forecasted sales of a particular product to numerous customers within a specified time period, such as a month, a quarter, or a year
- b. Forecasted purchases of a particular product from the same or different vendors at different dates within a specified time period
- c. Forecasted interest payments on several variable-rate debt instruments within a specified time period.

55-23 At the time of hedge designation only, the transactions in each group must share the risk exposure for which they are being hedged. For example, the interest payments in the group in (c) in the preceding paragraph shall vary with the same index to qualify for hedging with a single derivative instrument.

For a group (rather than an individual transaction) to be designated as the hedged transaction, the transactions must share the same risk exposure for which they are being hedged. The analysis to determine whether transactions share the same risk exposure in a cash flow hedge is generally qualitative.

Similar to a single forecasted transaction, a group of transactions must be identified with sufficient specificity so that it is possible to determine which transactions are the hedged transactions when they occur. The specifically identified group of transactions may be:

- a specific group of assets or liabilities for which the forecasted transaction relates; or
- the first cash flows received or paid up to a specific amount in a particular period (without reference to the specific asset or liability).

For example, an entity expects to sell at least 300,000 units of a particular product in its next fiscal quarter. [815-20-25-21]

	Is the designation specific enough to qualify for hedge accounting?	
	Yes	No
Specific group of assets or liabilities to which forecasted transaction relates	Sales of the <i>first</i> 300,000 units	<i>Any</i> sales of 300,000 units during the quarter
First cash flows received or paid to a specific amount in a particular period	Sales of the <i>first</i> 100,000 units in each month	Sales of the <i>last</i> 300,000 units

The entity could not designate *any* sales of 300,000 units during the quarter as the hedged transaction because it would be impossible to determine whether an individual sale during the quarter was a hedged transaction. In addition, the entity could not designate the *last* 300,000 sales because it would not be possible to determine whether sales during the quarter were hedged until the quarter had ended.



Future developments#

The FASB has a project to provide potential Codification improvements related to an entity's ability to change the hedged risk without terminating the hedging relationship. This project is expected to clarify how broadly or narrowly the hedged transaction is defined and whether (or when) a change in the hedged risk constitutes a change in the hedged transaction. This project is ongoing and we expect a final ASU to be issued in 2021.



Question 9.3.50

Can both forecasted purchases and sales be included in a group for hedge accounting?

Interpretive response: No. A hedged group of transactions cannot include both cash inflows and outflows, such as forecasted purchases and sales. Although the forecasted purchases and sales may be based on the same underlying, they have opposite exposures. [815-20-25-15(a)(2)]



Question 9.3.60

How does an entity assess whether forecasted transactions of nonfinancial assets or liabilities share similar risk exposure?

Interpretive response: Individual transactions in the hedged portfolio need to share the same risk exposure for which they are designated as being hedged. For nonfinancial assets and liabilities, the designated risk being hedged is either: [815-20-25-15(i)(2) – 25-15(i)(3)]

- all changes in the purchase price or sales price of the asset (i.e. price risk); or
- changes in a contractually specified component (i.e. component price risk).

The different risk exposures require different qualitative and quantitative considerations.

Risk	Qualitative considerations	Quantitative considerations
 Price risk	For forecasted purchases or sales of nonfinancial assets to be considered similar when hedging price risk, we believe the purchases or sales need to first involve the same asset of the same grade. Therefore, forecasted purchases or sales of individually unique assets would not qualify for aggregation. An entity should also consider whether the physical location of individual transactions in a group affects whether they share similar risk exposure. For example, purchasing jet fuel in the United States may have risk exposures different from jet fuel purchased in Singapore. For an illustration of grouping forecasted purchases when hedging price risk, see Example 9.3.30.	An entity also needs to demonstrate that the forecasted transactions are expected to be similar based on changes in the overall market price of the forecasted purchases or sales, including the asset's physical location (see Question 13.2.20). We believe the quantitative assessment of similar risks for fair value hedges can be used for cash flow hedges (see section 7.3.40).

Risk	Qualitative considerations	Quantitative considerations
Component price risk	We believe individual purchases or sales of different asset grades or in different locations may be considered similar in a hedge of a contractually specified component if each of the transactions is based on the <i>identical</i> contractually specified component. For example, an entity may determine that individual purchases of different plastic grades have exposure to changes in the same contractually specified plastic index. For an illustration of grouping forecasted purchases when hedging component price risk, see Subtopic 815-30's Example 23 later in this section.	Because each transaction within a group needs to be based on the <i>identical</i> contractually specified component, the forecasted transactions are expected to be similar. This is because all items in the group share the same risk exposure to the contractually specified component. Therefore, we believe performing a quantitative assessment of similar risks is not necessary.



Example 9.3.30

Forecasted purchases of fuel when hedging price risk – similarity assessment

This is a continuation of Example 6.9.50. For ease of reference, key facts from that example are summarized below.

Freight Co. purchases both jet fuel and diesel fuel at various locations across the US and internationally.

Types of fuel	Locations
Jet fuel	NY Harbor
Diesel fuel	US Gulf Coast
	LA
	Singapore
	Rotterdam

Hedged risk. Freight wants to hedge its exposure to variability in the overall cash outflows (i.e. price risk) for the purchase of fuel due to changes in spot prices at various locations.

Hedged forecasted transaction. The hedged forecasted transaction is defined as the first purchases of gallons of fuel over the 30-day period beginning on the first day of the month in which the derivative contract matures/settles that:

1. in aggregate represent the number of gallons (or equivalent barrels) equal to the notional amount of the hedging instrument; and

2. are not currently being hedged by another derivative instrument or were not previously identified in a relationship originally designated earlier in priority that has been terminated for which amounts remain in AOCI.

Assessing similarity of individual forecasted purchases within the group

The overall price of a gallon of fuel is significantly affected by both the type of fuel and the location of the purchase. Therefore, Freight expects purchases of jet fuel to have risk exposure different from purchases of diesel fuel. Furthermore, fuel purchased at different locations may have different risk exposures.

Only individual forecasted purchases that are *similar* to the risk being hedged can be included within the same hedging relationship. Freight preliminarily identifies transactions within each of the following groups as having similar risk exposure, based first by type of fuel and then more specifically by location:

- Group 1: Jet fuel; NY Harbor, US Gulf Coast, LA
- Group 2: Jet fuel; Singapore, Rotterdam
- Group 3: Diesel fuel; NY Harbor, US Gulf Coast
- Group 4: Diesel fuel; LA

To demonstrate that each group is similar, Freight performs a regression analysis to show that the changes in expected prices for the purchases of fuel at each location within the group are highly correlated with each other.

Because similarity is assessed at both inception and on an ongoing basis, Freight will update its analysis each time the hedging relationships are assessed for effectiveness (i.e. on a quarterly basis). Freight will also monitor both jet fuel and diesel fuel prices by location on a weekly basis for changes in general price trends to determine whether it needs to reconsider its similarity test.

Hedge effectiveness. For the forecasted transactions to qualify for hedge accounting, Freight also needs to demonstrate that the hedging instrument is highly effective at hedging the overall price risk for each individual group. Example 13.6.20 continues this example, illustrating regression analysis to quantitatively assess effectiveness for a cash flow hedge of total price risk for a group of similar transactions.

FASB Example: Cash flow hedge of a forecasted purchase of inventory for which commodity exposure is managed centrally



Excerpt from ASC 815-30

>> Example 23: Designation of a Cash Flow Hedge of a Forecasted Purchase of Inventory for Which Commodity Exposure Is Managed Centrally

55-142 This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to the designation of a **cash flow hedge** of a forecasted

purchase of inventory in which the commodity exposure is managed centrally at the aggregate level. Assume the entity elects to perform subsequent assessments of hedge effectiveness on a qualitative basis and all hedge documentation requirements were satisfied at inception.

55-143 Entity Q is seeking to hedge the variability in cash flows associated with commodity price risk of its monthly plastic purchases for the next 12 months. It has two different manufacturing plant locations (Plant A and Plant B) that are purchasing five different grades of plastic from Supplier A. The plastic purchase price for each month is based on the month-end Joint Plastic (JP) index and a fixed basis differential component. The fixed basis differential offered by the supplier is determined by:

- a. The grade of the plastic purchased
- b. The distance between the plant location and supplier location.

55-144 At January 1, 20X1, Entity Q enters into a supply agreement with Supplier A to purchase plastic over the next 12 months. The respective agreements allow Entity Q to purchase the various grades of plastic at both of its plant locations as the need arises over the following year. The following table summarizes the pricing provisions contained in the supply agreement for each grade of plastic.

	Grade 1	Grade 2	Grade 3	Grade 4	Grade 5
Plant A	JP + \$0.14	JP + \$0.11	JP + \$0.09	JP + \$0.05	JP – \$0.02
Plant B	JP + \$0.16	JP + \$0.12	JP + \$0.07	JP + \$0.06	JP – \$0.03

55-145 Entity Q's risk management objective is to hedge the variability in the purchase price of plastic attributable to changes in the JP index of the first 80,000 pounds of plastic purchased in each month regardless of grade or plant location delivered to. To accomplish this objective, Entity Q executes 12 separate forward contracts at January 1, 20X1, to purchase plastic as follows.

	Settlement Date	Notional Amount	Underlying Index
Jan forward	January 30, 20X1	80,000 (lbs)	JP
Feb forward	February 28, 20X1	80,000 (lbs)	JP
Mar forward	March 30, 20X1	80,000 (lbs)	JP
April forward	April 30, 20X1	80,000 (lbs)	JP
May forward	May 30, 20X1	80,000 (lbs)	JP
June forward	June 30, 20X1	80,000 (lbs)	JP
July forward	July 30, 20X1	80,000 (lbs)	JP
Aug forward	August 30, 20X1	80,000 (lbs)	JP
Sep forward	September 30, 20X1	80,000 (lbs)	JP
Oct forward	October 30, 20X1	80,000 (lbs)	JP
Nov forward	November 30, 20X1	80,000 (lbs)	JP
Dec forward	December 30, 20X1	80,000 (lbs)	JP

55-146 Entity Q determines that the variable JP index referenced in the supply agreement constitutes a contractually specified component and that the

requirements to designate variability in the cash flows attributable to changes in a contractually specified component as the hedged risk in paragraph 815-20-25-22A are met.

55-147 Because Entity Q determined that it will purchase at least 80,000 pounds of plastic each month in the coming 12 months to fulfill its expected manufacturing requirements, it documents that the hedged item (that is, the **forecasted transaction** within each month) is probable of occurring. Entity Q designates each forward contract as a cash flow hedge of the variability in cash flows attributable to changes in the contractually specified JP index on the first 80,000 pounds of plastic purchased (regardless of grade or plant location delivered to) for the appropriate month. The individual purchases of differing grades of plastic by Plant A and Plant B during each month share the risk exposure to the variability in the purchase price of the plastic attributable to changes in the contractually specified JP index. Therefore, the individual transactions in the hedged portfolio of plastic purchases for each month share the same risk exposure for which they are designated as being hedged in accordance with paragraph 815-20-25-15(a)(2).

55-148 In accordance with paragraph 815-20-25-3(b)(2)(iv)(01)(B), if Entity Q has determined the critical terms of the hedged item and hedging instrument match, it may elect to assess effectiveness qualitatively both at inception of the hedging relationship and on an ongoing basis on the basis of the following factors in accordance with paragraphs 815-20-25-84 through 25-85:

- a. The hedging instrument's underlying matches the index upon which plastic purchases will be determined (that is, the JP Index).
- b. The notional of the hedging instrument matches the forecasted quantity designated as the hedged item.
- c. The date on which the derivatives mature matches the timing in which the forecasted purchases are expected to be made. That is, the quantity of the hedged item, 80,000 pounds, is an aggregate amount expected to be purchased over the course of the respective month (that is, the same 31-day period) in which the derivative matures.
- d. Each hedging instrument was traded with at-market terms (that is, it has an initial fair value of zero).
- e. Assessment of effectiveness will be performed on the basis of the total change in the fair value of the hedging instrument.
- f. Although the amount of plastic being hedged each period is a cumulative amount across multiple grades of plastic, the basis differentials between grades of plastic and location are not required to be included in assessments of effectiveness because Entity Q has designated the variability in cash flows attributable to changes in the JP index (the contractually specified component) as the hedged risk within its purchases of plastics.

9.3.70 Hedging a group of transactions: First-payments-received (paid) approach on a group of variable-rate loans



Excerpt from ASC 815-20

>>>> First-Payments-Received Technique in Hedging Variable Interest Payments on a Group of Loans

55-33A A first-payments-received technique for identifying the hedged forecasted transactions (that is, the hedged interest payments) may be used in a cash flow hedge of interest rate risk associated with interest payments for a rolling portfolio of prepayable interest-bearing loans (or other interest-bearing financial assets), provided all other conditions for a cash flow hedge have been met. Such a technique involves identifying the hedged forecasted transactions in a cash flow hedge as the first interest payments based on the contractually specified interest rate received by an entity during each recurring period of a specified length and beginning date for the period covered by the hedging instrument. Example 4, Case A (see paragraphs 815-20-55-91 through 55-96) illustrates this technique.

55-33B Similarly, a comparable first-payments-made technique may be used to identify the hedged forecasted transactions in a cash flow hedge of the contractually specified rate-based interest payments for a group of the reporting entity's financial liabilities, provided all other conditions for a cash flow hedge have been met.

55-33E This implementation guidance regarding use of a first-cash-flows technique also may be applied to a cash flow hedging relationship in which the hedging instrument is a basis swap as discussed beginning in paragraph 815-20-25-50. However, use of that technique for those basis-swap hedging relationships may not be common because that paragraph limits designating a basis swap as the hedging instrument to cash flow hedges of the contractually specified interest payments of only recognized financial assets and liabilities existing at the inception of the hedge, whereas the first-cash-flows technique is typically applied to the contractually specified interest payments for rolling portfolios whose composition of financial assets changes over the period of the hedge.

55-33G Under the first-payments-received technique, an entity also may designate the risk of overall changes in the hedged cash flows, which includes the risk of decreases in cash flows attributable to credit default. The use of the first payments-received technique in those circumstances is permitted by this Subtopic as an exception even though that technique excludes the variable interest payments that are contractually due but not paid by the debtor from being hedged transactions, thereby excluding some of the risk of decreases in interest payment inflows attributable to credit default. This implementation guidance on applying the first-payments-received technique to overall changes in cash flows for interest bearing financial assets should not be applied by analogy to other circumstances.

 In a cash flow hedge of **interest rate risk**, an entity may use a first-payments-received (paid) approach for identifying the hedged forecasted transaction. This approach can be used for interest rate risk associated with interest payments for a rolling portfolio of prepayable interest-bearing loans, or other interest-bearing financial assets, provided all other conditions for a cash flow hedge are met.

When using this approach, the specifically identified group of transactions may be the first interest payments based on the contractually specified interest rate received by an entity during each recurring period of a specified length and beginning date for the period covered by the hedging instrument.

For example, an entity may specifically identify the hedged forecasted transaction as the *first* three-month LIBOR-based interest payments received each quarter for the next two years on its \$100 million LIBOR-based loan.

See Example 4 in Subtopic 815-20 (reproduced below) for an illustration of hedging variable interest payments on a group of variable-rate loans.



Question 9.3.70

Can the first-payments-received (paid) approach be used to hedge credit risk?

Interpretive response: No. We believe that when the designated risk being hedged is the risk of changes in cash flows solely attributable to credit, the entity must document the specific asset or liability for which the forecasted transaction relates.

In other words, no replacement or substitution is permitted without affecting the original hedging relationship.



Question 9.3.80#

How does an entity assess whether the cash flows from variable-rate financial instruments share the same risk exposure?

Interpretive response: Under the first-payments-received (paid) approach, an entity is hedging forecasted interest payments for a group of variable-rate financial instruments for exposure to changes in cash flows attributable to changes in an interest rate index (i.e. the contractually specified interest rate). Under this approach, each variable-rate financial instrument within the group must vary with the *same* interest rate index to qualify for hedge accounting with a single derivative instrument. [\[815-20-55-23\]](#)

Therefore, three-month LIBOR-based interest payments cannot be grouped with US Prime-based interest payments, even if a historical analysis of the movement in these rates indicates they are highly correlated.

We believe the *same* index is interpreted to be *exactly* the same index. For example, if a particular interest rate is published on a 30-day and a 60-day basis,

an interest payment that varies on a 30-day rate and an interest payment that varies on a 60-day rate would not vary with the *same* index. Therefore, they would not be eligible for grouping as a single hedged transaction.

The FASB has a project to provide potential Codification improvements related to an entity's ability to change the hedged risk without terminating the hedging relationship. A final ASU is expected to be issued in 2021 (see 'Future developments' above). These resulting amendments may provide additional guidance that could affect our interpretation that each variable-rate financial instrument must have *exactly* the same index to be eligible for grouping in a portfolio hedge. As a result, revisions to this interpretive response may be provided in a future edition.



Example 9.3.40

Group of variable-rate loans that do not share similar risk exposure

Bank has a pool of variable-rate commercial mortgages. The interest rates on these mortgages are based on US Treasury, Canadian Treasury or LIBOR. A historical analysis of the movement in these rates indicates that they are highly correlated.

Can Bank designate the pool of variable-rate commercial mortgages as the hedged transaction in a cash flow hedge of interest rate risk?

No. The forecasted interest payments on several variable-rate debt instruments must vary with the same index to qualify for hedge accounting with a single derivative instrument. Therefore, Bank cannot designate the pool of commercial mortgages with interest rates based on multiple indices as the hedged transaction in a cash flow hedge.

FASB Example: Variable interest payments on a group of variable-rate, interest-bearing loans as hedged item



Excerpt from ASC 815-20

>> Example 4: Variable Interest Payments on a Group of Variable-Rate, Interest-Bearing Loans as Hedged Item

55-88 The following Cases illustrate the implications of two different approaches to designation of variable interest payments on a group of variable-rate, interest-bearing loans:

- a. Designation based on first payments received (Case A)
- b. Designation based on a specific group of individual loans (Case B).

55-89 For Cases A and B, assume Entity A and Entity B both make to their respective customers London Interbank Offered Rate- (LIBOR-) indexed

variable-rate loans for which interest payments are due at the end of each calendar quarter, and the LIBOR-based interest rate resets at the end of each quarter for the interest payment that is due at the end of the following quarter. Both entities determine that they will each always have at least \$100 million of those LIBOR-indexed variable-rate loans outstanding throughout the next 3 years, even though the composition of those loans will likely change to some degree due to prepayments, loan sales, and potential defaults.

55-90 This Example does not address cash flow hedging relationships in which the hedged risk is the risk of overall changes in the hedged cash flows related to an asset or liability, as discussed in paragraph 815-20-25-15(j)(1).

>>> Case A: Designation Based on First Payments Received

55-91 In this Case, Entity A wishes to hedge its interest rate exposure to changes in the quarterly interest receipts on \$100 million principal of those LIBOR-indexed variable-rate loans by entering into a 3-year interest rate swap that provides for quarterly net settlements based on Entity A receiving a fixed interest rate on a \$100 million notional amount and paying a variable LIBOR-based rate on a \$100 million notional amount.

55-92 In a cash flow hedge of interest rate risk, Entity A may identify the hedged forecasted transactions as the first LIBOR-based interest payments received by Entity A during each 4-week period that begins 1 week before each quarterly due date for the next 3 years that, in the aggregate for each quarter, are payments on \$100 million principal of its then existing LIBOR-indexed variable-rate loans. The LIBOR-based interest payments received by Entity A after it has received payments on \$100 million aggregate principal would be unhedged interest payments for that quarter.

55-93 The hedged forecasted transactions for Entity A in this Case are described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction.

55-94 Because Entity A has designated the hedging relationship as hedging the risk of changes attributable to changes in the LIBOR interest rate in Entity A's first LIBOR-based interest payments received, any prepayment, sale, or credit difficulties related to an individual LIBOR-indexed variable-rate loan would not affect the designated hedging relationship.

55-95 Provided Entity A determines it is probable that it will continue to receive interest payments on at least \$100 million principal of its then existing LIBOR-indexed variable-rate loans, Entity A can conclude that the hedged forecasted transactions in the documented cash flow hedging relationships are probable of occurring.

55-96 An entity may not assume perfect effectiveness in such a hedging relationship as described in paragraph 815-20-25-102 because the hedging relationship does not involve hedging the interest payments related to the same recognized interest-bearing loan throughout the life of the hedging relationship. Consequently, at a minimum, Entity A must consider the timing of the hedged cash flows vis-à-vis the swap's cash flows when assessing effectiveness.

>>> Case B: Designation Based on a Specific Group of Individual Loans

55-97 In this Case, Entity B wishes to hedge its interest rate exposure to changes in the quarterly interest receipts on \$100 million principal of those LIBOR-indexed variable-rate loans by entering into a 3-year interest rate swap that provides for quarterly net settlements based on Entity B receiving a fixed interest rate on a \$100 million notional amount and paying a variable LIBOR-based rate on a \$100 million notional amount. Entity B initially designates cash flow hedging relationships of interest rate risk and identifies as the related hedged forecasted transactions each of the variable interest receipts on a specified group of individual LIBOR-indexed variable-rate loans aggregating \$100 million principal but then some of those loans experience prepayments, are sold, or experience credit difficulties.

55-98 This Case addresses whether the original cash flow hedging relationships remain intact if the composition of the group of loans whose interest payments are the hedged forecasted transactions is changed by replacing the principal amount of the specified loans with similar variable-rate interest-bearing loans. Entity B cannot conclude that the original cash flow hedging relationships have remained intact if the composition of the group of loans whose interest payments are the hedged forecasted transactions is changed by replacing the principal amount of the originally specified loans with similar variable-rate interest-bearing loans. Paragraph 815-20-25-15(a) requires that, for a cash flow hedge, the forecasted transaction be specifically identified as a single transaction or group of transactions. At inception, the entity designated cash flow hedging relationships for each of the variable interest receipts on a specified group of variable-rate loans. If a loan within the group experiences a prepayment, has been sold, or experiences an unexpected change in its **expected cash flows** due to credit difficulties, the remaining hedged interest payments to Entity B specifically related to that loan are now no longer probable of occurring. Pursuant to paragraphs 815-30-40-1 through 40-3, Entity B must discontinue the hedging relationships with respect to the hedged forecasted transactions that are now no longer probable of occurring. However, had the hedged forecasted transactions been designated in a manner similar to that described in Case A, the consequences of a loan's prepayment, a loan sale, or an unexpected change in a loan's expected cash flows due to credit difficulties would not have been the same. How the forecasted transaction in a cash flow hedge is designated can have a significant effect on the application of the Derivatives and Hedging Topic.

55-99 Changing the composition of the specified individual loans within the group of variable-rate interest-bearing loans due to prepayment, a loan sale, or an unexpected change in a loan's expected cash flows due to credit difficulties reflects a change in the probability of the identified hedged forecasted transactions for the hedging relationships related to the individual loans removed from the group of variable-rate interest-bearing loans. Consequently, the hedging relationships for future interest payments that are no longer probable of occurring must be terminated. The provisions related to immediately reclassifying a derivative instrument's gain or loss out of accumulated other comprehensive income into earnings are based on the hedged forecasted transaction being probable that it will not occur—not no longer being probable of occurring—and includes consideration of an additional two-month period of time. After the discontinuation of the hedging

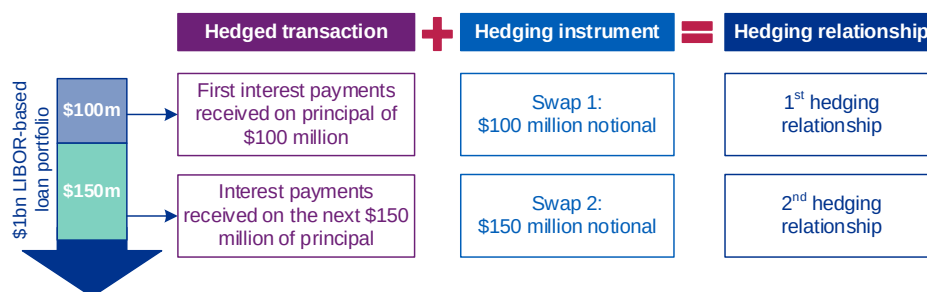
relationships for interest payments related to the individual loans removed from the group of variable-rate interest-bearing loans and the reclassification into earnings of the net gain or loss in accumulated other comprehensive income related to those hedging relationships, the derivative instrument (or a proportion thereof) specifically related to the hedging relationships that have been terminated is eligible to be redesignated as the hedging instrument in a new cash flow hedging relationship. However, paragraph 815-30-40-5 warns that a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both the entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.

9.3.80 Hedging a group of transactions: Layering with first-payments-received (paid) approach

When hedging groups of forecasted transactions using a first-payments-received (paid) approach, an entity may choose to enter into multiple derivative contracts and *layer* these contracts such that each derivative is designated in a separate individual hedging relationship.

For example, an entity has a LIBOR-based loan portfolio in excess of \$1 billion in principal. The entity currently has two swaps that it wishes to use to hedge the variability in some of the interest payments from the portfolio. While the entity intends to hold these swaps to maturity, it may elect to add more swaps in the future as the principal of the portfolio grows or as the entity decides to hedge more interest payments from the existing portfolio.

The illustration below demonstrates an example layering approach where an entity identifies the hedged transactions in two separate hedging relationships.



This example is in the context of hedging interest receipts. However, the layering approach for first-payments-received (paid) can be applied to other forecasted transactions, including forecasted sales or expenses in a foreign currency, sales of nonfinancial items, etc.



Question 9.3.90

How does an entity specifically identify the forecasted transaction when using the layering approach for first-payments-received (paid)?

Interpretive response: For each hedging relationship within the layer, an entity should specifically identify the hedged forecasted transaction as the *first payments received (paid)* after:

1. cash flows identified as hedged forecasted transactions in an active hedging relationship; and
2. probable cash flows previously identified in a hedging relationship that was terminated (i.e. is inactive), such that some portion of the gain or loss on the dedesignated hedging relationship remains in AOCI.

We believe that using this layering approach meets all the requirements in Topic 815 to identify – for each of the individual hedging relationships – the hedged forecasted transactions with sufficient specificity, meaning the transaction being hedged can be identified when it occurs.

Formal documentation. An entity is required to apply a hedge documentation approach that considers the ‘priority chain’ when designating forecasted transactions. This is because complexities arise when an entity is:

- actively managing groups of existing relationships (e.g. terminating or dedesignating derivatives before maturity); or
- experiencing shortfalls of forecasted transactions.

The following questions and examples in this section provide our view on how to address such complex hedging situations.



Question 9.3.100

If additional layers are added, or if existing layers are removed, is an entity required to dedesignate and redesignate other hedging relationships within the layers?

Interpretive response: No. We believe the layering approach provides an entity with the flexibility to add additional hedging relationships (i.e. add layers) and/or remove existing relationships (i.e. remove layers), without having to dedesignate and redesignate other hedging relationships. This is because no change to the identification of the hedged forecasted transactions associated with the other relationships is required.

The designation of each relationship will always identify the hedged forecasted transactions as the first payments received after:

1. cash flows identified as hedged forecasted transactions in an active hedging relationship; and

2. probable cash flows previously identified in a hedging relationship that was terminated (i.e. is inactive), such that some portion of the gain or loss on the dedesignated hedging relationship remains in AOCI.

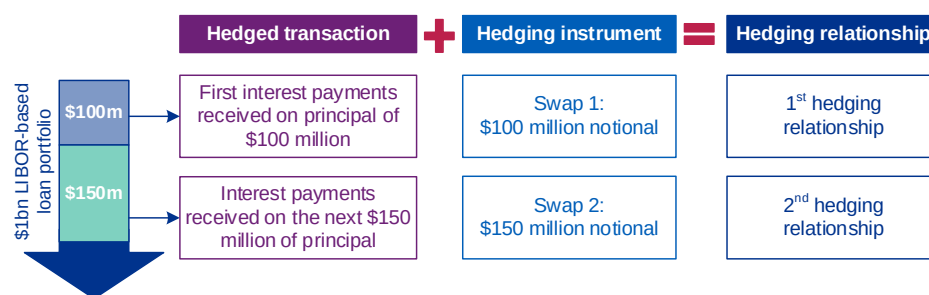
Adding a layer

Adding a derivative to the existing layers will put that relationship at the end of the priority chain, such that it will be designated as hedging the first forecasted transactions occurring after (1) and (2) above, without affecting the designation of those earlier relationships.

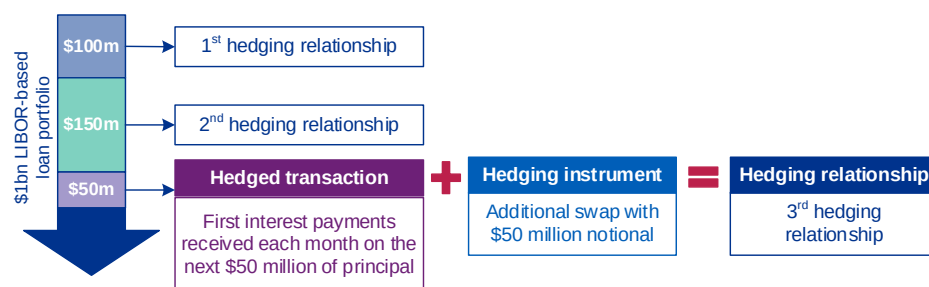
For example, an entity has two active hedging relationships:

- Swap 1 is designated as hedging the first interest payments made on \$100 million of principal of a LIBOR-based loan portfolio and is currently hedging interest payments on principal \$1–\$100 million.
- Swap 2 is designated as hedging the first interest payments made on \$150 million of principal of a LIBOR-based loan portfolio and is currently hedging interest payments on principal \$100,000,001–\$250 million.

The following illustration summarizes the two active hedging relationships.



The entity could designate the first payments received on the next \$50 million of principal of the LIBOR-based loan portfolio that (1) are not currently being hedged by a previously designated hedging relationship earlier in the priority chain or (2) were not included in a terminated hedging relationship with amounts remaining in AOCI earlier in the priority chain.



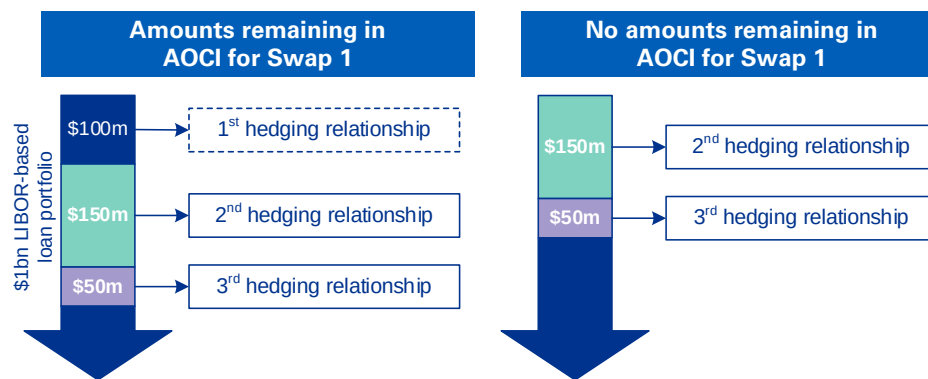
Removing a layer

If a derivative matures such that a relationship earlier in the priority chain terminates, the forecasted transactions for hedging relationships later in the priority chain will not be affected. This is because an entity would continue to hedge the first payments received after:

1. those that are already hedged in active hedging relationships; and
2. those that were previously identified in a hedging relationship that has been terminated with amounts remaining in AOCI.

If no amounts remain in AOCI, the forecasted transactions with active relationships or inactive relationships that continue to have amounts in AOCI will move up in the priority chain. This is because the original identification of the forecasted transaction has been described with sufficient specificity to identify it when it occurs and has not changed as a result of the maturity.

For example, if Swap 1 matured, the first hedging relationship would be discontinued and the second and third hedging relationships would continue. If no gains/losses related to Swap 1 remained in AOCI, the second and third hedging relationships would move up the priority chain. Alternatively, if Swap 1 was terminated early and some of its gains/losses remained in AOCI, the second and third hedging relationships would not move up the priority chain.



For guidance on when amounts related to a swap are reclassified from AOCI, see section 10.3.10. In general, the gain or loss related to a derivative that is terminated before maturity remains in AOCI unless it is probable that the forecasted transaction will not occur.

Hedge effectiveness. When a relationship moves up in the priority chain, the perfectly effective hypothetical (PEH) derivative instrument associated with that relationship must be adjusted to reflect the most recent best estimate of the forecasted transactions that are identified with that relationship for purposes of assessing hedge effectiveness. For further discussion of the PEH derivative, see section 13.7.30.



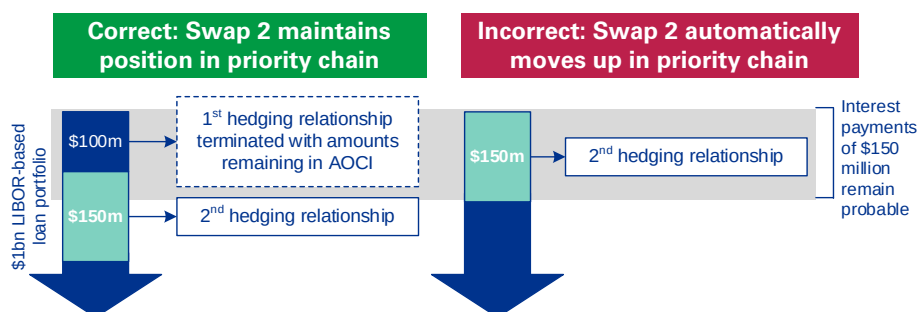
Question 9.3.110

When does a hedging relationship move up the priority chain into a vacated tranche of a discontinued hedging relationship?

Interpretive response: We believe when an entity dedesignates a hedging relationship under the layering approach, all the ongoing relationships occurring later in the priority chain maintain their position until all amounts associated with the discontinued relationship have been reclassified from AOCI. However, the

ongoing relationships could be repositioned in the priority chain through a formal dedesignation and redesignation (see Question 9.3.120).

Continuing the layering approach example in Question 9.3.100, assume Swap 1 is terminated early and only interest payments on \$150 million of principal remain probable.



For Swap 1, no reclassification of amounts from AOCI is necessary because the first payments received on \$100 million of principal (determined based on its original position in the priority chain) are still probable.

Swap 2 maintains its position in the priority chain:

Correct: Swap 2 maintains position in priority chain

Swap 2's relationship *must be fully or partially discontinued* because the relationship is no longer expected to be highly effective and a portion of the forecasted transaction is no longer probable of occurring (see section 10.5.20).

Swap 2 has a notional amount of \$150 million and only interest payments on \$50 million remain probable after interest payments on the first \$100 million of principal continue to be identified with Swap 1 to support retaining amounts in AOCI.

Incorrect: Swap 2 automatically moves up in priority chain

Swap 2's relationship *may continue undisturbed*.

Interest payments on \$150 million are still probable and the first payments received can be attributed entirely to Swap 2 because it has moved up into Swap 1's position in the priority chain.

An entity is required to discontinue hedge accounting for those specific hedged forecasted transactions that are no longer probable.

The entity is required to reclassify amounts from AOCI for any specific forecasted transactions that it is probable will not occur (i.e. interest payments related to \$100 million of the principal balance). For guidance on the discontinuation of hedge accounting when it is probable a forecasted transaction will not occur, see section 10.5.20.

Missed forecast. If it is probable that a forecasted transaction will not occur, an entity must consider this missed forecast when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions (see Question 10.5.110).

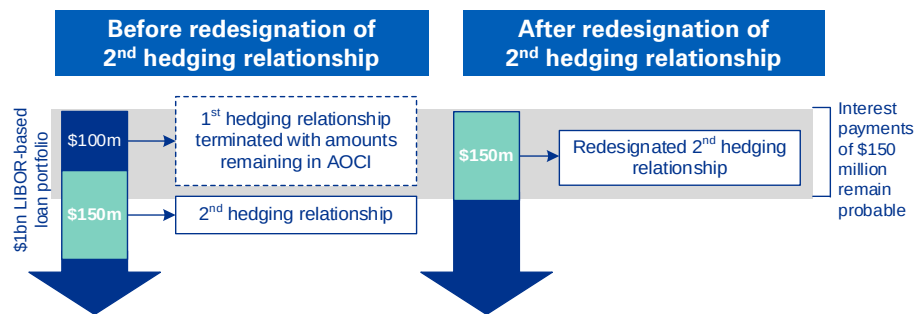


Question 9.3.120

Can a new or redesignated hedging relationship replace a vacated tranche earlier in the priority chain?

Interpretive response: Yes. Ongoing relationships can be repositioned in the priority chain through a formal dedesignation and redesignation, with certain limitations (see Question 9.3.140).

Continuing with the example in Question 9.3.110 assuming Swap 1 was terminated, the entity would be permitted to formally redesignate a new relationship using Swap 2 to hedge the first payments received on \$150 million of principal without regard to the fact that the interest payments on \$100 million of that \$150 million in expected remaining principal are also supporting the retention of amounts in AOCI related to Swap 1.



We believe this strategy executed through formal redesignation is appropriate because:

- it requires recognition in the financial statements for the effect of a shortfall in forecasted transactions based on each relationship's original position in the priority chain;
- it does not allow an entity to cherry pick which amounts from AOCI will be reclassified from the shortfall – a shortfall will always affect the last relationship in the priority chain first regardless of which swaps are terminated or dedesignated; and
- it requires an entity that must stop a hedging relationship due to a shortfall in forecasted transactions to formally redesignate that hedging relationship to continue hedge accounting.



Question 9.3.130

If a hedging relationship within a priority chain is redesignated, what happens to the hedging relationships later in the priority chain?

Interpretive response: When a hedging relationship is dedesignated within a priority chain and amounts remain in AOCI for that relationship, for an entity to formally re-hedge the position that was vacated (with a new or existing

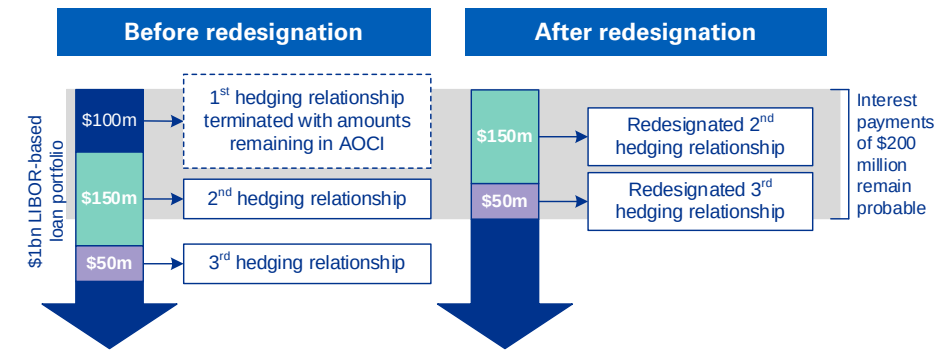
derivative), it needs to redesignate all the relationships that follow the dedesignated relationship in the priority chain.

Therefore, it cannot re-order/re-position certain relationships within the priority chain without formally redesignating all the relationships from the point at which the chain was broken.

For example, assume the same facts and circumstances in the example used in Question 9.3.120, except for the following:

- Swap 3 is designated as hedging interest payments on the next \$50 million of principal; and
- the entity terminates Swap 1, but interest payments on \$200 million principal remain probable.

If an entity wishes to re-hedge the position that Swap 1 vacated with one of the remaining swaps, it needs to dedesignate both Swaps 2 and 3 and then formally redesignate one or both, assuming there are enough interest payments that remain probable.

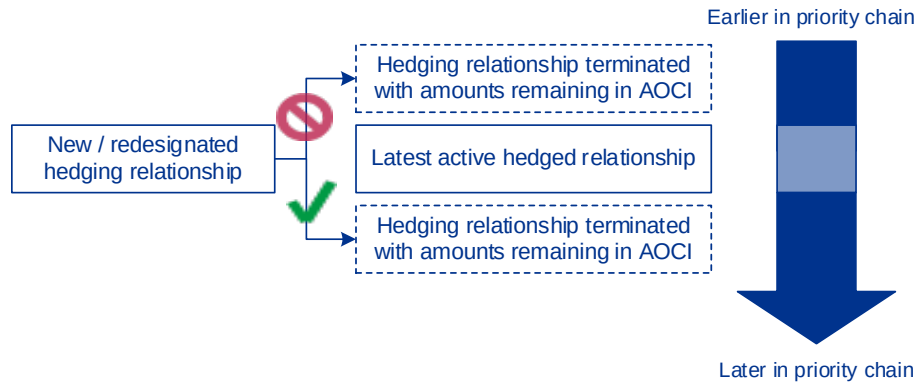


Question 9.3.140

Can a new hedging relationship be inserted earlier in the priority chain than an active hedging relationship?

Interpretive response: No. If a new relationship is layered on to an existing priority chain, that relationship must be designated to immediately follow the latest active relationship in the chain without disturbing any of the other relationships.

An entity may re-hedge a layer of forecasted transactions that was previously identified in a terminated hedging relationship with amounts remaining in AOCI, provided that terminated relationship was designated later in the priority chain than the latest active hedging relationship.



This occurs because the latest active relationship has not been dedesignated. Therefore, it and all the relationships before it in the prior chain (active and inactive for which amounts remain in AOCI), remain in their originally designated positions.

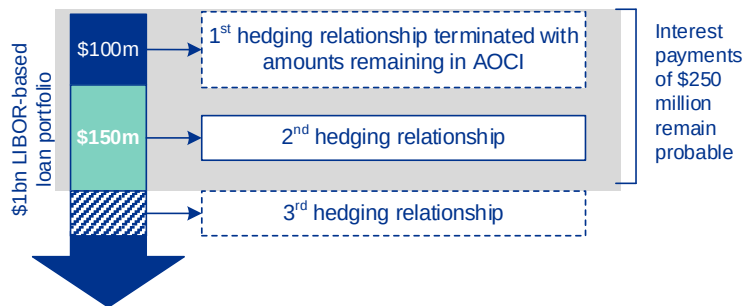
For example, assume the entity in Question 9.3.100 started with just the two original swaps (Swaps 1 and 2). The entity terminates Swap 1, but interest payments on \$250 million principal are still probable.

After considering Swap 2's original position in the priority chain after terminated Swap 1 – because amounts remain in AOCI for Swap 1 – forecasted interest payments on \$150 million of principal relationship remain probable and Swap 2 continues to be highly effective.

Assume the entity later elects to newly designate Swap 3. Swap 3 may be designated to immediately follow Swap 2 without disturbing Swap 2's relationship, but it would also remain behind Swap 1. If swaps designated after Swap 2 had been terminated with amounts remaining in AOCI, Swap 3 may re-hedge interest payments on the inactive layers in the priority chain after Swap 2.

This occurs because Swap 2's relationship has not been dedesignated. Therefore, Swap 2 and all the relationships before Swap 2 (active and inactive for which amounts remain in AOCI – Swaps 1 and 2 in this case) remain in their originally designated positions in the priority chain.

Therefore, for Swap 3 to be eligible for hedge accounting, in addition to the other hedge accounting criteria, there must be probable forecasted interest payments on principal equal to or greater than the notional amounts of Swap 1, Swap 2 and Swap 3 combined.



In this example, there are not sufficient forecasted transactions that are probable for Swap 3 to be eligible for hedge accounting.



Example 9.3.50

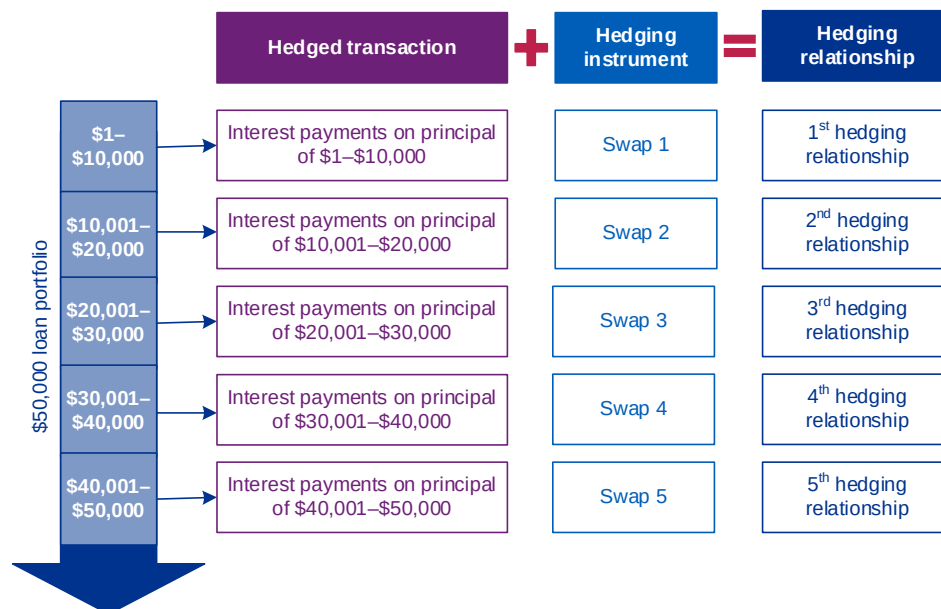
Layering approach: Swap matures and related amounts reclassified from AOCI

Designation of original hedging relationships

ABC Corp. has five swaps, each with a notional amount of \$10,000. ABC wishes to hedge interest payments on \$50,000 in total principal and designates five different hedging relationships as follows.

- Swap 1 is designated as hedging the first interest payments made on \$10,000 of principal expected to occur each month for the next five years. At inception of the hedge, Swap 1 is hedging interest payments on principal \$1–\$10,000.
- Swap 2 is designated as hedging the first interest payments made on \$10,000 of principal expected to occur each month for the next five years that (1) are not currently being hedged in another hedging relationship (i.e. hedged by a swap that is earlier in priority – in this case Swap 1) or (2) were not included in a terminated hedging relationship with amounts remaining in AOCI earlier in the priority chain. No relationships currently fall into category (2) because no relationships designated earlier in priority have been discontinued after Swap 2's designation. At inception of the hedge, Swap 2 is hedging interest payments on principal \$10,001–\$20,000.
- Swaps 3, 4 and 5 are all designated similar to the designation for Swap 2.
- All of the swaps have different maturities.

The following illustration summarizes the five hedging relationships.



Swap 3 matures and no amounts remaining in AOCI

When Swap 3 matures, the third hedging relationship is terminated and there are no amounts remaining in AOCI.

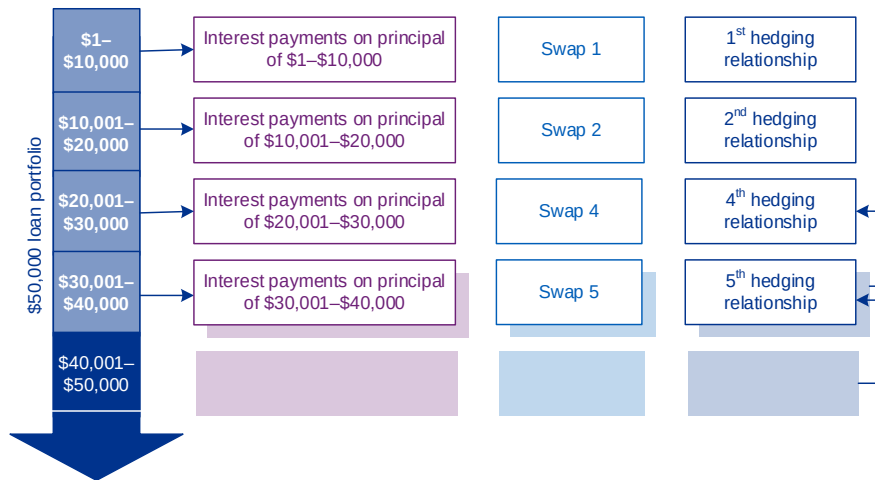
The hedging relationships involving Swaps 1, 2, 4 and 5 continue.

When a swap in the priority chain matures and all amounts related to the instrument have been reclassified out of AOCI, all the swaps that follow in the priority chain *move up* automatically without being dedesignated/redesignated.

When Swap 3 matures, Swap 4 is still hedging the first interest payments made on \$10,000 of principal expected to occur each month for the next five years that:

1. are not currently being hedged by a previously designated hedging relationship earlier in the priority chain (Swaps 1 and 2); or
2. were not included in a terminated hedging relationship with amounts remaining in AOCI earlier in the priority chain.

Therefore, Swaps 4 and 5 will move up in the priority chain. The following illustration summarizes the hedging relationships after the maturity of Swap 3.



Hedge effectiveness. ABC is required to adjust the PEH derivatives associated with the fourth and fifth hedging relationships to reflect any changes in the most recent best estimates of forecasted transactions associated with the new tranches of interest payments.



Example 9.3.60

Layering approach: Swap terminated and related amounts not reclassified from AOCI

Assume the same facts and circumstances as in Example 9.3.50, except that the hedging relationship involving Swap 3 is terminated early. However, all amounts of the originally specified hedged forecasted transactions remain probable, including the interest payments on principal \$20,001–\$30,000, which

were being hedged by Swap 3. Therefore, the amounts related to Swap 3 are not immediately reclassified from AOCI.

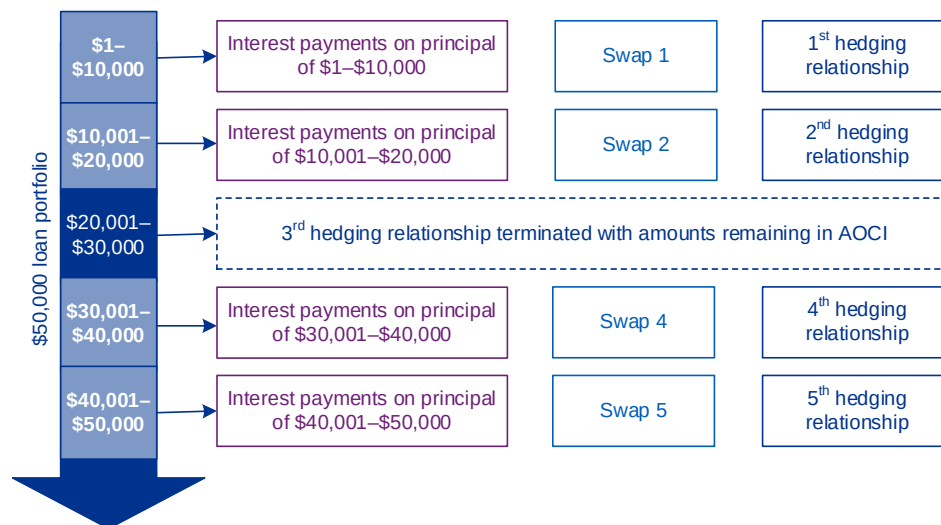
The hedging relationships involving Swaps 1, 2, 4 and 5 continue.

When a swap in the priority chain is terminated and amounts related to the hedging relationship have *not* been reclassified out of AOCI, all the swaps that follow in the priority will not move up.

When Swap 3 is terminated, Swap 4 is still hedging the first interest payments made on \$10,000 of principal expected to occur each month for the next five years that:

1. are not currently being hedged in a previously designated hedging relationship earlier in the priority chain (Swaps 1 and 2), or
2. were not included in a terminated hedging relationship with amounts remaining in AOCI earlier in the priority chain (Swap 3).

Therefore, Swaps 4 and 5 will *not* move up in the priority chain. The following illustration summarizes the hedging relationships after the termination of Swap 3.



The gain or loss on Swap 3 is reclassified from AOCI when interest payments on principal \$20,001–\$30,000 affect earnings. For further discussion on cash flow hedge accounting, see section 10.2.10. Once amounts related to Swap 3 are fully reclassified out of AOCI, Swaps 4 and 5 will automatically move up in the priority chain.

Hedge effectiveness. In this example, ABC does *not* adjust the PEH derivatives associated with the fourth and fifth hedging relationships because they continue to hedge the same tranche of forecasted transactions and their terms have not changed.



Example 9.3.70

Layering approach: Additional swap terminated and new swap designated at end of priority chain

Assume the same facts and circumstances as in Example 9.3.60, except that ABC also terminates Swap 5 and amounts are not immediately reclassified from AOCI. In addition, ABC obtains Swap 6 and wishes to designate a new hedging relationship. This requires ABC to add Swap 6 to the end of the existing priority chain.

An entity is not permitted to move the existing priority chain without dedesignating and redesignating the current hedging relationships that were originally designated as following the vacated tranche. Therefore, ABC is not permitted to insert Swap 6 to hedge interest payments on principal \$20,001–\$30,000 (the tranche previously hedged by Swap 3) without dedesignating and redesignating Swap 4. This is because doing so would break the existing priority chain.

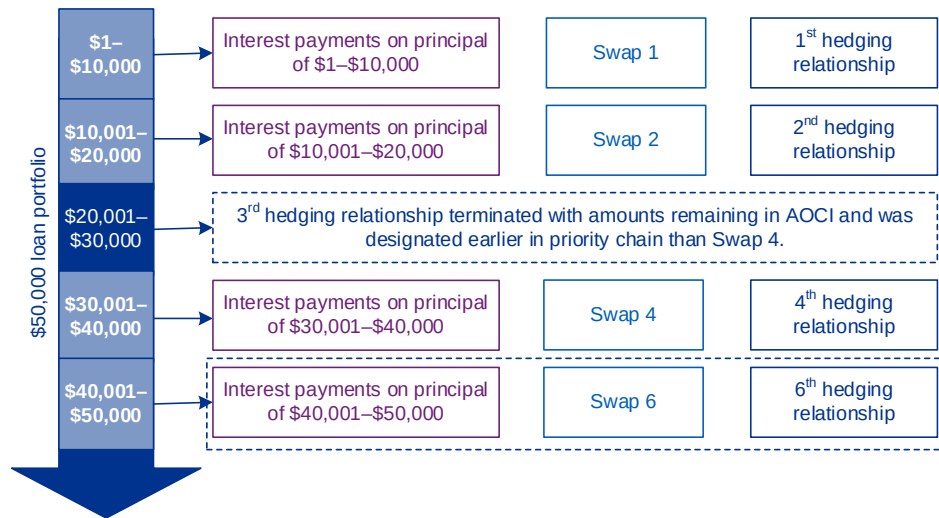
Instead, ABC identifies Swap 6 as hedging the first interest payments made on \$10,000 of principal expected to occur each month for the next five years that:

1. are not currently being hedged in a previously designated hedging relationship earlier in the priority chain (Swaps 1, 2 and 4); or
2. were not included in a terminated hedging relationship with amounts remaining in AOCI earlier in the priority chain (Swap 3).

Swap 6 may fill in the position vacated by Swap 5. Although Swap 5 was terminated before Swap 6's designation and related amounts remain in AOCI, it was originally designated later in the priority chain than the latest active relationship (i.e. Swap 4).

However, Swap 6 remains behind relationships designated earlier in the priority chain than Swap 4 that were terminated with amounts remaining in AOCI (i.e. Swap 3). This occurs because Swap 4's relationship has not been dedesignated. Accordingly, the fourth hedging relationship and all the relationships before it, both active and terminated with amounts remaining in AOCI (i.e. Swaps 1-3), remain in their originally designated positions in the priority chain.

This designation results in Swap 6 hedging interest payments on principal \$40,001–\$50,000. The following illustration summarizes the hedging relationships after the termination of Swap 5 and the addition of Swap 6.



The gain or loss on Swaps 3 and 5 is reclassified from AOCI when interest payments on principal \$20,001–\$30,000 and \$40,001–\$50,000 affect earnings, respectively.

Hedge effectiveness. In this example, ABC does *not* adjust the PEH derivatives associated with the first, second or fourth hedging relationships because they continue to hedge the same tranches of forecasted transactions and their terms have not changed.



Example 9.3.80

Layering approach: Swap terminated with interest payments on a portion of principal remaining probable

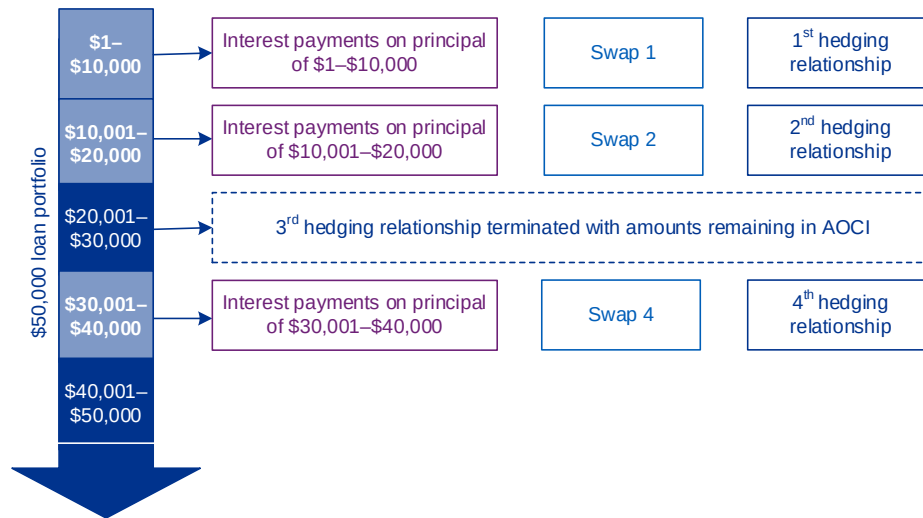
This example uses the same five hedging relationships originally designated in Example 9.3.50.

ABC terminates Swap 3 and the hedging relationship is discontinued. Additionally, interest on only \$40,000 of principal remains probable. It is probable that interest payments on \$10,000 of principal will not occur.

Because interest payments on principal \$20,001–\$30,000 (i.e. Swap 3's forecasted transaction) are still probable, amounts related to Swap 3 will remain in AOCI. Therefore, Swap 4 will not move up in priority and continues to hedge interest payments on principal \$30,001–\$40,000.

Because it is probable that interest payments on principal \$40,001–\$50,000 will not occur, ABC is required to terminate the original hedging relationship for each of the forecasted transactions that are not probable. Therefore, ABC is required to dedesignate Swap 5 and immediately reclassify any amounts in AOCI into earnings.

The following illustration summarizes the hedging relationships after the termination of Swaps 3 and 5.



The gain or loss on Swap 3 is reclassified from AOCI when interest payments on principal \$20,001–\$30,000 affect earnings.

Hedge effectiveness. In this example, ABC does *not* adjust the PEH derivative associated with the first, second or fourth hedging relationships because they continue to hedge the same tranches of forecasted transactions and their terms have not changed.



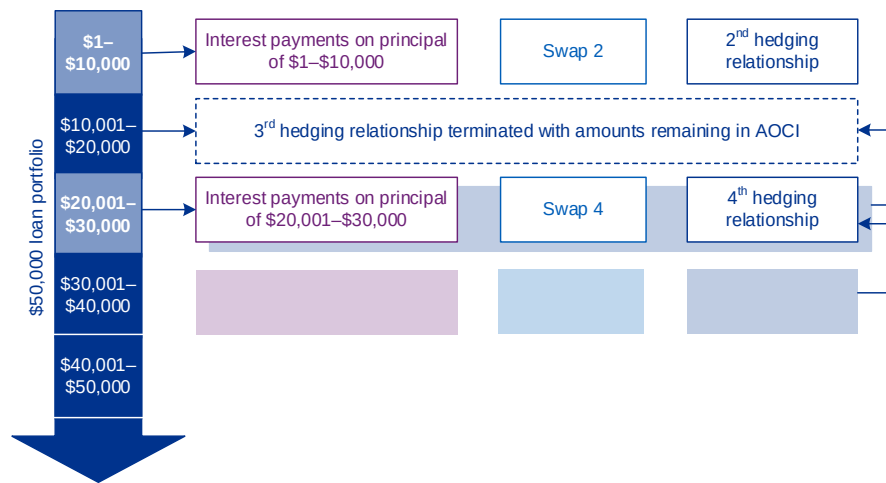
Example 9.3.90

Layering approach: Swap early in priority chain matures subsequent to other swap terminations

Assume the same facts as in Example 9.3.80, except that Swap 1 matures after the termination of Swaps 3 and 5. All amounts related to Swaps 1 and 5 have been reclassified out of AOCI.

The hedging relationships involving Swaps 2 and 4 continue and move up the priority chain. In addition, the amounts remaining in AOCI related to the discontinued Swap 3 move up the priority chain.

The following illustration summarizes the hedging relationships after the termination of Swaps 1, 3 and 5.



The gain or loss on Swap 3 is reclassified from AOCI when interest payments on principal \$10,001–\$20,000 affect earnings.

Hedge effectiveness. In addition, ABC is required to adjust the PEH derivatives associated with the second and fourth hedging relationships to reflect any changes in the most recent best estimates of forecasted transactions associated with the new tranches of interest payments.



Example 9.3.100

Layering approach: Redesignation of swaps

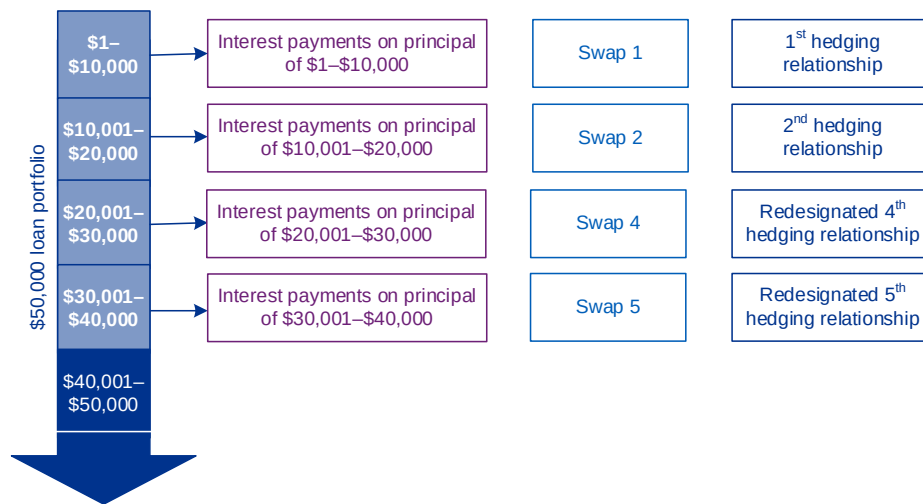
Assume the same facts as in Example 9.3.80. However, ABC now wishes to hedge all interest payments on principal that remains probable (i.e. \$1–\$40,000).

To hedge interest payments on \$20,001–\$30,000 that were previously hedged by Swap 3, ABC needs to dedesignate and redesignate all swaps prioritized later than Swap 3 (i.e. Swap 4). This is because a new swap cannot leapfrog Swap 4 in the priority chain, as demonstrated in Example 9.3.70 (i.e. a new swap cannot replace Swap 3's position in the priority chain). As a reminder, Swap 3 was previously terminated with amounts remaining in AOCI.

Therefore, ABC decides to dedesignate Swap 4 and formally redesignate both Swaps 4 and 5 (similar to hedges in the previous examples) to hedge interest payments on principal \$20,001–\$30,000 and \$30,001–\$40,000, respectively. The newly redesignated Swap 4 may re-hedge the tranche previously hedged by Swap 3, even though amounts remain in AOCI pertaining to Swap 3.

If any relationships had been designated earlier in the priority chain than Swap 2 and were terminated with amounts remaining in AOCI, Swaps 4 and 5 would also remain behind those relationships because Swap 2's relationship had not been dedesignated. Therefore, all the relationships designated before Swap 2 in the priority chain (active and inactive for which amounts remain in AOCI) would remain in their originally designated positions.

The following illustration summarizes the hedging relationships after the redesignation of Swaps 4 and 5.



The gain or loss on Swap 3, which was terminated in Example 9.3.80, is reclassified from AOCI when the related interest payments on principal \$20,001–\$30,000 affect earnings. For amounts remaining in AOCI related to Swap 4 before its dedesignation and redesignation, the gain or loss is reclassified from AOCI when the related interest payments on principal \$30,001–\$40,000 affect earnings.

9.3.90 All-in-one hedge



Excerpt from ASC 815-20

>> All-in-one hedge

25-21 Paragraph 815-10-15-4 states that, if a contract meets the definition of both a derivative instrument and a firm commitment under the Derivatives and Hedging Topic (as illustrated in Example 8 [see paragraph 815-20-55-111]), then an entity shall account for the contract as a derivative instrument unless one of the exceptions in this Topic applies. In that circumstance, either of the following may be true:

- The forecasted transaction and the derivative instrument used to hedge it are with the same counterparty.
- The derivative instrument is the same contract under which the entity executes the forecasted transaction.

25-22 Assuming other cash flow hedge criteria are met, a derivative instrument that will involve gross settlement may be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in a forecasted transaction that will occur upon gross settlement of the derivative instrument itself (an **all-in-one hedge**). This guidance applies to fixed-price contracts to acquire or sell a nonfinancial or financial asset that are accounted for as derivative instruments under this Topic provided the criteria for a cash flow hedge are met.

20 Glossary

All-in-one hedge – In an all-in-one hedge, a derivative instrument that will involve gross settlement is designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the forecasted transaction that will occur upon gross settlement of the derivative instrument itself.

In many cases, a firm commitment (such as a forward contract) can itself meet the definition of a derivative. If the derivative does not meet any of the scope exceptions in Subtopic 815-10, it must be recorded at fair value through earnings and cannot be designated as the hedged item or transaction in a fair value or cash flow hedge. [815-10-15-4, 815-20-25-21]

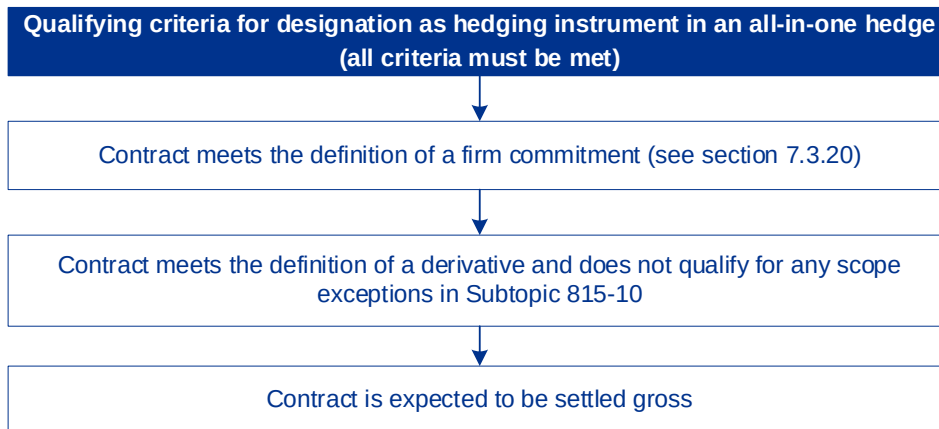
However, if the derivative instrument (i.e. the contract) is expected to be settled gross through a delivery of the underlying asset, an entity may designate the derivative instrument as a hedge of the implicit forecasted transaction that created the need for the fixed-price contract in the first place. This is referred to as an 'all-in-one' hedge. [815-20-25-22]



An entity that is concerned about variability in cash flows from its forecasted purchases or sales can economically fix the price of those purchases or sales by entering into a fixed-price contract. If the fixed-price purchase or sale contract is a derivative instrument, it is eligible to be a hedging instrument. In addition, the entity may hedge the forecasted purchase or sale that implicitly caused it to enter into the fixed-price contract.

An all-in-one hedge is most commonly used with forecasted transactions related to nonfinancial assets, where contracts for the purchase or sale of a commodity that is readily convertible to cash do not meet the NPNS scope exception. However, all-in-one hedges can also be applied to financial assets. Examples 9.3.110 and 9.3.120 illustrate the application of all-in-one hedges for nonfinancial assets and financial assets, respectively. [815-20-25-22]

The criteria that must be met for a contract to qualify for designation in an all-in-one hedge are summarized in the following diagram.



Gross settlement of a contract involves delivery of an asset in exchange for payment of cash or other assets. This is different from net settlement, which typically involves payment for the change in a contract's value. [815-20-55-112]

In addition to the contract meeting the above criteria to be the hedging instrument, the implicit forecasted purchase or sale needs to meet the qualifying criteria to be designated as a hedged transaction in a cash flow hedge. This includes a requirement that the implicit forecasted transaction presents an exposure to variations in cash flows for the hedged risk that could affect earnings. [815-20-25-15(c)(2)]

The contract meets the definition of a firm commitment only if its price is fixed. However, the implied forecasted purchase or sale exposes an entity to variability in cash flows (which is a requirement to be a hedged transaction) because the total consideration paid or received is variable. Total consideration is the fixed amount of cash paid or received and the fair value of the fixed-price purchase or sale contract, which is a derivative instrument recognized as an asset or liability that may fluctuate over time. [815-20-55-113 – 55-114]



Question 9.3.150

Which risks are eligible to be designated in an all-in-one hedge?

Interpretive response: An all-in-one hedge must be a hedge of total variability in cash flows (i.e. total price risk), not a hedge of a contractually specified component.

Topic 815 allows an entity to designate a contractually specified component of a hedged transaction. However, the proportion of a derivative that is designated as the hedging instrument must have the same risk exposure profile as the entire derivative instrument (see section 6.6.30). Therefore, an entity cannot designate a contractually specified component of the derivative as the *hedging instrument*.

Because the derivative instrument is the same contract under which the transactions will be purchased or sold, we believe an entity is precluded from designating a contractually specified component as the hedged risk.

**Example 9.3.110****All-in-one hedge of forecasted sales of gold**

Goldco wants to manage the price risk associated with forecasted sales of gold. To do so, it enters into a forward contract to sell gold at a fixed price.

The forward gold sales contract contains a net settlement provision and meets the definition of a derivative instrument. The contract does not meet any of the scope exclusions in Subtopic 815-10.

As a derivative instrument, the forward gold sales contract is recorded at fair value with changes in fair value reported in earnings. However, the forward contract may be designated as an all-in-one hedge of total price risk provided the contract is expected to be settled gross. Goldco expects to deliver the gold in exchange for cash.

Goldco can designate the fixed-price forward gold sales contract (i.e. the derivative instrument) as a cash flow hedge of the variability of the consideration to be received for the sale of gold (i.e. the forecasted transaction) even though the derivative instrument is the same contract under which the gold itself will be sold.

**Example 9.3.120****All-in-one hedge of forecasted sales of loans**

Bank wants to manage the total price risk associated with forecasted sales of loans that it originates by entering into a forward loan sale agreement to sell mortgage loans at a fixed price.

The forward contract meets the definition of a firm commitment and a derivative. The contract does not meet any of the scope exclusions in Subtopic 815-10.

Bank expects to gross settle the contract by transferring the mortgage loans in exchange for cash. Therefore, all criteria have been met for an all-in-one hedge of total price risk.

Bank can designate the fixed-price forward loan sales agreement (i.e. the derivative instrument) as a cash flow hedge of the variability of the consideration to be received for the sale of mortgage loans (i.e. the forecasted transaction) even though the derivative instrument is the same contract under which the mortgage loans themselves will be sold.

**Question 9.3.160****Is an all-in-one hedge assumed to be perfectly effective?**

Interpretive response: It depends. If the hedging relationship is designated at the inception of the fixed price contract and the contract is at market terms (i.e.

contract has a fair value of zero), we believe an entity can assume that the all-in-one hedging relationship will be perfectly effective.

Under these circumstances, changes in the fair value of the derivative instrument (i.e. the contract) are expected to entirely offset the change in cash flows attributable to the change in the entire price of the hedged transaction. This is because the hedged transaction and the hedging instrument are in effect the same. Therefore, an entity may use the critical terms match method to assess effectiveness of an all-in-one hedge. For further guidance on the conditions that must be met to apply the critical terms match method, which assumes perfect effectiveness, see section 13.4.

If the hedging relationship is not designated at inception of the fixed price contract, the contract will not have a fair value of zero at inception of the hedging relationship. This may result in a hedge that is not perfectly effective. See section 13.7 for guidance on assessing effectiveness of cash flow hedges when the critical terms are not the same – e.g. because the fair value of the forward contract is not zero at inception of the hedging relationship.

FASB Example: All-in-one hedges



Excerpt from ASC 815-20

>> Example 8: All-in-One Hedges

55-111 The following Cases illustrate the application of paragraph 815-20-25-21:

- a. Purchase of a nonfinancial asset (Case A)
- b. Purchase of a financial asset (Case B).

55-112 Settling a forward contract gross involves delivery of an asset in exchange for the payment of cash or other assets and is differentiated from settling net, which typically involves a payment for the change in a contract's value as the method of settling the contract.

55-113 A forecasted purchase or sale meets the definition of forecasted transaction and, if it is probable, meets the criteria in paragraph 815-20-25-15 for designation as a hedged transaction. An entity concerned about variability in cash flows from its forecasted purchases or sales can economically fix the price of those purchases or sales by entering into a fixed-price contract. Because the fixed-price purchase or sale contract is a derivative instrument, it is eligible for use as a hedging instrument.

55-114 The forecasted purchase or sale at a fixed price is eligible for cash flow hedge accounting because the total consideration paid or received is variable. The total consideration paid or received for accounting purposes is the sum of the fixed amount of cash paid or received and the fair value of the fixed price purchase or sale contract, which is recognized as an asset or liability, and which can vary over time.

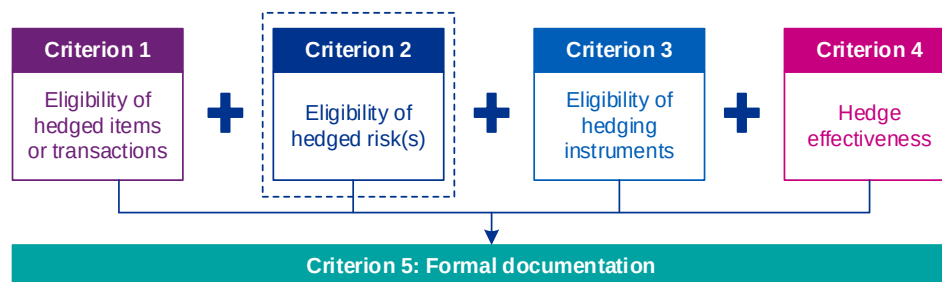
>>> Case A: Purchase of a Nonfinancial Asset

55-115 Entity A plans to purchase a nonfinancial asset. To fix the price to be paid (that is, to hedge the price), Entity A enters into a contract that meets the definition of a firm commitment with an unrelated party to purchase the asset at a fixed price at a future date. Assume that the terms of the contract (such as net settlement under the default provisions) or the nature of the asset cause the contract to meet the definition of a derivative instrument and the contract is not excluded by paragraphs 815-10-15-13 through 15-82 from the scope of the Derivatives and Hedging Topic. As such, Entity A has entered into a derivative instrument under which it is expected to take delivery of the asset. Entity A may designate the fixed-price purchase contract (that is, the derivative instrument) as a cash flow hedge of the variability of the consideration to be paid for the purchase of the asset (that is, the forecasted transaction) even though the derivative instrument is the same contract under which the asset itself will be acquired.

>>> Case B: Purchase of a Financial Asset

55-116 Entity B plans to purchase U.S. government bonds and expects to classify those bonds in its available-for-sale portfolio. To fix the price to be paid (that is, to hedge the price), Entity B enters into a contract that meets the Derivatives and Hedging Topic's definition of a firm commitment with an unrelated party to purchase the bonds at a fixed price at a future date. Assume the contract meets the definition of a derivative instrument and is not excluded by paragraphs 815-10-15-13 through 15-82 from the scope of this Topic. As such, Entity B has entered into a derivative instrument under which it is expected to take delivery of the asset. Entity B may designate the fixed-price purchase contract (that is, the derivative instrument) as a cash flow hedge of the variability of the consideration to be paid for the purchase of the bonds (that is, the forecasted transaction) even though the derivative instrument is the same contract under which the asset itself will be acquired.

9.4 Eligibility of hedged risks



Sections 6.3 and 6.4 provide an overview of the eligible hedged risks for both financial and nonfinancial instruments, including limitations on certain risks for hedged transactions.

Section 9.4 provides detail around eligibility criteria of hedged risks that are specific to cash flow hedges, including:

- contractually specified component price risk for nonfinancial items (see sections 9.4.10 to 9.4.30);
- interest rate risk on the forecasted issuance or purchase of debt instruments (see sections 9.4.40 to 9.4.50); and
- changing the hedged risk (see section 9.4.60).

 **Foreign currency risk.** For further guidance on foreign currency risk as it relates to cash flow hedges, see chapter 11.



Future developments#

The FASB has a project to provide potential Codification improvements related to hedging contractually specified components of purchases or sales of nonfinancial items. A proposed ASU was issued in November 2019. This project is ongoing and we expect a final ASU to be issued in 2021. [\[Proposed ASU\]](#)

9.4.10 Contractually specified component price risk for nonfinancial items



Excerpt from ASC 815-20

>>>> Determining Whether a Contractually Specified Component Exists

55-26A The definition of a contractually specified component is considered to be met if the component is explicitly referenced in agreements that support the price at which a nonfinancial asset will be purchased or sold. For example, an entity intends to purchase a commodity in the commodity's spot market. If as part of the governing agreements of the transaction or commodities exchange it is noted that prices are based on a pre-defined formula that includes a specific index and a basis, those agreements may be utilized to identify a contractually specified component. After an entity determines that a contractually specified component exists, it must assess whether the variability in cash flows attributable to changes in the contractually specified component may be designated as the hedged risk in accordance with paragraphs 815-20-25-22A through 25-22B.

20 Glossary

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

 **Price risk.** For a cash flow hedge of a forecasted transaction that involves a nonfinancial asset or liability, an entity is permitted to designate either:

- all changes in the purchase price or sales price (i.e. **total price risk**); or
- a contractually specified component of the purchase or sale of a nonfinancial asset or liability (i.e. **contractually specified component price risk**).

A contractually specified component is an index or price explicitly referenced in an agreement to purchase or sell a nonfinancial asset other than an index or price calculated or measured solely by reference to an entity's own operations. Additionally, the definition of a contractually specified component is considered to be met if the component is explicitly referenced in agreements that support the price at which a nonfinancial asset will be purchased or sold. [815-20 Glossary, 815-20-55-26A]

Once a contractually specified component is identified, it needs to be included in either:

Existing contracts (section 9.4.20)	— An existing contract that meets the definition of a derivative and qualifies for the NPNS scope exception, which requires a price based on an underlying that is clearly and closely related to the asset being sold or purchased. [815-20-25-22A(a)] or — An existing contract that does not meet the definition of a derivative and includes a price based on an underlying that is clearly and closely related to the asset being sold or purchased. [815-20-25-22A(b)]
Not-yet-existing contracts (section 9.4.30)	A not-yet-existing contract if the entity expects that the contract, when executed, will meet the criteria outlined for existing contracts. [815-20-25-22B]



Example 9.4.10

Contractually specified component

At the beginning of Year 1, ABC Corp. enters into a contract to purchase natural gas at Location 1. The contract specifies the purchase price per unit of measure as the NYMEX Henry Hub futures price plus a fixed basis reflecting local supply/demand and transportation.

The NYMEX Henry Hub futures price meets the definition of a contractually specified component. Therefore, ABC is eligible to designate the NYMEX Henry Hub futures price as the hedged risk in its cash flow hedge of forecasted purchases of natural gas.

**Question 9.4.10****Can an entity hedge an index or rate that is not specified in the contract?**

Background: A contract to buy or sell a nonfinancial asset is based on a price that is derived/calculated by reference to another index or rate pursuant to market convention. The contract does not specify how the price is calculated.

Interpretive response: No. We believe the FASB's intent in permitting hedges of components (e.g. indices, rates) is to allow such hedges only when the components are specified in the contract or a contract that supports the price.

The FASB considered, but rejected, an approach that would have permitted hedge accounting for components that are not contractually specified when it is market convention to use the component as the underlying basis for determining the price of the overall product. The FASB rejected this approach because the concept of market convention would: [\[ASU 2017-12.BC58\]](#)

- be difficult to define across industries;
- lead to confusion when there is no market convention or multiple market conventions; and
- potentially be difficult to demonstrate objectively to third parties.

Therefore, if the contract (or a contract that supports the price) does not specify an index or rate, an entity cannot designate it as a contractually specified component.

**Example 9.4.20****Underlying index or price as a contractually specified component**

At the beginning of Year 1, ABC Corp. enters into a contract to purchase Commodity X in Canada. The contract specifies the purchase price per unit of measure is based on the Industry Standard price at the time of delivery.

Although not defined in the contract, ABC considers it is market convention that the Industry Standard price is calculated as the XYZ index plus a fixed basis reflecting transportation. ABC is not permitted to designate the XYZ index as a contractually specified component because the XYZ index is not specified in the contract (or a contract that supports the price).

**Question 9.4.20****If the contract price includes a variable basis spread, can an entity hedge the contractually specified component?**

Interpretive response: It depends. If the contract pricing includes a variable basis spread, an entity should evaluate whether it has exposure to the contractually specified component.

We believe it would be inappropriate to identify the hedged risk as a contractually specified component in a contract with pricing structured such that an entity does not have exposure to the contractually specified component.

For example, an entity has a contract with a price defined as ABC index plus a variable spread based on the difference between ABC index and XYZ index. The entity should evaluate whether it has exposure to the ABC index, or whether its exposure is actually to the XYZ index.



Question 9.4.30#

Can an entity hedge a contractually specified component of a forecasted purchase or sale of a nonfinancial asset in a spot market transaction?

Interpretive response: It depends. Topic 815 contemplates that an entity is able to hedge a contractually specified component of a forecasted purchase or sale in a spot market transaction if the component is specifically referenced in an agreement that supports the price at which the asset will be purchased or sold.

The FASB did not elaborate on the nature or form of contracts that could contain a contractually specified component or whether a contract/agreement needs to be entered into before completion of the spot purchase or sale transaction.

However, Topic 815 provides examples of circumstances in which a component is considered specifically referenced in the contract, such as when a pre-defined formula is incorporated into agreements that govern either: [\[815-20-55-26A\]](#)

- the transaction – i.e. an agreement between the counterparties to the spot purchase transaction; or
- the market exchange on which the transaction will take place.

It is not clear how broadly this guidance was intended to be interpreted. The FASB has a project to provide potential Codification improvements that are expected to clarify the nature or form of contracts that could contain a contractually specified component and whether a contract/agreement needs to be entered into before completion of the spot purchase or sale transaction. A final ASU is expected to be issued in 2021. As a result, revisions to this interpretive response may be provided in a future edition. [\[Proposed ASU\]](#)

9.4.20 Contractually specified component price risk: Existing contracts



Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

>>> Eligibility Criteria for Designating the Variability in Cash Flows Attributable to Changes in a Contractually Specified Component for the Purchase or Sale of a Nonfinancial Asset as the Hedged Risk

25-22A For existing contracts, determining whether the variability in cash flows attributable to changes in a contractually specified component may be designated as the hedged risk in a cash flow hedge is based on the following:

- a. If the contract to purchase or sell a nonfinancial asset is a derivative in its entirety and an entity applies the normal purchases and normal sales scope exception in accordance with Subtopic 815-10, any contractually specified component in the contract is eligible to be designated as the hedged risk. If the entity does not apply the normal purchases and normal sales scope exception, no pricing component is eligible to be designated as the hedged risk.
- b. If the contract to purchase or sell a nonfinancial asset is not a derivative in its entirety, any contractually specified component remaining in the host contract (that is, the contract to purchase or sell a nonfinancial asset after any embedded derivatives have been bifurcated in accordance with Subtopic 815-15) is eligible to be designated as the hedged risk.

After an entity determines that a contractually specified component exists, it needs to determine whether it can designate that risk as the hedged risk.



Question 9.4.40

What conditions need to be met to designate a contractually specified component as the hedged risk?

Interpretive response: We believe the following conditions need to be met for a contractually specified component to be designated as the hedged risk:

- the contractually specified component is included in a contract that is not being accounted for as a derivative in the scope of Topic 815 (either freestanding or bifurcated); and
- the contract has pricing that is clearly and closely related to the asset being sold or purchased (see Question 9.4.50).

Topic 815 states that if the contract to purchase or sell a nonfinancial asset is not a derivative in its entirety, *any* contractually specified component remaining in the host contract is eligible to be designated as the hedged risk. [\[815-20-25-22A\]](#)

However, the FASB's intention in applying the NPNS scope exception in combination with the embedded derivatives guidance was to prevent any extraneous pricing feature from being designated as the hedged risk. The FASB was concerned that an entity could inappropriately elect hedge accounting by fabricating a contractually specified component that it does not have price exposure to and then enter into a derivative to hedge that component. [IASU 2017-12.BC53](#)

Therefore, we believe a contractually specified component is eligible to be designated as the hedged risk only if the contract has pricing that is clearly and closely related to the asset being sold or purchased. An extraneous contractually specified component in a contract does not meet the clearly and closely related criteria and therefore is not eligible to be the hedged risk.

This is also true for contracts that meet the definition of a derivative in their entirety. For a contractually specified component to be eligible for designation as the hedged risk, the existing contract must meet the NPNS scope exception, which includes a requirement to meet the clearly and closely related criteria. As discussed in section 6.5.70, freestanding derivatives cannot be designated as hedged items or transactions because they are remeasured with changes in fair value reported in earnings. [\[815-10-15-30 – 15-34, 815-20-25-22A\]](#)



Question 9.4.50

What are the requirements to meet the clearly and closely related criteria?

Interpretive response: For a contract to qualify for the NPNS scope exception, it cannot have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased. As discussed in Question 9.4.40, we believe a contractually specified component within a contract must meet the clearly and closely related criteria to be eligible for designation as a hedged risk. [\[815-10-15-30\]](#)

The underlying in a price adjustment feature may incorporate a purchase or sale contract that is reasonably related to either the cost or the fair value of the asset subject to the contract. In that case, generally the price adjustment feature would not be an impediment for the contract to qualify for the NPNS scope exception.

A price adjustment feature incorporated into a contract is *not clearly and closely related* to the asset being sold or purchased in any of the following circumstances. [\[815-10-15-32\]](#)

- The underlying is extraneous (i.e. irrelevant and not pertinent) to both the changes in the cost *and* the changes in the fair value of the asset being sold or purchased; this includes being extraneous to an ingredient or direct factor in the customary or specific production of that asset.
- The magnitude and direction of the effect of the price adjustment is not consistent with the relevancy of the underlying. That is, the magnitude of the price adjustment based on the underlying is significantly disproportionate to the effect of the underlying on the fair value or cost of

the asset being purchased or sold (or of an ingredient or direct factor, as appropriate).

- The underlying is a currency exchange rate involving a foreign currency that meets none of the criteria in paragraph 815-15-15-10(b).



Example 9.4.30

Contract not accounted for as derivative because NPNS scope exception is met

ABC Corp. enters into a forward contract to buy crude oil at a price that is based on a crude oil futures price in the month of delivery plus a fixed basis differential for transportation costs. There is no net settlement provision in the contract. Furthermore, the quantities of crude oil delivered under the contract are expected to be used by ABC over a reasonable period in the normal course of business.

ABC has met two of the important elements needed to qualify for the NPNS scope exception:

- the underlying (price of crude oil) is clearly and closed related to the asset being purchased (crude oil); and [\[815-10-15-30 – 15-34\]](#)
- the quantities delivered under the contract are expected to be used over a reasonable period in the normal course of business. [\[815-10-15-27 – 15-29\]](#)

All other criteria to apply the NPNS scope exception are met, and therefore the contract is not accounted for as a derivative under Topic 815.

Designating the contractually specified component

The conditions to designate the contractually specified component (the crude oil futures price in the month of delivery, excluding the fixed basis differential) as the hedged risk have been met because:

- the forward contract is not accounted for as a derivative under Topic 815; and
- the contract pricing is clearly and closely related.



Example 9.4.40

Contractually specified component is not eligible to be the hedged risk

Goldco, a gold miner, requires crude oil in its extraction business and enters into a forward contract to buy crude oil at a price that is indexed to gold. The forward contract meets the definition of a derivative in its entirety.

The price is based on an underlying (gold) that is not clearly and closely related to the asset being purchased (crude oil).

Therefore, Goldco may not designate the contractually specified component (i.e. the gold index) as the hedged risk.

**Example 9.4.50****Contract pricing with underlying that is clearly and closely related**

Candy Co. enters into a forward contract to sell chocolate at a price that is based on a sugar cane index plus a fixed spread. The forward contract meets the definition of a derivative in its entirety.

The price of sugar is reasonably related to the cost and fair value of chocolate. Even though the contract contains a price adjustment clause that is based on an underlying (price of sugar) that is different from the asset being sold (chocolate), it is not considered an impediment for the contract to meet the clearly and closely related criteria.

Candy concludes that the underlying (price of sugar) is clearly and closely related to the asset being sold (chocolate).

If Candy concludes that the forward contract should not be accounted for as a derivative under Topic 815 (e.g. the other criteria to apply the NPNS scope exception are met), it may designate the contractually specified component (the sugar cane index) as the hedged risk.

9.4.30 Contractually specified component price risk: Not-yet-existing contracts

**Excerpt from ASC 815-20****>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only****>>> Eligibility Criteria for Designating the Variability in Cash Flows Attributable to Changes in a Contractually Specified Component for the Purchase or Sale of a Nonfinancial Asset as the Hedged Risk**

25-22B An entity may designate the variability in cash flows attributable to changes in a contractually specified component in accordance with paragraph 815-20-25-15(i)(3) to purchase or sell a nonfinancial asset for a period longer than the contractual term or for a not-yet-existing contract to purchase or sell a nonfinancial asset if the entity expects that the requirements in paragraph 815-20-25-22A will be met when the contract is executed. Once the contract is executed, the entity shall apply the guidance in paragraph 815-20-25-22A to determine whether the variability in cash flows attributable to changes in the contractually specified component can continue to be designated as the hedged risk. See paragraphs 815-20-55-26A through 55-26E for related implementation guidance.

The ability to hedge a contractually specified component extends to a not-yet-existing contract if the entity expects that the contract, when executed, will meet the criteria in paragraph 815-20-25-22A, and all other cash flow hedge criteria are met. [\[815-20-25-22B\]](#)

This means that an entity needs to consider whether the contract to be executed will meet the conditions outlined in Question 9.4.40 for the contractually specified component to be eligible to be a hedged risk.



Question 9.4.60

What threshold is required to support an entity's expectation that the criteria to designate a contractually specified component will be met?

Interpretive response: There is no threshold related to an entity's expectation that the criteria will be met. The FASB cited the practical issues encountered in applying the 'probable' threshold for hedging forecasted transactions and determined that there does not need to be an expectation that it is probable that the criteria will be met. [\[ASU 2017-12.BC56\]](#)

Once the contract is executed, an entity undergoes a more rigorous analysis to:

- assess whether the contract is accounted for as a derivative within the scope of Topic 815; and
- evaluate the clearly and closely related guidance to determine if it can continue to designate the contractually specified component as the hedged risk.



Example 9.4.60

Contractually specified component in not-yet-existing contracts

ABC Corp. expects to make future purchases from a supplier of natural gas in December Year 1 at a price based on the NYMEX natural gas index plus a fixed basis. This forward contract is expected to meet the definition of a derivative in its entirety.

ABC expects the contractually specified component that will be in the contract once it is executed to be the NYMEX natural gas index.

ABC further concludes that this contractually specified component will meet the criteria to be a hedged risk because:

- the underlying (price of natural gas) is clearly and closed related to the asset being purchased (natural gas); and
- the contract, once executed, will qualify for the NPNS scope exception based on similar contracts executed in the past – i.e. the forward contract will not be accounted for as a derivative under Topic 815.

On January 1, Year 1, ABC enters into a futures contract indexed to the NYMEX Henry Hub natural gas index to serve as the hedging instrument.

ABC determines that all of the requirements for cash flow hedge accounting are met and the requirements to designate the contractually specified component as the hedged risk will be met once the contract with the supplier is executed.

Therefore, ABC may designate the hedged risk as variability in cash flows attributable to changes in the contractually specified NYMEX natural gas index in the not-yet-existing purchase contract.

After contract with the supplier is executed

Once the contract with the supplier is executed, ABC is required to evaluate whether the requirements to designate a contractually specified component for existing contracts are met.

At the beginning of Year 1, ABC enters into a contract to purchase natural gas at Location 1. The contract specifies the purchase price per unit of measure as the NYMEX Henry Hub futures price plus a fixed basis reflecting local supply/demand and transportation.

The NYMEX Henry Hub futures price meets the definition of a contractually specified component. ABC concludes that:

- the forward contract will not be accounted for as a derivative under Topic 815; and
- the contract pricing is clearly and closely related.

Therefore, ABC is eligible to designate the NYMEX Henry Hub futures price as the hedged risk in its cash flow hedge of forecasted purchases of natural gas.

FASB Example: Contractually specified component in a not-yet-existing contract



Excerpt from ASC 815-20

>>>> Contractually Specified Component in a Not-Yet Existing Contract

55-26B This guidance discusses the implementation of paragraphs 815-20-25-22B and 815-30-35-37A. Entity A's objective is to hedge the variability in cash flows attributable to changes in a contractually specified component in forecasted purchases of a specified quantity of soybeans on various dates during June 20X1. Entity A has executed contracts to purchase soybeans only through the end of March 20X1. Entity A's contracts to purchase soybeans typically are based on the ABC soybean index price plus a variable basis differential representing transportation costs. Entity A expects that the forecasted purchases during June 20X1 will be based on the ABC soybean index price plus a variable basis differential.

55-26C On January 1, 20X1, Entity A enters into a forward contract indexed to the ABC soybean index that matures on June 30, 20X1. The forward contract is designated as a hedging instrument in a cash flow hedge in which the hedged item is documented as the forecasted purchases of a specified quantity of soybeans during June 20X1. As of the date of hedge designation, Entity A expects the contractually specified component that will be in the contract once it is executed to be the ABC soybean index. Therefore, in accordance with paragraph 815-20-25-3(d)(1), Entity A documents as the hedged risk the variability in cash flows attributable to changes in the contractually specified ABC soybean index in the not-yet-existing contract. On January 1, 20X1,

Entity A determines that all requirements for cash flow hedge accounting are met and that the requirements of paragraph 815-20-25-22A will be met in the contract once executed in accordance with paragraph 815-20-25-22B. Entity A also will assess whether the criteria in 815-20-25-22A are met when the contract is executed.

55-26D As part of its normal process of assessing whether it remains probable that the hedged forecasted transactions will occur, on March 31, 20X1, Entity A determines that the forecasted purchases of soybeans in June 20X1 will occur but that the price of the soybeans to be purchased will be based on the XYZ soybean index rather than the ABC soybean index. As of March 31, 20X1, Entity A begins assessing the hedge effectiveness of the hedging relationship on the basis of the changes in cash flows associated with the forecasted purchases of soybeans attributable to variability in the XYZ soybean index. Because the hedged forecasted transactions (that is, purchases of soybeans) are still probable of occurring, Entity A may continue to apply hedge accounting if the hedging instrument (indexed to the ABC soybean index) is highly effective at achieving offsetting cash flows attributable to the revised contractually specified component (the XYZ soybean index). On April 30, 20X1, Entity A enters into a contract to purchase soybeans throughout June 20X1 based on the XYZ soybean index price plus a variable basis differential representing transportation costs.

55-26E If the hedging instrument is not highly effective at achieving offsetting cash flows attributable to the revised contractually specified component, the hedging relationship must be discontinued. As long as the hedged forecasted transactions (that is, the forecasted purchases of the specified quantity of soybeans) are still probable of occurring, Entity A would reclassify amounts from accumulated other comprehensive income to earnings when the hedged forecasted transaction affects earnings in accordance with paragraphs 815-30-35-38 through 35-41. The reclassified amounts should be presented in the same income statement line item as the earnings effect of the hedged item. Immediate reclassification of amounts from accumulated other comprehensive income to earnings would be required only if it becomes probable that the hedged forecasted transaction (that is, the purchases of the specified quantity of soybeans in June 20X1) will not occur. As discussed in paragraph 815-30-40-5, a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of applying cash flow hedge accounting in the future for similar forecasted transactions.

9.4.40 Interest rate risk on the forecasted issuance or purchase of debt instruments



Excerpt from ASC 815-20

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

>>> Forecasted Issuances or Purchases of Debt Instruments

25-17 In this Subtopic, the phrase *issuance of fixed-rate debt* includes the issuance of a zero-coupon instrument because the interest element in a zero-coupon instrument is fixed at its issuance.

25-18 Provided the entity meets all the other cash flow hedging criteria, an entity may designate as the hedged risk the risk of changes in either of the following:

- a. The coupon payments (or the interest element of the final cash flow if interest is paid only at maturity) related to the forecasted issuance of fixed-rate debt
- b. The total proceeds attributable to changes in the benchmark interest rate related to the forecasted issuance of fixed-rate debt.

The derivative instrument used to hedge either of these risks must provide offsetting cash flows for the hedging relationship to be effective in accordance with paragraph 815-20-35-3.

25-19 An entity shall not characterize its variable-rate debt as fixed-rate debt that, at each interest reset date, is effectively rolled over to another issuance of fixed-rate debt that has a new fixed interest rate until the next reset date.

25-19A In accordance with paragraph 815-20-25-6, if an entity designates a cash flow hedge of interest rate risk attributable to the variability in cash flows of a forecasted issuance or purchase of a debt instrument, it shall specify the nature of the interest rate risk being hedged as follows:

- a. If an entity expects that it will issue or purchase a fixed-rate debt instrument, the entity shall designate the variability in cash flows attributable to changes in the benchmark interest rate as the hedged risk.
- b. If an entity expects that it will issue or purchase a variable-rate debt instrument, the entity shall designate the variability in cash flows attributable to changes in the contractually specified interest rate as the hedged risk.

25-19B If an entity does not know at the inception of the hedging relationship whether the debt instrument that will be issued or purchased will be fixed rate or variable rate, the entity shall designate as the hedged risk the variability in cash flows attributable to changes in a rate that would qualify both as a benchmark interest rate if the instrument issued or purchased is fixed rate and as a contractually specified interest rate if the instrument issued or purchased is variable rate.

An entity can apply cash flow hedge accounting to the variability in cash proceeds from a forecasted issuance or purchase of a debt instrument, or to the forecasted interest payments on the future issuance or purchase of a debt instrument.

 **Interest rate risk.** An entity may specify the hedged risk based on its expectation of the interest rate on the debt as follows. [815-20-25-19A]

- If the entity expects to issue or purchase fixed-rate debt, it designates the hedged risk as the variability in cash flows attributable to changes in the benchmark interest rate.
- If the entity expects to issue or purchase variable-rate debt, it designates the hedged risk as the variability in cash flows attributable to changes in the contractually specified interest rate.

If the entity does not know whether the debt instrument will have a fixed or variable rate, it designates the hedged risk as variability in cash flows attributable to changes in a rate that would qualify both as a benchmark interest rate and a contractually specified interest rate. [815-20-25-19B]



Example 9.4.70

Forecasted issuance of fixed-rate debt

ABC Corp. forecasts that it will issue a five-year fixed-rate debt instrument in six months. The debt's fixed rate will be determined on the date it is issued and will be based on current market interest rates.

ABC may designate the hedged risk as changes in either:

- the interest payments related to the forecasted issuance of fixed-rate debt; or
- the total proceeds attributable to changes in the benchmark interest rate related to the forecasted issuance of fixed-rate debt.

ABC wants to hedge its exposure to variability in cash flows related to changes in its forecasted interest payments on the debt to be issued.

ABC enters into a forward-starting pay-fixed, receive-LIBOR interest rate swap with a LIBOR leg to hedge the interest rate risk associated with the forecasted interest payments. At inception of the hedge of the forecasted interest payments, ABC designates the variability in cash flows attributable to changes in the LIBOR rate as the hedged risk. The LIBOR rate may be designated as the hedged risk because it is a benchmark interest rate.



Example 9.4.80

Forecasted issuance of debt when it is not known whether the interest rate will be fixed or variable

Assume the same fact pattern as in Example 9.4.70 except that ABC Corp. does not know whether the interest rate on the debt will be fixed or variable rate.

ABC expects that if variable-rate debt is issued, the debt agreement will specify the variable index as the LIBOR rate plus a spread.

ABC enters into a forward-starting pay-fixed, receive-LIBOR interest rate swap to hedge the interest rate risk associated with the forecasted interest payments. At inception of the hedge of the forecasted interest payments, ABC designates the variability in cash flows attributable to changes in the LIBOR rate as the hedged risk.

The LIBOR rate qualifies as a:

- benchmark interest rate if the debt issued is fixed-rate; and
- contractually specified interest rate if the debt issued is variable-rate.

9.4.50 Hedging interest rate risk on forecasted issuances of fixed-rate debt: Rollover strategies

 **Interest rate risk.** Cash flow hedging relationships for forecasted debt issuances commonly include rollovers of short-term, fixed-rate debt such as commercial paper or certificates of deposit issued by banks.

Commercial paper and similar instruments are issued on a fixed-rate discounted basis with relatively short maturities (e.g. seven to 270 days). Specifically, the issuer receives a single discounted amount as proceeds of the issuance and makes a single payment of the stated amount at maturity. There are no periodic interest payments. The interest rate established on the issuance of these fixed-rate instruments is based on current market interest rates for a specific debtor.

An entity may seek to hedge the variability in cash flows that will or are expected to occur when fixed-rate instruments mature and are reissued at prevailing fixed rates of interest (i.e. rolled over). Because the debt is fixed-rate, an entity can designate either the benchmark interest rate or the total change in cash flows as the hedged risk.



Question 9.4.70

How does an entity assess whether forecasted issuances or purchases of short-term, fixed-rate debt in a rollover strategy share similar interest rate risk exposure?

Interpretive response: To designate a group of forecasted transactions as the hedged transactions, they must share the same risk exposure for which they are being hedged. [\[815-20-55-23\]](#)

For hedging strategies involving rollovers of short-term, fixed-rate debt issuances (or purchases), an entity has to demonstrate that the implicit index of each individual fixed-rate instrument in the portfolio (based on its maturity) is highly correlated with the benchmark interest rate designated as being hedged.

Because an entity is hedging the forecasted issuance of fixed-rate debt with an interest rate that has yet to be determined, we believe the guidance for

assessing the similarity of interest payments related to variable-rate debt instruments in Question 9.3.80 does not necessarily apply.



Example 9.4.90

Hedging interest rate risk on a group of individual transactions related to a rollover strategy

This example has been adapted from a draft DIG Issue referred to as Agenda Item 13-11.

ABC Corp. has an ongoing five-year commercial paper (CP) program involving a series of issuances of short-term fixed-rate borrowings with varying maturities (e.g. 7 days to 270 days) that are expected to rollover at each maturity date.

Each individual CP borrowing is issued at a fixed rate through its term to maturity (at a discount, similar to a Treasury Bill or other zero-coupon instrument). ABC expects a virtually constant average maturity of 30 days across its entire portfolio of CP borrowings over the life of the program.

ABC wishes to hedge the forecasted interest payments arising from future issuances of CP borrowings. It enters into a LIBOR-based interest rate swap that reprices every 30 days to match the average rollover period.

Similarity test

ABC has to determine whether the portfolio of commercial paper issuances share the same risk exposure. For guidance on the similarity test when hedging a group of forecasted transactions, see section 9.3.60.

ABC expects interest payments on seven-day CP borrowings to have exposure related to one-week LIBOR, whereas interest payments on 270-day CP borrowings will have exposure related to nine-month LIBOR. To group issuances with maturities ranging from seven days to 270 days, ABC has to demonstrate that seven-day and nine-month LIBOR rates share the same risk exposure.

To accomplish this, ABC performs regression analysis to determine whether historical changes in the CP borrowing rates for each maturity ranging from seven days to 270 days have been highly correlated with the seven-day and nine-month LIBOR rates.

If ABC is unable to demonstrate high correlation, it may need multiple groupings with narrower ranges of maturities. For example, ABC may consider grouping issuances with maturities in the following ranges:

- 7 days – 30 days
- 31 days – 60 days
- 61 days – 90 days
- 91 days – 180 days
- 181 days – 270 days

Similarly, the hedging instruments for each grouping must have benchmark interest rates that align with the maturities of each respective group.

Hedge effectiveness

Because the terms of the forecasted debt issuances will vary from period to period, ABC has to estimate the changes in the hedged forecasted cash flows or construct a hypothetical derivative that represents the best estimate of the future cash flows of each hedged portfolio. This requires an estimate of the hedged forecasted cash flows at the beginning and end of the period for which effectiveness is being assessed.

To do this, ABC could assume that the underlying portfolio is a single instrument with a single maturity equal to the average maturity of the actual portfolio (e.g. 30 days). The cash flow forecast would be developed by assuming the hypothetical item will be continually reissued on its maturity for the same average term as the average maturity.



Question 9.4.80

Should deposit/investment arrangements without contractually stipulated maturity dates be characterized as rollovers of fixed-rate instruments?

Interpretive response: No. Deposit/investment arrangements without contractually stipulated maturity dates (e.g. money market deposits, negotiable order of withdrawal (NOW) accounts and savings accounts), cannot be characterized as a series of daily, or other periodic, rollovers of fixed-rate instruments. This is true even if such arrangements permit both the financial institution and the investor to cancel the arrangement at any time.

Instead, we believe these represent ongoing variable-rate arrangements. Specifically, the daily, or other periodic, *rollover* of the arrangement is a contractual continuation of a single debtor-creditor relationship. Accordingly, because the interest rates on these arrangements typically do not vary explicitly on a benchmark interest rate index, the risk being hedged would be either overall changes in cash flows, or the contractually specified interest rate.

However, this assumes an entity would be able to find a derivative instrument that is highly effective. This may be difficult due to the nature of the rate-setting process for these products.

Interest rates for these products may be set based on factors other than changes in the interest rate index of the derivative instrument. For example, the rates may be set based on the need for funds, to calibrate the mix of the sources of funds, celebration of a branch opening or other competitive factors. In addition, the timing of the product's rate-setting process may not coincide with the derivative.

FASB Example: Prohibition on characterization of variable-rate debt as rolled fixed-rate debt

The following FASB example illustrates that an entity cannot characterize variable-rate debt as fixed-rate debt that is effectively rolled over at each interest reset date. [\[815-20-25-19\]](#)

**Excerpt from ASC 815-25****>> Example 6: Prohibition on Characterization of Variable-Rate Debt as Rolled Fixed-Rate Debt**

55-105 This Example illustrates the application of paragraph 815-20-25-19. Consider an entity with existing variable-rate debt that is prepayable, resets monthly based on a specified bank's prime rate plus 1 percent as of the beginning of each month, and matures in 5 years. Although the variable-rate debt does, after each reset, have a fixed rate for each monthly period, it is inappropriate to characterize that debt as a series of fixed-rate debt instruments. When each reset occurs, it is not a new issuance of fixed-rate debt based on current market interest rates for that debtor; instead, it is a contractual continuation of a debtor-creditor relationship and the fixed rate for each month is explicitly (and contractually) based on a specific index (a specified bank's prime rate).

9.4.60 Changing the hedged risk**Excerpt from ASC 815-30****>> Change in Designated Hedged Risk**

35-37A If the designated hedged risk changes during the life of a hedging relationship, an entity may continue to apply hedge accounting if the hedging instrument is highly effective at achieving offsetting cash flows attributable to the revised hedged risk. The guidance in paragraph 815-20-55-56 does not apply to changes in the hedged risk for a cash flow hedge of a forecasted transaction.

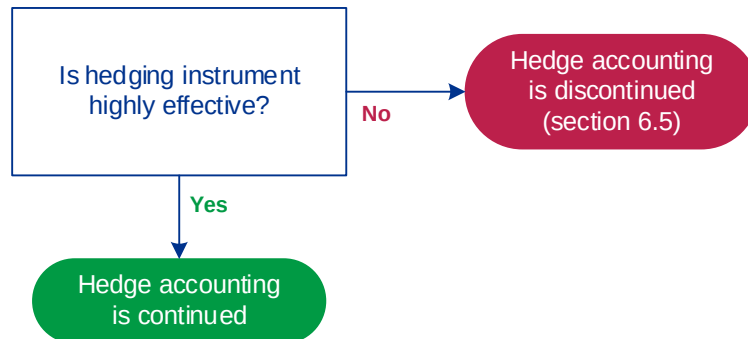
Topic 815 requires an entity to discontinue hedge accounting when the critical terms of the original hedging relationship have changed (see section 6.10), with the exception of changes to hedged risk when hedging forecasted transactions. [\[815-20-55-56\]](#)

A unique attribute of a cash flow hedge of a forecasted transaction is that: [\[ASU 2017-12.BC65\]](#)

- an entity's expectation about the terms of the transaction as established at hedge inception may change during the forecast period; but
- the forecasted transaction may remain probable and the hedging relationship may remain highly effective based on the revised terms.

Topic 815 specifies that if there is a change to the hedged risk in a cash flow hedge of a forecasted transaction, an entity is not required to automatically dedesignate the hedging relationship. Instead, it determines whether the

hedging instrument continues to be highly effective at achieving offsetting cash flows attributable to the revised forecasted transaction. [815-30-35-37A]



This guidance applies to both nonfinancial and financial risks, and is demonstrated in the following examples.

- Contractually specified component in a not-yet existing contract (Example 9.4.100).
- Changes in a cash flow hedge of forecasted interest payments with an interest rate swap (see Subtopic 815-30's Example 9 in section 10.5.10).



Example 9.4.100

Change in hedged risk for a contractually specified component in not-yet-existing contracts

The following example is adapted from the example in paragraphs 815-20-55-26B to 55-26E (reproduced in section 9.4.60).

Contractually specified component in not-yet-existing contract

On January 1, Year 1, ABC Corp. expects to make future purchases of soybeans on December 31, Year 1. ABC's contracts to purchase soybeans are typically at a price based on XYZ soybean index plus a variable basis differential for transportation costs.

ABC enters into a forward derivative contract indexed to the XYZ soybean index that will mature on December 31, Year 1. The forward derivative is designated as the hedging instrument in a cash flow hedge. The hedged transaction is the forecasted purchase of a specified quantity of soybeans on December 31, Year 1.

As of the date of the hedge designation, ABC expects that XYZ index will be the contractually specified component in the contract once the contract is executed. ABC documents as the hedged risk the variability in cash flows attributable to changes in the contractually specified XYZ soybean index in the not-yet-existing purchase contract.

On January 1, Year 1, ABC determines that all of the requirements for cash flow hedge accounting are met and the requirements in paragraph 815-20-25-22A will be met once the contract is executed.

Change in hedged risk

On July 1, Year 1, ABC executes a contract to purchase soybeans on December 31, Year 1 at a price based on the DEF soybean index plus a variable basis differential for transportation costs instead of the XYZ soybean index. When ABC executes the contract on July 1, Year 1, it does not automatically dedesignate the hedging relationship because the hedged risk changed from XYZ soybean index to DEF soybean index. Instead, it evaluates whether the hedge is highly effective considering the revised soybean index.

If the hedging relationship is not highly effective using the DEF soybean index, ABC discontinues the hedging relationship.

**Question 9.4.90#**

Does the ability to change the hedged risk also extend to the hedged forecasted transaction?

Interpretive response: No. The ability to change the hedged risk does not extend to the hedged forecasted transaction. However, it is not clear how to distinguish hedged risk from the hedged forecasted transaction.

The FASB has a project that is expected to clarify how an entity would distinguish the hedged risk from the hedged forecasted transaction. This project is ongoing and we expect a final ASU to be issued in 2021. As a result, revisions to this interpretive response may be provided in a future edition.

**Example 9.4.110**

Defining hedged risk for a cash flow hedge of interest rate payments of You Pick 'Em debt

You Pick 'Em debt is a type of variable-rate debt instrument with an option that allows the debtor, on specified dates, to change the interest rate index (e.g. one-month LIBOR, three-month LIBOR, US Treasury or Prime) on which its interest payments are based.

ABC issues *You Pick 'Em* debt and at each reset date, it may select the one-month LIBOR rate, three-month LIBOR rate or the Prime rate.

ABC wishes to hedge the risk of changes in interest rates associated with this instrument. It enters into a receive three-month LIBOR, pay-fixed interest rate swap to hedge the variable interest payments.

Defining the forecasted transaction and hedged risk

ABC specifically identifies and defines the forecasted transaction as LIBOR based payments on the specified *You Pick 'Em* Debt.

ABC expects to select the three-month LIBOR at each reset date and documents the hedged risk as variability in cash flows attributable to changes in three-month LIBOR. ABC determines that all of the requirements for cash flow hedge accounting are met.

Hedge effectiveness. ABC must select a specific tenor of LIBOR as the hedged risk to support hedge effectiveness. The PEH derivative would be a receive three-month LIBOR, pay-fixed interest rate swap. The terms of the PEH do not need to consider the optionality of other rates that may be elected. This is because ABC needs to perform a single hedge effectiveness assessment based on the hedged risk *currently expected* to occur in the forecasted transaction (i.e. three-month LIBOR). There is no requirement for ABC to perform effectiveness tests associated with multiple potential hedged risks. [\[ASU 2017-12.BC66–BC67\]](#)

For further guidance on PEH derivatives, see section 13.7.30.

ABC selects a different LIBOR tenor at reset date

ABC chooses to reset the interest rate during the period from three-month LIBOR to one-month LIBOR. The forecasted interest payments remain probable.

ABC does not automatically dedesignate the hedging relationship because the hedged risk changed from three-month to one-month LIBOR. Instead, it evaluates whether the hedge is highly effective considering the revised LIBOR tenor – i.e. whether the hedging instrument (indexed to three-month LIBOR) is highly effective at achieving offsetting cash flows attributable to the revised contractually specified component (one-month LIBOR).

Further, the change in the designated hedged risk does not represent a missed forecast for ABC because the interest payments remain probable. [\[ASU 2017-12.BC66\]](#)

Hedge effectiveness. Because of the change in the LIBOR tenor from three-month to one-month, the PEH must be adjusted to reflect the most recent best estimate of the forecasted transactions that are identified with that relationship for purposes of assessing hedge effectiveness. ABC performs an assessment based on the hedged risk *currently expected* to occur, which is now one-month LIBOR. [\[ASU 2017-12.BC66–BC67\]](#)

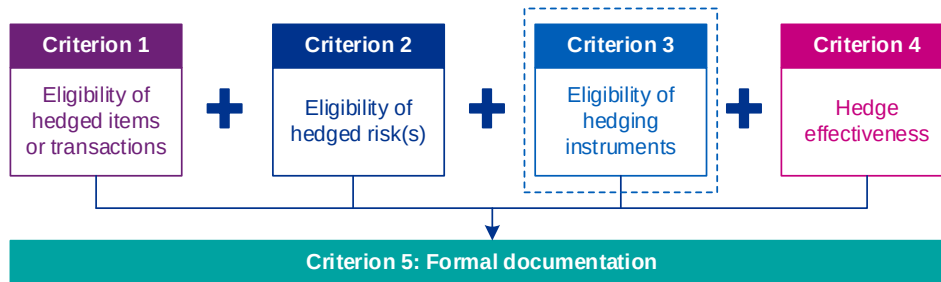
If the hedging relationship is not highly effective using one-month LIBOR, ABC will discontinue the hedging relationship.

ABC selects Prime rate at reset date

If ABC chooses to reset the interest rate during the period from three-month LIBOR to the Prime rate, the reset would be a change in hedged risk.

Current guidance is unclear as to whether this represents a change in the hedging relationship that would require dedesignation, or if the hedging relationship could continue if it remained highly effective. The FASB discussed potential Codification improvements that would clarify this issue. Revisions to this example may be provided in a future edition.

9.5 Hedging instruments in cash flow hedges



Topic 815 specifies certain criteria that must be met for financial instruments to be eligible for designation as hedging instruments, the primary requirement being that the instrument meets the definition of a derivative. Topic 815 also specifically prohibits certain instruments and outlines limitations involving written options. These concepts are discussed in sections 6.6 and 6.7.

Topic 815 includes additional guidance specific to cash flow hedges around the eligibility of hedging instruments, including:

- special rules for basis swaps (see section 9.5.10); and
- limitations on mixed-attribute derivative commodity contracts (see section 9.5.20).

 **Foreign currency risk.** For guidance on the eligibility of hedging instruments in a cash flow hedge of foreign currency risk, see section 11.6.10.

9.5.10 Special rule for basis swaps



Excerpt from ASC 815-20

> Hedging instrument in a Cash Flow Hedge of Basis Risk

25-50 If a hedging instrument is used to modify the contractually specified interest receipts or payments associated with a recognized financial asset or liability from one variable rate to another variable rate, the hedging instrument shall meet both of the following criteria:

- a. It is a link between both of the following:
 1. An existing designated asset (or group of similar assets) with variable cash flows
 2. An existing designated liability (or group of similar liabilities) with variable cash flows.
- b. It is highly effective at achieving offsetting cash flows.

25-51 For purposes of paragraph 815-20-25-50, a link exists if both of the following criteria are met:

- a. The basis (that is, the rate index on which the interest rate is based) of one leg of an interest rate swap is the same as the basis of the contractually specified interest receipts for the designated asset.

- b. The basis of the other leg of the swap is the same as the basis of the contractually specified interest payments for the designated liability.

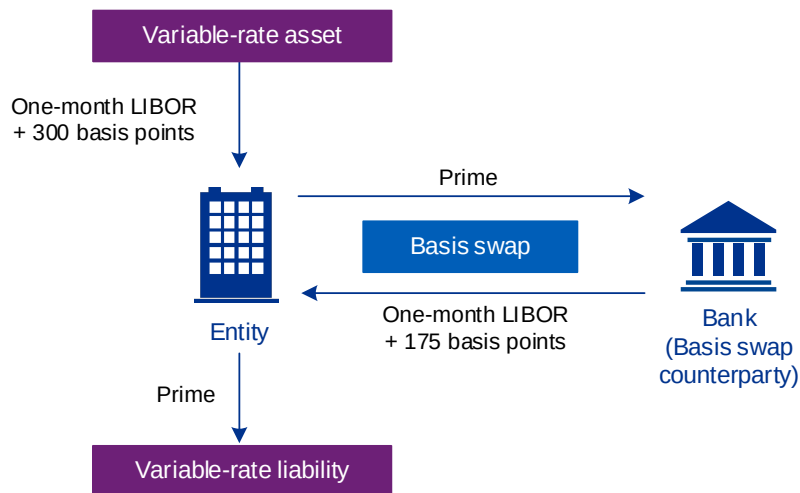
In this situation, the criterion in paragraph 815-20-25-15(a) is applied separately to the designated asset and the designated liability.

A basis swap is a derivative instrument that is used to change the interest rate characteristics of a variable-rate financial asset or liability from one variable-rate index to another. Instead of fixing the cash flows associated with a variable-rate instrument, a basis swap reduces basis risk by changing the variability of the interest cash flows from one index to another.

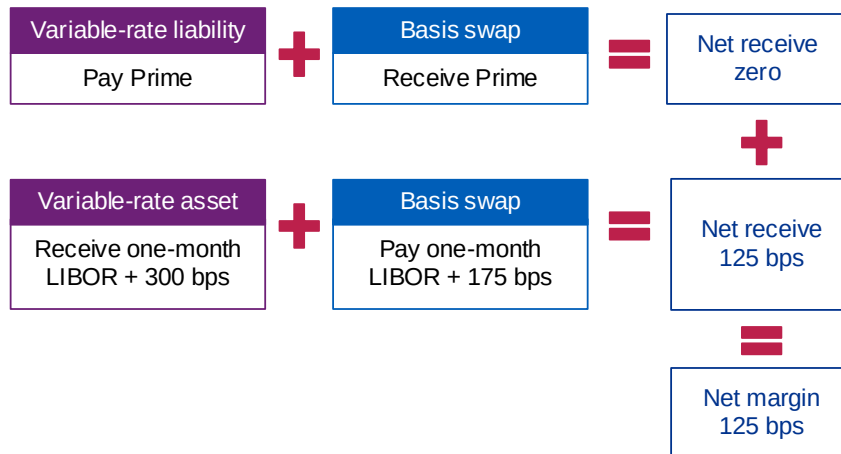
Basis risk arises when an entity acquires a financial asset that is funded with a financial liability. Both financial instruments have variable-rate cash flows, but the variability of one position does not move in unison with the variability of the other position.

For example, an entity that has a one-month LIBOR-based asset funded by a Prime-based liability has economic basis risk between LIBOR and Prime interest rates. If one-month LIBOR rates decrease significantly and Prime rates remain unchanged, the entity would experience a significant change in the margin between the interest rates associated with the two positions. A basis swap could effectively alter future cash flows from a LIBOR basis to a prime basis, or vice versa.

The following illustrates a basis swap strategy.



By using a basis swap, an entity is able to lock in a net margin of 125 bps.



Basis swaps do not reduce or eliminate the variability of cash flows associated with the *individual* financial instruments. However, they reduce or eliminate the variability of cash flows attributable to the combined asset-liability position.

Topic 815 only allows a basis swap to be used to modify the interest receipts of a recognized financial asset and the interest payments of a recognized financial liability. To designate a basis swap as the hedging instrument in a cash flow hedging relationship, the following criteria must be met: [\[815-20-25-50\]](#)

- each leg of the basis swap is linked to a designated item with the same underlying; and
- the basis swap is highly effective in achieving offsetting cash flows.

Basis swap links with same underlying

To qualify for hedge accounting, each leg of the basis swap must provide a link between the variable-rate interest receipts associated with a recognized financial asset and the variable-rate interest payments associated with a recognized financial liability. This requirement mandates that each leg of the basis swap be linked to a designated item with the same underlying. [\[815-20-25-50\(a\), 25-51\]](#)

For example, an entity with one-month LIBOR-based assets funded by variable-rate debt that has an interest rate of Prime is required to use a swap with one leg based on one-month LIBOR and one leg based on the Prime rate. In contrast, it cannot use a swap with one one-month LIBOR-based leg and one leg based on the bond market association (BMA) rate. This is illustrated in the following table, along with other combinations and whether the requirement is met.

Variable-rate asset	Variable-rate liability	Basis swap	Permitted?
One-month LIBOR	Prime	One-month LIBOR and Prime	✓
One-month LIBOR	Prime	One-month LIBOR and BMA rate	✗
One-month LIBOR + 300 bps	Prime	(One-month LIBOR + 175 bps) and Prime	✓
One-month LIBOR	Prime	Six-month LIBOR and Prime	✗

Basis swap is highly effective in offsetting net interest cash flows

To qualify for hedge accounting, the basis swap must be highly effective in achieving offsetting cash flows attributable to the hedged risk. [815-20-25-50(b)]

Specifically, the cash flows from the swap must be highly effective in achieving offsetting cash flows attributable to the hedged risk of the hedged forecasted net interest cash flows.



Question 9.5.10

How is the hedged forecasted transaction defined in a cash flow hedging relationship involving a basis swap?

Interpretive response: We believe a cash flow hedging relationship involving a basis swap is considered a single hedging relationship.

As a result, an entity must identify the net interest cash flows (of the recognized financial asset and recognized financial liability) as the **hedged forecasted transactions**.

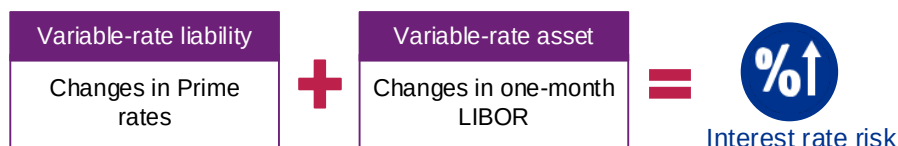


Although each leg of the basis swap must be linked to the designated item with the same underlying, the hedged forecasted transactions are the net interest cash flows of those combined designated items. [815-20-25-51]

The ability to hedge the net interest cash flows of a recognized financial asset and a recognized financial liability is not permitted anywhere else in Topic 815.

Formal documentation. The recognized financial asset, the recognized financial liability, and the related net interest cash flows being hedged must be specifically identified in the hedge documentation. [815-20-25-3(d)(1)]

When an entity designates a cash flow hedge of interest rate risk, it must formally document the hedged risk as exposure to both contractually specified interest rates. For example (using the basis swap strategy above).



Example 9.5.10

Basis swap that qualifies for cash flow hedge accounting

Bank has a five-year \$10,000,000 variable-rate commercial loan that earns one-month LIBOR plus 4%. The loan is funded by a five-year, \$10,000,000 debt obligation that pays interest at Prime plus 1%.

To reduce its basis risk, Bank enters into a five-year basis swap with a notional amount of \$10,000,000 to receive interest at a variable rate equal to Prime and to pay interest at a variable rate equal to one-month LIBOR plus 2%. The rates and payment dates of the swap mirror those of the commercial loan and debt obligation.

Bank identifies the basis swap as the hedging instrument in a hedging relationship to hedge the risk of changes in the contractually specified interest rates.

Bank links the one-month LIBOR-based leg of the basis swap to the \$10,000,000 commercial loan and the Prime-based leg of the basis swap to the \$10,000,000 debt obligation.

If the other requirements for hedge accounting have been met (including high effectiveness), this basis swap would qualify for cash flow hedge accounting because:

- the underlying asset is a recognized financial asset and the underlying liability is a recognized financial liability, and both have been individually identified;
- the basis swap is used to offset changes in the contractually specified interest rates associated with the commercial loan and the debt obligation; and
- each leg of the basis swap has been linked to a designated hedged transaction with the same underlying.

**Example 9.5.20****Basis swap that does not qualify for cash flow hedge accounting**

Bank has a five-year \$10,000,000 variable-rate commercial loan that earns one-month LIBOR.

ABC Corp. wants to obtain five-year, Prime-based funding. It can do so in several ways, including:

- entering into a five-year debt obligation indexed to Prime;
- borrowing at fixed rates while simultaneously entering into an interest rate swap that converts the fixed rate into Prime; or
- borrowing at variable rates linked to another index while simultaneously entering into a basis swap that converts that other index to Prime.

ABC issues a five-year, \$10,000,000 debt obligation. The interest rate on the debt obligation is variable at one-month LIBOR.

ABC simultaneously enters into a five-year basis swap with a notional amount of \$10,000,000 to receive interest at a variable rate equal to one-month LIBOR and to pay interest at a variable rate equal to Prime.

Based on the information presented, this strategy does not qualify for hedge accounting because the swap has only one leg that could be linked to a recognized financial asset or liability, not both legs. Among other requirements, for a basis swap to qualify for hedge accounting, each leg of the swap must be separately linked to a recognized financial asset and a recognized financial liability.

**Question 9.5.20****How does an entity assess whether a basis swap is highly effective at offsetting changes in the net interest cash flows?**

Interpretive response: Although the interest rate index of each leg of the basis swap must be identical to the contractually specified interest rates of the underlying, an entity cannot automatically assume the hedge will perfectly offset the net interest cash flows or always be highly effective.

For example, an entity should consider whether the recognized financial asset, the recognized financial liability and/or the basis swap reprice or have payments at different dates. This could affect whether the hedge is highly effective.

For an example of assessing effectiveness of a cash flow hedge with a basis swap, see Subtopic 815-30's Example 2 in section 13.2.10.



Question 9.5.30

Can an entity hedge net interest cash flows from a group of recognized assets or liabilities in a cash flow hedging relationship involving a basis swap?

Interpretive response: It depends. The hedged forecasted net interest cash flows in a cash flow hedging relationship involving a basis swap may relate to a group of recognized financial assets (or liabilities) that comprises similar individual assets (or similar individual liabilities) with the same underlying.

However, the requirement that a group of individual transactions share the same risk exposure for which they are being hedged (see section 9.3.60) must be met separately for the group of assets and/or group of liabilities to qualify for hedge accounting.



Question 9.5.40

Can an entity apply the first-payments-received (paid) approach when designating the net interest cash flows in a hedging relationship involving a basis swap?

Background: In a cash flow hedge of interest rate risk, the specifically identified group of transactions may be the first interest payments received (paid) for a rolling portfolio of prepayable interest-bearing loans, or other interest-bearing financial assets, provided all other conditions for a cash flow hedge have been met. For further guidance, see section 9.3.70.



Excerpts from ASC 815-20

>>>> First-Payments-Received Technique in Hedging Variable Interest Payments on a Group of Loans

55-33E This implementation guidance regarding use of a first-cash-flows technique also may be applied to a cash flow hedging relationship in which the hedging instrument is a basis swap as discussed beginning in paragraph 815-20-25-50. However, use of that technique for those basis-swap hedging relationships may not be common because that paragraph limits designating a basis swap as the hedging instrument to cash flow hedges of the contractually specified interest payments of only recognized financial assets and liabilities existing at the inception of the hedge, whereas the first-cash-flows technique is typically applied to the contractually specified interest payments for rolling portfolios whose composition of financial assets changes over the period of the hedge.

Interpretive response: Yes. An entity may apply the first-payments-received (paid) approach to a cash flow hedging relationship in which the hedging instrument is a basis swap. [\[815-20-55-33E\]](#)

However, using this approach may not be common because Topic 815 limits designating a basis swap as a hedging instrument for contractually specified interest receipts (or payments) associated with a recognized financial asset or liability existing at hedge inception. In contrast, the first-payments-received (paid) approach is typically applied to the contractually specified interest receipts (or payments) for a rolling portfolio of financial liabilities (or assets) that change over the life of the hedging relationship. [815-20-55-33E]

We believe the hedged net interest cash flows identified over the life of the relationship may be associated with differing assets or liabilities within a portfolio of identified similar assets or similar liabilities provided that:

- the entity is using the first-payments-received approach to identify the hedged forecasted transactions; and
- all identified hedged cash flows are associated with assets or liabilities that existed at the inception of the hedge.



Example 9.5.30

First-payments-received (paid) approach with basis swap as the hedging instrument

Bank has a portfolio of variable-rate loans totaling \$400 million in principal that earn Prime plus 1%. These loans are funded by a portfolio of variable-rate financial liabilities totaling \$500 million in principal that pays one-month LIBOR plus 4%.

To reduce its basis risk, Bank enters into a basis swap with a notional amount of \$100 million to receive interest at a variable rate equal to one-month LIBOR plus 2% and to pay interest at a variable rate equal to Prime.

Bank uses the first-payments-received (paid) approach and identifies the hedged transaction as follows:

- first Prime-based interest payments received at the beginning of each quarter that are payments on \$100 million principal of Prime-based loans existing at inception of the hedge – e.g. Prime-based loans totaling \$400 million in principal; and
- first LIBOR-based interest payments at the beginning of each quarter that are payments on \$100 million principal of LIBOR-based debt obligations existing at inception of the hedge – e.g. LIBOR-based loans totaling \$500 million in principal.



Question 9.5.50

Is a cash flow hedge with a basis swap automatically dedesignated if there is a change to the contractually specified interest rate?

Interpretive response: Yes. Because each leg of the basis swap must be linked to the designated item with the same underlying, we do not believe an

entity could change the contractually specified interest rate without dedesignating the hedging relationship.

For example, an entity designates the hedged forecasted transaction as interest receipts and payments on a recognized asset and liability, respectively. The hedged risk is identified as changes in the contractually specified interest rates, being one-month LIBOR for the asset and Prime for the liability. Each leg of the basis swap properly links to the index of the underlying.

If the contractually specified interest rate for the asset changed from one-month LIBOR to a different index (e.g. BMA or six-month LIBOR), there would be a mismatch and the requirement that each leg of the basis swap properly link to the index of the underlying would no longer be met.



Question 9.5.60

Can basis swaps other than those involving interest rates be designated as a hedging instrument?

Interpretive response: No. There are basis swaps for underlyings other than interest rates. For example, the spot price of oil can be swapped for the spot price of natural gas.

However, we believe an entity is prohibited from using basis swaps other than those involving exchanges of interest rates in a cash flow hedging relationship.

9.5.20 Limitations on mixed-attribute derivative commodity contracts



Excerpt from ASC 815-20

>>> Mixed-Attribute Derivative Commodity Contracts as Cash Flow Hedging Instruments

55-46 Commodity contracts commonly have features of both fixed-price contracts and variable-price contracts, such as an agreement to purchase a commodity in the future at the prevailing market index price at that future date plus or minus a fixed basis differential set at the inception of the contract. Assume an example mixed-attribute contract has the characteristics of notional amount, underlying, and no initial net investment and the commodity to be delivered is **readily convertible to cash** pursuant to the guidance beginning in paragraph 815-10-15-119.

55-47 Because that mixed-attribute contract is a derivative instrument and has an underlying related solely to changes in the basis differential, that contract (as a derivative instrument) would generally not be sufficiently effective if designated as the sole hedging instrument in a cash flow hedge of the anticipated purchase or sale of the commodity—a forecasted transaction whose variability in cash flows is based on changes in both the basis

differential and the base commodity price. Because its underlying relates solely to changes in the basis differential, the mixed-attribute contract would essentially be hedging only a portion of the variability in cash flows. The entity is not permitted to designate a cash flow hedging relationship as hedging only the change in cash flows attributable to changes in the basis differential. For an entity to be able to conclude that such a hedging relationship is expected to be highly effective in achieving offsetting cash flows, the entity would need to consider the likelihood of changes in the base commodity price as remote or insignificant to the variability in hedged cash flows (for the total purchase or sales price). However, the mixed-attribute contract may be combined with another derivative instrument whose underlying is the base commodity price, with the combination of those derivative instruments designated as the hedging instrument in a cash flow hedge of the overall variability of cash flows for the anticipated purchase or sale of the commodity. Such a combination would address the risk of changes in both the basis differential and the base commodity price.

Contracts with both a fixed and variable exercise price are commonly referred to as mixed-attribute contracts or fixed-basis contracts. These are common in the commodities industry.

For example, a buyer seeks to use crude oil in the production of unleaded gasoline. In January, the buyer agrees to buy 1,000 barrels of a specific type of crude oil in July from a seller at the July 1 West Texas Intermediate (WTI) price index price plus \$1.00 per barrel. The contract appears to be primarily a floating-price contract, but includes a fixed margin above that price. While the fixed \$1.00 differential is commonly referred to as the basis differential, it reflects multiple factors, such as quality of the oil, and the timing and location of delivery.

In general, this type of mixed-attribute contract would qualify as a derivative instrument. The basis differential is an underlying to the contract and changes in the basis differential will affect the fair value of the contract as a whole.

However, the mixed-attribute contract is unlikely to be able to function as the sole hedging instrument in a cash flow hedge of the anticipated purchase or sale of the commodity. This is because that forecasted transaction is one whose variability in cash flows is based on changes in *both* the basis differential and the base commodity price (e.g. WTI price index). This type of derivative contract would essentially be hedging only a portion of the variability in cash flows (i.e. the basis differential). In other words, it doesn't consider changes in the base commodity price. [\[815-20-55-47\]](#)

However, this mixed-attribute contract may be effective if combined with another derivative whose underlying is the base commodity price. This would address both the basis differential and the base commodity price. [\[815-20-55-47\]](#)

10. Accounting for cash flow hedges

Detailed contents

Item significantly updated in this edition: #

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- 10.2.30 Accounting for a cash flow hedge of a forecasted purchase of inventory with a forward contract (critical terms match – forward value method)
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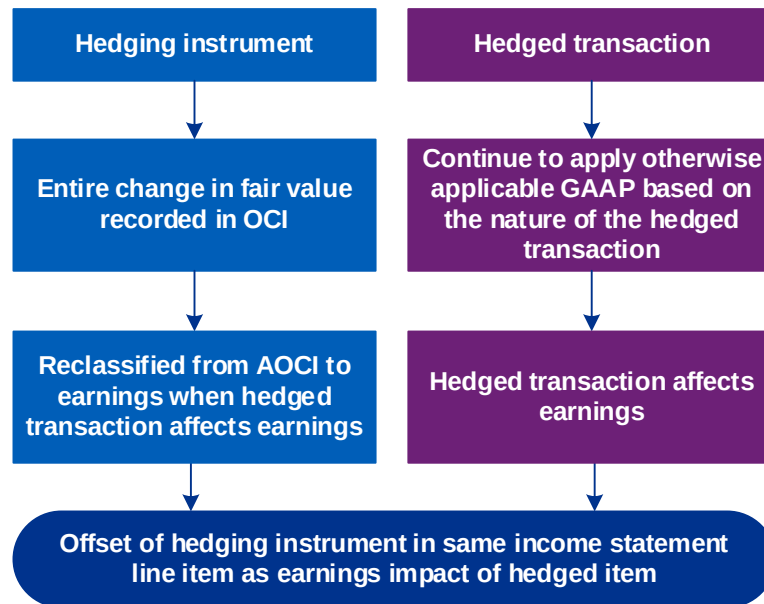
10.1 How the standard works

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

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

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

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



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

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

10.2 Cash flow hedge accounting model

10.2.10 Overview



Excerpt from Subtopic 815-20

35-1 Paragraph 815-10-35-2 states that the accounting for subsequent changes in the fair value (that is, gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Specifically, subsequent gains and losses on derivative instruments shall be accounted for as follows: ...

- c. **Cash flow hedge.** The gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged **forecasted transaction** affects earnings, as provided in paragraphs 815-30-35-3 and 815-30-35-38 through 35-41. If an entity excludes a portion of the hedging instrument from the assessment of hedge effectiveness in accordance with paragraph 815-20-25-82, the initial value of the excluded component shall be recognized in earnings using a systematic and rational method over the life of the hedging instrument with any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method recognized in other comprehensive income in accordance with paragraph 815-20-25-83A. An entity also may elect to recognize the excluded component of the gain or loss currently in earnings in accordance with paragraph 815-20-25-83B. The gain or loss on the hedging derivative instrument in a hedge of a forecasted foreign-currency-denominated **transaction** shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraph 815-20-25-65.



Excerpt from ASC 815-30

> Subsequent Recognition and Measurement of Gains and Losses on Hedging Instrument

35-3 When the relationship between the hedged item and hedging instrument is highly effective at achieving offsetting changes in cash flows attributable to the hedged risk, an entity shall record in **other comprehensive income** the entire change in the fair value of the designated hedging instrument that is included in the assessment of hedge effectiveness. More specifically, a qualifying **cash flow hedge** shall be accounted for as follows: ...

- b. Amounts in accumulated other comprehensive income related to the derivative designated as a hedging instrument included in the assessment of hedge effectiveness are reclassified to earnings in the same period or periods during which the hedged forecasted transaction affects earnings in accordance with paragraphs 815-30-35-38 through 35-41 and presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A. The balance in accumulated other comprehensive income associated with the hedged transaction shall be the cumulative gain or loss on the derivative instrument from inception of the hedge less all of the following:
1. Subparagraph superseded by Accounting Standards Update No. 2017-12.
 - 1a. The derivative instrument's gains or losses previously reclassified from accumulated other comprehensive income into earnings pursuant to paragraphs 815-30-35-38 through 35-41.
 - 1b. The cumulative amount amortized to earnings related to excluded components accounted for through an amortization approach in accordance with paragraph 815-20-25-83A.
 - 1c. The cumulative change in fair value of an excluded component for which changes in fair value are recorded currently in earnings in accordance with paragraph 815-20-25-83B.
 2. Subparagraph superseded by Accounting Standards Update No. 2017-12.

If hedge accounting has not been applied to a cash flow hedging relationship in a previous effectiveness assessment period because the entity's retrospective evaluation indicated that the relationship had not been highly effective in achieving offsetting changes in cash flows in that period, the cumulative gain or loss on the derivative referenced in (b) would exclude the gains or losses occurring during that period. That situation may arise if the entity had previously determined, for example, under a regression analysis or other appropriate statistical analysis approach used for prospective assessments of hedge effectiveness, that there was an expectation in which the hedging relationship would be highly effective in future periods. Consequently, the hedging relationship continued even though hedge accounting was not permitted for a specific previous effectiveness assessment period.

A derivative **hedging instrument** that qualifies for cash flow hedge accounting is measured at fair value in the balance sheet. Changes in its fair value that are included in the assessment of hedge effectiveness are reported in OCI. Net gains or losses on derivative hedging instruments that are included in AOCI are displayed as a separate classification within AOCI. These amounts are reclassified from AOCI into earnings – in the same income statement line item as the effect of the hedged transaction – when the hedged transaction affects earnings. When the earnings effect of the hedged transaction is presented in more than one line item, the change in the fair value of the hedging instrument is allocated to the different line items. [815-20-45-3, 55-79Z – 55-79AD, 815-30-35-3]

In contrast, changes in the derivative hedging instrument's fair value related to components that are excluded from the assessment of hedge effectiveness are recognized in earnings using either an amortization approach or a mark-to-market approach. When an amortization approach is used, the difference

between the amount that is amortized and the change in fair value of the excluded component each period is recognized in OCI. [815-20-25-83A – 25-83B, 815-30-35-3]

The following table summarizes the timing and presentation for recognizing in earnings changes in a derivative hedging instrument's fair value that arise during the hedging relationship.

Component	Timing of earnings recognition for changes in fair value	Presentation in income statement (see also section 14.3.10) [815-20-45-1A – 45-1B, 55-79Z – 55-79AD, 815-30-35-3]
Changes in fair value that are included in the assessment of hedge effectiveness ¹	Reclassified from AOCI into earnings when the hedged transaction affects earnings (see sections 10.3 and 10.4). However, when it is probable that a forecasted transaction will <i>not</i> occur (i.e. a missed forecast), related amounts in AOCI are immediately reclassified into earnings (see section 10.5.20).	Same line item as effect of hedged transaction . ² However, Topic 815 provides no guidance when amounts are reclassified from AOCI due to a missed forecast (see Question 10.5.110).
Changes in fair value of excluded components ¹	Depends on the approach elected (see section 10.2.20): — Amortization approach. Recognized in earnings using a systematic and rational method over the life of the hedging instrument. However, when it is probable that a forecasted transaction will <i>not</i> occur (i.e. a missed forecast), related amounts in AOCI are immediately reclassified into earnings (see section 10.5.20). — Mark-to-market approach. Immediately recognized in earnings (i.e. as the changes occur).	Same line item as effect of hedged transaction . ² However, Topic 815 provides no guidance when amounts are reclassified from AOCI due to a missed forecast (see Question 10.5.110).
Notes: 1. These amounts do not include changes in fair value arising during periods that the hedging relationship was not highly effective retrospectively (see Question 6.10.90). 2. When the earnings effect of the hedged transaction is presented in more than one line item, the change in the fair value of the hedging instrument is allocated to the different line items.		

The effect of the cash flow hedge accounting model is to defer earnings recognition of changes in fair value of the hedging instrument (that are included

in the assessment of effectiveness) until the hedged transaction affects earnings.

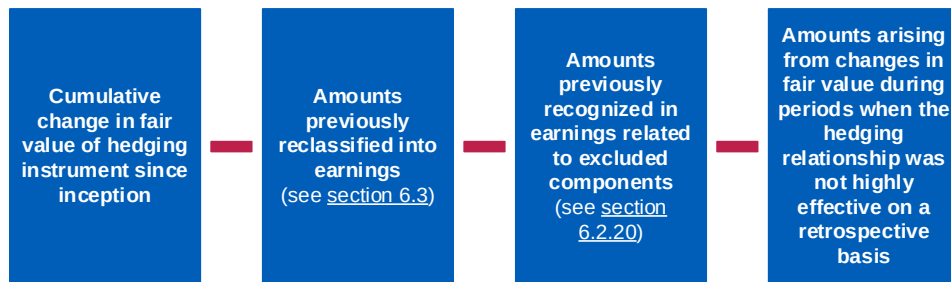
If the hedging relationship is:

- **Perfectly effective.** The net derivative gain or loss that is reclassified from AOCI will exactly offset gains or losses on the hedged transaction that are attributable to the hedged risk within one line item of the income statement.
- **Not perfectly effective.** The extent to which the gains and losses on the hedging instrument do not offset gains and losses on the forecasted transaction is reflected in a single line item of the income statement.

Entities that do not report earnings are not permitted to apply cash flow hedge accounting; see further discussion in section 16.4.

Cumulative measurement

The amount recognized in AOCI for a derivative hedging instrument is a cumulative measurement. This means that the balance in AOCI related to a cash flow hedging instrument comprises the following. [815-30-35-3(b)]



An example of an adjustment that may occur (in the right box) is discussed in Question 6.10.90. In limited circumstances, it may be appropriate to continue applying hedge accounting when the entity's:

- retrospective hedge effectiveness assessment for the assessment period indicates that the relationship was not highly effective; but
- prospective assessment indicates that the relationship is expected to be highly effective in the future.

Discontinuance of hedging relationship

When a cash flow hedge is discontinued (see section 10.5), the net derivative gain or loss reported in AOCI generally is not immediately recognized in earnings. Instead, it generally is recognized in earnings when the hedged forecasted transaction is reported in earnings (see section 10.3). However, a net derivative gain or loss reported in AOCI is immediately reclassified into earnings if it is probable that the hedged forecasted transaction will *not* occur in the original period specified in the hedge documentation or within an additional two-month period (see section 10.5.20).

Income tax considerations

The tax effect of gains or losses recorded in OCI also should be charged or credited directly to OCI. This includes gains or losses arising from changes in fair value of derivatives designated in qualifying cash flow hedging relationships and from derivatives designated in qualifying fair value hedging relationships for which an amortization approach is used to recognize excluded components. See KPMG's Handbook, [Accounting for Income Taxes](#), including paragraphs 9.043 and 9.050, for further information.

Examples

The examples in this section demonstrate cash flow hedge accounting.

- Accounting for a cash flow hedge of a variable-rate loan with an interest rate swap (Example 10.2.10).
- Accounting for a cash flow hedge of a variable-rate debt obligation with an interest rate swap that has a cap and a floor (Example 10.2.20).
- Accounting for a cash flow hedge of a forecasted purchase of inventory with a forward contract (critical terms match – forward value method) (Example 10.2.30).
- Accounting for a cash flow hedge of a variable-rate interest-bearing asset (Subtopic 815-30's Example 6).
- Reporting cash flow hedges in the income statement and AOCI (Subtopic 815-30's Example 12).



Example 10.2.10

Accounting for a cash flow hedge of a variable-rate loan with an interest rate swap

On January 1, Year 1, Bank originates a three-year, \$10,000,000 loan receivable that matures on December 31, Year 3. The interest rate earned on the loan is variable at 12-month LIBOR plus 2%.

Because it is concerned that 12-month LIBOR will decline, Bank simultaneously enters into a three-year interest rate swap with a notional amount of \$10,000,000 to receive interest at a fixed rate equal to 7% and pay interest at a variable rate equal to 12-month LIBOR.

The combination of the swap and the loan receivable results in a net cash inflow of 9%. Both the loan receivable and interest rate swap require payments to be made or received and to reprice on December 31.

Bank designates the swap as a cash flow hedge of the variability in interest payments received on the loan attributable to the changes in the contractually specified interest rate, which is 12-month LIBOR.

The following additional facts are relevant.

- All criteria for cash flow hedge accounting have been met.
- The hedging relationship was highly effective in all periods.
- 12-month LIBOR and related amounts are as follows.

Date	12-month LIBOR on January 1	Swap net receipt for the year ¹	Loan interest for the year ²	Net interest for the year ³
Year 1	7%	\$ -	\$900,000	\$900,000
Year 2	6%	100,000	800,000	900,000
Year 3	5%	200,000	700,000	900,000
Notes:				
1. \$10,000,000 notional amount of the swap × (fixed rate - 12-month LIBOR for the respective Year).				
2. \$10,000,000 principal amount of the loan × 12-month LIBOR + 2% for the respective Year.				
3. Swap net receipt for the year + Loan interest for the year.				

- The fair value of the interest rate swap and changes therein at the end of each accounting period (i.e. December 31) after cash settlement (which is referred to as 'clean' pricing) are as follows.

Date	Fair value asset	Change in fair value gain (loss)
Year 1	\$300,000	\$300,000
Year 2	125,000	(175,000)
Year 3	-	(125,000)

For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
- It is based on annual periods; normally the assessment of effectiveness and related accounting entries would be performed at least quarterly.
- Journal entries (for all years) are presented gross for illustrative purposes but could be combined.
- There has been no change in creditworthiness of either party that would affect the likelihood of hedged transactions occurring.

Journal entries – January 1, Year 1

Bank records the following journal entry on January 1, Year 1.

	Debit	Credit
Loan receivable	10,000,000	
Cash		10,000,000
<i>To record origination of 12-month LIBOR + 2% loan.</i>		

There is also a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship. The financial records of Bank are not otherwise affected as of this date because the interest rate swap had a fair value of zero at inception.

Journal entries – December 31, Year 1

Bank records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash	900,000	
Interest income		900,000
<i>To record interest received on 12-month LIBOR + 2% loan.</i>		
Interest rate swap	300,000	
OCI – Gain (loss) on cash flow hedge		300,000
<i>To record change in fair value of interest rate swap (hedging instrument).</i>		

Journal entries – December 31, Year 2

Bank records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash	800,000	
Interest income		800,000
<i>To record interest received on 12-month LIBOR + 2% loan.</i>		
Cash	100,000	
AOCI – Gain (loss) on cash flow hedge		100,000
<i>To record cash paid on settlement of interest rate swap in AOCI.</i>		
AOCI – Gain (loss) on cash flow hedge	100,000	
Interest income		100,000
<i>To reclassify into earnings amounts in AOCI as a result of cash flow hedge.¹</i>		
OCI – Loss on cash flow hedge	175,000	
Interest rate swap		175,000
<i>To record change in fair value of interest rate swap (hedging instrument).</i>		
Note:		
1. This is the adjustment required to bring interest income on the loan to \$900,000.		

Journal entries – December 31, Year 3

Bank records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cash	700,000	
Interest income		700,000

	Debit	Credit
<i>To record interest received on 12-month LIBOR + 2% loan.</i>		
Cash	200,000	
AOCI – Gain (loss) on cash flow hedge		200,000
<i>To record cash paid on settlement of interest rate swap in AOCI.</i>		
AOCI – Gain (loss) on cash flow hedge	200,000	
Interest income		200,000
<i>To reclassify into earnings amounts in AOCI as a result of cash flow hedge.¹</i>		
OCI – Loss on cash flow hedge	125,000	
Interest rate swap		125,000
<i>To record change in fair value of interest rate swap (hedging instrument).</i>		
Cash	10,000,000	
Loan receivable		10,000,000
<i>To record cash received from borrower on maturity of 12-month LIBOR +2% loan.</i>		
Note:		
1. This is the adjustment required to bring interest income on the loan to \$900,000.		

Financial statement excerpts

At the end of Years 1–3, Bank’s financial statements reflect the following.

Account	Year 1	Year 2	Year 3
Balance sheet – assets			
Loan receivable	\$10,000,000	\$10,000,000	-
Interest rate swap	300,000	125,000	-
Balance sheet – equity			
AOCI – Gain (loss) on cash flow hedge	\$300,000	\$125,000	-
Income statement			
Interest income	\$900,000	\$900,000	\$900,000

As a result of entering into the hedging relationship, Bank locked in a 9% rate for the term of the loan. Because cash flow hedge accounting is used and the hedge is highly effective, earnings do not reflect any volatility that would otherwise result from changes in the interest rate swap’s fair value.

However, Bank’s OCI reflects volatility as a result of the requirement to report the interest rate swap (derivative hedging instrument) at fair value on the balance sheet. This is evidenced by the following roll-forward of AOCI.

	Debit (credit)		
	Year 1	Year 2	Year 3
Opening balance	\$ -	\$300,000	\$125,000
Cash settlement	-	100,000	200,000
Reclassification to earnings	-	(100,000)	(200,000)
Gain (loss) on the swap	300,000	(175,000)	(125,000)
Closing balance	\$300,000	\$125,000	\$ -



Example 10.2.20

Accounting for a cash flow hedge of a variable-rate debt obligation with an interest rate swap that has a cap and a floor

On January 1, Year 1, ABC Corp. issues a three-year, \$10,000,000 debt instrument that matures on December 31, Year 3. The interest rate on the debt instrument is variable at six-month LIBOR.

ABC is concerned that six-month LIBOR will increase above the current level. Therefore, on January 1, Year 1, ABC enters into a three-year interest rate swap with a notional amount of \$10,000,000 to pay interest at a fixed rate equal to 7% and receive interest at a variable rate equal to six-month LIBOR. The terms of the swap indicate that the variable rate to be paid to ABC is capped at 12% and has a floor of 1%.

The debt reprices and requires payments to be made on January 1 of each year. The swap reprices and requires payments to be made or received on January 1 of each year. No premium is paid or received to enter into the interest rate swap.

ABC designates the swap as a cash flow hedge of the variability in interest payments on the debt instrument attributable to the changes in the contractually specified interest rate, which is six-month LIBOR.

The following additional facts are relevant.

- All criteria for cash flow hedge accounting have been met.
- The variable leg of the interest rate swap is capped at 12% and has a floor of 1%, whereas the variable leg of the debt instrument does not contain similar features.
 - Before designating the interest rate swap as the hedging instrument of the changes in cash flows of the interest payments on the debt instrument due to changes in the contractually specified interest rate (six-month LIBOR), ABC determines that the interest rate swap is not a net written option (see section 6.7.60).

Based on statistical analysis, ABC concludes and documents that the hedging relationship is expected to be highly effective at inception and

on an ongoing basis – i.e. the changes in the cash flows on the interest rate swap and the changes in the present value of the expected future cash flows of the forecasted interest payment on the debt are expected to be highly effective in achieving offset. This is taking into account the effect of the interest rate cap and floor on the swap.

That is, at inception and at each assessment period during the hedging relationship, ABC determines that the interest rate cap and floor are expected to be out of the money. Based on a probability-weighted analysis of the range of possible changes in interest rates, the cap and floor are expected to have minimal effect on changes in cash flows of the swap, and the hedging relationship meets the requirement for an expectation of high effectiveness at inception of the hedging relationship. ABC notes that it could have entered into the same interest rate swap on January 1, Year 1 without the cap and floor and without paying or receiving a premium.

- ABC assesses effectiveness using the hypothetical derivative method. The hypothetical swap is a three-year interest rate swap with a notional amount of \$10,000,000 to pay interest at a fixed rate equal to 7% and receive interest at a variable rate equal to six-month LIBOR, whereby the payments are made or received and six-month LIBOR will reprice on January 1 of each year. There is no cap or floor in the hypothetical derivative.
- Six-month LIBOR and related amounts are as follows.

Date	Six-month LIBOR on January 1	Swap net payment for the year ¹	Debt interest for the year ²	Net interest for the year ³
Year 1	7%	\$ -	\$700,000	\$700,000
Year 2	6%	100,000	600,000	700,000
Year 3	5%	200,000	500,000	700,000
Notes:				
1. \$10,000,000 notional amount of the swap × (six-month LIBOR for the respective Year - fixed rate).				
2. \$10,000,000 principal amount of the debt × six-month LIBOR for the respective Year.				
3. Swap net payment for the year + Debt interest for the year.				

- The fair value of the interest rate swap and changes therein at the end of each accounting period (i.e. December 31) after cash settlement (which is referred to as 'clean' pricing) are as follows.

Date	Fair value liability	Change in fair value gain (loss)
Year 1	\$(300,000)	\$(300,000)
Year 2	(125,000)	175,000
Year 3	-	125,000

For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
- It is based on annual periods; normally the assessment of effectiveness and related accounting entries would be done at least quarterly.
- Journal entries (for all years) are presented gross for illustrative purposes but could be combined.

Journal entries – January 1, Year 1

ABC records the following journal entry as of January 1, Year 1.

	<i>Debit</i>	<i>Credit</i>
Cash	10,000,000	
Debt obligation		10,000,000
<i>To record issuance of six-month LIBOR debt obligation.</i>		

There is also a memorandum entry made on January 1, Year 1, documenting the existence of this hedging relationship. ABC's financial records are not otherwise affected as of this date because the interest rate swap had a fair value of zero at inception.

Journal entries – December 31, Year 1

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	700,000	
Cash		700,000
<i>To record interest paid on six-month LIBOR debt obligation.</i>		
OCI – Loss on cash flow hedge	300,000	
Interest rate swap		300,000
<i>To record change in fair value of interest rate swap (hedging instrument).</i>		

Journal entries – December 31, Year 2

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	600,000	
Cash		600,000
<i>To record interest paid on six-month LIBOR debt obligation.</i>		

	<i>Debit</i>	<i>Credit</i>
AOCl – Loss on cash flow hedge	100,000	
Cash		100,000
<i>To record cash paid on settlement of interest rate swap in AOCl.</i>		
Interest expense	100,000	
AOCl – Loss on cash flow hedge		100,000
<i>To reclassify into earnings amounts in AOCl as a result of cash flow hedge.¹</i>		
Interest rate swap	175,000	
OCI – Loss on cash flow hedge		175,000
<i>To record change in fair value of interest rate swap (hedging instrument).</i>		
Note:		
1. This is the adjustment required to bring interest expense on the debt to \$700,000.		

Journal entries – December 31, Year 3

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	500,000	
Cash		500,000
<i>To record interest paid on six-month LIBOR debt obligation.</i>		
AOCl – Loss on cash flow hedge	200,000	
Cash		200,000
<i>To record cash paid on settlement of interest rate swap in AOCl.</i>		
Interest expense	200,000	
AOCl – Loss on cash flow hedge		200,000
<i>To reclassify into earnings amounts in AOCl as a result of cash flow hedge.¹</i>		
Interest rate swap	125,000	
OCI – Loss on cash flow hedge		125,000
<i>To record change in fair value of interest rate swap (hedging instrument).</i>		
Debt obligation	10,000,000	
Cash		10,000,000
<i>To record cash paid by borrower on maturity of the six-month LIBOR debt obligation.</i>		

Note:

1. This is the adjustment required to bring interest expense on the debt to \$700,000.

Financial statement excerpts

At the end of Years 1–3, ABC’s financial statements reflect the following.

Account	Year 1	Year 2	Year 3
Balance sheet – liabilities			
Debt obligation	\$10,000,000	\$10,000,000	-
Interest rate swap	300,000	125,000	-
Balance sheet – equity			
AOCI – Gain (loss) on cash flow hedge	\$(300,000)	\$(125,000)	-
Income statement			
Interest expense	\$700,000	\$700,000	\$700,000

As a result of entering into the hedging relationship, ABC locked in a 7% rate for the term of the debt. Because cash flow hedge accounting is used and the hedge is highly effective, earnings do not reflect any volatility that would otherwise result from changes in the interest rate swap’s fair value.

- This is the case even though the terms of the interest rate swap included a cap and a floor on the interest rate, because neither the cap nor the floor was triggered during the hedging relationship. If the cap or the floor had been triggered in any periods, the interest rate would not have been 7% during those periods.
- The existence of the cap and floor in the interest rate swap – but not in the debt – would cause the relationship to not be perfectly effective. This is because these features would not affect the changes in cash flows of the debt obligation, but would affect the fair value of the interest rate swap.

However, ABC’s OCI reflects volatility as a result of the requirement to report the interest rate swap (derivative hedging instrument) at fair value in the balance sheet. This is evidenced by the following roll-forward of AOCI.

	Debit (credit)		
	Year 1	Year 2	Year 3
Opening balance	\$ -	\$(300,000)	\$(125,000)
Cash settlement	-	(100,000)	(200,000)
Reclassification to earnings	-	100,000	200,000
Gain (loss) on the swap	(300,000)	175,000	125,000
Closing balance	\$(300,000)	\$(125,000)	\$ -



Example 10.2.30

Accounting for a cash flow hedge of a forecasted purchase of inventory with a forward contract (critical terms match – forward value method)

ABC Corp. purchases gold to use in its manufacturing process. On January 1, Year 1, ABC determines that it will not be able to increase its sales prices during the next year and therefore may suffer losses when it sells its product if the price of gold rises.

ABC estimates that it has sufficient gold inventory to meet its manufacturing needs for only the next six months and wants to hedge the forecasted purchase of 10,000 ounces of gold that it expects to purchase on June 30, Year 1. It has a contract with Supplier DEF for which the purchase price is based on the spot price of gold at the date of purchase (a contractually specified component).

To hedge against an increase in the market price of gold, on January 1, Year 1, ABC enters into a forward contract to purchase gold. The forward contract settles in cash for the difference between the price stated in the contract and the spot price of gold on June 30, Year 1. The price stated in the forward contract is \$310 per ounce for 10,000 ounces of gold. The spot price of gold as of January 1, Year 1 is \$300 per ounce.

ABC designates the forward contract as a hedge of variability of cash flows attributable to changes in the spot price of gold (a contractually specified component) for its forecasted purchase of 10,000 ounces of gold on or around June 30, Year 1.

The following additional facts are relevant.

- All criteria for cash flow hedge accounting have been met.
- ABC's contract to purchase gold from Supplier DEF represents a derivative for which the NPNS scope exception is applied.
- ABC will assess hedge effectiveness based on the changes in the forward price of gold.
- Given that the critical terms of the forward contract and the forecasted purchase are the same, ABC concludes at inception and documents that the hedging relationship is expected to be highly effective (in this example, 100% effective) in achieving offsetting cash flows attributable to changes in the forward price of gold.

On an ongoing basis, ABC will ascertain and document that the critical terms of the forward contract and the forecasted purchases have not changed, including that there have been no adverse developments concerning the risk of default by the counterparty to the forward contract or its own nonperformance risk; therefore, not causing a different conclusion about hedge effectiveness.

- Because the hedge is expected to be 100% effective, it is assumed that the cumulative gains or losses on the forward contract will equal the cumulative change in expected future cash flows on the forecasted purchase of gold.

- The forward contract is at market rates; therefore, no cash is exchanged at inception of the contract.
- The spot and forward prices per ounce of gold and the fair value of the forward contract are as follows.

Date	Spot price (per ounce)	Forward price (per ounce)	Change in expected future cash flows ¹	Fair value asset (liability) ²	Change in fair value gain (loss)
Jan 1, Year 1	\$300	\$310	\$ -	\$ -	\$ -
Mar 31, Year 1	310	315	50,000	49,008	49,008
Jun 30, Year 1	330	N/A	200,000	200,000	150,992
Notes:					
1. 10,000 ounce notional of the forward contract × (forward price for the respective date - forward price at January 1, Year 1). The forward price at June 30, Year 1 is equal to the spot price because it is the settlement date.					
2. Present value of the change in expected future cash flows discounted at the risk-free rate.					

For simplicity, this example ignores the effect of commissions and other transaction costs, initial margins and income taxes.

Journal entries – January 1, Year 1

There is a memorandum entry made on January 1, Year 1, documenting the existence of this hedging relationship. ABC's financial records are not otherwise affected as of this date because the forward contract had a fair value of zero at inception.

Journal entries – March 31, Year 1

ABC records the following journal entry.

	Debit	Credit
Forward contract	49,008	
OCI – Gain on forward contract		49,008
<i>To recognize in OCI change in fair value of forward contract attributable to changes in forward price of gold.</i>		

Journal entries – June 30, Year 1

ABC records the following journal entries.

	Debit	Credit
Forward contract	150,992	
OCI – Gain on forward contract		150,992

	Debit	Credit
<i>To recognize in OCI change in fair value of forward contract attributable to changes in forward price of gold.</i>		
Cash	200,000	
Forward contract		200,000
<i>To record cash received on settlement of forward contract.</i>		
Gold inventory	3,300,000	
Cash		3,300,000
<i>To record purchase of 10,000 ounces of gold on June 30, Year 1 at market price of \$330 per ounce.</i>		

Financial statement excerpts

At the end of March 31 and June 30, Year 1, ABC's financial statements reflect the following.

Account	March 31	June 30
Balance sheet – assets		
Gold inventory	\$ -	\$3,300,000
Forward contract	49,008	-
Balance sheet – equity		
AOCI – Gain (loss) on forward contract	\$49,008	\$200,000
Income statement		
Cost of goods sold	-	-

ABC was concerned that gold prices would increase between January 1 and June 30, Year 1 (the date of the forecasted purchase of the gold). Using a forward contract as a hedging instrument ensured that the cost of its gold inventory was not subject to fluctuations in the price of gold.

The \$200,000 gain on the forward contract will remain in AOCI until the gold inventory whose purchase was hedged is sold, at which point the gain will be credited to the cost of the gold sold. Therefore, the cost of goods sold related to the sale of the hedged forecasted purchase of gold inventory will be reported in earnings at \$3,100,000.



Excerpt from ASC 815-30

20 Glossary

Zero-Coupon Method – A swap valuation method that involves computing and summing the present value of each future net settlement that would be required by the contract terms if future spot interest rates match the forward rates implied by the current yield curve. The discount rates used are the spot interest rates implied by the current yield curve for hypothetical zero coupon bonds due on the date of each future net settlement on the swap.

>> Example 6: Cash Flow Hedge of Variable-Rate Interest-Bearing Asset

55-24 This Example demonstrates the mechanics of accounting for an interest rate swap used as a cash flow hedge of variable interest receipts in accordance with the guidance in Subtopic 815-20 and this Subtopic. It is not intended to demonstrate how to compute the fair value of an interest rate swap. As in Example 8 (see paragraph 815-25-55-40), the **zero-coupon method** is used to determine the fair values. (Unlike in that Example, the yield curve in this Example is assumed to be upward sloping, that is, interest rates are higher for payments due further into the future.) In this Example, the term, notional amount, and repricing date of the interest rate swap match the term, repricing date, and principal amount of the interest-bearing asset on which the hedged interest receipts are due. The swap terms are at the market (as described in paragraphs 815-20-25-104, 815-20-25-106, and 815-20-25-109), so it has a zero value at inception. Thus, the reporting entity is permitted to assume that the hedging relationship will achieve perfect offset in the variability of cash flows of the hedged item.

55-25 As discussed beginning in paragraph 815-20-25-102, a shortcut method can be used to produce the same reporting results as the method illustrated in this Example. This shortcut is appropriate only if the assumption of perfect offset applies for an interest rate swap used as a cash flow hedge of interest receipts on a variable-rate asset (or interest payments on a variable-rate liability). The steps in the shortcut method are as follows:

- a. Determine the difference between the variable rate to be paid on the interest rate swap and the variable rate to be received on the bond.
- b. Combine that difference with the fixed rate to be received on the interest rate swap.
- c. Compute and recognize interest income using that combined rate and the variable-rate asset's principal amount. (Amortization of any purchase premium or discount on the asset must also be considered, although that complication is not incorporated in this Example.)
- d. Determine the fair value of the interest rate swap.
- e. Adjust the carrying amount of the interest rate swap to its fair value and adjust other comprehensive income by an offsetting amount.

A slightly different shortcut method for interest rate swaps used as **fair value hedges** is illustrated in Example 8 (see paragraph 815-25-55-40)

55-26 For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-27 On July 1, 20X1, Entity XYZ invests \$10,000,000 in variable-rate corporate bonds that pay interest quarterly at a rate equal to the 3-month USD LIBOR rate plus 2.25 percent. The \$10,000,000 principal will be repaid on June 30, 20X3.

55-28 Also on July 1, 20X1, Entity XYZ enters into a two-year receive-fixed, pay-variable interest rate swap and designates it as hedging instrument in a cash flow hedge of the variable-rate interest receipts on the corporate bonds. The risk designated as being hedged is the risk of variability in cash flows received attributable to changes in the contractually specified interest rate. The terms of the interest rate swap and the corporate bonds are shown in the following table.

	Interest Rate Swap	Corporate Bonds
Trade date and borrowing date ^(a)	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 ^(b)	3-month USD LIBOR	3-month USD LIBOR + 2.25%
Settlement dates and interest payment dates ^(a)	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

(a) These terms need not match for the assumption of perfect offset to be appropriate. (See paragraphs 815-20-25-102 through 25-110.)

(b) Only the interest rate basis (for example, LIBOR) must match. The spread over LIBOR does not invalidate the assumption of perfect offset.

55-29 Because the conditions described in paragraphs 815-20-25-104 and 815-20-25-106 are met, Entity XYZ is permitted to assume that there is perfect offset in the hedging relationship and to recognize in other comprehensive income the entire change in the fair value of the interest rate swap.

55-30 The three-month USD LIBOR rates in effect at the inception of the hedging relationship and at each of the quarterly reset dates are assumed to be as follows.

Reset Date	3-Month LIBOR Rate
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%

55-31 Entity XYZ must reclassify to earnings the amount in accumulated other comprehensive income as each interest receipt affects earnings. In determining the amounts to reclassify each quarter, it is important to recognize that the interest rate swap does not hedge the bonds. Instead, it hedges the eight variable interest payments to be received. That is, each of the eight quarterly settlements on the swap is associated with an interest payment to be received on the bonds. Under the zero-coupon method discussed in paragraph 815-30-55-24, the present value of each quarterly settlement is computed separately. Because each payment occurs at a different point on the yield curve, a different interest rate must be used to determine its present value. As each individual interest receipt on the bonds is recognized in earnings, the fair value of the related quarterly settlement on the swap is reclassified to earnings. The fair values and changes in fair values of the interest rate swap and the effects on earnings and other comprehensive income for each quarter are as follows.

	Swap Debit (Credit)	Other Comprehensive Income Debit (Credit)	Earnings Debit (Credit)	Cash Debit (Credit)
July 1, 20X1	\$ -			
Interest accrued	-			
Payment (receipt)	(27,250)			\$ 27,250
Effect of change in rates	52,100	\$ (52,100)		
Reclassification to earnings		27,250	\$ (27,250)	
September 30, 20X1	24,850	(24,850)	\$ (27,250)	\$ 27,250
Interest accrued	330	(330)		
Payment (receipt)	(25,500)			\$ 25,500
Effect of change in rates	74,120	(74,120)		
Reclassification to earnings		25,500	\$ (25,500)	
December 31, 20X1	73,800	(73,800)	\$ (25,500)	\$ 25,500
Interest accrued	1,210	(1,210)		
Payment (receipt)	(27,250)			\$ 27,250
Effect of change in rates	38,150	(38,150)		
Reclassification to earnings		27,250	\$ (27,250)	
March 31, 20X2	85,910	(85,910)	\$ (27,250)	\$ 27,250
Interest accrued	1,380	(1,380)		
Payment (receipt)	(29,500)			\$ 29,500
Effect of change in rates	(100,610)	100,610		
Reclassification to earnings		29,500	\$ (29,500)	

	Swap Debit (Credit)	Other Comprehensive Income Debit (Credit)	Earnings Debit (Credit)	Cash Debit (Credit)
June 30, 20X2	(42,820)	42,820	\$ (29,500)	\$ 29,500
Interest accrued	(870)	870		
Payment (receipt)	2,500			\$ (2,500)
Effect of change in rates	8,030	(8,030)		
Reclassification to earnings		(2,500)	\$ 2,500	
September 30, 20X2	(33,160)	33,160	\$ 2,500	\$ (2,500)
Interest accrued	(670)	670		
Payment (receipt)	5,250			\$ (5,250)
Effect of change in rates	6,730	(6,730)		
Reclassification to earnings		(5,250)	\$ 5,250	
December 31, 20X2	(21,850)	21,850	\$ 5,250	\$ (5,250)
Interest accrued	(440)	440		
Payment (receipt)	8,000			\$ (8,000)
Effect of change in rates	16,250	(16,250)		
Reclassification to earnings		(8,000)	\$ 8,000	
March 31, 20X3	1,960	(1,960)	\$ 8,000	\$ (8,000)
Interest accrued	40	(40)		
Payment (receipt)	(2,000)			\$ 2,000
Reclassification to earnings		2,000	\$ (2,000)	
June 30, 20X3	\$ -	\$ -	\$ (2,000)	\$ 2,000

55-32 The preceding table shows that, in each quarter, the net cash receipt or payment on the swap equals the income or expense to be recorded. The net effect on earnings of the interest on the bonds and the reclassification of gains or losses on the interest rate swap are presented in the same income statement line item as the earnings effect of the hedged item. The net earnings effect is shown in the following table.

For the Quarter Ending	Earnings		
	Interest on Bonds	Gains (Losses) Reclassified from Other Comprehensive Income	Net Effect
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	220,500	2,000	222,500
Totals	\$ 1,684,250	\$ 95,750	\$ 1,780,000

55-33 In this Example, the shortcut method described in paragraph 815-30-55-25 works as follows. The difference between the variable rate on the interest rate swap and the variable rate on the asset is a net receipt of 2.25 percent. That rate combined with the 6.65 percent fixed rate received on the interest rate swap is 8.9 percent. The computed interest income is \$890,000 per year

or \$222,500 per quarter, which is the same as the amount in the table in the preceding paragraph.



Excerpt from ASC 815-30

>> Example 12: Reporting Cash Flow Hedges in Comprehensive Income and Accumulated Other Comprehensive Income

55-77 This Example illustrates application of the guidance in this Subtopic to reporting cash flow hedges in **comprehensive income** and accumulated other comprehensive income. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-78 Entity TUV's cash flow hedge transactions through the end of 20X4 include all of the following:

- a. It continually purchases pork belly futures contracts to hedge its anticipated purchases of pork belly inventory.
- b. In 20X2, it entered into a Euro (EUR) forward exchange contract to hedge the foreign currency risk associated with the expected purchase of a pork belly processing machine with a five-year life that it bought from a vendor in Germany at the end of 20X2.
- c. In 20X2, it entered into a 10-year interest rate swap concurrent with the issuance of 10-year variable rate debt (cash flow hedge of future variable interest payments).
- d. In January 20X4, it entered into a two-year Swiss franc (CHF) forward exchange contract to hedge a forecasted export sale (denominated in CHF, expected to occur in December 20X5) of hot dogs to a large customer in Switzerland. In June 20X4, it closed the forward contract, but the forecasted transaction is still expected to occur.

55-79 The following table reconciles the beginning and ending accumulated other comprehensive income balances for 20X4. It supports the comprehensive income display and disclosures that are required under Topic 220. It is assumed that there are no other amounts in accumulated other comprehensive income. The after-tax amounts assume a 30 percent effective tax rate.

	Other Comprehensive Income—Debit (Credit)			
	Accumulated Other Comprehensive Income as of 1/1/X4	Changes in Fair Value Recognized in 20X4	Reclassification Adjustments	Accumulated Other Comprehensive Income as of 12/31/X4
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	-	(50)	-	(50)
Before-tax totals	\$ 310	\$ 45	\$ (295)	\$ 60
After-tax totals	\$ 217	\$ 32	\$ (207)	\$ 42

55-80 The following tables illustrate an acceptable method, under the provisions of Topic 220, of reporting the transactions described by this Example in earnings, comprehensive income, and shareholders' equity.

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

	Debit (Credit)
Effect on earnings before taxes:	
Cost of goods sold	\$ 270
Depreciation	30
Interest	(5)
Total	295
Income tax effect	(88) ^(a)
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	(175)
Effect on total comprehensive income	\$ 32

(a) This Example assumes that it is appropriate under the circumstances, in accordance with Topic 740, to recognize the related income tax benefit in the current year.

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

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

10.2.20 Excluded components



Excerpt from ASC 815-30

> Subsequent Recognition and Measurement of Gains and Losses on Hedging Instrument

35-3 When the relationship between the hedged item and hedging instrument is highly effective at achieving offsetting changes in cash flows attributable to the hedged risk, an entity shall record in **other comprehensive income** the entire change in the fair value of the designated hedging instrument that is included in the assessment of hedge effectiveness. More specifically, a qualifying **cash flow hedge** shall be accounted for as follows:

- a. An entity's defined risk management strategy for a particular hedging relationship may exclude a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in paragraphs 815-20-25-81 through 25-83B). That excluded component of the gain or loss shall be recognized in earnings either through an amortization approach in accordance with paragraph 815-20-25-83A or through a mark-to-market approach in accordance with paragraph 815-20-25-83B. Under either approach, the amount recognized in earnings for an excluded component shall be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A. For example, if the effectiveness of a hedging relationship with an option is assessed based on changes in the option's **intrinsic value**, the changes in the option's **time value** would be excluded from the assessment of hedge effectiveness and either may be recognized in earnings through an amortization approach in accordance with paragraph 815-20-25-83A or currently in earnings in accordance with paragraph 815-20-25-83B. ...

>> Amounts Excluded from the Assessment of Effectiveness under an Amortization Approach

40-6A When applying the guidance in paragraph 815-20-25-83A, if the hedged forecasted transaction is probable of not occurring, any amounts remaining in accumulated other comprehensive income related to amounts excluded from the assessment of effectiveness shall be recorded in earnings in the current period. For all other discontinued cash flow hedges, any amounts associated with the excluded component remaining in accumulated other comprehensive income shall be recorded in earnings when the hedged forecasted transaction affects earnings.

If an entity has excluded components of the **hedging instrument** from its assessment of **hedge effectiveness**, it recognizes the initial value of the excluded components in earnings using either an amortization approach or a mark-to-market approach. [815-20-25-83A – 25-83B]

- **Amortization approach.** The initial value of the excluded component is amortized into earnings using a systematic and rational method over the life of the hedging instrument. The difference between the amortized amount and the change in the excluded component's fair value is recognized in OCI for the period.
- **Mark-to-market approach.** The entire change in fair value of the excluded component is immediately recognized in earnings.

Under both methods, any amount recognized in earnings is presented in the same income statement line item that is used to present the earnings effect of the hedged transaction. [815-20-45-1A(b)]

Any amounts associated with the excluded component remaining in AOCI when a cash flow hedge is discontinued are recognized in earnings when the hedged forecasted transaction affects earnings. However, these amounts are immediately recognized in earnings if it is probable that the forecasted transaction will *not* occur within the originally specified period or within a two-month period thereafter. See also section 10.5. [815-30-40-6A]

Examples

The following examples demonstrate cash flow accounting for excluded components.

- Accounting for a derivative instrument's gain or loss in a cash flow hedge – effectiveness based on changes in intrinsic value (Subtopic 815-30's Example 10).
- Comparison of approaches to recognize the excluded component for a cash flow hedge (Example 10.2.40).
- Accounting for a cash flow hedge of forecasted purchase of inventory with a call option (critical terms do *not* match – intrinsic value method) (Example 10.2.50).



Excerpt from ASC 815-30

>> Example 10: Accounting for a Derivative Instrument's Gain or Loss in a Cash Flow Hedge—Effectiveness Based on Changes in Intrinsic Value

55-63 This Example illustrates application of the accounting guidance for cash flow hedges described in paragraph 815-30-35-3. At the beginning of Period 1, Entity XYZ purchases for \$9.25 an at-the-money call option on 1 unit of Commodity X with a strike price of \$125.00 to hedge a forecasted purchase of 1 unit of that commodity projected to occur early in Period 5. Entity XYZ's documented policy is to assess hedge effectiveness by comparing changes in expected cash flows on the hedged transaction (based on changes in the Commodity X spot price) with changes in the option contract's intrinsic value. Because the hedging instrument is a purchased call option, its intrinsic value cannot be less than zero. If the price of the commodity is less than the option's

strike price, the option is out-of-the-money. Its intrinsic value cannot decrease further regardless of how far the commodity price falls, and the intrinsic value will not increase until the commodity price increases to exceed the strike price. Thus, changes in cash flows from the option due to changes in its intrinsic value will offset changes in cash flows on the forecasted purchase only when the option is in the money or at the money. That phenomenon is demonstrated in Period 3 in the following table when the commodity price declines by \$1.25. Because the commodity price is \$.75 below the option's strike price, the option's intrinsic value declines by only \$.50 (to zero). The effect reverses in Period 4 when the commodity index price increases by \$6.50 and the option's intrinsic value increases by \$5.75. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

	Period 1	Period 2	Period 3	Period 4
Assumptions				
Ending market price of Commodity X	\$ 127.25	\$ 125.50	\$ 124.25	\$ 130.75
Ending fair value of option:				
Time value	\$ 7.50	\$ 5.50	\$ 3.00	\$ -
Intrinsic value	2.25	0.50	-	5.75
Total	\$ 9.75	\$ 6.00	\$ 3.00	\$ 5.75
Change in time value	\$ (1.75)	\$ (2.00)	\$ (2.50)	\$ (3.00)
Change in intrinsic value	2.25	(1.75)	(0.50)	5.75
Total current-period gain (loss) on derivative	\$ 0.50	\$ (3.75)	\$ (3.00)	\$ 2.75
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	-	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)

55-64 The following are the entries required to account for the cash flow hedge. Note that consistent with paragraph 815-20-35-1(c), the change in fair value of the hedging instrument that is included in the assessment of hedge effectiveness is recorded in other comprehensive income for qualifying hedging relationships. For this type of hedging relationship, Entity XYZ elects to record changes in the option's time value excluded from the assessment of hedge effectiveness currently in earnings in accordance with paragraph 815-20-25-83B. Amounts recorded in earnings should be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

Period	Description	Debit (Credit)		
		Derivative	Earnings	Other Comprehensive Income
1	Adjust derivative to fair value and other comprehensive income by the calculated amount	\$ 0.50	\$ 1.75	\$ (2.25)
2	Adjust derivative to fair value and other comprehensive income by the calculated amount	(3.75)	2.00	1.75
3	Adjust derivative to fair value and other comprehensive income by the calculated amount	(3.00)	2.50	0.50
4	Adjust derivative to fair value and other comprehensive income by the calculated amount	2.75	3.00	(5.75)

55-65 Paragraph superseded by Accounting Standards Update No. 2017-12

55-66 The amount reflected in earnings relates to the component excluded from the effectiveness test, that is, the time value component. The change in cash flows from the hedged transaction was not fully offset in Period 3. However, as described in paragraph 815-20-25-76, a purchased call option is considered effective if it provides one-sided offset.



Example 10.2.40

Comparison of approaches to recognize the excluded component for a cash flow hedge

In Subtopic 815-30's Example 10, Entity XYZ elects to use the mark-to-market method to account for the excluded component (in this case, the hedging instrument's time value). This example shows the effect on earnings if Entity XYZ had elected to recognize the change in the excluded component using the straight-line method (an example of an amortization approach).

Assumptions	Period 1	Period 2	Period 3	Period 4
Fair value of the option (end of period):				
Time value	\$7.50	\$5.50	\$3.00	\$ -
Intrinsic value	2.25	0.50	-	5.75
Total	\$9.75	\$6.00	\$3.00	\$5.75
Change in time value	(1.75)	(2.00)	(2.50)	(3.00)
Change in intrinsic value	2.25	(1.75)	(0.50)	5.75
Total current-period gain (loss) on derivative	\$0.50	\$(3.75)	\$(3.00)	\$2.75

Assumptions	Period 1	Period 2	Period 3	Period 4
Amortization of initial time value ¹	\$(2.31)	\$(2.31)	\$(2.31)	\$(2.32)
Difference between change in fair value of excluded component (time value) and its amortization	\$0.56	\$0.31	\$(0.19)	\$(0.68)
Total change in time value	\$(1.75)	\$(2.00)	\$(2.50)	\$(3.00)
Note: 1. Initial time value of the option \$(9.25) ÷ 4 periods.				

The following are the journal entries required to adjust the derivative to fair value and OCI by its calculated amount.

Period	(Debit) credit		
	Derivative ¹	Earnings ²	Other comprehensive income (loss) ³
1	\$(0.50)	\$(2.31)	\$2.81
2	3.75	(2.31)	(1.44)
3	3.00	(2.31)	(0.69)
4	(2.75)	(2.32)	5.07
Notes: 1. The total current-period gain (loss) on derivative. 2. The straight-line amortization of the option's initial time value. 3. The difference between the total current-period gain (loss) on derivative less the straight-line amortization of the option's initial time value. It represents the intrinsic value of the option plus the difference between the change in the fair value of the excluded component (time value) and its amortization.			

The following table compares the earnings effect of the excluded component under the two methods:

- amortization approach (KPMG example); and
- mark-to-market approach (FASB example).

Approach	Period 1	Period 2	Period 3	Period 4	Total
Amortization	\$2.31	\$2.31	\$2.31	\$2.32	\$9.25
Mark-to-market	1.75	2.00	2.50	3.00	9.25
Difference	\$0.56	\$0.31	\$(0.19)	\$(0.68)	\$ -



Example 10.2.50

Accounting for a cash flow hedge of forecasted purchase of inventory with a call option (critical terms do *not* match – intrinsic value method)

ABC Corp. expects to purchase 10,000 units of Commodity B on December 31, Year 1. ABC is concerned that the market price of Commodity B will increase in the interim, but wants to retain the ability to benefit if the market price falls.

On January 1, Year 1, ABC purchases for \$10,000 an at-the-money call option with Commodity A as the underlying. ABC purchased the call option on Commodity A because it is more economical than purchasing a call option on Commodity B. The call option is settled in net cash and enables ABC to purchase 10,000 units of Commodity A at a strike price of \$10.00 per unit on December 31, Year 1.

ABC designates the purchased call option as a cash flow hedge of the market price risk attributable to its forecasted purchase of 10,000 units of Commodity B, which is expected to occur on December 31, Year 1.

The following additional facts are relevant.

- All criteria for cash flow hedge accounting have been met.
- Based on statistical analysis, ABC concluded and documented that the hedging relationship is expected to be highly effective at inception and on an ongoing basis – i.e. the changes in the spot rates of Commodity A are highly effective at offsetting the changes in the cash flows of the purchase price (at spot) of Commodity B.
 - ABC will exclude changes in the time value of the option from the assessment of the hedge's effectiveness. ABC has elected to recognize changes in the fair value of the excluded component (i.e. time value) using the mark-to-market method (i.e. currently in earnings).
 - ABC assesses effectiveness of the hedging relationship using the hypothetical derivative method and considers only the changes in the intrinsic value of that hypothetical derivative.

The hypothetical derivative is an at-the-money call option with Commodity B as the underlying. The hypothetical derivative is settled in net cash and enables ABC to purchase 10,000 units of Commodity B at a strike price of \$15.00 per unit on December 31, Year 1.

The difference between the strike price in the hypothetical derivative and the actual derivative results from the different underlyings – i.e. there is a basis difference between the hypothetical and actual derivatives because the underlying of the forecasted purchase is Commodity B and the underlying of the purchased call option is Commodity A.

- The spot price, fair value, intrinsic value, time value and change in time value of the call option related to Commodity A (i.e. the *actual* derivative) are as follows.

	Jan 1, Year 1	Mar 31, Year 1	Jun 30, Year 1	Sep 30, Year 1	Dec 31, Year 1
Spot price	\$10.00	\$10.10	\$12.10	\$12.30	\$14.80
Fair value before settlement:					
Intrinsic value ¹	\$ -	\$1,000	\$21,000	\$23,000	\$48,000
Time value ²	10,000	8,000	5,000	1,000	-
Total fair value before settlement	\$10,000	\$9,000	\$26,000	\$24,000	\$48,000
Change in intrinsic value		1,000	20,000	2,000	25,000
Change in time value		(2,000)	(3,000)	(4,000)	(1,000)
Total change in fair value before settlement		\$(1,000)	\$17,000	\$(2,000)	\$24,000
Settlement	-	-	-	-	48,000
Fair value after settlement	\$10,000	\$9,000	\$26,000	\$24,000	\$ -
Note:					
1. ABC measures intrinsic value as the difference between the strike price and the spot price of the underlying asset (see Question 13.2.240).					
2. Total fair value before settlement - Intrinsic value (see Question 13.2.230).					

- The spot prices of Commodity B (i.e. spot price for the *hypothetical* derivative) are \$15.00 as of January 1, Year 1 and \$19.78 as of December 31, Year 1. Settlement for the hypothetical derivative would have been \$47,800.
- Because the hedging relationship was highly effective in all periods, the financial statements will reflect the following.
 - The fair value of the *actual* call option will be recorded on the balance sheet.
 - Changes in the time value of the *actual* call option will be recorded in cost of goods sold (earnings) because ABC elected the mark-to-market approach for the excluded component.
 - AOCI will be adjusted to a balance that represents the cumulative change in the intrinsic value of the *actual* call option.

For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
- Journal entries (for all years) are presented gross for illustrative purposes but could be combined.

Journal entries – January 1, Year 1

ABC records the following journal entry on January 1, Year 1.

	Debit	Credit
Purchased call option	10,000	
Cash		10,000

To record purchase of call option on Commodity A.

There is also a memorandum entry made on January 1, Year 1, documenting the existence of this hedging relationship.

Journal entries – March 31, Year 1

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cost of goods sold ¹	2,000	
Purchased call option		1,000
OCI – Gain on purchased call option ²		1,000
<i>To record change in fair value of purchased call option on Commodity A (hedging instrument).</i>		
Notes:		
1. Represents the change in value of the excluded component (time value), which is recognized using the mark-to-market method (i.e. currently in earnings).		
2. Represents the change in the intrinsic value of the derivative hedging instrument.		

Journal entries – June 30, Year 1

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cost of goods sold ¹	3,000	
Purchased call option	17,000	
OCI – Gain on purchased call option ²		20,000
<i>To record change in fair value of purchased call option on Commodity A (hedging instrument).</i>		
Notes:		
1. Represents the change in value of the excluded component (time value), which is recognized using the mark-to-market method (i.e. currently in earnings).		
2. Represents the change in the intrinsic value of the derivative hedging instrument.		

Journal entries – September 30, Year 1

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Cost of goods sold ¹	4,000	
Purchased call option		2,000
OCI – Gain on purchased call option ²		2,000
<i>To record change in fair value of purchased call option on Commodity A (hedging instrument).</i>		

Notes:

1. Represents the change in value of the excluded component (time value), which is recognized using the mark-to-market method (i.e. currently in earnings).
2. Represents the change in the intrinsic value of the derivative hedging instrument.

Journal entries – December 31, Year 1

ABC records the following journal entries.

	Debit	Credit
Cost of goods sold ¹	1,000	
Purchased call option	24,000	
OCI – Gain on purchased call option ²		25,000
<i>To record change in fair value of purchased call option on Commodity A (hedging instrument).</i>		
Cash	48,000	
Purchased call option		48,000
<i>To record settlement of purchased call option on Commodity A (hedging instrument).</i>		
Inventory – Commodity B ³	197,800	
Cash		197,800
<i>To record purchase of Commodity B at market rates.</i>		

Notes:

1. Represents the change in value of the excluded component (time value), which is recognized using the mark-to-market method (i.e. currently in earnings).
2. Represents the change in the intrinsic value of the derivative hedging instrument before settlement.
3. 10,000 units of Commodity B × \$19.78 per unit.

Financial statement excerpts

At the end of each quarter during Year 1, ABC's financial statements reflect the following.

Account	3 months ended Mar 31	6 months ended Jun 30	9 months ended Sep 30	Year ended Dec 31
Balance sheet – assets				
Inventory - Commodity B	\$ -	\$ -	\$ -	\$197,800
Purchased call option	9,000	26,000	24,000	-
Balance sheet – equity				
AOCI – Gain (loss) on purchased call option	\$1,000	\$21,000	\$23,000	\$48,000

Account	3 months ended Mar 31	6 months ended Jun 30	9 months ended Sep 30	Year ended Dec 31
Income statement				
Cost of goods sold	\$2,000	\$5,000	\$9,000	\$10,000

The effect of the hedge during the hedging relationship on the income statement is a \$10,000 increase to cost of goods sold. This represents the time value of the purchased call option, which was excluded from the assessment of effectiveness (with changes recognized using the mark-to-market approach – i.e. currently in earnings).

Changes in the value of the excluded component (time value) are recognized using the mark-to-market approach (i.e. when they occur). Because the hedged transaction (the purchase of inventory) does not affect earnings until the inventory is sold, this results in the changes in time value affecting cost of goods sold (earnings) before the hedged transaction affects earnings.

The \$48,000 gain on the call option remains in AOCI until the hedged Commodity B inventory is sold. At that point, the \$48,000 is reclassified into earnings, reducing the inventory's cost of goods sold. Therefore, the cost of goods sold related to the sale of the hedged forecasted purchase of Commodity B will be reported in earnings as \$149,800 (\$197,800 purchase price - \$48,000 gain on call option).

ABC was concerned that Commodity B prices would increase between January 1 and December 31, Year 1 (the date of the forecasted purchase of 10,000 units of Commodity B). Using a purchased call option as a hedging instrument reduced the effect of increased prices during the hedging relationship. However, because the purchased call option was tied to price changes of Commodity A – rather than Commodity B – the relationship was not perfectly effective.

Had the relationship been perfectly effective:

- the amount recognized in AOCI as of December 31, Year 1 would have been \$47,800; and
- the cost of goods sold related to the sale of Commodity B would have been \$150,000 (10,000 units of Commodity B at the \$15.00 spot price of Commodity B at inception of the hedging relationship).

The extent to which the relationship was not perfectly effective (\$200) is recognized when the hedged forecasted transaction is reported in earnings.

10.3 Reclassifying amounts from AOCI into earnings

10.3.10 Overview



Excerpt from ASC 815-30

> Reclassifications from Accumulated Other Comprehensive Income into Earnings

35-38 Amounts in accumulated other comprehensive income that are included in the assessment of effectiveness shall be reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings (for example, when a forecasted sale actually occurs) and shall be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A. If an entity excludes a component of a hedging instrument from the assessment of effectiveness, an entity shall apply the guidance in paragraphs 815-20-25-83A through 25-83B.

35-39 If the hedged transaction results in the acquisition of an asset or the incurrence of a liability, the gains and losses in accumulated other comprehensive income that are included in the assessment of effectiveness shall be reclassified into earnings in the same period or periods during which the asset acquired or liability incurred affects earnings (such as in the periods that depreciation expense, interest expense, or cost of sales is recognized).

35-40 However, if an entity expects at any time that continued reporting of a loss in accumulated other comprehensive income would lead to recognizing a net loss on the combination of the hedging instrument and the hedged transaction (and related asset acquired or liability incurred) in one or more future periods, a loss shall be reclassified immediately into earnings for the amount that is not expected to be recovered..

35-41 For example, a loss shall be reported in earnings for a derivative instrument that is designated as hedging the forecasted purchase of inventory to the extent that the cost basis of the inventory plus the related amount reported in accumulated other comprehensive income exceeds the amount expected to be recovered through sales of that inventory. (Impairment guidance is provided in paragraphs 815-30-35-42 through 35-43.)

>> Gains or Losses from Cash Flow Hedges of Debt That Is Extinguished

35-44 If the reclassification to earnings of the amount in accumulated comprehensive income resulting from a cash flow hedge of debt is required under this Subsection when that debt is extinguished, the amount reclassified from accumulated comprehensive income to earnings shall be excluded from extinguishment gain or loss.

> Hedging Relationship's Timing Involves Uncertainty within a Range

35-46 For forecasted transactions whose timing involves some uncertainty within a range, paragraph 815-20-25-16(c) states that, as long as it remains probable that the forecasted transaction will occur by the end of the originally

specified time period, cash flow hedge accounting for that hedging relationship shall continue.

Net derivative gains or losses reported in AOCI that are included in the assessment of effectiveness are reclassified into earnings in the same period(s) that the forecasted hedged transaction is reported in earnings. [815-30-35-38 – 35-39]

However, if an entity expects that continued reporting of a net derivative loss in AOCI would lead to recognizing a net loss on the combination of the hedging instrument and hedged transaction (and related asset acquired or liability incurred) in future periods, the loss is immediately reclassified into earnings (see Question 10.3.30 and Example 10.3.20). For additional discussion of assessing impairment, see section 10.4. [815-30-35-40 – 35-41]

When amounts are reclassified into earnings from AOCI, they are presented in the same income statement line item as the effect of the hedged transaction. If the event causing reclassification is extinguishment of debt, the amount reclassified from AOCI into earnings is not included in the extinguishment gain or loss. See also Question 14.3.30. [815-20-45-1A(a), 815-30-35-3, 35-38, 35-44]



Question 10.3.10

What method is used to reclassify amounts in AOCI into earnings?

Interpretive response: Topic 815 does not specifically address the method for reclassifying amounts in AOCI into earnings. We believe the method should be consistent with the accounting policy used for recognizing income or expense on the hedged transaction. [815-30-35-38 – 35-39]

The following table illustrates reclassifications into earnings of amounts from AOCI that are included in the assessment of effectiveness, including the timing and method for recognition in earnings. [815-30-35-38 – 35-39]

Hedged transaction	Reclassification from AOCI
Forecasted acquisition of a depreciable asset	The related amount in AOCI continues to be reported in AOCI after the acquisition of the asset. It is reclassified into earnings (as depreciation expense) in the same periods that the entity recognizes depreciation expense on the acquired asset (e.g. straight line over the asset's estimated useful life).
Forecasted purchase of inventory	The related amount in AOCI is reclassified into earnings in the period that the sale of the inventory whose purchase was hedged is recognized. This includes consideration of the method used to account for the inventory (e.g. FIFO, LIFO, weighted-average cost).

Hedged transaction	Reclassification from AOCI
Forecasted interest receipt or payment on a financial asset or liability	The related amounts in AOCI are reclassified into earnings when interest is accrued on the hedged transaction.



Example 10.3.10 Accounting for an all-in-one hedge of a forecasted equipment purchase

On September 1, Year 1, ABC Corp. forecasts that it will purchase equipment on January 1, Year 2. The equipment's current price is \$100,000.

ABC is concerned that the price of the equipment will rise in the next three months and enters into a forward purchase contract with Retailer to buy the equipment for \$102,000 (the at-market price for the equipment to be purchased in three months). The forward purchase contract is binding on both ABC and Retailer, specifies all significant terms, and includes a disincentive for nonperformance that is sufficiently large to make performance probable. Therefore, it meets the definition of a firm commitment.

Although ABC expects to settle the contract gross, the forward purchase contract includes a clause that requires net settlement under its default provisions. Retailer does not own the equipment. Therefore, it also meets the definition of a derivative instrument.

ABC designates the forward purchase contract as a hedge of the variability in cash flows attributable to price risk associated with the forecasted purchase of equipment.

The following additional facts are relevant.

- All cash flow hedging criteria are met.
- The equipment's price as of December 31, Year 1 is \$110,000.
- The equipment has an estimated useful life of two years.

For simplicity, this example ignores the effect of commissions and other transaction costs, initial margins and income taxes.

Journal entries – September 30, Year 1

There is a memorandum entry made on September 30, Year 1 documenting the existence of this hedging relationship.

Journal entries – December 31, Year 1

ABC records the following journal entry.

	Debit	Credit
Forward purchase contract ¹	8,000	
OCI – Gain on forward contract		8,000
<i>To record change in fair value of forward contract (derivative instrument).</i>		

	Debit	Credit
Note:		
1. Current price of the equipment (\$110,000) less the fixed price of the equipment in the forward purchase contract (\$102,000).		

Journal entries – January 1, Year 2

On January 1, Year 2, ABC takes delivery of the equipment and records the following journal entry.

	Debit	Credit
Equipment ¹	110,000	
Cash		102,000
Forward purchase contract		8,000
<i>To record gross settlement of forward contract.</i>		
Note:		
1. Cost of the equipment under the forward purchase contract (\$102,000) plus the fair value of the forward contract (\$8,000).		

Journal entries – December 31, Years 2-3

ABC records the following journal entries at the end of each of Years 2 and 3.

	Debit	Credit
Depreciation expense ¹	55,000	
Equipment – accumulated depreciation		55,000
<i>To record depreciation expense on equipment over its two-year useful life.</i>		
AOCI – Gain on forward contract	4,000	
Depreciation expense ²		4,000
<i>To reclassify amounts in AOCI into earnings when hedged forecasted transaction affects earnings.</i>		
Notes:		
1. Equipment's carrying amount of \$110,000 ÷ 2 years (its useful life).		
2. Amount in AOCI as of the date of the equipment's purchase (i.e. the hedged forecasted transaction) of \$8,000 ÷ 2 years (its useful life).		

Financial statement excerpts

At the end of Years 1–3, ABC's financial statements reflect the following.

Account	Year 1	Year 2	Year 3
Balance sheet – assets			
Equipment	\$ -	\$110,000	\$110,000
Equipment – accumulated depreciation	-	(55,000)	(110,000)

Account	Year 1	Year 2	Year 3
Forward contract	8,000	-	-
Balance sheet – equity			
AOCI – Gain (loss) on cash flow hedge	\$8,000	\$4,000	-
Income statement			
Depreciation expense	-	\$51,000	\$51,000

Because the equipment is recorded as the sum of the cash paid under the forward contract and the fair value of the forward contract, its carrying amount to be depreciated is the current price of the equipment as of the purchase date.

However, depreciation expense on the equipment's carrying amount is partially offset because the \$8,000 derivative gain reported in AOCI is reclassified into earnings as the purchased equipment is depreciated. The effect of the amounts reclassified from AOCI into earnings result in total net depreciation expense over the estimated useful life of the equipment of \$102,000, which is the forward purchase price of the equipment.

Reclassifying AOCI when hedging relationship is discontinued



Excerpt from ASC 815-30

>> Example 20: Amounts Reclassified into Earnings for Purchased Option Used in a Cash Flow Hedge

55-126 This Example illustrates when the hedging instrument's gain or loss that is reported in accumulated other comprehensive income should be reclassified out of accumulated other comprehensive income into earnings under paragraph 815-30-35-36.

55-127 An entity forecasts that 1 year later it will purchase 1,000 ounces of gold at then current market prices for use in its operations. The entity wishes to protect itself against increases in the cost of gold above the current market price of \$275 per ounce. The entity purchases a 1-year cash-settled at-the-money gold option on 1,000 ounces of gold, paying a premium of \$10,000. If the price of gold is above \$275 at the maturity (settlement) date, the counterparty will pay the entity 1,000 times the difference. If the price of gold is \$275 or below at the maturity date, the contract expires worthless. The option cannot be exercised before its contractual maturity date. The entity designates the purchased option contract as a hedge of the variability in the purchase price (cash outflow) of the 1,000 ounces of gold for prices above \$275 per ounce. The entity would reclassify the purchased option's gain or loss that is reported in accumulated other comprehensive income in earnings when the cost of the gold affects earnings (such as being included in cost of

goods sold) and present that gain or loss in the same income statement line item as the earnings effect of the hedged item.



Question 10.3.20

When are amounts in AOCI related to specific borrowings associated with assets under construction reclassified into earnings?

Background: Subtopic 835-20 requires capitalizing interest cost as part of the historical cost of acquiring certain assets. An entity's financing plans may associate a specific borrowing with such an acquisition. If the variability in interest payments under a specific borrowing is hedged in a cash flow hedge that is highly effective, gains and losses on the hedging instrument are recognized in AOCI and are reclassified into earnings when the forecasted transaction affects earnings. [\[835-20-05-1, 30-3, 30-7\]](#)



Excerpt from ASC 815-30

>> Forecasted Interest Payment Capitalized as a Cost of an Asset under Construction

35-45 If the variable-rate interest on a specific borrowing is associated with an asset under construction and capitalized as a cost of that asset, the amounts in accumulated other comprehensive income related to a cash flow hedge of the variability of that interest shall be reclassified into earnings over the depreciable life of the constructed asset, because that depreciable life coincides with the amortization period for the capitalized interest cost on the debt.

Interpretive response: If variable-rate interest on a specific borrowing is capitalized as a cost of an asset under construction, amounts reported in AOCI that were included in the assessment of effectiveness related to a cash flow hedge of the variability of that interest are reclassified into earnings over the depreciable life of the constructed asset. This is because that depreciable life coincides with the amortization period for the capitalized interest cost on the debt – i.e. the manner in which the hedged risk affects earnings. [\[815-30-35-45\]](#)

This guidance relates only to the amount reported in AOCI attributable to interest incurred during the construction period. If the debt and the hedging derivative remain outstanding after completion of the construction project, the reclassification from AOCI for subsequent variability in interest is made when the hedged variable interest is reported in earnings.



Question 10.3.30

Why is a loss in AOCI reclassified into earnings if the combination of the hedging instrument and hedged transaction would result in a future loss?

Interpretive response: When a net derivative loss is reported in AOCI related to a hedged transaction in a cash flow hedge, it represents an amount that is expected to offset a future gain (revenue) related to the hedged transaction. In other words, the loss reported in AOCI offsets an unrecognized gain on the hedged transaction that arose during the hedging relationship. However, market prices may fall to the point that there are no longer anticipated revenues (gains) being offset by the loss in AOCI.

If an entity does not expect to recover *both* the amount recognized as the cost of the hedged transaction and the net derivative loss reported in AOCI when the hedged item is sold, the amount that is not expected to be recovered is immediately reclassified from AOCI into earnings. The FASB's rationale for including this guidance was that it could not justify delaying recognizing a derivative loss in earnings when the loss is not expected to be recovered through revenues from the hedged transaction. [\[815-30-35-40 – 35-41, FAS 133.BC499\]](#)



Example 10.3.20

Combination of loss reported in AOCI and hedged transaction would give rise to a loss

ABC Corp. produces silver platters for sale to department stores. The sales price of the silver platters depends in large part on the market price of silver as of the date of sale.

ABC expects that it will purchase 100,000 ounces of silver on June 30, Year 1. ABC has a contract with a supplier for which the purchase price is based on the spot price of silver. ABC is concerned about fluctuations in the price of silver. Therefore, on January 1, Year 1, ABC enters into an OTC silver forward contract to purchase 100,000 ounces of silver at \$16 per ounce on June 30, Year 1. The forward contract will settle in cash on a net basis (i.e. for the difference between the \$16 per ounce stated price and the spot rate) on June 30, Year 1.

The forward contract is designated as a cash flow hedge of variability of cash flows attributable to changes in the spot price of silver (a contractually specified component) for ABC's forecasted purchase of 100,000 ounces of silver on or around June 30, Year 1. ABC's contract to purchase silver from a supplier represents a derivative for which the NPNS scope exception is applied.

Throughout the hedging relationship, the hedge was highly effective. As a result, ABC records changes in the fair value of the forward contract in OCI.

On June 30, Year 1, the spot price for silver is \$15.50 per ounce. ABC purchases 100,000 ounces of silver as forecast, and pays the market price of \$1,550,000. ABC also pays \$50,000 to settle the forward contract, which represents the fair value (liability) of the forward contract on June 30, Year 1

and therefore also represents the loss reported in AOCI related to the cash flow hedge on that date.

As a result of the forward contract, ABC locked in a purchase price for the silver of \$1,600,000 (100,000 ounces at \$16 per ounce). This is reflected in ABC's balance sheet on June 30, Year 1 as follows.

Account	Amount (debit balances)
Silver platter inventory	\$1,550,000
AOCI – Loss on hedging instrument (forward contract)	50,000
Total amounts related to inventory for which the purchase was hedged	\$1,600,000

Three months later on September 30, Year 1, the net realizable value of the silver platter inventory to which the cash flow hedge relates is \$2,030,000. The inventory has a carrying amount of \$2,000,000 – i.e. the initial purchase of silver of \$1,550,000 plus costs incurred after the silver was purchased.

In addition, ABC:

- uses the first-in-first-out (FIFO) method to account for its inventory; and
- continues to report in AOCI the loss on the forward contract.

As of September 30, Year 1, ABC evaluates the combination of the inventory and the net loss on the forward contract that is reported in AOCI as follows.

Account	Amount (debit balances)
Silver platter inventory	\$2,000,000
AOCI – Loss on hedging derivative	50,000
Total amounts related to hedged inventory ¹	2,050,000
Net realizable value of inventory	2,030,000
Amount that is not expected to be recovered²	\$ 20,000
Notes:	
1. Silver platter inventory + AOCI – Loss on hedging derivative.	
2. Total amounts related to hedged inventory - Net realizable value of inventory.	

ABC reclassifies \$20,000 from AOCI into cost of goods sold – i.e. the same income statement line item as the earnings effect of the hedged inventory will be in when it is sold. This represents the amount recognized in ABC's balance sheet related to the silver platter inventory that is not expected to be recovered through its sale.



Question 10.3.40

Can an impairment loss be recognized before a forecasted transaction occurs?

Interpretive response: Yes. Ordinarily, forecasted transactions that are not related to an existing asset are not subject to impairment assessments until the assets are acquired. This is because forecasted transactions or events occur – by definition – at the prevailing market price. However, the requirement to review any amount in AOCI related to a current or previous hedging relationship that represents a net loss may result in recognition of an impairment loss before the forecasted transaction occurs.

10.3.20 Hedging instruments with periodic settlements



Excerpt from ASC 815-30

>> Non-Zero Fair Value of Hedging Derivative at Hedge Inception

35-41A An entity may designate a hedging derivative with periodic cash settlements and a non-zero fair value at hedge inception as the hedging instrument in a qualifying cash flow hedging relationship. In this situation, amounts related to the initial fair value that are recorded in other comprehensive income during the hedging relationship shall be reclassified from accumulated other comprehensive income to earnings on a systematic and rational basis over the periods during which the hedged forecasted transactions affect earnings. Amounts reclassified to earnings shall be presented in the same income statement line item as the earnings effect of the hedged item. This guidance applies to both option-based and non-option-based derivatives designated as hedging instruments in a cash flow hedge.

35-41B This paragraph illustrates a method of reclassifying amounts from accumulated other comprehensive income to earnings when an option-based derivative is designated as a hedging instrument and the assessment of effectiveness is based on total changes in the derivative's cash flows. Those amounts include changes in fair value related to the derivative's initial intrinsic value in accordance with paragraph 815-30-35-41A. For example, the fair value of a single cap at the inception of a hedging relationship of interest rate risk on variable-rate debt with quarterly interest payments over the next two years should be allocated to the respective caplets within the single cap on a fair value basis at the inception of the hedging relationship. The change in each respective allocated fair value amount should be reclassified out of accumulated other comprehensive income into earnings when each of the hedged forecasted transactions (the eight interest payments) affects earnings. Because the amount in accumulated other comprehensive income is a net amount composed of both derivative instrument gains and derivative instrument losses, the change in the respective allocated fair value amount for an individual caplet that is reclassified out of accumulated other comprehensive

income into earnings may possibly be greater than the net amount in accumulated other comprehensive income.

35-41C This guidance has no effect on the accounting for fair value hedging relationships. In addition, in determining the accounting for seemingly similar cash flow hedging relationships, it would be inappropriate to analogize to this guidance.

When an entity is hedging the variability of a single cash flow with a single hedging instrument, the reclassification from AOCI into earnings is relatively straightforward. However, when an entity is hedging the variability in multiple cash flows with a single hedging instrument, the reclassification from AOCI into earnings is more complex.

If a single derivative is used to hedge the variability in multiple cash flows, an entity should reclassify an amount out of AOCI into earnings only when the hedged forecasted transaction affects earnings. The amount that is reclassified should equal the net derivative gain or loss within AOCI that will offset the changes in the specific hedged forecasted transaction for the risk being hedged.

Additional complexity: Derivative instrument has a non-zero fair value at hedge inception

An additional complexity occurs when a single derivative with a non-zero fair value at hedge inception is used to hedge the variability in multiple cash flows. For example, if an interest rate swap with a fair value of zero at hedge inception is used to hedge the payments on a variable-rate debt obligation, it may be appropriate to reclassify amounts from AOCI based on the periodic net cash settlements of the interest rate swap.

In contrast, if the interest rate swap has a non-zero fair value at hedge inception, reclassifying amounts from AOCI based solely on the periodic net cash settlements will not result in that initial fair value being reclassified from AOCI into earnings by the end of the hedge term. Instead, the initial non-zero fair value will remain in AOCI after all hedged interest payments have been made and the swap has expired.

As a result of that additional complexity, Topic 815 provides specific guidance related to hedging instruments with multiple cash flows or periodic cash settlements (e.g. interest rate swaps, purchased caps) that have non-zero fair values at hedge inception. In these situations, amounts in AOCI that are related to the initial fair value are required to be reclassified into earnings on a systematic and rational basis over the periods during which the hedged forecasted transactions affect earnings. [815-30-35-41A]

When amounts are reclassified from AOCI related to an initial non-zero fair value of a hedging instrument, they are presented in the same income statement line item as the earnings effect of the hedged transaction. [815-30-35-41A]



Question 10.3.50

What are acceptable methods to reclassify the initial non-zero fair value of a hedging instrument with periodic cash settlements?

Interpretive response: Topic 815 describes one acceptable method for reclassifying the initial non-zero fair value of a hedging instrument with periodic cash settlements into earnings. This is the 'caplet method' used for interest rate caps.

The caplet method involves associating the initial fair value of an interest rate cap with each caplet within the rate cap, and reclassifying the amount of each caplet from AOCI into earnings when the respective forecasted interest payment occurs. [815-30-35-41B]

In addition to the caplet method, other systematic and rational methods that may be appropriate for recognizing the initial fair value over the term of the hedging relationship include:

- straight-line amortization – as interest expense is recognized in earnings during the hedging relationship; or
- the interest method, resulting in a constant rate of interest expense during the hedging relationship.

Whether the caplet method or another method is appropriate depends on the nature and terms of the hedging instrument and the hedged transaction(s).



Question 10.3.60

What method is appropriate to reclassify amounts from AOCI when an interest rate swap with scheduled increases in its fixed leg is used to hedge interest payments on variable-rate debt?

Background: ABC Corp. designates a pay-fixed, receive-floating interest rate swap as a cash flow hedge of interest payments on variable-rate debt. The interest rate on the pay-fixed leg of the swap increases at fixed intervals over the life of the instrument, which is anticipated to result in lower cash outflows during the early periods of the swap and better match the upward sloping yield curve of market interest rates at inception of the instrument.

All hedge accounting criteria are met, including that the swap is expected to be highly effective at offsetting changes in interest payment cash flows throughout the life of the hedging relationship.

Interpretive response: We believe the net derivative gain or loss reported in AOCI should be reclassified into earnings over the life of the hedging relationship using the interest method, resulting in a constant rate of interest expense over the life of the hedging relationship despite the increasing interest rate on the pay-fixed leg of the swap. This treatment is consistent with paragraphs 470-10-35-1 and 35-2, which require debt with a fixed increasing

interest rate to be accounted for under the effective interest method using the contractual cash flows over the estimated term of that debt.

In this situation, the hedged transaction is a series of interest payments on variable-rate debt. If each swap payment were related to each interest payment individually, applying hedge accounting would result in an increasing rate of interest expense over the course of the hedging relationship. We do not believe it would be appropriate in this circumstance to view each interest payment as a separate hedging relationship given the inherently interrelated nature of the hedged interest payments and the swap instrument.



Question 10.3.70

What method is appropriate to reclassify amounts from AOCI when multiple derivatives are used to hedge interest payments on variable-rate debt?

Background: ABC Corp. issues variable-rate debt with a maturity of three years. ABC separately enters into three derivative instruments: a one-year interest rate swap, a forward-starting one-year interest rate swap that starts one year in the future, and a forward-starting one-year interest rate swap that starts two years in the future. The rates on the fixed legs of the three derivative instruments differ – i.e. the longer duration derivatives have higher fixed rates.

ABC documents each derivative in a separate hedging relationship (i.e. three hedging relationships in total), with each derivative hedging a different year of variable-rate interest payments on ABC's debt.

All hedge accounting criteria are met for each relationship, including that each swap is expected to be highly effective at offsetting changes in interest payment cash flows throughout the life of its separate hedging relationship.

Interpretive response: We believe the net derivative gain or loss reported in AOCI should be reclassified into earnings over the life of each separate hedging relationship on an individual hedging relationship-by-relationship basis – e.g. following the periodic net settlements on each interest rate swap.

The net result of applying hedge accounting for the three individual relationships results in an increasing rate of interest expense over the course of the hedging relationship. This result differs from that in Question 10.3.60 because it is the result of three separately documented hedge accounting relationships with three separate derivatives.



Example 10.3.30

Accounting for a cash flow hedge of a variable-rate, long-term debt with an interest rate cap

On January 1, Year 1, ABC issues a \$10,000,000 debt obligation that matures on December 31, Year 3 (i.e. three years). The interest rate on the debt obligation is variable at a rate of 12-month LIBOR plus 2%.

ABC is concerned that 12-month LIBOR may rise during the three-year term of the debt obligation, but wants to retain the ability to benefit when it is below 8%. To protect itself from this exposure, ABC purchases for \$300,000 an out-of-the-money interest rate cap from Bank. The interest rate cap pays interest to ABC when 12-month LIBOR exceeds 8%. The amount paid to ABC by Bank is equal to \$10,000,000 multiplied by (12-month LIBOR minus 8%) in those years in which 12-month LIBOR exceeds 8%. The interest rate cap can be exercised only at its contractual dates.

The combination of the cap and the debt obligation results in ABC paying interest at a variable rate (12-month LIBOR plus 2%) not to exceed 10%. The variable-rate debt obligation and interest rate cap both require payments to be made on December 31 of each year. The variable rate on the debt obligation and purchased interest rate cap reset on January 1 of each year.

ABC designates the purchased interest rate cap as a hedge of risk of changes in cash flows of the forecasted interest payments that are attributable to the changes in the contractually specified interest rate (i.e. 12-month LIBOR) that exceed 8%.

The following additional facts are relevant.

- All criteria for cash flow hedge accounting have been met.
- ABC determines that:
 - the critical terms of the interest rate cap completely match the related terms of the hedged forecasted transactions;
 - the strike price of the interest rate cap matches the specified level beyond which the entity's exposure is being hedged;
 - the interest rate cap's inflows at its periodic settlement dates completely offset the changes in the hedged transaction's cash outflows for the risk being hedged.
- Given that the critical terms of the cap are identical to those of the debt obligation, at inception of the hedge ABC concludes and documents that the hedging relationship is expected to be highly effective (in this example, 100% effective) in achieving offsetting cash flows attributable to changes in 12-month LIBOR when 12-month LIBOR is greater than 8%.

On an ongoing basis, ABC will ascertain and document that the critical terms of the cap and the debt obligation have not changed, including that there have been no adverse developments concerning the risk of default by the counterparty to the cap or its own nonperformance risk; therefore, not causing a different conclusion about hedge effectiveness.

Because the cap is being used to purchase one-way protection against an increase in 12-month LIBOR, ABC does not need to assess effectiveness if 12-month LIBOR is less than 8%.

- 12-month LIBOR and related amounts are as follows.

Date	12-month LIBOR at January 1	Cap receipt for the year ¹	Debt interest for the year ²	Net interest for the year ³
Year 1	7%	\$ -	\$ 900,000	\$ 900,000
Year 2	9%	(100,000)	1,100,000	1,000,000

Date	12-month LIBOR at January 1	Cap receipt for the year ¹	Debt interest for the year ²	Net interest for the year ³
Year 3	10%	(200,000)	1,200,000	1,000,000
Notes:				
1. Calculated as follows:				
— When 12-month LIBOR for year is less than 8%, \$0.				
— When 12-month LIBOR for year is greater than 8%: the \$10,000,000 notional amount of the interest rate cap × (8% - 12-month LIBOR for the respective year).				
2. \$10,000,000 principal amount of the debt × (12-month LIBOR + 2%) for the respective year.				
3. Cap receipt for the year + Debt interest for the year.				

- The fair value of the interest rate cap and changes therein at the end of each accounting period before cash settlement are as follows.

	Jan 1, Year 1	Dec 31, Year 1	Dec 31, Year 2	Dec 31, Year 3
Fair value before settlement:				
Intrinsic value ¹	\$ -	\$ - ⁴	\$200,000 ⁵	\$200,000
Time value ²	300,000	280,000	150,000	-
Total fair value before settlement	\$300,000	\$280,000	\$350,000	\$ 200,000
Changes in fair value after settlement:				
Fair value after settlement, beginning of period	\$ -	\$300,000	\$280,000	\$150,000
Purchase of option	300,000	-	-	-
Change in intrinsic value ³	-	-	200,000	100,000
Change in time value	-	(20,000)	(130,000)	(150,000)
Settlement of intrinsic value	-	-	(100,000)	(200,000)
Fair value after settlement, end of period	\$300,000	\$280,000	\$250,000	\$ -
Notes:				
1. This example assumes that the intrinsic value of the cap is equal to the expected future cash flows, holding constant the cap's current period cash flow for the remaining term of the hedge (see Question 13.2.250).				
2. Total fair value before settlement - Intrinsic value before settlement.				
3. Intrinsic value at respective date - Settlement at immediately preceding period-end - Intrinsic value at immediately preceding period-end-				

4. As of December 31, Year 1, the cap's current period cash flow is \$0 because 12-month LIBOR is less than 8%. Using the method explained in Note 1 above, the current period cash flow of \$0 is held constant for expected future cash flows. As a result, the intrinsic value is assumed to be \$0 as of December 31, Year 1 despite the fact that the rate cap resets on the next day (January 1, Year 2).
5. As of December 31, Year 2, the cap's current period cash flow is 1% (i.e. 9% - 8%) of \$1,000,000, or \$100,000. The intrinsic value of \$200,000 represents \$100,000 related to the current period and \$100,000 related to the projected receipt for the next period using the method explained in Note 1 above.

For simplicity, this example makes the following assumptions.

- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
- It is based on annual periods; normally the assessment of effectiveness and related accounting entries would be done at least quarterly.
- Journal entries (for all years) are presented gross for illustrative purposes but could be combined.

Scenario 1: Intrinsic value method – excluded component (time value) recognized in earnings using mark-to-market approach

In this scenario, ABC uses the intrinsic value method to assess effectiveness. ABC excludes changes in the time value of the option from the assessment of the hedge's effectiveness.

ABC has elected to recognize changes in the fair value of the excluded component (i.e. time value) using the mark-to-market method (i.e. currently in earnings).

Journal entries – January 1, Year 1

ABC records the following journal entries on January 1, Year 1.

	<i>Debit</i>	<i>Credit</i>
Cash	10,000,000	
Debt obligation		10,000,000
<i>To record origination of 12-month LIBOR + 2% debt obligation.</i>		
Interest rate cap	300,000	
Cash		300,000
<i>To record purchase of interest rate cap at fair value.</i>		

There is also a memorandum entry made on January 1, Year 1, documenting the existence of this hedging relationship.

Journal entries – December 31, Year 1

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	900,000	
Cash		900,000

	<i>Debit</i>	<i>Credit</i>
<i>To record interest paid on 12-month LIBOR + 2% debt obligation.</i>		
Interest expense	20,000	
Interest rate cap		20,000
<i>To record change in time value of interest rate cap.¹</i>		
Note: 1. The entire change in fair value of the interest rate cap relates to the change in the value of the excluded component (time value), which is recognized using the mark-to-market method (i.e. currently in earnings).		

Journal entries – December 31, Year 2

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	1,100,000	
Cash		1,100,000
<i>To record interest paid on 12-month LIBOR + 2% debt obligation.</i>		
Interest rate cap	200,000	
OCI – Gain (loss) on interest rate cap		200,000
<i>To record change in intrinsic value of interest rate cap.¹</i>		
Interest expense	130,000	
Interest rate cap		130,000
<i>To record change in time value of interest rate cap.</i>		
Cash	100,000	
Interest rate cap		100,000
<i>To record cash received on settlement of interest rate cap.</i>		
AOCI – Gain (loss) on interest rate cap	100,000	
Interest expense		100,000
<i>To reclassify into earnings amounts in AOCI that hedged variable interest expense recognized in earnings.</i>		
Note: 1. Represents the change in the intrinsic value of the interest rate cap before settlement.		

Journal entries – December 31, Year 3

ABC records the following journal entries.

	Debit	Credit
Interest expense	1,200,000	
Cash		1,200,000
<i>To record interest paid on 12-month LIBOR + 2% debt obligation.</i>		
Interest rate cap	100,000	
OCI – Gain (loss) on interest rate cap		100,000
<i>To record change in intrinsic value of interest rate cap.¹</i>		
Interest expense	150,000	
Interest rate cap		150,000
<i>To record change in time value of interest rate cap.</i>		
Cash	200,000	
Interest rate cap		200,000
<i>To record cash received on settlement of interest rate cap.</i>		
AOCI – Gain (loss) on interest rate cap	200,000	
Interest expense		200,000
<i>To reclassify into earnings amounts in AOCI that hedged variable interest expense recognized in earnings.</i>		
Debt obligation	10,000,000	
Cash		10,000,000
<i>To record repayment of 12-month LIBOR + 2% debt obligation.</i>		
Note:		
1. Represents the change in the intrinsic value of the interest rate cap before settlement.		

Financial statement excerpts

At the end of Years 1–3, ABC's financial statements reflect the following.

Account	Year 1	Year 2	Year 3
Balance sheet – assets			
Interest rate cap	\$280,000	\$250,000	-
Balance sheet – liabilities			
Debt obligation	\$10,000,000	\$10,000,000	-
Balance sheet – equity			
AOCI – Gain (loss) on cash flow hedge	-	\$100,000 ¹	-

Income statement			
Interest expense	\$920,000	\$1,130,000	\$1,150,000
Note:			
1. Represents the \$100,000 intrinsic value of the interest rate cap after settlement.			

As a result of entering into the hedging relationship, ABC effectively capped its interest expense at 10% on the three-year debt obligation. During periods in which the contractual terms of the debt obligation resulted in interest expense greater than 10% (because 12-month LIBOR exceeded 8% plus the fixed spread of 2%), the payments received from the interest rate cap effectively reduced interest expense to 10% as illustrated below. However, recognition in earnings of changes in the fair value of the cap due to changes in the excluded component (time value) resulted in additional variability of total interest expense.

	Debit (credit)		
	Year 1	Year 2	Year 3
Interest on debt obligation	\$900,000	\$1,100,000	\$1,200,000
Reclassification to earnings from AOCI	-	(100,000)	(200,000)
Change in time value of interest rate cap	20,000	130,000	150,000
Total interest expense	\$920,000	\$1,130,000	\$1,150,000

Scenario 2: Intrinsic value method – excluded component (time value) recognized using straight-line method (an amortization approach)

As in Scenario 1, ABC uses the intrinsic value method to assess effectiveness and ABC excludes changes in the time value of the option from the assessment of the hedge's effectiveness.

Unlike Scenario 1 in which ABC used the mark-to-market approach, in this scenario ABC elects to recognize the initial value of the excluded component (time value) using the straight-line method (an amortization approach) over the life of the interest rate cap (the hedging instrument).

The following table shows the effect on earnings of the time value using the straight-line method.

	Dec 31, Year 1	Dec 31, Year 2	Dec 31, Year 3
Amortization of initial time value ¹	\$(100,000)	\$(100,000)	\$(100,000)
Difference between change in fair value of time value and amortization of initial time value	80,000	(30,000)	(50,000)
Total change in time value	\$(20,000)	\$(130,000)	\$(150,000)

Note:

1. Initial time value of the interest rate cap of $\$300,000 \div 3$ periods.

Journal entries – January 1, Year 1

ABC records the following journal entries on January 1, Year 1.

	<i>Debit</i>	<i>Credit</i>
Cash	10,000,000	
Debt obligation		10,000,000
<i>To record origination of 12-month LIBOR + 2% debt obligation.</i>		
Interest rate cap	300,000	
Cash		300,000
<i>To record purchase of interest rate cap at fair value.</i>		

There is also a memorandum entry made on January 1, Year 1, documenting the existence of this hedging relationship.

Journal entries – December 31, Year 1

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	900,000	
Cash		900,000
<i>To record interest paid on 12-month LIBOR + 2% debt obligation.</i>		
OCI – Gain (loss) on interest rate cap	20,000	
Interest rate cap		20,000
<i>To record change in time value of excluded component in OCI.¹</i>		
Interest expense	100,000	
OCI – Gain (loss) on interest rate cap		100,000
<i>To record amortization of excluded component (time value).¹</i>		
Note: 1. The entire change in fair value of the interest rate cap relates to the change in the value of the excluded component (time value), which is recognized using the straight-line method (an amortization approach).		

Journal entries – December 31, Year 2

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	1,100,000	
Cash		1,100,000
<i>To record interest paid on 12-month LIBOR + 2% debt obligation.</i>		
Interest rate cap	200,000	
OCI – Gain (loss) on interest rate cap		200,000
<i>To record change in intrinsic value of interest rate cap.¹</i>		
OCI – Gain (loss) on interest rate cap	130,000	
Interest rate cap		130,000
<i>To record change in fair value of excluded component in OCI.</i>		
Interest expense	100,000	
OCI – Gain (loss) on interest rate cap		100,000
<i>To record amortization of excluded component.</i>		
Cash	100,000	
Interest rate cap		100,000
<i>To record cash received on settlement of interest rate cap.</i>		
AOCI – Gain (loss) on interest rate cap	100,000	
Interest expense		100,000
<i>To reclassify into earnings amounts in AOCI that hedged variable interest expense recognized in earnings.</i>		
Note:		
1. Represents the change in the intrinsic value of the interest rate cap before settlement.		

Journal entries – December 31, Year 3

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense	1,200,000	
Cash		1,200,000
<i>To record interest paid on 12-month LIBOR + 2% debt obligation.</i>		
Interest rate cap	100,000	
OCI – Gain (loss) on interest rate cap		100,000
<i>To record change in intrinsic value of interest rate cap.¹</i>		

	Debit	Credit
OCI – Gain (loss) on interest rate cap Interest rate cap <i>To record change in fair value of excluded component in OCI.¹</i>	150,000	150,000
Interest expense OCI – Gain (loss) on interest rate cap <i>To record amortization of excluded component.</i>	100,000	100,000
Cash Interest rate cap <i>To record cash received on settlement of interest rate cap.</i>	200,000	200,000
AOCI – Gain (loss) on interest rate cap Interest expense <i>To reclassify into earnings amounts in AOCI that hedged variable interest expense recognized in earnings.</i>	200,000	200,000
Debt obligation Cash <i>To record repayment of 12-month LIBOR + 2% debt obligation.</i>	10,000,000	10,000,000
Note: 1. Represents the change in the intrinsic value of the interest rate cap before settlement.		

Financial statement excerpts

At the end of Years 1–3, ABC's financial statements reflect the following.

Account	Year 1	Year 2	Year 3
Balance sheet – assets			
Interest rate cap	\$280,000	\$250,000	-
Balance sheet – liabilities			
Debt obligation	\$10,000,000	\$10,000,000	-
Balance sheet – equity			
AOCI – Gain (loss) on cash flow hedge ¹	\$80,000	\$150,000	-
Income statement			
Interest expense	\$1,000,000	\$1,100,000	\$1,100,000

Account	Year 1	Year 2	Year 3
Note:			
1. Intrinsic value of the interest rate cap + Cumulative difference between the change in fair value of time value (excluded component) and the amortization of the initial time value.			

As a result of entering into the hedging relationship, ABC effectively capped its interest expense at 10% on the three-year debt obligation. During periods in which the contractual terms of the debt obligation resulted in interest expense greater than 10% (because 12-month LIBOR exceeded 8% plus the fixed spread of 2%), the payments received from the interest rate cap effectively reduced interest expense to 10% (plus amortization of the excluded component – time value) as illustrated below.

	Debit (credit)		
	Year 1	Year 2	Year 3
Interest on debt obligation	\$ 900,000	\$1,100,000	\$1,200,000
Reclassification into earnings from AOCI	-	(100,000)	(200,000)
Amortization of excluded component (time value)	100,000	100,000	100,000
Total interest expense	\$1,000,000	\$1,100,000	\$1,100,000

Scenario 3: Terminal value method – caplet method used for recognizing initial non-zero fair value

The assessment of effectiveness is documented based on total changes in the purchased option's cash flows – i.e. the assessment includes the purchased option's entire change in fair value. As explained in section 13.7.20, this approach focuses on the rate cap's terminal value – i.e. the expected pay-off at its maturity date. As a result, the entity concludes that the hedging relationship is considered perfectly effective and all changes in the purchased option's fair value will be recorded in AOCI.

Under this approach, the time value component of the interest rate cap is *included* in the assessment of effectiveness – i.e. is *not* an excluded component. As a result, the premium paid (which reflects time value and results in the rate cap having a non-zero fair value at hedge inception) for the interest rate cap is required to be recognized when the hedged transaction affects earnings.

In this scenario, ABC elects to use the caplet method for recognizing the premium paid when the hedged transactions affect earnings.

At inception of the hedging relationship, the interest rate cap consists of three individual caplets with fair values that total the \$300,000 premium paid for the cap. The fair value of each of those caplets on January 1, Year 1 is as follows.

Caplet	Fair value at inception
December 31, Year 1 ¹	\$ -
December 31, Year 2	140,000
December 31, Year 3	160,000
Total	\$300,000
Note: 1. The debt's interest rate for a payment period is set at the beginning of the period and paid at the end of the period. That is, the first interest payment on December 31, Year 1 is based on 12-month LIBOR in effect at December 31, Year 1. Accordingly, the first interest payment on December 31, Year 1 has no variability at the inception of the hedging relationship and is not being hedged.	

Journal entries – January 1, Year 1

ABC records the following journal entries on January 1, Year 1.

	Debit	Credit
Cash	10,000,000	
Debt obligation		10,000,000
<i>To record origination of 12-month LIBOR + 2% debt obligation.</i>		
Interest rate cap	300,000	
Cash		300,000
<i>To record purchase of interest rate cap at fair value.</i>		

There would also be a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship.

Journal entries – December 31, Year 1

ABC records the following journal entries.

	Debit	Credit
Interest expense	900,000	
Cash		900,000
<i>To record interest paid on 12-month LIBOR + 2% debt obligation.</i>		
OCI – Gain (loss) on interest rate cap	20,000	
Interest rate cap		20,000
<i>To record change in time value of interest rate cap.¹</i>		
Note: 1. The entire change in fair value of the interest rate swap relates to the change in time value of the interest rate cap.		

Journal entries – December 31, Year 2

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense Cash <i>To record interest paid on 12-month LIBOR + 2% debt obligation.</i>	1,100,000	1,100,000
Interest rate cap OCI – Gain (loss) on interest rate cap <i>To record change in intrinsic value of interest rate cap.¹</i>	200,000	200,000
OCI – Gain (loss) on interest rate cap Interest rate cap <i>To record change in time value of interest rate cap.</i>	130,000	130,000
Cash Interest rate cap <i>To record cash received on settlement of interest rate cap.</i>	100,000	100,000
AOCI – Gain (loss) on interest rate cap Interest expense <i>To reclassify into earnings amounts in AOCI that hedged variable interest expense recognized in earnings.</i>	100,000	100,000
Interest expense AOCI – Gain (loss) on interest rate cap <i>To reclassify original fair value of first caplet from AOCI into earnings as debt interest payment being hedged is reported in earnings.</i>	140,000	140,000
Note: 1. Represents the change in the intrinsic value of the interest rate cap before settlement.		

Journal entries – December 31, Year 3

ABC records the following journal entries.

	<i>Debit</i>	<i>Credit</i>
Interest expense Cash <i>To record interest paid on 12-month LIBOR + 2% debt obligation.</i>	1,200,000	1,200,000

	Debit	Credit
Interest rate cap	100,000	
OCI – Gain (loss) on interest rate cap		100,000
<i>To record change in intrinsic value of interest rate cap.¹</i>		
OCI – Gain (loss) on interest rate cap	150,000	
Interest rate cap		150,000
<i>To record change in time value of interest rate cap.</i>		
Cash	200,000	
Interest rate cap		200,000
<i>To record cash received on settlement of interest rate cap.</i>		
AOCI – Gain (loss) on interest rate cap	200,000	
Interest expense		200,000
<i>To reclassify into earnings amounts in AOCI that hedged variable interest expense recognized in earnings.</i>		
Interest expense	160,000	
AOCI – Gain (loss) on interest rate cap		160,000
<i>To reclassify original fair value of first caplet from AOCI into earnings as debt interest payment being hedged is reported in earnings.</i>		
Debt obligation	10,000,000	
Cash		10,000,000
<i>To record repayment of 12-month LIBOR + 2% debt obligation.</i>		
Note:		
1. Represents the change in the intrinsic value of the interest rate cap before settlement.		

Financial statement excerpts

At the end of Years 1–3, ABC's financial statements reflect the following.

Account	Year 1	Year 2	Year 3
Balance sheet – assets			
Interest rate cap	\$280,000	\$250,000	-
Balance sheet – liabilities			
Debt obligation	\$10,000,000	\$10,000,000	-
Balance sheet – equity			
AOCI – Gain (loss) on cash flow hedge	\$(20,000)	\$90,000 ¹	-

Account	Year 1	Year 2	Year 3
Income statement			
Interest expense	\$900,000	\$1,140,000	\$1,160,000
Note: 1. Represents the \$100,000 intrinsic value of the interest rate cap less the \$10,000 change (i.e. decrease) in time value of the interest rate cap that has not yet been recognized in earnings. The \$10,000 change in time value that has not yet been recognized in earnings is calculated as the \$150,000 total decrease in time value less the initial time value of \$140,000 associated with the first caplet that was recognized in earnings.			

As a result of entering into the hedging relationship, ABC effectively capped its interest expense at 10% on the three-year debt obligation. During periods in which the contractual terms of the debt obligation resulted in interest expense greater than 10% (because the contractually specified interest rate – 12-month LIBOR – exceeded 8% plus the fixed spread of 2%), the payments received from the interest rate cap effectively reduced interest expense to 10% as illustrated below. However, recognition in earnings of each caplet at its expiration date resulted in variability of total interest expense.

	Debit (credit)		
	Year 1	Year 2	Year 3
Interest on debt obligation	\$900,000	\$1,100,000	\$1,200,000
Reclassification of amounts from AOCI that hedged the variable interest expense into earnings	-	(100,000)	(200,000)
Reclassification from AOCI of caplet's initial fair value	-	140,000	160,000
Total interest expense	\$900,000	\$1,140,000	\$1,160,000

Comparison of scenarios – recognition of time value

The following table compares the amount by which earnings are decreased in each period for recognition of the options' time value under each method:

Approach	Year 1	Year 2	Year 3	Total
Approach for recognizing time value when it is an excluded component				
Mark-to-market approach (Scenario 1)	\$20,000	\$130,000	\$150,000	\$300,000
Amortization approach (Scenario 2)	100,000	100,000	100,000	300,000
Method that includes time value in effectiveness assessment				
Terminal value (Scenario 3)	-	\$140,000	\$160,000	\$300,000

10.4 Assessing impairment or credit losses

10.4.10 Overview



Excerpt from ASC 815-30

>> Interaction with Impairment and Credit Loss Principles

35-42 Existing requirements in generally accepted accounting principles (GAAP) for assessing asset impairment or credit losses or recognizing an increased obligation apply to an asset or liability that gives rise to variable cash flows (such as a variable-rate **financial instrument**) for which the variable cash flows (the forecasted transactions) have been designated as being hedged and accounted for pursuant to paragraphs 815-30-35-3 and 815-30-35-38 through 35-41. Those impairment or credit loss requirements shall be applied each period after hedge accounting has been applied for the period, pursuant to those paragraphs. The fair value or expected cash flows of a hedging instrument shall not be considered in applying those requirements. The gain or loss on the hedging instrument in accumulated other comprehensive income shall, however, be accounted for as discussed in paragraphs 815-30-35-38 through 35-41.

35-43 If, under existing requirements in GAAP, an asset impairment loss or writeoff due to credit losses is recognized on an asset or an additional obligation is recognized on a liability to which a hedged forecasted transaction relates, any offsetting or corresponding net gain related to that transaction in accumulated other comprehensive income shall be reclassified immediately into earnings. Similarly, if a recovery is recognized on the asset or liability to which the forecasted transaction relates, any offsetting net loss that has been accumulated in other comprehensive income shall be reclassified immediately into earnings.

An entity is required to apply the existing requirements in other applicable US GAAP for:

- assessing asset impairment or credit losses; and
- recognizing an increased obligation regarding an existing asset or liability for which the variable cash flows have been or currently are designated as being hedged.

Those requirements are performed *after* cash flow hedge accounting is applied for the period. This includes performing those requirements after evaluating whether a net derivative loss is reported in AOCI that should be reclassified because, when combined with the hedged transaction, it would lead to a loss in a future reporting period, as discussed in section 10.3.10. [\[815-30-35-42\]](#)

The following table shows examples of US GAAP that may be applicable for impairment or credit losses of assets that are related to hedged transactions in cash flow hedging relationships.

Hedged transaction (related asset or liability)	Guidance for assessing impairment
Forecasted sale of a long-lived asset that is recognized on the balance sheet	Subtopic 360-10 (property, plant and equipment)
Inventory recognized on the balance sheet for which the purchase was a hedged forecasted transaction	Paragraphs 330-10-35-1A to 35-2: — for inventory measured using LIFO or the retail inventory method: lower of cost or market principles — for inventory measured using all other methods: lower of cost or net realizable value
Variability in cash flows associated with a specific variable-rate commercial loan receivable	Subtopic 326-20 (credit losses)
Variability in cash flows associated with a specific variable-rate held-for-sale mortgage loan receivable	Subtopic 948-310 (mortgage banking receivables) based on the lower of cost or fair value
Variability in cash flows associated with a specific variable-rate debt security classified as AFS	Subtopic 320-10 (debt securities)

When applying applicable US GAAP for assessing asset impairment or credit losses or recognizing an increased obligation to an existing asset or liability, generally neither the fair value (or the expected cash flows) of the related derivative instruments nor any derivative gains or losses reported in AOCI related to the hedging relationship should be considered. However, in three situations, an entity may be required to reclassify certain amounts from AOCI into earnings when considering the combination of the hedged transaction and the amount in AOCI: [815-30-35-40, 35-42 – 35-43]

- **A net derivative loss is reported in AOCI that, when combined with the hedged transaction, would lead to a loss in a future reporting period.** As discussed in section 10.3.10, if an entity expects that continued reporting of a loss in AOCI would lead to recognizing a net loss on the combination of the hedging instrument and hedged transaction (and related asset acquired or liability incurred) in one or more future periods, the loss is immediately reclassified into earnings. This evaluation is required to be performed before applying applicable US GAAP for assessing asset impairment or credit losses, or recognizing an increased obligation to an existing asset or liability.
- **An asset impairment loss or writeoff due to credit loss is recognized and a net derivative gain is reported in AOCI.** If an asset impairment loss or writeoff due to credit loss is recognized on an existing asset to which a current or previous hedged forecasted transaction relates and the measure

for that impairment results from the risk being hedged, any offsetting or corresponding net gain in AOCI that relates directly to that transaction is reclassified into earnings. See question 10.4.20.

A recovery is recognized and a net derivative loss is reported in AOCI.

If a recovery is recognized, any related offsetting net loss in AOCI is immediately reclassified into earnings.

Additionally, when an impairment or credit loss is recognized for a hedged asset, the entity should consider whether:

- the likelihood of the forecasted transaction occurring has changed; and
- additional amounts are required to be reclassified from AOCI into earnings due to such a change (see section 10.5.20).



Question 10.4.10

Are the fair value or expected cash flows of a hedging instrument ever considered when evaluating impairment of an asset related to the hedged transaction?

Interpretive response: Generally, no. Ordinarily, the fair value or expected cash flows of a derivative hedging instrument do not affect the determination of whether an asset related to the hedged transaction is impaired because the derivative is a separate asset or liability. [815-30-35-42]

However, the SEC staff has specific guidance for entities with oil- and gas-producing activities that apply the full cost method of accounting. In this situation, the prices to be received *after* taking into account cash flow hedging arrangements are used to calculate the current price of the quantities of the future production of oil and gas reserves covered by the hedges as of the reporting date. The current price is then used to determine whether the capitalized cost of the oil- and gas-producing entity exceeds the full cost limitation. [932-360-S99-2]



Example 10.4.10

Hedged asset is impaired and related amount in AOCI is a net derivative loss

This example is a modification of Example 10.3.20.

In that example, ABC Corp. uses a forward contract in a cash flow hedge of a forecasted purchase of silver. As a result of the forward contract, ABC locks in a purchase price for the silver of \$1,600,000 (100,000 ounces at \$16 per ounce). After settlement of the forward contract and purchase of silver, ABC's balance sheet on June 30, Year 1 reflects the following amounts.

Account	Amount (debit balances)
Silver platter inventory	\$1,550,000

AOCI – Loss on hedging instrument (forward contract)	50,000
Total amounts related to inventory for which the purchase was hedged	\$1,600,000

Three months later on September 30, Year 1, the net realizable value of the silver platter inventory to which the cash flow hedge relates is \$1,975,000. The inventory has a carrying amount of \$2,000,000 – i.e. the initial purchase of silver of \$1,550,000 plus costs incurred after the silver was purchased.

In addition, ABC:

- uses the FIFO method to account for its inventory; and
- continues to report in AOCI the loss on the forward contract.

As of September 30, Year 1, ABC first evaluates the combination of the inventory and the net loss on the forward contract that is reported in AOCI as follows.

Account	Amount (debit balances)
Silver platter inventory	\$2,000,000
AOCI – Loss on hedging derivative	50,000
Total amounts related to hedged inventory ¹	2,050,000
Net realizable value of inventory	1,975,000
Portion of total amount that is not expected to be recovered²	\$75,000
Amount of AOCI – loss on hedging derivative to be reclassified into earnings³	\$50,000
Notes:	
1. Silver platter inventory + AOCI – Loss on hedging derivative.	
2. Total amounts related to hedged inventory – Net realizable value of inventory.	
3. Represents the entire amount in AOCI – Loss on hedging derivative (\$50,000).	

ABC records the following journal entry.

	Debit	Credit
Cost of goods sold	50,000	
AOCI – Loss on hedging derivative		50,000
<i>To reclassify from AOCI to earnings a loss on hedging derivative not expected to be recovered.</i>		

As of September 30, Year 1, ABC next evaluates whether the silver platter inventory is impaired as follows.

Account	Amount (debit balances)
Silver platter inventory	\$2,000,000
Net realizable value of inventory	1,975,000
Amount of impairment to recognize¹	\$25,000

Note:

1. Silver platter inventory - Net realizable value of inventory.

ABC records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cost of goods sold	25,000	
Inventory		25,000
<i>To recognize impairment of inventory due to market value being less than carrying amount.</i>		

As this example demonstrates, when the net realizable value is less than the carrying amount of inventory, related net derivative losses reported in AOCI are required to be reclassified into earnings *in addition to* (and in advance of) recognition of the inventory's impairment loss. This is because Topic 815 is applied before the impairment guidance.



Question 10.4.20

Are net gains in AOCI reclassified if an impairment loss is recognized on an existing asset to which a current or previous hedged forecasted transaction relates?

Interpretive response: When an impairment loss is recognized on an existing asset to which a current or previous hedged forecasted transaction relates, it generally is necessary to reclassify an offsetting net gain related to the transaction (if any) from AOCI into earnings. However, before any offsetting net gain in AOCI is reclassified into earnings, an entity should ascertain that the net gain directly relates to that asset or liability being measured for impairment. In addition, we believe an entity should also ascertain that the measure for that impairment results from the risk being hedged. [\[815-30-35-43\]](#)

For example, if interest rate risk is hedged on a variable-rate financial asset and results in a gain in AOCI, that gain would not be reclassified into earnings if a credit loss is recognized on the financial asset. This is because the hedged risk that resulted in the gain in AOCI was interest rate risk while the risk resulting in recognition of a credit loss is credit risk.

Additionally, the entity would need to consider whether recognizing the impairment loss indicates the likelihood of the forecasted transaction is no longer probable (and may indicate it is probable that the forecasted transaction will *not* occur). See section 10.5.20, which discusses the impact on hedge accounting and the treatment of the net derivative gain or loss reported in AOCI when the likelihood of the forecasted transaction is no longer probable.



Example 10.4.20

Hedged asset is impaired and related amount in AOCI is a net derivative gain

This example is a modification of Example 10.3.20.

In that example, ABC Corp. uses a forward contract in a cash flow hedge of a forecasted purchase of silver. As a result of the forward contract, ABC locked in a purchase price for the silver of \$1,600,000 (100,000 ounces at \$16 per ounce).

Unlike that example, it is now assumed that the spot price for silver is \$16.30 per ounce. ABC purchases 100,000 ounces of silver as forecast, and pays the market price of \$1,630,000. Additionally, ABC receives \$30,000 to settle the forward contract, which represents the fair value (asset) of the forward contract on June 30, Year 1. As a result, ABC's balance sheet reflects a net derivative gain in this example – rather than loss as in Example 10.3.20 – in AOCI after settlement of the forward contract and purchase of silver.

After settlement of the forward contract and purchase of silver, ABC's balance sheet on June 30, Year 1 reflects the following amounts.

Account	Amount
Silver platter inventory	\$1,630,000
AOCI – Gain on hedging instrument (forward contract)	30,000
Total amounts related to inventory for which the purchase was hedged	\$1,600,000

Three months later on September 30, Year 1, the net realizable value of the silver platter inventory to which the cash flow hedge relates is \$1,975,000. The inventory has a carrying amount of \$2,000,000 – i.e. the initial purchase of silver of \$1,630,000 plus costs incurred after the silver was purchased.

In addition, ABC:

- continues to report in AOCI the gain on the forward contract; and
- uses the FIFO method to account for its inventory.

As of September 30, Year 1, ABC evaluates whether the silver platter inventory is impaired as follows.

Account	Amount (debit balances)
Silver platter inventory	\$2,000,000
Net realizable value of inventory	1,975,000
Amount of impairment to recognize¹	\$ 25,000
Note:	
1. Silver platter inventory - Net realizable value of inventory.	

ABC records the following journal entry.

	Debit	Credit
Cost of goods sold	25,000	
Inventory		25,000
<i>To recognize impairment of inventory due to market value being less than carrying amount.</i>		

ABC performs an analysis to determine why the inventory's net realizable value is less than its cost. ABC concludes that it is primarily because of a decrease in the spot price of silver (i.e. the hedged risk) after the silver was purchased. Therefore, ABC evaluates the amount of the net gain on the forward contract that is reported in AOCI by comparing it to the amount of the impairment loss that was recognized.

Account	Amount
Impairment loss recognized	\$25,000
AOCI – Gain on hedging instrument (forward contract)	30,000
Amount of AOCI – gain on hedging derivative to be reclassified into earnings¹	\$25,000
Note:	
1. Represents the lesser of the impairment loss recognized and the amount in AOCI – Gain on hedging instrument (forward contract).	

ABC records the following journal entry.

	Debit	Credit
AOCI – Gain on hedging derivative	25,000	
Cost of goods sold		25,000
<i>To reclassify from AOCI into earnings a gain on hedging derivative to offset impairment loss recognized on hedged transaction.</i>		

As this example demonstrates, when an impairment loss is recognized, net derivative gains reported in AOCI related to the hedged forecasted transaction are required to be reclassified into earnings to the extent of that impairment loss.

10.5 Discontinuing hedge accounting

10.5.10 Overview



Excerpt from ASC 815-30

>> Change in Designated Hedged Risk

35-37A If the designated hedged risk changes during the life of a hedging relationship, an entity may continue to apply hedge accounting if the hedging instrument is highly effective at achieving offsetting cash flows attributable to the revised hedged risk. The guidance in paragraph 815-20-55-56 does not apply to changes in the hedged risk for a cash flow hedge of a forecasted transaction.

> Discontinuing Hedge Accounting

40-2 In the circumstances discussed in paragraph 815-30-40-1, the net gain or loss shall remain in accumulated other comprehensive income and be reclassified into earnings as specified in paragraphs 815-30-35-38 through 35-41. Example 16 (see paragraph 815-30-55-94) illustrates the application of paragraph 815-30-35-3 if a hedging relationship is terminated.

The following table provides an overview of circumstances that would require an entity to discontinue or partially dedesignate a hedging relationship.

Change in eligibility or critical terms of hedged transactions (section 6.10.20)	— Hedged transaction no longer meets the eligibility criteria [815-30-40-1(a)] — Modification of hedged transaction such that critical terms of the original hedging relationship have changed [815-20-55-56]
Change in eligibility or critical terms of hedging instrument (section 6.10.30)	— Hedging instrument no longer meets the eligibility criteria [815-30-40-1(a)] — Hedging instrument expires or is sold, terminated or exercised [815-30-40-1(b)] — Modification of hedging instrument such that critical terms of the original hedging relationship have changed [815-20-55-56]
Change in hedged risk (sections 6.10.40 and 9.4.60)	— Change in the hedged risk, except in certain circumstances [815-20-55-56]

Change in hedge effectiveness (section 6.10.50)	— Hedge no longer highly effective on a retrospective and/or prospective basis, with certain exceptions (see Question 6.10.90) [815-30-40-1(a)] — Change in quantitative method to assess hedge effectiveness, including whether a component of the hedging instrument is excluded from the assessment (see section 13.6.40) [815-20-55-56]
Elective dedesignation	An entity may elect to discontinue the hedging relationship [815-30-40-1(c)]

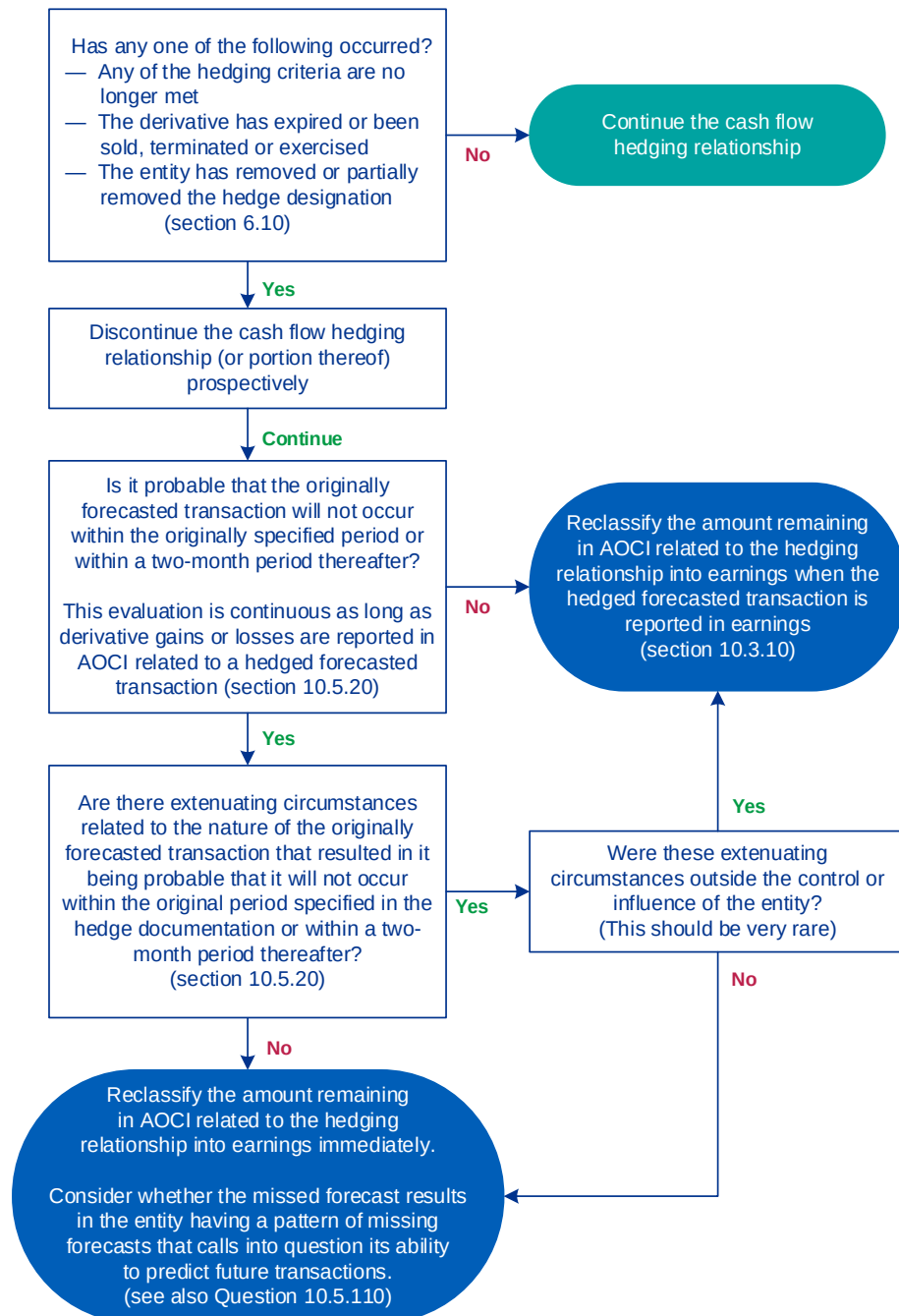


Future developments#

The FASB has a project to provide potential Codification improvements related to an entity's ability to change the hedged risk and/or the hedged forecasted transaction (see Question 9.4.90). This would include clarifying how broadly or narrowly the hedged transaction is defined and whether a change in the hedged risk constitutes a change in the hedged transaction. A proposed ASU was issued in November 2019. This project is ongoing and we expect a final ASU to be issued in 2021. [\[Proposed ASU\]](#)

Treatment of hedging instruments. If the derivative instrument remains outstanding after hedge accounting is discontinued, it continues to be recorded on the balance sheet at fair value. However, changes in the derivative's fair value (including changes in excluded components) are reflected in earnings – rather than AOCI – unless the derivative is designated as the hedging instrument in a new hedging relationship. It may be used as the hedging instrument in a new hedging relationship as long as the hedging criteria are met for the new relationship. [815-30-40-3]

Treatment of amounts remaining in AOCI and effect of discontinuation on future hedging relationships. When a hedging relationship is discontinued, accounting for the net derivative gain or loss reported in AOCI and the effect of the discontinuation on future hedging relationships depends on several considerations. Those considerations are summarized in the following decision tree.



Examples

The following examples demonstrate discontinuation of cash flow hedge accounting.

- Terminating an interest rate swap used in a cash flow hedge (Example 10.5.10).
- Terminating a cash flow hedge when hedge designation is removed (Example 10.5.20).

- Accounting for amounts in AOCI when a hedged forecasted transaction becomes a firm commitment (Example 10.5.30).
- Designation and discontinuance of a cash flow hedge of the forecasted purchase of inventory (Subtopic 815-30's Example 8).
- Changes in a cash flow hedge of forecasted interest payments with an interest rate swap (Subtopic 815-30's Example 9).



Example 10.5.10

Terminating an interest rate swap used in a cash flow hedge

Three years ago, ABC Corp. entered into a five-year interest rate swap to receive interest at a variable rate (US Treasury rates) and to pay interest at a fixed rate. The swap was designated as a hedge of the risk of changes in its cash flows attributable to changes in the contractually specified interest rate (i.e. US Treasury rates) on a specific five-year, variable-rate debt obligation.

Since that time, interest rates have declined and ABC has recognized a liability of \$1,000,000 related to this interest rate swap (unrealized net loss), with an offsetting charge of \$1,000,000 reported in AOCI.

ABC pays the swap counterparty \$1,000,000 to terminate the interest rate swap and derecognizes the \$1,000,000 liability related to the swap.

In this example, the hedging instrument is terminated but the hedged transaction (interest cash flows on a specific five-year, variable-rate debt obligation) continues to be probable. As a result, the net derivative loss reported in AOCI related to the discontinued hedging relationship is reclassified into earnings when the hedged forecasted transactions affect earnings – e.g. over the remaining two-year life of the specific debt obligation.



Example 10.5.20

Terminating a cash flow hedge when hedge designation is removed

Three years ago, ABC Corp. entered into a five-year interest rate swap to receive interest at a fixed rate and to pay interest at a variable rate (six-month LIBOR). The swap was designated as a hedge of the risk of changes in its cash flows attributable to changes in the contractually specified rate (six-month LIBOR) on a specific five-year, variable-rate (six-month LIBOR) AFS debt security.

Since that time, interest rates decreased and ABC recognized an asset of \$1,000,000 relating to this interest rate swap (an unrealized net gain), with an offsetting credit of \$1,000,000 reported in AOCI.

ABC removes the hedging designation.

In this example, the hedging relationship has been discontinued but the hedged transaction (interest cash flows on a specific five-year, variable-rate AFS debt

security) continues to be probable. As a result, the net derivative gain reported in AOCI related to the discontinued hedging relationship is reclassified into earnings when the hedged forecasted transactions affect earnings – e.g. over the remaining two-year life of the specific debt security.

As of the date the hedging designation is removed, ABC accounts for the swap as a nonhedging derivative instrument with all subsequent changes in its fair value recognized currently in earnings unless it is designated as the hedging instrument in a new hedging relationship that meets all of the relevant hedging criteria.



Example 10.5.30

Accounting for amounts in AOCI when a hedged forecasted transaction becomes a firm commitment

On January 1, Year 1, ABC Corp. purchases a call option to hedge the total price risk of a forecasted purchase of 10,000 units of inventory, which is expected to occur in 12 months. At June 30, Year 1, a \$5,000,000 net gain on the call option remains in AOCI.

On July 1, Year 1, ABC enters into a firm commitment to acquire the 10,000 units of inventory in six months at a fixed price, thereby transforming the forecasted transaction into a firm commitment.

When the hedged forecasted transaction becomes a firm commitment, it no longer qualifies as a cash flow hedge because there is no variability in expected future cash flows. As a result, ABC discontinues prospectively applying cash flow hedge accounting to the forecasted transaction/call option hedging relationship.

ABC continues to report the \$5,000,000 net derivative gain in AOCI until the date the hedged forecasted transaction is reported in earnings. Because the hedged forecasted transaction is the purchase of inventory, the \$5,000,000 gain in AOCI will be reclassified into earnings when either the hedged inventory is sold or impairment is recognized (section 10.3.10 and 10.4.10).



Excerpt from ASC 815-30

>> Example 8: Designation and Discontinuance of a Cash Flow Hedge of the Forecasted Purchase of Inventory

55-40 This Example illustrates the effect on earnings and other comprehensive income of discontinuing a cash flow hedge by dedesignating the hedging derivative under paragraph 815-30-40-1(c) before the variability of the cash flows from the hedged forecasted transaction has been eliminated. It also discusses the effect that the location of a physical asset has on the

effectiveness of a hedging relationship. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-41 On February 3, 20X1, Entity JKL forecasts the purchase of 100,000 bushels of corn on May 20, 20X1. The contract does not contain a contractually specified component, and Entity JKL designates changes in cash flows related to the forecasted transaction attributable to all changes in the purchase price as the hedged risk. It expects to sell finished products produced from the corn on May 31, 20X1. On February 3, 20X1, Entity JKL enters into 20 futures contracts, each for the purchase of 5,000 bushels of corn on May 20, 20X1 (100,000 in total), and designates those contracts as a hedging instrument in a cash flow hedge of the forecasted purchase of corn.

55-42 Entity JKL chooses to assess effectiveness by comparing the entire change in fair value of the futures contracts to changes in the expected cash flows on the forecasted transaction. Entity JKL estimates its expected cash flows on the forecasted transaction based on the futures price of corn adjusted for the difference between the cost of corn delivered to Chicago and the cost of corn delivered to Minneapolis. Entity JKL does not choose to use a tailing strategy (as described in paragraph 815-20-25-121). Entity JKL expects changes in fair value of the futures contracts to be highly effective at offsetting changes in the expected cash outflows for the forecasted purchase of corn because both of the following conditions exist:

- a. The futures contracts are for the same variety and grade of corn that Entity JKL plans to purchase.
- b. On May 20, 20X1, the futures price for delivery on May 20, 20X1 will be equal to the spot price (because futures prices and spot prices converge as the delivery date approaches).

However, the hedge may not achieve perfect offset between the hedged item and hedging instrument because of the difference in the delivery location between the hedging instrument and forecasted transaction.

55-43 Entity JKL will purchase corn for delivery to its production facilities in Minneapolis, but the price of the futures contracts is based on delivery of corn to Chicago. Changes in the difference between the price of corn delivered to Chicago and the price of corn delivered to Minneapolis would result in not achieving perfect offset between the hedged item and hedging instrument and, if of significant magnitude, may preclude the hedging relationship from achieving highly effective offset.

55-44 On February 3, 20X1, the futures price of corn for delivery to Chicago on May 20, 20X1, is \$2.6875 per bushel resulting in a total price of \$268,750 for 100,000 bushels.

55-45 On May 1, 20X1, Entity JKL dedesignates the related futures contracts and closes them out by entering into offsetting contracts on the same exchange. As of that date, Entity JKL had recognized in accumulated other comprehensive income gains on the futures contracts of \$26,250. Entity JKL still plans to purchase 100,000 bushels of corn on May 20, 20X1. Consequently, the gains that occurred before dedesignation will remain in other comprehensive income until the finished product is sold. If Entity JKL

had not closed out the futures contracts when it dedesignated them, any further gains or losses would have been recognized in earnings.

55-46 On May 20, 20X1, Entity JKL purchases 100,000 bushels of corn, and on May 31, 20X1, Entity JKL sells the finished product.

55-47 The futures prices of corn that are in effect on key dates are assumed to be as follows.

Date	Futures Price per Bushel for Delivery to Chicago on May 20, 20X1	Futures Price Adjusted for Delivery to Minneapolis on May 20, 20X1
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

55-48 The changes in fair value of the futures contracts between inception (February 3, 20X1) and discontinuation (May 1, 20X1) of the hedge are as follows.

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

55-49 The following table displays the entries to recognize the effects of all of the following:

- Entering into futures contracts as a hedge of the forecasted purchase of corn
- Dedesignating and closing out the futures contracts
- Completing the forecasted purchase of corn
- 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 815-30-55-47) did not change during the period of the hedge, the hedging relationship achieved perfect offset between the hedged item and the hedging instrument. If that difference had changed, the entire change in fair value of the futures contracts would still have been recorded in accumulated other comprehensive income until the discontinuation date assuming the hedging relationship remained highly effective at offsetting variability in cash flows and the hedged forecasted transaction was still probable of occurring.

	Debit (Credit)			
	Cash	Inventory	Other Comprehensive Income	Earnings ^(a)
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	\$ (263,750)	\$ -	\$ -	\$ 263,750

(a) The change in the fair value of the hedging derivative is presented in the same income statement line item as the earnings effect of the hedged item.

55-50 To simplify this Example and focus on the effects of the hedging relationship, the margin account with the clearinghouse and certain amounts that would be involved in a sale of Entity JKL's inventory (for example, additional costs of production, selling costs, and sales revenue) have been ignored.

55-51 The effect of the hedging strategy is that the cost of the corn recognized in earnings when the finished product was sold was \$263,750. If the hedging relationship had not been discontinued early, the cost recognized in earnings would have been \$273,750, which was the futures price of the corn, adjusted for delivery to Minneapolis, at the inception of the hedge. Without the strategy, Entity JKL would have recognized \$290,000, which was the price of corn delivered to Minneapolis at the time it was purchased.



Excerpt from ASC 815-30

>> Example 9: Changes in a Cash Flow Hedge of Forecasted Interest Payments with an Interest Rate Swap

55-52 The following Cases describe the effects on earnings and other comprehensive income of certain changes in a cash flow hedging relationship:

- The variability of the hedged interest payments is eliminated before the hedging derivative expires (Case A).

- b. The interest rate index that is the basis for the hedged interest payments is changed to a different index before the hedging derivative expires (Case B).

55-53 Cases A and B share the following assumptions. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-54 Entity MNO enters into an interest rate swap (Swap 1) and designates it as a hedge of the variable quarterly interest payments on Entity MNO's 5-year \$5 million borrowing program, initially expected to be accomplished by a series of \$5 million notes with 90-day terms. Entity MNO plans to continue issuing new 90-day notes over the next 5 years as each outstanding note matures. The interest on each note will be determined based on the contractually specified LIBOR rate at the time each note is issued. Swap 1 requires a settlement every 90 days, and the variable interest rate is reset immediately following each payment. Entity MNO pays a fixed rate of interest (6.5 percent) and receives interest at LIBOR. Entity MNO neither pays nor receives a premium at the inception of Swap 1. The notional amount of the contract is \$5 million, and it expires in 5 years.

55-55 Because Swap 1 and the hedged forecasted interest payments are based on the same notional amount, have the same reset dates, and are based on the same contractually specified interest rate (that is, the LIBOR rate) designated under paragraph 815-20-25-15(j)(2), Entity MNO may conclude that the hedging relationship will perfectly offset changes in cash flows of the hedged item attributable to the hedged risk and the hedging instrument (absent a default by the interest rate swap counterparty).

55-56 This paragraph explains why the guidance in Example 4, Case B (see paragraph 815-20-55-97) does not conflict with the guidance in this Example. In the cash flow hedge in this Example, had the hedged forecasted transaction been narrowly limited to the interest payments on specific future debt issuances rather than on the five-year borrowing program, the failure to engage in future debt issuances would cause the related derivative instrument net gain or loss in other comprehensive income to be immediately reclassified into earnings pursuant to paragraphs 815-30-40-4 through 40-5 because it would have been probable that the hedged forecasted transactions would not occur. Furthermore, if that failure is part of a pattern of hedged forecasted transactions being probable of not occurring, it would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions, pursuant to paragraph 815-30-40-5. In contrast, in Example 4, Case B (see paragraph 815-20-55-97), the hedged quarterly interest payments were directly linked to Entity B's existing LIBOR-indexed floating-rate assets. When those existing assets are later prepaid or sold, the future quarterly interest payments on those specific assets are no longer probable of occurring (that is, no longer probable of being received by Entity B). Consequently, the hedging relationships for those future quarterly interest payments fail to meet the criterion in paragraph 815-20-25-15(b) and must be discontinued under paragraph 815-30-40-1. Because it is probable that the hedged quarterly interest payments that were directly linked to assets that were prepaid or sold

will not occur, the related derivative instrument net gain or loss in other comprehensive income must be immediately reclassified into earnings pursuant to paragraphs 815-30-40-4 through 40-5.

>>> Case A: Variability of Hedged Forecasted Transactions Is Eliminated

55-57 At the end of the second year of the 5-year hedging relationship, Entity MNO discontinues its practice of issuing 90-day notes. Instead, Entity MNO issues a 3-year, \$5 million note with a fixed rate of interest (7.25 percent). Because the interest rate on the three-year note is fixed, the variability of the future interest payments has been eliminated. Thus, Swap 1 no longer qualifies for cash flow hedge accounting. However, the net gain or loss on Swap 1 in accumulated other comprehensive income is not reclassified to earnings immediately. Immediate reclassification is required (and permitted) only if it becomes probable that the hedged transactions (future interest payments) will not occur. The variability of the payments has been eliminated, but it still is probable that they will occur. Thus, those gains or losses will continue to be reclassified from accumulated other comprehensive income to earnings as the interest payments affect earnings (as required by paragraphs 815-30-35-38 through 35-41) and presented in the same income statement line item as the earnings effect of the hedged item. If the term of the fixed rate note had been longer than three years, the amounts in accumulated other comprehensive income still would have been reclassified into earnings over the next three years, which was the term of the designated hedging relationship.

55-58 Rather than liquidate the pay-fixed, receive-variable Swap 1, Entity MNO enters into a pay-floating, receive-fixed interest rate swap (Swap 2) with a 3-year term and a notional amount of \$5 million. Entity MNO neither pays nor receives a premium. Like Swap 1, Swap 2 requires a settlement every 90 days and reprices immediately following each settlement. The relationship between 90-day interest rates and longer term rates has changed since Entity MNO entered into Swap 1 (that is, the shape of the yield curve is different). As a result, Swap 2 has different terms and its settlements do not exactly offset the settlements on Swap 1. Under the terms of Swap 2, Entity MNO will receive a fixed rate of 7.25 percent and pay interest at LIBOR.

55-59 The two swaps are not designated as hedging instruments and are reported at fair value. The changes in fair value are reported immediately in earnings and offset each other to a significant degree.

>>> Case B: Basis of Hedged Forecasted Transactions Is Changed

55-60 At the end of the second year of the 5-year hedging relationship, Entity MNO discontinues its practice of issuing 90-day notes and issues a 3-year, \$5 million note with a different contractually specified interest rate (that is, an interest rate that is not LIBOR) that adjusts every 90 days. As of this date, Entity MNO must begin performing assessments of effectiveness for the hedging relationship by comparing changes in fair value of the hedging instrument (indexed to LIBOR) with changes in the value of the hedged item based on the revised contractually specified interest rate. Because the hedged forecasted transactions (future interest payments) are still probable of occurring, Entity MNO may continue to apply hedge accounting in accordance with paragraph 815-30-35-37A if the hedging instrument (indexed to LIBOR) is

highly effective at achieving offsetting cash flows attributable to the revised contractually specified interest rate.

55-61 If the revised hedging relationship is not determined to be highly effective, the hedging relationship must be discontinued. However, the net gain or loss on Swap 1 in accumulated other comprehensive income as of the date Entity MNO issues the three-year note is not reclassified into earnings immediately. Immediate reclassification would be required only if, as part of its normal process of assessing whether it remains probable that the hedged forecasted transaction will occur, Entity MNO determines that it is probable that the hedged transactions (future interest payments) will not occur. In this case, the expected amounts of those payments have changed (because they will be based on a revised contractually specified interest rate instead of LIBOR, as originally expected), but it still is probable that the payments will occur. Thus, those gains or losses will continue to be reclassified to earnings as the interest payments affect earnings and presented in the same income statement line item as the earnings effect of the hedged item.

Accounting in the period a hedge is discontinued

The following Questions and Examples address several interpretive issues regarding how to account for a cash flow hedge in the period it is discontinued.



Question 10.5.10

If a hedging relationship has been retrospectively highly effective, is hedge accounting required to be applied in the previous period?

Interpretive response: Yes. If an entity determines that a hedging relationship had been retrospectively highly effective at the current assessment date, the entity is required to apply hedge accounting.

This means that the amount reported in AOCI should be measured through the date of the assessment (see section 10.2.10). This is the case even if the entity believes the hedging relationship will not be highly effective on a prospective basis or if the entity is discontinuing hedge accounting prospectively.



Example 10.5.40

Dedesignation and redesignation of a hedging relationship due to failing to qualify for cash flow hedge accounting in one period

On January 1, Year 1, ABC Corp. enters into a hedging relationship of a forecasted transaction that will occur in Year 2. ABC documents that it will use a regression analysis approach for its prospective assessment of effectiveness and the period-by-period, dollar-offset method for its retrospective assessment of effectiveness. The fair value of the hedging instrument is zero at inception.

On March 31, Year 1 (the first assessment period), ABC concludes that the hedging relationship was highly effective retrospectively and is expected to continue to be highly effective prospectively.

On June 30, Year 1 (the second assessment period), ABC concludes that the hedging relationship was not highly effective retrospectively but is expected to be highly effective prospectively. There are circumstances in which it is appropriate to continue applying hedge accounting when a hedging relationship is expected to be highly effective prospectively when it was not retrospectively (see Question 6.10.90). However, ABC concludes that this is not one of those limited circumstances – i.e. ABC does not identify any specific event during the period that caused the hedging relationship not to be highly effective on a retrospective basis. As a result, hedge accounting may *not* be applied in the period just ended and the hedging relationship must be terminated.

On June 30, Year 1, ABC immediately redesignates the derivative to a new hedging relationship with terms identical to the previous hedging relationship (except that its retrospective and prospective assessments of effectiveness will be based on regression analyses rather than by period-by-period dollar-offset).

On September 30, Year 1, and December 31, Year 1, ABC concludes that the new hedging relationship was highly effective retrospectively and is expected to continue to be highly effective prospectively.

The following data are also relevant.

Assessment date	Derivative fair value asset (liability)	Cumulative change in derivative fair value during the hedging relationship gain (loss)	Change in derivative's fair value during current assessment period (Adjustment to AOCI) (debit) credit
Original hedging relationship			
March 31, Year 1	\$(100)	\$(100)	\$(100) ¹
June 30, Year 1	(120)	(120)	- ²
New hedging relationship			
September 30, Year 1	\$80	\$200	\$200 ¹
December 31, Year 1	30	150	(50) ¹
Notes:			
1. Because the hedge was highly effective in the retrospective assessment period, the change in derivative fair value is recognized in OCI. It is calculated as the cumulative change in derivative fair value during the hedge as of the current assessment date less the cumulative change in the derivative fair value during the hedge as of the previous assessment date. 2. Because the hedge was not highly effective in the retrospective assessment period, hedge accounting is not applied. As a result, the change in the fair value of the derivative is recognized in earnings rather than in OCI.			

Journal entry – January 1, Year 1

There is a memorandum entry made on January 1, Year 1, documenting the existence of this hedging relationship. ABC's financial records are not otherwise affected as of this date because the derivative hedging instrument had a fair value of zero at inception.

Journal entries – March 31, Year 1

ABC records the following journal entry.

	Debit	Credit
OCI – Gains (losses) on cash flow hedging derivatives	100	
Derivative liability		100
<i>To record change in fair value of derivative during period as a result of applying hedge accounting.</i>		

Journal entries – June 30, Year 1

ABC records the following journal entry.

	Debit	Credit
Gains (losses) on derivatives (income statement)	20	
Derivative liability		20
<i>To record change in fair value of derivative during period for which hedge accounting is not applied.</i>		

Journal entries – September 30, Year 1

ABC records the following journal entry.

	Debit	Credit
Derivative asset ¹	80	
Derivative liability ¹	120	
OCI – Gains (losses) on cash flow hedging derivatives		200
<i>To record change in fair value of derivative during period as a result of applying hedge accounting.</i>		

Note:

1. The derivative instrument represented a liability as of June 30, Year 1 and an asset as of September 30, Year 1.

Journal entries – December 31, Year 1

ABC records the following journal entry.

	Debit	Credit
OCI – Gains (losses) on cash flow hedging derivatives	50	
Derivative asset		50
<i>To record change in fair value of derivative during period as a result of applying hedge accounting.</i>		

Financial statement excerpts

At the end of each period, ABC's financial statements reflect the following related to this hedging relationship.

Account	3 months ended Mar 31	6 months ended Jun 30	9 months ended Sep 30	Year ended Dec 31
Balance sheet – assets				
Derivatives	-	-	\$80	\$30
Balance sheet – liabilities				
Derivatives	\$100	\$120	-	-
Balance sheet – equity				
AOCI – Gains (losses) on cash flow hedging derivatives	\$(100)	\$(100)	\$100	\$50
Income statement				
Gains (losses) on derivatives (P&L)	-	\$(20)	\$(20)	\$(20)

Because the original hedging relationship was not highly effective under the retrospective assessment of effectiveness during the second assessment period, the entire change in the derivative's fair value for that period is recognized in earnings.

The net derivative gains or losses reported in AOCI related to the new hedging relationship established subsequently includes changes in the derivative's fair value for the new hedging period – i.e. July 1, Year 1 to December 31, Year 1.



Question 10.5.20

What is the accounting for amounts in AOCI related to a partially dedesignated cash flow hedging relationship?

Background: We believe it is acceptable to partially dedesignate a cash flow hedging relationship under certain circumstances (see section 6.10.60).

Interpretive response: The accounting when a hedging relationship is partially dedesignated is summarized as follows.

Treatment of hedging instruments. The derivative instrument continues to be recorded on the balance sheet at fair value. However, changes in its fair value are recorded differently for the portion that was (versus was not) dedesignated from the hedging relationship.

- Portion that remains designated in the hedging relationship: Changes in this portion of the derivative's fair value that are included in the effectiveness assessment continue to be reported in OCI. Changes in the portion of the fair value that relate to excluded components continue to be recognized in earnings using either an amortization or mark-to-market approach (see section 10.2). These amounts relate to the forecasted transactions that continue to be hedged.
- Portion that is no longer designated: Subsequent changes in this portion of the derivative's fair value (including changes in excluded components) are reflected in earnings – rather than OCI – unless this portion is designated as the hedging instrument in a new hedging relationship.

Treatment of amounts remaining in AOCI and other considerations. When a hedging relationship is partially dedesignated because some of the originally forecasted transactions are no longer probable, a portion of the net derivative gain or loss reported in AOCI at the time of partial dedesignation relates to the forecasted transactions that continue to be hedged and another portion relates to those forecasted transactions that are no longer hedged.

- Forecasted transactions that continue to be hedged: The entity continuously evaluates the likelihood that the forecasted transactions will occur. These amounts generally remain in AOCI until the period(s) that the forecasted transactions are reported in earnings (see sections 10.3 and 10.4).
- Forecasted transactions that are no longer hedged: Until these transactions occur, the entity continuously evaluates related amounts that remain in AOCI. If at any time it is probable that the previously hedged forecasted transactions will *not* occur in the originally specified period or within an additional two months, related amounts remaining in AOCI are immediately reclassified into earnings unless extenuating circumstances apply. Additionally, this represents a missed forecast that the entity would be required to consider when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions (see also Question 10.5.110).



Question 10.5.30

Is hedge accounting applied through the date an event causes a hedging relationship to no longer be highly effective?

Background: If in a *fair value hedge* an event or change in circumstances results in the hedging relationship not being retrospectively highly effective for the current period and the date that event or change in circumstances occurred can be identified, the entity must apply fair value hedge accounting through that date (see section 8.5.20). Topic 815 does not contain similar language for a cash flow hedge. [815-25-40-4]

Interpretive response: Yes. Based on discussions with the FASB staff, we believe cash flow hedge accounting should be applied through the date of such an event or change.

When an entity determines that a hedging relationship had not been retrospectively highly effective at the current assessment date, the entity generally should discontinue hedge accounting (see section 6.10.50) and should not recognize changes in the fair value of the hedging instrument in AOCI for that assessment period.

However, if the entity is able to identify the event or change in circumstances that resulted in the cash flow hedging relationship being discontinued, the entity must apply hedge accounting up to the date of that event or change in circumstances. All subsequent changes in fair value of the derivative that occurred from that date to the current assessment date are reported in earnings.



Question 10.5.40

Is it appropriate to assume the last date of high effectiveness is the date insolvency is declared or significant financial difficulties are disclosed?

Background: In some circumstances, an entity will be required to discontinue a cash flow hedging relationship because the hedging relationship is not highly effective due to changes in the creditworthiness of the counterparty to the derivative (or in the entity's own nonperformance risk).

Interpretive response: Not necessarily. If a hedge is no longer highly effective because of the counterparty's creditworthiness or the entity's nonperformance risk, the hedging relationship is discontinued as of the date it is no longer probable that the counterparty or the entity will *not* default. Careful analysis and significant judgment are often necessary to determine this date.

Deterioration in credit can occur over a period of time. As a result, an entity should review all available information, including the pricing of relevant instruments in the financial markets to determine when the total changes in the cash flows of the derivative hedging instrument began to deviate from the changes in the cash flows of the hedged transaction due to changes in the hedged risk. For example, credit spreads may widen to the point of causing the

changes in the fair value of a derivative to cease being highly effective at offsetting changes in the cash flows of the hedged transaction in advance of insolvency being declared, public disclosure of significant financial difficulties, and/or a credit downgrade by the national rating agencies.



Example 10.5.50

Identification of the date credit deterioration caused a hedge to cease being highly effective

On September 30, Year 1, ABC Corp. has a highly effective cash flow hedging relationship that involves a derivative in an asset position with a fair value of \$18. ABC has not excluded any components from the assessment of effectiveness; therefore, the cumulative change in the derivative's fair value (i.e. \$18) is in AOCI at September 30, Year 1.

On December 31, Year 1, the fair value of the derivative hedging instrument decreases to \$1 due to credit deterioration of the derivative counterparty. As a result, ABC determines that the cash flow hedging relationship was not highly effective for the three months ended December 31, Year 1 and is not expected to be highly effective on a prospective basis.

ABC performs an analysis and determines that the fair value of the derivative was \$16 on October 14, Year 1 but decreased overnight to \$2 on October 15 because of a severe increase in the credit spread of the counterparty. ABC determines that the hedging relationship was highly effective through October 14, Year 1. Therefore, ABC applies hedge accounting through October 14, Year 1 – i.e. ABC recognizes the change in fair value of the hedging instrument through that date in AOCI.

ABC then discontinues hedge accounting. All changes in the fair value of the derivative after October 14, Year 1 are reflected in earnings.



Excerpt from ASC 815-30

>> Example 16: Impact on Accumulated Other Comprehensive Income of Issuing Debt with a Term That Is Shorter Than Originally Forecasted

55-94 This Example illustrates the effect on accumulated other comprehensive income of issuing debt with a term that is shorter than originally forecasted.

55-95 Entity A expects to borrow \$100 million over a 10-year period beginning in 6 months. Entity A initially plans to issue \$100 million of 10-year fixed-rate debt at or near par at the then-current market interest rate; consequently, Entity A will be exposed to variability in cash flows in the future quarterly interest payments on the debt due to changes in credit risk and interest rate risk that occur during this 6-month period before issuance. To hedge the risk of changes in these 40 quarterly interest payments attributable to changes in the

benchmark interest rate for the 6-month period, Entity A does all of the following:

- a. It enters into a derivative instrument (for example, a forward-starting interest rate swap).
- b. It documents that it is hedging the variability in the 40 future quarterly interest payments, attributable to changes in the benchmark interest rate, over the next 10 years related to its 10-year \$100 million borrowing program that begins in 6 months.
- c. It documents that it will assess the effectiveness of the hedging relationship semimonthly on a quantitative basis.

55-96 Six months after inception of the hedging relationship, Entity A issues debt. However, due to market conditions, Entity A decides in the week before issuance that it will issue \$100 million of fixed-rate debt with a 5-year maturity and quarterly interest payments.

55-97 When Entity A decides that the term of the debt to be issued will differ from the term of the debt originally expected to be issued, Entity A should not immediately reclassify into earnings the entire net gain or loss in accumulated other comprehensive income related to the derivative instrument. Instead, Entity A must first apply the requirements of paragraph 815-30-35-3 using its originally documented hedging strategy and the newly revised best estimate of the cash flows. That is, the assessment of hedge effectiveness should be based on the most recent best estimate of the hedged forecasted transaction as of the date that a cash flow hedge is discontinued prospectively.

55-98 Entity A's strategy is a cash flow hedge of 40 individual probable quarterly interest payments. A cash flow hedge of future interest payments is a hedge of a series of forecasted transactions; consequently, Entity A must first determine the likelihood of whether and when each forecasted transaction in the series will occur. If at any time during the hedging relationship Entity A determines that it is no longer probable that any of the forecasted transactions in the series will occur by the date (or within the time period) originally specified, it must terminate the original hedging relationship for each of those specific nonprobable forecasted transactions (even if the forecasted transaction will occur within an additional two-month period of time after that originally specified date).

55-98A When Entity A performs its semimonthly assessment of effectiveness for the half-month period immediately preceding the issuance of the debt, it could also possibly conclude that the hedging relationship is no longer considered highly effective under paragraph 815-20-25-75 because the actual variability in the hedged interest payments for Years 1–5 is now based on the 5-year borrowing rate—not on 10-year rates as expected at the inception of the hedge when the entity selected the hedging derivative. In that circumstance, the hedging relationship is terminated. After the hedging relationship is terminated, Entity A must determine whether it is probable that any or all of those specific nonprobable forecasted transactions will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter (see paragraphs 815-30-40-4 through 40-5).

55-99 When Entity A originally documented the hedging relationship, it was hedging 40 forecasted transactions (forecasted quarterly interest payments) that would begin in 6 months' time and continue over a 10-year period. In this

Example, Entity A terminates the hedging relationship no later than on the date it issues the 5-year debt (because the variability of the first 20 hedged payments ceases on that date) and must determine the amount, if any, to be reclassified into earnings from accumulated other comprehensive income related to the net derivative gain or loss of the terminated cash flow hedge. Because Entity A issued a 5-year debt instrument, Entity A would determine that it is probable that the first 20 forecasted transactions would occur because they are now contractual obligations. Entity A must determine that it is not probable that any of the last 20 forecasted transactions will not occur to continue reporting the net derivative gain or loss related to these forecasted transactions in accumulated other comprehensive income. At issue is whether it is probable that the five-year debt will not be replaced by new borrowings that will involve the quarterly payment of interest. Provided that the entity determines that it is not probable that any of the original 40 forecasted transactions will not occur, Entity A must apply paragraph 815-30-35-3 and continue to report an amount in accumulated other comprehensive income based on the most recent best estimate of the hedged forecasted transactions related to all 40 forecasted transactions and reclassify an appropriate amount into earnings when each hedged forecasted transaction affects earnings and present those amounts in the same income statement line item as the earnings effect of the hedged item. If Entity A determines that it is probable that any of those forecasted transactions will not occur either by the end of the date (or within the time period) originally specified or within an additional two-month period of time thereafter (see paragraphs 815-30-40-4 through 40-5), Entity A should reclassify into earnings from accumulated other comprehensive income the amount of the net derivative instrument gain or loss related to those specific nonoccurring forecasted transactions. That amount should be equivalent to the portion of the present value of the derivative instrument's cash flows intended to offset the changes in the original forecasted transactions for which Entity A has determined it is probable that they will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter. Thus, the nonoccurrence of one of the hedged forecasted transactions described in this Example could potentially jeopardize Entity A's ability to use cash flow hedge accounting in the future for the situation described.

10.5.20 When it is probable a forecasted transaction will *not* occur



Excerpt from ASC 815-30

> Discontinuing Hedge Accounting

40-4 The net derivative instrument gain or loss related to a discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income unless it is probable that the forecasted transaction will not occur by the end of the originally specified time period (as documented at the inception of the hedging relationship) or within an additional two-month period of time thereafter,

except as indicated in the following sentence. In rare cases, the existence of extenuating circumstances that are related to the nature of the forecasted transaction and are outside the control or influence of the reporting entity may cause the forecasted transaction to be probable of occurring on a date that is beyond the additional two-month period of time, in which case the net derivative instrument gain or loss related to the discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income until it is reclassified into earnings pursuant to paragraphs 815-30-35-38 through 35-41.

40-5 If it is probable that the hedged forecasted transaction will not occur either by the end of the originally specified time period or within the additional two-month period of time and the hedged forecasted transaction also does not qualify for the exception described in the preceding paragraph, that derivative instrument gain or loss reported in accumulated other comprehensive income shall be reclassified into earnings immediately. A pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.

40-6 Derivative instrument gains and losses that had initially been reported in other comprehensive income as a result of a cash flow hedge and then reclassified to earnings (because the entity subsequently concluded that it was probable that the forecasted transaction would not occur within the originally specified time period or the additional period of time described in paragraph 815-30-40-4) shall not later be reclassified out of earnings and back into accumulated other comprehensive income due to a reassessment of probabilities.

Hedge accounting is required to be discontinued when a forecasted transaction is not probable. When a net derivative gain or loss related to the hedge of a forecasted transaction is reported in earnings depends on the likelihood of the forecasted transaction occurring within the original specified time period plus two months. [815-30-40-4 – 40-5, 40-6A, 815-20-45-1B]

The following table summarizes the effect of different levels of likelihood of the forecasted transaction occurring on the application of hedge accounting and the treatment of amounts remaining in AOCI. [815-30-40-4 – 40-6]

Likelihood that the forecasted transaction will occur in the originally specified time period	Impact on hedge accounting and treatment of the net derivative gain or loss reported in AOCI
Forecasted transaction is probable	— Hedge accounting is permitted to continue. — Amounts in AOCI are reclassified into earnings when the forecasted transaction affects earnings (section 10.3).
Forecasted transaction is reasonably possible but not probable	— Hedge accounting must be discontinued. Further changes in the hedging instrument's fair value are recognized in earnings rather than in OCI unless it is

Likelihood that the forecasted transaction will occur in the originally specified time period	Impact on hedge accounting and treatment of the net derivative gain or loss reported in AOCI
	designated in a different cash flow hedging relationship. — Amounts in AOCI are reclassified into earnings when the forecasted transaction affects earnings (section 10.3).
It is probable that forecasted transaction will <i>not</i> occur (a 'missed forecast')	— Hedge accounting must be discontinued. Further changes in the hedging instrument's fair value are recognized in earnings rather than in OCI unless it is designated in a different cash flow hedging relationship. — Amounts in AOCI are immediately reclassified into earnings (see income statement presentation guidance in Question 14.3.30), unless the forecasted transaction will occur within an additional two-month period or extenuating circumstances apply (see Question 10.5.90).

An entity continuously evaluates the likelihood of the hedged forecasted transaction occurring as long as derivative gains or losses are reported in AOCI related to a hedged forecasted transaction. Once an amount has been reclassified from AOCI into earnings because it is probable that a transaction will *not* occur, that amount is never reclassified back into AOCI from earnings, even if the likelihood of the transaction occurring changes. [815-30-40-4 – 40-6A]

A pattern of missing forecasts (i.e. determining that it is probable that hedged forecasted transactions will *not* occur by the end of the originally specified time period or within the two months thereafter) calls into question an entity's ability to predict future transactions and the propriety of using cash flow hedge accounting in the future for similar forecasted transactions. [815-30-40-6]



Question 10.5.50

Can amounts be reclassified from AOCI when a hedge is discontinued, even if the forecasted transaction is reasonably possible?

Interpretive response: No. If the forecasted transaction is still reasonably possible, the net derivative gains or losses reported in AOCI (i.e. that arose before the hedge was discontinued) continue to be reported in AOCI and to be reclassified into earnings when the hedged forecasted transaction is reported in earnings.

If it was permissible to immediately reclassify amounts reported in AOCI into earnings when a forecasted transaction no longer is probable but is still

reasonably possible, an entity would have the opportunity to manipulate earnings simply by changing its estimate of probability. As a result, net derivative gains or losses reported in AOCI when a hedge is discontinued are immediately reclassified into earnings only when an entity determines it is probable that the forecasted transaction will *not* occur in the originally specified time period or within a two-month period thereafter. [FAS 133.BC494]

Applying the additional two-month period



Question 10.5.60

Does an entity consider an additional two-month period when deciding whether to discontinue hedge accounting?

Interpretive response: No. An entity should not factor an additional two months into its consideration when determining whether a cash flow hedging relationship must be discontinued; instead, the entity should discontinue the hedging relationship because the hedged forecasted transaction will *not* occur within the originally specified time period.

The additional two-month period is relevant only after the entity discontinues a cash flow hedging relationship and it is evaluating whether to reclassify amounts related to the discontinued hedging relationship from AOCI into earnings.

However, Topic 815 does provide flexibility for documenting – at inception of the hedging relationship – when the forecasted transaction will occur if the timing of the forecasted transaction involves some uncertainty within a range (see section 9.3.40).



Question 10.5.70

May an entity ignore the additional two-month period when deciding whether to immediately reclassify amounts from AOCI into earnings?

Interpretive response: No. Once a hedging relationship has been discontinued, an entity is *required* to evaluate the likelihood of the forecasted transaction occurring within the originally specified time period plus an additional two months. Including the additional two months in this evaluation is not optional. [815-30-40-4]

See Question 10.5.80 regarding how to consider the additional two-month period when an entity has a series of hedging relationships.



Excerpt from ASC 815-30

>> Example 17: Discontinuation of a Cash Flow Hedge

55-100 The following Cases illustrate the application of paragraphs 815-30-40-4 through 40-5 to changes in timing of a forecasted transaction in relation to an originally specified time period:

- a. Transactions to occur within two months of end of originally specified time period (Case A)
- b. Transactions not to occur within two months of end of originally specified time period (Case B).

55-101 Cases A and B share the following assumptions. On January 1, an entity enters into a hedge of the variability in the total cash flows of a forecasted sale of the first 100 units of a specified product during the 3-month period from February 1 to April 30. Gains and losses on the hedging instrument are accumulated in other comprehensive income and reclassified into earnings as sales occur and are presented in the same income statement line item as the earnings effect of the hedged item. However, as of March 10, only 60 units of the product have been sold and the entity determines that it is probable that the sale of the remaining 40 units will not occur by April 30. As a result, the entity must discontinue cash flow hedge accounting under the originally designated hedging relationship as of March 10 (pursuant to paragraph 815-30-40-1(a)).

>>> Case A: Transactions to Occur within Two Months of End of Originally Specified Time Period

55-102 In this Case, the entity determines that it is probable that the sale of the remaining 40 units will occur by June 20. Based on this new information, the entity is permitted to designate a new cash flow hedge under which subsequent derivative instrument gains and losses would receive cash flow hedge accounting. This Example focuses on the derivative instrument gains and losses that have been accumulated in other comprehensive income at March 10 with respect to the remaining 40 unsold units. The derivative instrument gains or losses accumulated in other comprehensive income related to the sale of the remaining 40 units should not be reclassified into earnings as of March 10 because the entity determined on that date that it is at least reasonably possible that the forecasted transactions will occur within the two-month period following April 30 (the end of the originally specified time period).

>>> Case B: Transactions Not to Occur within Two Months of End of Originally Specified Time Period

55-103 In this Case, the entity determined on March 10 that it is probable that the sale of the remaining 40 units will not occur by June 30 but it was reasonably possible that the sale would occur in July or August.

55-104 In that circumstance, the derivative instrument gains or losses accumulated in other comprehensive income related to the sale of the

remaining 40 units must be reclassified into earnings as of March 10 because the entity would have determined on that date that it is probable that the forecasted transactions will neither occur by the end of the originally specified time period (that is, April 30) nor within the allowable additional two-month period of time (ending on June 30).

55-105 Furthermore, the example indicates no extenuating circumstances that could justify applying the exception related to a forecasted transaction that is probable of occurring on a date beyond the additional two-month period of time.



Excerpt from ASC 815-30

>> Example 21: Effect on Accumulated Other Comprehensive Income from Issuing Debt at a Date That Is Not the Same as Originally Forecasted

55-128 The following Cases illustrate the application of paragraph 815-30-40-5 in determining whether an entity should immediately reclassify into earnings the entire net gain or loss related to the derivative instrument in accumulated other comprehensive income when issuing debt at a date that is not the same as originally forecasted:

- a. Amounts are not reclassified immediately into earnings (Case A).
- b. Amounts are reclassified immediately into earnings (Case B).

>>> Case A: Amounts Are Not Reclassified Immediately into Earnings

55-129 This Case has the following assumptions:

- a. Entity A expects to borrow \$100 million over a 10-year period beginning in 6 months.
- b. Entity A initially plans to issue \$100 million of 10-year fixed-rate debt at or near par at the then-current market interest rate.
- c. Entity A will be exposed to variability in cash flows for the future quarterly interest payments on the debt due to changes in credit risk and interest rate risk that occur during this six-month period before issuance.
- d. To hedge the risk of changes in these 40 quarterly interest payments attributable to changes in the benchmark interest rate for the 6-month period, Entity A does both of the following:
 1. Enters into a derivative instrument (for example, a forward-starting interest rate swap)
 2. Documents that it is hedging the variability in the 40 future quarterly interest payments, attributable to changes in the benchmark interest rate, over the next 10 years related to its 10-year \$100 million borrowing program that begins in 6 months.
- e. Entity A documents that it will assess the effectiveness of the hedging relationship semimonthly on a quantitative basis.
- f. Six months after inception of the hedging relationship, Entity A decides to delay the issuance of the 10-year debt for 3 months..

55-130 When Entity A decides to delay the issuance of the 10-year debt for 3 months, Entity A should not immediately reclassify into earnings the entire net gain or loss in accumulated other comprehensive income related to the derivative instrument. Entity A's strategy is a cash flow hedge of 40 individual probable quarterly interest payments. A cash flow hedge of future interest payments is a hedge of a series of forecasted transactions; consequently, Entity A must first determine the likelihood of whether and when each forecasted transaction in the series will occur. If at any time during the hedging relationship Entity A determines that it is no longer probable that any of the forecasted transactions in the series will occur by the date (or within the time period) originally specified, it must terminate the original hedging relationship for each of those specific nonprobable forecasted transactions—even if the forecasted transaction will occur within an additional two-month period of time after that originally specified date. Entity A need not terminate the original hedging relationship for those specific forecasted transactions that remain probable of occurring by the date or within the time period originally specified. After the hedging relationship is terminated, Entity A must determine whether it is probable that any or all of those specific nonprobable forecasted transactions will not occur either by the date (or within the time period) originally specified or within an additional two-month period of time thereafter (see paragraphs 815-30-40-4 through 40-5). Entity A should reclassify into earnings from accumulated other comprehensive income the amount of the net derivative instrument gain or loss related to those specific nonprobable forecasted transactions for which it is probable they will not occur. That amount should be equivalent to the present value of the derivative instrument's cash flows intended to offset the changes in the original forecasted transactions for which Entity A has determined it is probable that they will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter.

55-131 In this Case, when Entity A originally documented the hedging relationship, it was hedging 40 forecasted transactions (forecasted interest payments) that would begin in 6 months' time and continue over a 10-year period. Because Entity A did not issue the debt instrument as originally documented, Entity A would determine that it is probable that the first forecasted transaction will not occur at the time forecasted; consequently, Entity A must terminate the original hedging relationship with respect to that first forecasted transaction. However, Entity A would also determine that it is probable that the other 39 forecasted transactions will occur at the time forecasted. After the hedging relationship is terminated for the specific nonprobable first forecasted transaction, Entity A must determine whether it is probable that specific nonprobable first forecasted transaction will not occur by the forecasted date or within an additional two-month period of time thereafter. In this Case, Entity A determines that it is probable that the first hedged quarterly interest payment will not occur within two months of its specified date. The amount reclassified into earnings from accumulated other comprehensive income is the portion of the interest rate swap's net gain or loss equivalent to the present value of the cash flows from the interest rate swap intended to offset the changes in the first forecasted transaction that is probable not to occur.

>>> Case B: Amounts Are Reclassified Immediately into Earnings

55-132 This Case has the following assumptions:

- a. Entity B expects to issue \$100 million of 10-year, 9 percent debt in 6 months.
- b. Because the debt will have a fixed interest rate of 9 percent, Entity B will not be exposed to variability in the future quarterly interest payments at 9 percent, but it will be exposed to variability in the cash flows received as proceeds on the debt due to changes in credit risk and interest rate risk that occur during the 6-month period before issuance.
- c. To hedge the risk of changes in the total proceeds attributable to changes in the benchmark interest rate, Entity B does both of the following:
 1. Enters into a derivative instrument (for example, a short position in U.S. Treasury note futures contracts)
 2. Documents that it is hedging the variability in the cash proceeds attributable to changes in the benchmark interest rate to be received from the 9 percent fixed-rate debt it will issue in 6 months and that it will assess effectiveness on a quantitative basis.
- d. Because Entity B plans to issue \$100 million of 10-year, 9 percent debt regardless of the then-current interest rate environment, the effect of increases or decreases in interest rates will be reflected in issuing the debt at a discount or a premium, respectively.
- e. Six months after inception of the hedging relationship, Entity B decides to delay the issuance of the debt for three months.

55-133 This strategy is a cash flow hedge of the variability in proceeds attributable to changes in the benchmark interest rate to be received from the issuance of debt in six months. A cash flow hedge of the proceeds attributable to changes in the benchmark interest rate is a hedge of a single forecasted transaction specified to occur in six months; consequently, when the single forecasted transaction is no longer probable of occurring by the date (or within the time period) originally specified, Entity B must terminate the hedging relationship. After the hedging relationship is terminated, Entity B must determine whether it is probable that the specific nonprobable forecasted transaction will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter. Because Entity B decided to delay the issuance of the debt for a three-month period of time, Entity B concludes that it is probable that the forecasted transaction will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter. Consequently, Entity B should immediately reclassify into earnings the entire net gain or loss related to the derivative instrument in accumulated other comprehensive income. Given the guidance in paragraph 815-30-40-5, the nonoccurrence of the hedged forecasted transactions described in this Case could potentially jeopardize Entity B's ability to use cash flow hedge accounting in the future for the situation described.



Question 10.5.80

How is the additional two-month period considered when an entity has a series of hedging relationships?

Background: Determining whether a hedged forecasted transaction will occur in the originally specified time period or with an additional two-month period can be complicated. It is particularly complicated when an entity enters into separate derivative contracts to hedge forecasted transactions that will occur over several periods and – at a later date – some of those forecasted transactions are not expected to occur as originally documented.

For example, an entity initially expects to sell inventory in the amounts specified and on the dates indicated in the following table. To hedge against changes in prices of these forecasted sales, the entity purchases three forward contracts, each having a notional amount and maturing on the date that coincides with the forecasted unit sales. It designates the forward contracts as hedging instruments in three separate hedging relationships.

Hedge #	Date	Forecast unit sales
1	March 31	80
2	April 30	20
3	May 31	30

Subsequent to the hedge inception dates, the entity believes that it will have only 60 unit sales on March 31. It determines that Hedge #1 is not highly effective and discontinues hedge accounting for that relationship. The entity continues to believe the forecast unit sales on April 30 and May 31 are probable.

The entity must evaluate the likelihood that the 80 unit sales that were forecast to occur on March 31 will occur on March 31 or within an additional two-month period. If it is probable that they will *not* occur during that timeframe, amounts in AOCI related to the forecasted sales that it is probable will *not* occur are immediately reclassified into earnings.

Interpretive response: We believe an entity makes an accounting policy election when it chooses to consider transactions that are expected to occur within the additional two-month period – but that are hedged transactions in separate hedging relationships – in evaluating whether the net derivative gains (losses) in AOCI should be reclassified into earnings immediately. This accounting policy election must be consistently applied.

Accounting policy	Summary of effects
Future transactions that are designated in separate existing hedging relationships are <i>included</i> when evaluating whether the net derivative gains	— In the background example, the entity considers <i>all</i> unit sales from March 31 through May 31 (i.e. two months after March 31) – without regard to whether they are hedged in separate existing hedging relationships – when evaluating whether it is probable that the 80 unit sales that were hedged in Hedge #1 will <i>not</i> occur. Because there are 20 unit sales

Accounting policy	Summary of effects
(losses) in AOCI should be immediately reclassified into earnings	forecast to occur on April 30 and 30 on May 1, the 80 unit sales from Hedge #1 are still at least reasonably possible (i.e. it is not probable that they will <i>not</i> occur) and the amounts in AOCI are <i>not</i> immediately reclassified into earnings. — Because the amounts in AOCI related to Hedge #1 under the updated forecast are expected to be reclassified into earnings on March 31 (for 60 units) and on April 30 (i.e. for 20 units), there are no longer 20 unit sales available for Hedge #2. As a result, Hedge #2 is discontinued and the entity determines whether amounts in AOCI should be immediately reclassified into earnings. All future transactions – including the 30 sales expected to occur on May 31 – are considered in this analysis. — A similar process is applied to Hedge #3 as for Hedge #2. — If at any time it is probable that previously hedged forecasted sales will <i>not</i> occur in the originally specified period or an additional two months, net derivative gains or losses reported in AOCI related to those sales are immediately reclassified into earnings. Additionally, this represents a missed forecast that the entity would be required to consider when evaluating whether it has a pattern of missing forecasts that calls into question its ability to predict future transactions (see also Question 10.5.110).
Future transactions that are designated in separate existing hedging relationships are <i>not</i> included when evaluating whether the net derivative gains (losses) in AOCI should be immediately reclassified into earnings	In the background example, the entity considers only <i>unhedged</i> unit sales from March 31 through May 31 (i.e. two months after March 31) when evaluating whether it is probable that the 80 unit sales from Hedge #1 will <i>not</i> occur. Because all future projected sales are hedged in separate hedging relationships, there are no sales during the additional two-month period to consider. As a result, the entity would conclude that it is probable that the remaining 20 unit sales will <i>not</i> occur in the originally specified period or an additional two months and immediately reclassify net derivative gains or losses reported in AOCI related to those sales into earnings. Additionally, this represents a missed forecast that the entity would be required to consider when evaluating whether it has a pattern of missing forecasts that calls into question its ability to adequately forecast future transactions (see also Question 10.5.110). Hedge #2 and Hedge #3 would be unaffected by the 20 unit sales that did not occur on March 31, provided the missed forecast did not result in the entity concluding that it could not accurately forecast future transactions.

Extending the two-month period due to extenuating circumstances

In certain instances, the additional two months may be extended because of extenuating circumstances that are related to the nature of the forecasted transaction and are outside the control or influence of the entity.

In these cases, the net derivative gain or loss reported in AOCI related to the discontinued cash flow hedge: [815-30-40-4]

- generally should continue to be reported in AOCI until the hedged forecasted transaction occurs (see section 10.3); or
- earlier if the entity determines it is probable that the forecasted transaction will *not* occur by the end of the original specified period plus the additional extended period.



Question 10.5.90

How common are extenuating circumstances that extend the additional two-month period?

Interpretive response: We believe it would be rare for extenuating circumstances to result in the additional two-month period being extended. In addition, we believe the extenuating circumstances should be identified at the inception of the hedge and should not relate to subsequent economic circumstances that have the effect of delaying the date of occurrence of the forecasted transaction.

For example, the building and selling of locomotives takes a significant amount of time and significant delays may occur that are outside the control of the builder/seller. Estimating when a locomotive will be completed and sold is difficult even if an entity considers an additional two-month period beyond its best estimate. In this example, we believe the entity hedging the forecasted sale of a locomotive can extend the two-month period to something more in line with the process of building and selling locomotives when evaluating whether net derivative gains or losses reported in AOCI should be immediately reclassified into earnings. However, the period and extenuating circumstances must be documented at inception of the hedging relationship.



Example 10.5.60

Whether a delay in a forecasted transaction is due to extenuating circumstances that extend the additional two-month period

On January 1, Year 1, ABC Corp. forecasts that it will sell 100 barrels of oil on September 30, Year 1. To hedge the variability in overall changes in cash flows of the forecasted sale, it enters into a net cash-settled forward contract to fix the amount of proceeds it will receive on the sale of the oil on September 30, Year 1. All the cash flow hedging requirements are met at inception of the hedge.

On March 31, Year 1 (the first assessment period), ABC concludes that the hedging relationship was highly effective retrospectively and is expected to continue to be highly effective prospectively. ABC recognizes the change in fair value of the forward (unrealized loss of \$100,000) in AOCI.

On June 30, Year 1 (the second assessment period), ABC concludes that the hedging relationship was not highly effective retrospectively and is not expected to be highly effective prospectively; this is because there has been a significant increase in the supply of oil in the marketplace. ABC did not identify a specific event during the period that caused the hedging relationship not to be highly effective on a retrospective basis. As a result, hedge accounting may *not* be applied in the period just ended and the hedging relationship must be discontinued prospectively.

On discontinuance of the cash flow hedging relationship, ABC concludes that it is probable that the forecasted sale of 100 barrels of oil will *not* occur by September 30, Year 1 or within a two-month period thereafter (i.e. by November 30, Year 1) because of the significant projected oversupply of oil in the marketplace during that period.

Although the delay in the final sale of the oil was caused by events outside ABC's control, the delay is not related to the nature of the forecasted transaction. That is, the forecasted sale date of 100 barrels of oil is, by nature, not difficult to estimate. Instead, the forecasted sale is delayed because of economic factors that arose after the inception of the hedging relationship. As a result, any derivative gains or losses reported in AOCI are reclassified into earnings on June 30, Year 1.

Effect of missed forecasts



Question 10.5.110

What factors are considered when evaluating whether missed forecasts represent a pattern?

Interpretive response: We believe instances in which it is probable that a forecasted transaction will *not* occur should be rare. We understand that the SEC staff will challenge management's previous and future assertions about forecasted transactions when a registrant displays a pattern of determining that it is probable that hedged forecasted transactions will *not* occur.

Determining what constitutes a pattern is a matter of judgment based on individual facts and circumstances. However, we believe the following should be considered when determining whether there is a pattern in which it is probable that forecasted transactions will *not* occur:

- the business or operating circumstances that led the entity to its conclusion;
- whether the entity experienced other instances with similar forecasted transactions. If so:
 - when and what those business or operating circumstances were; and

- whether the current circumstances are different from the previous instance(s);
 - whether the circumstances or events that led to the conclusion were within the control of the entity; and
 - whether the entity anticipates a similar forecasted transaction in the near future.
-

11. Hedging foreign currency exposures

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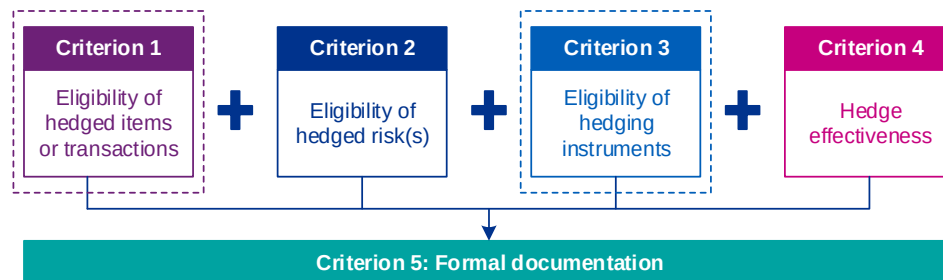
11.7.50 Single cash flow hedge with a foreign currency purchased option

11.1 How the standard works

Throughout this chapter, FCD means foreign currency denominated.

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

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



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

- **Hedging instrument.** The entity with the foreign currency exposure needs to be a party to the hedging instrument (see section 11.3.20).
- **Hedged item or transaction.** The hedged transaction needs to be denominated in a currency other than the entity's functional currency (see section 11.3.30).

In addition, there are qualifying criteria specific to the type of foreign currency hedge. This chapter will focus on the general qualifying criteria and the criteria specific to foreign currency fair value and cash flow hedges. For guidance on qualifying criteria specific to **net investment hedges**, see chapter 12.

This chapter builds on the previous discussion of qualifying criteria for fair value hedges (see chapter 7) and cash flow hedges (see chapter 9). It also builds on the foreign currency concepts in Topic 830 (foreign currency matters) that are discussed in our Handbook, [Foreign currency](#).

Foreign currency fair value hedge. An entity establishes a foreign currency fair value hedge to hedge against changes in fair value due to changes in:

- foreign currency exchange rates; or
- both foreign currency exchange rates and interest rates (see section 11.4).

Foreign currency cash flow hedge. An entity establishes a foreign currency cash flow hedge to hedge against changes in future cash flows due to changes in foreign currency exchange rates (see section 11.6).

For each type of hedge, there are permitted hedged items and hedging instruments.

	Criterion 1: Eligibility of hedged items or transactions	Criterion 3: Eligibility of hedging instruments
Foreign currency fair value hedge (section 11.4)	FCD asset or liability	Derivative
	Unrecognized FCD firm commitment	Derivative or Nonderivative financial instrument
Foreign currency cash flow hedge (section 11.6)	FCD asset or liability	Derivative
	Unrecognized FCD firm commitment	Derivative
	FCD forecasted transaction	Derivative

The accounting for foreign currency fair value and cash flow hedges is the same as for all other fair value hedges (see chapter 8) and cash flow hedges (see chapter 10), respectively. However, Topic 815 provides additional guidance for certain items and transactions designated in a fair value (see section 11.5) and cash flow (see section 11.7) hedge of foreign currency risk.

11.2 Basic concepts in foreign currency hedges

A foreign currency hedge is a hedge of a foreign currency exposure. Foreign currency exposure exists when a transaction, asset or liability, or net investment in a foreign operation is denominated in a currency other than an entity's functional currency. Therefore, an entity whose functional currency is the US dollar has a foreign currency exposure only in instances when it has transactions, assets or liabilities, or a net investment in a foreign operation denominated in a currency other than the US dollar. [\[815-20-25-24\]](#)

Topic 830 states that an entity's functional currency "is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash." Topic 830 requires FCD assets and liabilities to be remeasured to the entity's functional currency at the spot rate through earnings. [\[830-10 Glossary\]](#)

A foreign currency hedging transaction allows an entity to hedge the resulting variability in functional currency. When establishing a foreign currency hedging transaction, an entity can use either the fair value or cash flow hedging models, as explained in sections 11.5 and 11.7, respectively. In a foreign currency hedging transaction, an entity is hedging the risk that foreign currency exchange rate movements could have on its financial statements (i.e. a foreign currency risk).

11.3 General qualifying criteria for foreign currency hedges

11.3.10 Overview

Regardless of the hedging model used in a foreign currency hedge (i.e. fair value, cash flow or net investment model) a foreign currency hedge needs to meet the following criteria: [\[815-20-25-30\]](#)

- the entity with the foreign currency exposure needs to be a party to the **hedging instrument** (see section 11.3.20); and
- the **hedged item or transaction** needs to be denominated in a currency other than the entity's functional currency (see section 11.3.30).



Excerpt from ASC 815-20

>> Hedged Items and Transactions Involving Foreign Exchange Risk

25-26 The functional currency concepts of Topic 830 are relevant if the foreign currency exposure being hedged relates to any of the following:

- a. An unrecognized foreign-currency-denominated firm commitment
- b. A recognized foreign-currency-denominated asset or liability
- c. A foreign-currency-denominated forecasted transaction
- d. The forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability
- e. A net investment in a foreign operation.

25-27 Because a parent entity whose functional currency differs from its subsidiary's functional currency is not directly exposed to the risk of exchange rate changes due to a subsidiary transaction that is denominated in a currency other than a subsidiary's functional currency, the parent cannot qualify for hedge accounting for a hedge of that risk. Accordingly, a parent entity that has a different functional currency cannot qualify for hedge accounting for direct hedges of a subsidiary's recognized asset or liability, unrecognized firm commitment or forecasted transaction denominated in a currency other than the subsidiary's functional currency. Also, a parent that has a different functional currency cannot qualify for hedge accounting for a hedge of a net investment of a first-tier subsidiary in a second-tier subsidiary.

25-28 If the hedged item is denominated in a foreign currency, an entity may designate any of the following types of hedges of foreign currency exposure:

- a. A fair value hedge of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale debt security)
- b. A cash flow hedge of any of the following:
 1. A forecasted transaction
 2. An unrecognized firm commitment
 3. The forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability
 4. A forecasted intra-entity transaction.

c. A hedge of a net investment in a foreign operation.

25-29 The recognition in earnings of the foreign currency transaction gain or loss on a foreign-currency-denominated asset or liability based on changes in the foreign currency **spot rate** is not considered to be the remeasurement of that asset or liability with changes in fair value attributable to foreign exchange risk recognized in earnings, which is discussed in the criteria in paragraphs 815-20-25-15(d) and 815-20-25-43(c). Thus, those criteria are not impediments to either of the following:

- a. A foreign currency fair value or cash flow hedge of such a foreign-currency-denominated asset or liability
- b. A foreign currency cash flow hedge of the forecasted acquisition or incurrence of a foreign-currency-denominated asset or liability whose carrying amount will be remeasured at spot exchange rates under paragraph 830-20-35-1.

25-30 Both of the following conditions shall be met for foreign currency cash flow hedges, foreign currency fair value hedges, and hedges of the net investment in a foreign operation:

- a. For consolidated financial statements, either of the following conditions is met:
 1. The operating unit that has the foreign currency exposure is a party to the hedging instrument.
 2. Another member of the consolidated group that has the same functional currency as that operating unit is a party to the hedging instrument and there is no intervening subsidiary with a different functional currency. See guidance beginning in paragraph 815-20-25-52 for conditions under which an intra-entity foreign currency derivative can be the hedging instrument in a cash flow hedge of foreign exchange risk.
- b. The hedged transaction is denominated in a currency other than the hedging unit's functional currency.



Question 11.3.10

Can an entity hedge recognized FCD assets and liabilities?

Interpretive response: Yes. An overall limitation on any type of hedging transaction is that the hedged item cannot be remeasured at fair value with changes in fair value recognized in earnings. Therefore, an entity is not permitted to hedge assets and liabilities that are remeasured for changes in fair value attributable to the hedged risk reported currently in earnings (e.g. trading securities) or forecasted transactions that become recognized and subsequently remeasured for changes in fair value attributable to the hedged risk through earnings. [815-20-25-15(d), 25-43(c)(3)]

However, the remeasurement of FCD monetary assets and liabilities to the entity's functional currency at the spot rate through earnings (in accordance with Topic 830) is not a remeasurement at fair value. Therefore, FCD monetary

assets and liabilities can be the hedged item in a foreign currency hedge, if all other hedge criteria are met. In addition, FCD AFS debt securities can also be designated as hedged items even though they are nonmonetary assets (see sections 11.4.40 and 11.6.50) [815-20-25-29]



Question 11.3.20

What risk(s) may be hedged in FCD assets and liabilities?

Interpretive response: FCD assets and liabilities may be hedged for the following risk(s):

- only for foreign currency risk; or
- for multiple risks simultaneously – e.g. foreign currency risk and interest rate risk; for additional discussion on hedging multiple risks, see section 11.3.40.

11.3.20 Entity with foreign currency risk is party to the hedging instrument



Excerpt from ASC 815-20

>> Hedged Items and Transactions Involving Foreign Exchange Risk

25-23 Under the functional currency concept of Topic 830, exposure to a foreign currency exists only in relation to a specific operating unit's designated functional currency cash flows. Therefore, exposure to foreign currency risk shall be assessed at the unit level.

25-24 A unit has exposure to foreign currency risk only if it enters into a transaction (or has an exposure) denominated in a currency other than the unit's functional currency.

25-25 Due to the requirement in Topic 830 for remeasurement of assets and liabilities denominated in a foreign currency into the unit's functional currency, changes in exchange rates for those currencies will give rise to exchange gains or losses, which results in direct foreign currency exposure for the unit but not for the parent entity if its functional currency differs from its unit's functional currency.

25-27 Because a parent entity whose functional currency differs from its subsidiary's functional currency is not directly exposed to the risk of exchange rate changes due to a subsidiary transaction that is denominated in a currency other than a subsidiary's functional currency, the parent cannot qualify for hedge accounting for a hedge of that risk. Accordingly, a parent entity that has a different functional currency cannot qualify for hedge accounting for direct hedges of a subsidiary's recognized asset or liability, unrecognized firm commitment or forecasted transaction denominated in a currency other than

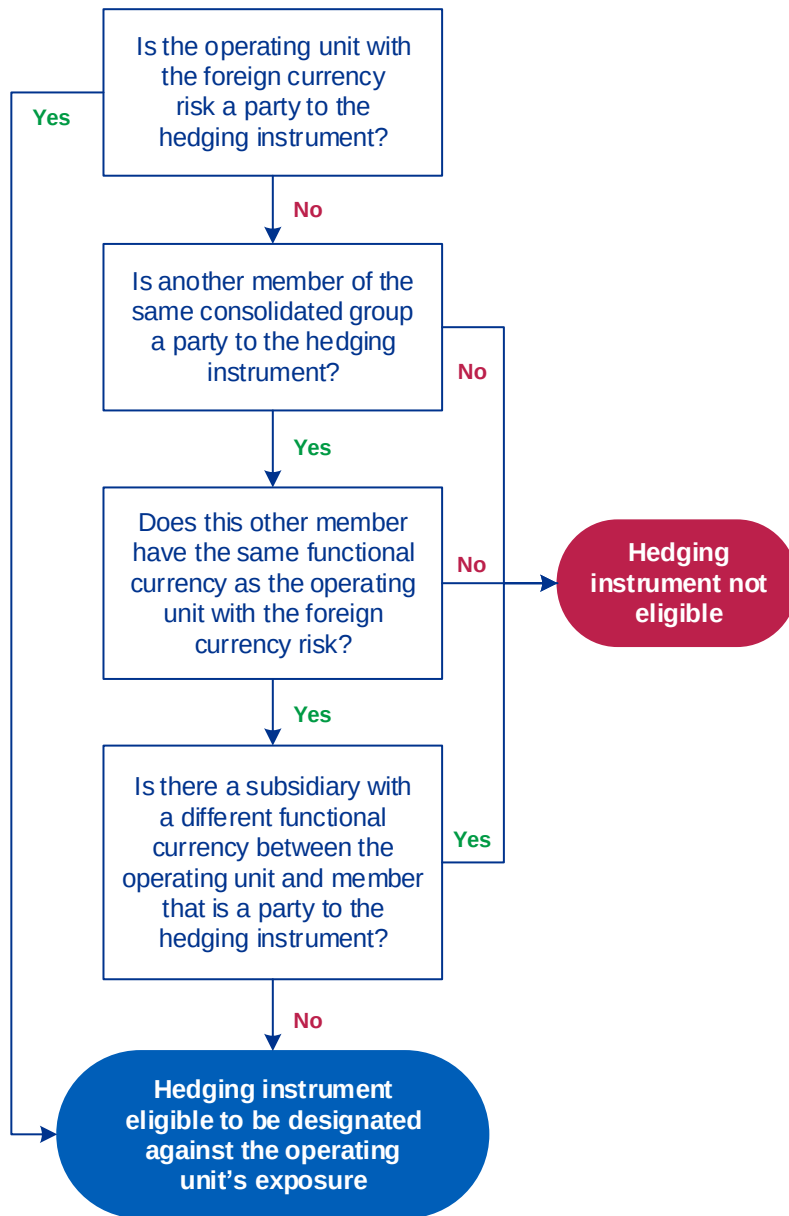
the subsidiary's functional currency. Also, a parent that has a different functional currency cannot qualify for hedge accounting for a hedge of a net investment of a first-tier subsidiary in a second-tier subsidiary.

25-30 Both of the following conditions shall be met for foreign currency cash flow hedges, foreign currency fair value hedges, and hedges of the net investment in a foreign operation:

- a. For consolidated financial statements, either of the following conditions is met:
 1. The operating unit that has the foreign currency exposure is a party to the hedging instrument.
 2. Another member of the consolidated group that has the same functional currency as that operating unit is a party to the hedging instrument and there is no intervening subsidiary with a different functional currency. See guidance beginning in paragraph 815-20-25-52 for conditions under which an intra-entity foreign currency derivative can be the hedging instrument in a cash flow hedge of foreign exchange risk.

A required element of a foreign currency hedge is that the entity with the foreign currency exposure is a party to the **hedging instrument**. This criterion is necessary because under Topic 830's functional currency approach, all foreign currency exposures exist only in relation to an entity's functional currency. Therefore, exposure to foreign currency risk must be assessed at the operating unit level. [\[815-20-25-23\]](#)

In consolidated financial statements, foreign currency risk is assessed at the operating unit level. Therefore, the operating unit (e.g. parent, subsidiary) with the foreign currency risk generally needs to be a party to the hedging instrument. In consolidated financial statements, there is an exception that allows another member of the consolidated group to be a party to the hedging instrument in certain circumstances, as illustrated in the following flowchart. [\[815-20-25-23, 25-30\(a\)\]](#)



Question 11.3.30

Can a parent entity that has a functional currency different from its subsidiary hedge the subsidiary's foreign currency risk?

Interpretive response: No. A parent entity whose functional currency differs from that of its subsidiary is not directly exposed to the risk of exchange rate changes for a subsidiary's foreign currency transactions. Therefore, the parent entity cannot hedge the subsidiary's foreign currency risk. [815-20-25-27]



Question 11.3.40

How is an operating unit evaluated when determining whether foreign currency exposure can be hedged?

Interpretive response: In consolidated financial statements, the operating unit is evaluated by using a functional currency approach rather than a legal entity approach. Therefore, if the subsidiary has the same functional currency as the parent entity, the parent may enter into a hedging instrument that is designated as the hedge of the subsidiary's foreign currency risk in the consolidated financial statements. This is because when a subsidiary and its parent have the same functional currency, they also have the same foreign currency exposure.

However, this same foreign currency exposure does not exist if there is an *intervening* subsidiary with a functional currency different from that of the parent between the parent and the subsidiary that has the foreign currency risk being hedged.

The following illustrates application of this guidance, as does Subtopic 815-20's Example 11 that follows. For illustrative purposes, the discussion assumes that the subsidiary's functional currency is not yen and the forecasted transaction is yen-denominated sales.

- **Parent and subsidiary with different functional currencies.** A US dollar functional currency parent cannot directly hedge the foreign currency risk in its euro functional currency subsidiary's forecasted yen-denominated export sales because the parent has no direct exposure to exchange risk for the yen-denominated sales.
- **Parent and subsidiary with same functional currencies.** If both the parent and subsidiary have the US dollar as their functional currency, the parent can directly hedge the yen-denominated forecasted sales of the subsidiary, provided there is no intervening subsidiary with a different functional currency.
- **Parent and subsidiary with same functional currencies and intervening subsidiary.** If both the parent and second-tier subsidiary have the US dollar as their functional currency, and there is an intervening UK subsidiary with a pound sterling functional currency, the US dollar functional currency parent cannot directly hedge the second-tier US dollar functional currency subsidiary's yen-denominated forecasted sales.

This analysis also applies if another member of the consolidated group (instead of the parent) enters into the hedging instrument. For example, a first-tier subsidiary and its subsidiary (i.e. a second-tier subsidiary) have the same functional currency. If that is the case, the first-tier subsidiary can hedge the second-tier subsidiary's foreign currency risk.

**Excerpt from ASC 815-20****>> Example 11: Identifying an Intervening Subsidiary with a Different Functional Currency**

55-130 This Example illustrates the application of paragraph 815-20-25-30(a)(2). If a dollar- (USD-) functional, second-tier subsidiary has a Euro (EUR) exposure, the USD-functional consolidated parent entity could designate its USD–EUR derivative instrument as a hedge of the second-tier subsidiary’s exposure if the functional currency of the intervening first-tier subsidiary (that is, the parent of the second-tier subsidiary) is also USD. In contrast, if the functional currency of the intervening first-tier subsidiary was the Japanese yen (JPY) (thus requiring the financial statements of the second-tier subsidiary to be translated into JPY before the JPY-denominated financial statements of the first-tier subsidiary are translated into USD for consolidation), the consolidated parent entity could not designate its USD–EUR derivative instrument as a hedge of the second-tier subsidiary’s exposure.

**Question 11.3.50**

If a parent entity hedges its subsidiary’s foreign currency risk, can the subsidiary recognize the effects of the hedge in its stand-alone financial statements?

Interpretive response: No. To recognize the effects of hedge accounting in a subsidiary’s stand-alone financial statements, the subsidiary needs to enter into the hedging instrument. In this case, the parent entered into the hedging instrument to hedge the subsidiary’s foreign currency risk.

11.3.30 Currency other than functional currency

**Excerpt from ASC 815-20****>> Hedged Items and Transactions Involving Foreign Exchange Risk**

25-30 Both of the following conditions shall be met for foreign currency cash flow hedges, foreign currency fair value hedges, and hedges of the net investment in a foreign operation:...

- b. The hedged transaction is denominated in a currency other than the hedging unit’s functional currency.

To apply foreign currency hedge accounting, not only does the entity with the foreign currency risk need to be a party to the hedging instrument, but the **hedged transaction** needs to be denominated in a currency other than the hedging entity's functional currency. This is because foreign currency exposure exists in relation to an entity's functional currency. [815-20-25-30(b)]



Example 11.3.10

Currency other than functional currency

Scenario 1: Functional currency is the same as the transaction currency

ABC Corp. is a euro functional currency entity that enters into euro-denominated transactions. The euro-denominated transactions are not eligible for foreign currency hedging because they do not present a foreign currency exposure in relation to ABC's functional currency.

Scenario 2: Parent and subsidiary functional currency is the same as the transaction currency

ABC Corp.'s functional currency is the US dollar. It wants to enter into a foreign currency forward contract to hedge the foreign currency risk of a subsidiary's US dollar purchases. Because ABC's functional currency is the US dollar and the hedged transaction is denominated in US dollars (i.e. there is no foreign currency exposure for ABC), the hedged transaction does not meet the 'currency other than functional currency' requirement. Therefore, ABC may not designate the forward contract as a foreign currency hedge.



Question 11.3.60

Can hedge accounting be applied if the hedged transaction is denominated in the hedging entity's functional currency but the settlement amount is based on a foreign currency?

Interpretive response: Yes. We believe hedge accounting may be applied for a transaction that is settled in an entity's functional currency, but whose settlement amount is determined by converting a specified amount of a foreign currency into the entity's functional currency at the spot or average exchange rate at the time of settlement.



Example 11.3.20

Settlement of hedged transaction is based on a foreign currency

ABC Corp. (which has the US dollar as its functional currency) enters into an agreement with a third party that entitles the third party to produce and distribute one of ABC's products in exchange for quarterly royalty payments based on a percentage of euro-denominated sales.

The calculation of the royalty payment is based on euro-denominated sales, but the royalty payment received by ABC is in US dollars; the euro-denominated sales are converted to US dollars using the average exchange rate for the period. In this case, we believe that in effect the transaction is denominated in a currency other than ABC's functional currency (i.e. payment based on euro). Accordingly, ABC may designate its foreign currency risk on the forecasted cash receipts in euro in a cash flow hedge.

In contrast, ABC may receive royalty payments in euros with the calculation of such payments based on a percentage of US dollar denominated sales converted to euros at the spot rate. In this case, ABC does not have foreign currency exposure and may not designate the forecasted cash receipt in euros in a cash flow hedge.

7.3.40 Other matters relevant to foreign currency hedges

The following topics, discussed in this section, apply to both **fair value** and **cash flow** foreign currency hedges, and require special attention:

- intercompany transactions;
- hedging multiple risks; and
- tandem or cross-currency hedges.

Intercompany transactions

Eligibility of hedged items or transactions. An entity is permitted to hedge forecasted intercompany foreign currency transactions and intercompany FCD recognized assets and liabilities. For a discussion of internal derivatives, see sections 11.4.70 (fair value hedges) and 11.6.60 (cash flow hedges). [815-20-25-28]



Question 11.3.70

Are there limitations on hedging an intercompany FCD transaction involving a recognized asset or liability?

Interpretive response: Yes. In consolidated financial statements, an intercompany FCD transaction involving a recognized asset or liability can be the hedged item as long as only the foreign currency risk is being hedged. Hedging the foreign currency risk associated with an intercompany transaction is permitted because the gain or loss created under Topic 830 when an intercompany FCD transaction is remeasured to the entity's functional currency is not eliminated in consolidation. Therefore, the risk affects consolidated earnings. [815-20-25-28 – 25-29]

In contrast, in consolidated financial statements, an intercompany FCD transaction cannot be hedged for overall changes in fair value or cash flows, interest rate or credit risk because these risks do not affect consolidated earnings. The exposure to these risks of one party to the contract will be offset

by the opposite exposure of the other party within a consolidated group. Therefore, any potential earnings exposure will be eliminated in consolidation.

However, for purposes of the subsidiary's stand-alone financial statements, any of the previously mentioned risks, including foreign currency risk, presents exposure to that subsidiary's earnings and are therefore eligible for hedge accounting.



Question 11.3.80

Can an intercompany commitment be hedged?



Excerpt from ASC 815-10

20 Glossary

Firm Commitment – An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

- a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield. The binding provisions of an agreement are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject. A price that varies with the market price of the item that is the subject of the firm commitment cannot qualify as a fixed price. For example, a price that is specified in terms of ounces of gold would not be a fixed price if the market price of the item to be purchased or sold under the firm commitment varied with the price of gold.
- b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment.

Forecasted Transaction – A transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

Interpretive response: Yes, but only under the **cash flow hedge** model. An unrecognized FCD firm commitment can be the hedged item in either a cash flow hedge or a fair value hedge. However, the definition of a firm commitment

states that it must be with an unrelated party. Therefore, an intercompany commitment does not meet the definition of a firm commitment and cannot be hedged under the fair value hedge model. [815-20-25-28, 815-10 Glossary]

Nevertheless, a FCD intercompany commitment or a firm commitment with a related party (e.g. subsidiary to subsidiary within a consolidated group, or entity to related party outside the consolidated financial statements) is eligible to be hedged in a cash flow hedge as a forecasted transaction. This is because the criteria for forecasted transactions do not require the contract to be with an unrelated party – an intercompany and related party commitment exposes an entity to variability in the functional currency equivalent cash flows that could affect reported earnings (see sections 11.6.20 and 11.6.40).

Hedging multiple risks



Excerpt from ASC 815-20

>> Hedged Item Criteria Applicable to Fair Value Hedges Only

25-12(f) If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is any of the following:

1. The risk of changes in the overall fair value of the entire hedged item...
5. If the risk designated as being hedged is not the risk in paragraph 815-20-25-12(f)(1), two or more of the other risks (interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged.

>> Hedged Transaction Criteria Applicable to Cash Flow Hedges

25-15(j) If the hedged transaction is the forecasted purchase or sale of a financial asset or liability (or the interest payments on that financial asset or liability) or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is any of the following:

1. The risk of overall changes in the hedged cash flows related to the asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency) ...

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

Eligibility of hedged risks. As discussed in section 6.3.80, for both fair value and cash flow hedges, an entity may simultaneously hedge two or more risks (e.g. foreign currency risk, interest rate risk and credit risk).

The following table summarizes various approaches to hedging foreign currency risk and/or interest rate risk in either a fair value or cash flow model for

11. Hedging foreign currency exposures

recognized FCD financial assets or liabilities. The table assumes that the US dollar (USD) is the functional currency and that the interest rate is the benchmark rate for a fair value hedge or the contractually specified interest rate for a cash flow hedge.

Hedged item or transaction	Hedge objective	Hedge result	Hedge approach
Fixed-rate, FCD instrument	Reduce foreign currency and interest rate risk	USD variable-rate interest and USD principal	Fair value hedge of foreign currency and interest rate risk
Fixed-rate, FCD instrument	Fix variability due to foreign currency risk	USD fixed-rate interest and USD principal	Cash flow or fair value hedge ¹ of foreign currency risk
Fixed-rate, FCD instrument	Eliminate change in FCD fair value of instrument due to FCD interest rate risk	FCD variable-rate interest and FCD principal	Fair value hedge of FCD interest rate risk
FCD trade payable or receivable	Fix variability due to foreign currency risk	USD fixed payment amount	Cash flow or fair value hedge ¹ of foreign currency risk
Variable-rate, FCD instrument	Fix variability of principal and interest payments due to foreign currency and interest rate risk ²	USD fixed interest rate and USD principal	Cash flow hedge of variability of foreign currency and interest rate risk
Variable-rate, FCD instrument	Reduce variability of foreign currency risk ²	USD variable-rate interest and USD principal	Fair value hedge ¹ of foreign currency risk ³
Variable-rate, FCD instrument	Reduce variability due to interest rate risk	FCD fixed-rate interest and FCD principal	Cash flow hedge of variability of FCD interest rate risk
Variable-rate, FCD instrument	Fix variability of principal payment due to foreign currency risk	Fixed USD principal	Cash flow or fair value hedge ¹ of foreign currency risk for principal
Notes:			
1. If no components are excluded from the assessment of hedge effectiveness, there may be volatility in earnings for the fair value hedging model due to spot/forward differences or currency basis spreads. Earnings volatility can be reduced if an entity excludes the spot/forward difference or currency basis spreads from its assessment of hedge effectiveness and elects to recognize the initial value of the excluded			

Hedged item or transaction	Hedge objective	Hedge result	Hedge approach
component using an amortization approach. For additional discussion of excluded components, see section 8.2.20. 2. Alternatively, the hedged item can be designated as the functional currency equivalent cash flows of a specified amount of a variable-rate based foreign currency interest payment(s). For example, if an entity has a 100,000 euro (€) variable-rate loan, it can designate as the hedged item the first €3,000 of a specified variable-rate interest payment(s) if it is probable that the hedged variable interest payment(s) will exceed €3,000. Then the entity can enter into a cash flow hedge with a foreign currency forward contract because all of the variability associated with the first €3,000 of the variable interest payment(s) would be eliminated. For additional discussion, see section 11.6.50. [815-20-25-41] 3. Alternatively, as demonstrated in the last approach in the table, if the hedged item is designated to be the principal payment component only, the cash flow hedging model can be used. As discussed in section 11.6.50, to apply cash flow hedging, all variability of the hedged item's functional currency cash flows must be eliminated by the effect of the hedge. [815-20-25-39(d) – 25-41]			



Question 11.3.90

If the hedged item affects more than one income statement line item, where should the effect of the hedging instrument be presented?

Interpretive response: When the earnings effect of the hedged item is presented in more than one line item, the FASB concluded that it is appropriate to present the change in the fair value of the hedging instrument in those same line items. The change in the fair value of the hedging instrument should be appropriately allocated to the different line items. [ASU 2017-12.BC134]

For example, if a hedging relationship involves hedging both the interest rate risk and the foreign currency risk of an interest-earning asset or interest-bearing liability denominated in a currency other than the entity's functional currency, the earnings effect of the hedged item is typically presented in:

- an interest income or interest expense line item; and
- another line item that the entity uses to present the spot remeasurement of the FCD assets and liabilities under Topic 830 (e.g. foreign currency transaction gain or loss).

The portion of the hedging instrument associated with converting the interest cash flows from fixed-rate to floating-rate and/or from a foreign currency to the entity's functional currency is presented in interest income or interest expense, except for the portion that the entity determines should be presented in the income statement line item used to present the remeasurement of FCD assets and liabilities. [ASU 2017-12.BC134]

The FASB examples below (paragraphs 815-20-55-79Z to 55-79AD) illustrate one way that an entity might allocate the effect of the hedging relationship between multiple income statement line items.



Excerpt from Subtopic 815-20

>>> Income Statement Presentation of Hedging Instruments

55-79W Paragraph 815-20-45-1A requires an entity to present the change in the fair value of the hedging instrument included in the assessment of hedge effectiveness and the amount excluded from the assessment of hedge effectiveness in the same income statement line item that is used to present the earnings effect of the hedged item. The following scenarios include implementation guidance on the meaning of the phrase *the same income statement line item that is used to present the earnings effect of the hedged item*.

>>>> Scenario B

55-79Z Entity B designates a fair value hedge of foreign exchange risk in which the hedged item is an issued variable-rate debt instrument denominated in a currency other than Entity B's functional currency. The derivative designated as the hedging instrument is a receive-floating-rate (in foreign currency), pay-floating-rate (in functional currency) cross-currency swap that requires an initial and final exchange of notional amounts. In this scenario, Entity B's objective is to convert the cash flows of the debt instrument (both interest cash flows and the principal cash flow) from a foreign currency to Entity B's functional currency.

55-79AA The currency swap is a highly effective hedge of the currency risk of both the interest cash flows and the principal cash flows of the debt instrument. Therefore, the change in fair value of the currency swap should be presented in the same income statement line item(s) used to present the earnings effects of the hedged item. Before applying hedge accounting, Entity B presents the earnings effect associated with the hedged item in two income statement line items. That is, interest accruals are presented in an interest expense line item, and the spot remeasurement of the foreign-currency-denominated debt under Topic 830 on foreign currency matters is presented in a foreign currency transaction gain or loss line item. Therefore, in this scenario, because the hedging instrument is highly effective at offsetting changes in fair values associated with the hedged item that are reported in more than one income statement line item, the effects of the hedging instrument also should be presented in those corresponding income statement line items. Entity B should present all changes in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same interest expense line item that is used to present the earnings effect of the hedged item before applying hedge accounting, except for the change in the fair value of the hedging instrument that the entity determines should be presented in the same foreign currency transaction gain or loss line item used to present the spot remeasurement of the hedged item before applying hedge accounting.

>>>> Scenario C

55-79AB Entity C designates a fair value hedge of interest rate risk and foreign currency risk in which the hedged item is a foreign-currency-denominated fixed-rate available-for-sale debt security. The derivative designated as the hedging instrument is a pay-fixed-rate (in foreign currency), receive-floating-rate (in functional currency) cross-currency interest rate swap. In this scenario, Entity C's objective is to convert the interest cash flows of the fixed-rate security to floating-rate and also to convert the cash flows of the security (both interest cash flows and the principal cash flow) from a foreign currency to Entity C's functional currency.

55-79AC The cross-currency interest rate swap is a highly effective hedge of both the interest rate risk and foreign currency risk of the available-for-sale debt security. Therefore, the change in fair value of the cross-currency interest rate swap should be presented in the same income statement line item or items used to present the earnings effect of the hedged item. Before applying hedge accounting, Entity C recognizes the earnings effect of the hedged item (that is, interest accruals on the available-for-sale debt security) in an interest income line item in the income statement and recognizes all other changes in fair value in other comprehensive income in accordance with paragraph 320-10-35-1(b). Entity C should present changes in fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same income statement line item used to present the earnings effect of the hedged item. However, if Entity C's policy is to present the effect of foreign exchange rate changes on the fair value of the security that are recognized in earnings after applying hedge accounting in accordance with paragraph 815-25-35-6 in a different income statement line item (consistent with its presentation policies when reflecting other foreign exchange rate changes), then the related changes in fair value of the hedging instrument also should be presented in that income statement line item.

55-79AD This scenario illustrates that a single hedging instrument (a cross-currency interest rate swap) may be highly effective at offsetting changes in fair values or cash flows associated with the hedged item in which the earnings effect of the hedged item is presented in more than one income statement line item. If a hedging instrument is highly effective at offsetting changes in fair values or cash flows of the hedged item and the earnings effect of the hedged item is presented in more than one income statement line item, then the earnings effects of the hedging instrument also should be presented in those corresponding income statement line item(s).

Tandem or cross-currency hedging**Excerpt from ASC 815-20****>> Hedged Items and Transactions Involving Foreign Exchange Risk**

25-33 In some instances, it may not be practical or feasible to hedge in the same currency and, therefore, a hedging instrument also may be denominated in a currency for which the exchange rate generally moves in tandem with the exchange rate for the currency in which the hedged item is denominated.

Eligibility of hedging instruments. Topic 815 does not require an entity to use a derivative instrument denominated in the same foreign currency as the hedged item. Instead, a hedging transaction can involve 'tandem' currencies – i.e. currencies from two different countries that are highly correlated.

The requirement that a hedging relationship be highly effective also applies to tandem currencies. Therefore, an entity may designate a hedging instrument denominated in a tandem currency if, based on historical experience, it expects that the hedging relationship between the hedged exposure in one currency and the tandem currency will be highly effective. Subtopic 815-20's Example 10 is a fair value hedge of a FCD firm commitment with a forward to purchase a different currency (see section 11.5.30). [\[815-20-25-33\]](#)

**Example 11.3.30****Forecasted purchase in foreign currency**

ABC Corp.'s functional currency is the US dollar. It wants to hedge a firmly committed Canadian-dollar sales transaction with an Australian-dollar-denominated foreign currency forward contract.

ABC can use this forward contract as the hedging instrument in this hedge if movements in the fair value of the forward contract are highly effective at offsetting the fair value changes in the foreign currency exposure in a firmly committed Canadian-dollar sales transaction.

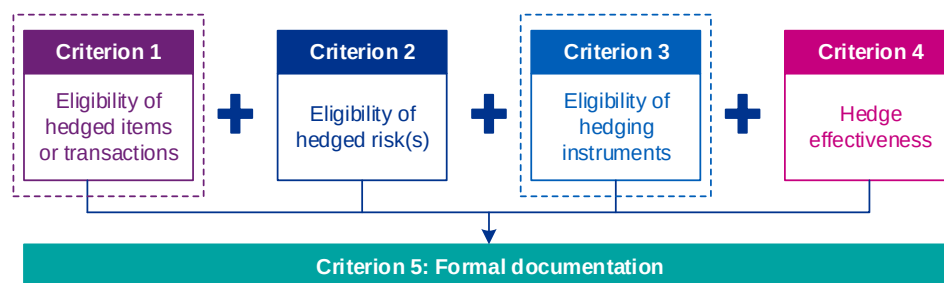
11.4 Specific qualifying criteria for foreign currency fair value hedges

11.4.10 Overview

To qualify for foreign currency fair value hedge accounting, a hedging relationship must meet the following qualifying criteria.

General hedging requirements	Chapter 6
Qualifying criteria for all fair value hedges	Chapter 7
General qualifying criteria for all foreign currency hedges	Section 11.3
Specific qualifying criteria for foreign currency fair value hedges	Section 11.4

This section discusses the specific qualifying criteria for foreign currency fair value hedges related to the eligibility of hedged items and hedging instruments.



Topic 815 permits foreign currency fair value hedges of the following items using the following types of hedging instruments.

Criterion 1: Items eligible for fair value hedges of foreign currency risk	Criterion 3: Hedging instruments eligible for fair value hedges of foreign currency risk
FCD recognized assets and liabilities (section 11.4.30)	Derivative
AFS debt securities (section 11.4.40)	Derivative
Unrecognized firm commitments (section 11.4.50)	Derivative or Nonderivative financial instrument (section 11.4.60)

Hedged items continue to be subject to other applicable US GAAP, including for assessing impairment.

11.4.20 Eligibility of hedged items and hedging instruments in a fair value hedge of foreign currency risk



Excerpt from ASC 815-20

>>> Items in Fair Value Hedges of Foreign Exchange Risk

25-37 This paragraph identifies possible hedged items in fair value hedges of foreign exchange risk. If every applicable criterion is met, all of the following are eligible for designation as a hedged item in a fair value hedge of foreign exchange risk:

- a. Recognized asset or liability. A derivative instrument can be designated as hedging the changes in the fair value of a recognized asset or liability (or a specific portion thereof) for which a foreign currency transaction gain or loss is recognized in earnings under the provisions of paragraph 830-20-35-1. All recognized foreign-currency-denominated assets or liabilities for which a foreign currency transaction gain or loss is recorded in earnings shall qualify for the accounting specified in Subtopic 815-25 if all the fair value hedge criteria in this Section (including the conditions in paragraph 815-20-25-30(a) through (b)) are met.
- b. Available-for-sale debt security. A derivative instrument can be designated as hedging the changes in the fair value of an available-for-sale debt security (or a specific portion thereof) attributable to changes in foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in Subtopic 815-25 if all the fair value hedge criteria in this Section (including the conditions in paragraph 815-20-25-30(a) through (b)) are met.
- c. Subparagraph superseded by Accounting Standards Update No. 2016-01.
- d. Unrecognized firm commitment. Paragraph 815-20-25-58 states that a derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Topic 830 can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates.

Hedged items. If the general criteria for all fair value hedges and general criteria for all foreign currency hedges are met, the following items (or a specific portion thereof) can be hedged items in a fair value hedge of foreign currency risk: [\[815-20-25-37\]](#)

- recognized assets or liabilities for which transaction gains or losses are recognized in earnings (section 11.4.30);
- AFS debt securities (section 11.4.40); and
- unrecognized firm commitments (section 11.4.50).

See section 7.3.60 for additional information about hedging portions of a hedged item.

Absent from this list is a forecasted transaction. A forecasted transaction can be the hedged item in a foreign currency **cash flow hedge** but not in a foreign currency fair value hedge.

Hedging instruments. A derivative may be designated as the hedging instrument for FCD recognized assets or liabilities, AFS debt securities and unrecognized firm commitments. A nonderivative financial instrument can also be designated as the hedging instrument for unrecognized firm commitments (see section 11.4.60).

In addition, Topic 815 allows internal derivatives to be designated as hedging instruments for fair value hedges of FCD recognized assets or liabilities if certain conditions are met (see section 11.4.70).

11.4.30 Hedged item: Recognized assets or liabilities for which transaction gains or losses are recognized in earnings

If an item gives rise to foreign currency transaction gains or losses in earnings under Topic 830 it may be a hedged item in a foreign currency fair value hedge. Recognized FCD monetary assets and liabilities are remeasured into the functional currency based on spot exchange rates. The remeasurement represents a foreign currency transaction gain or loss that is recognized in earnings. [830-20-35-1]

FCD asset/liability:	Hedged item?	Why?
HTM debt securities Loans Debt obligations	Yes	The remeasurement of FCD HTM securities, loans and debt obligations represent foreign currency transaction gains or losses that are recognized in earnings.
Trading debt securities	No	FCD trading securities are measured at fair value each reporting period with all fair value changes recognized in earnings. An entity is not permitted to hedge assets or liabilities that are measured at fair value with changes in fair value recognized in earnings.

FCD recognized assets or liabilities may be hedged with a derivative instrument.

11.4.40 Hedged item: AFS debt securities

AFS debt securities are nonmonetary assets for which the change in fair value is expressed in an entity's functional currency as the total of the changes in: [320-10-35-36 – 35-37]

- the market price of the security expressed in the foreign currency due to factors such as changes in interest rates and credit risk; and
- the currency exchange rates between the foreign currency and the entity's functional currency.

Although AFS debt securities do not give rise to transaction gains and losses, a FCD AFS debt security (or specific portion thereof) may be the hedged item in a foreign currency fair value hedge because it embodies cash flows denominated in a foreign currency. FCD AFS debt securities may be hedged only with a derivative instrument. [FAS 133.BC480]

11.4.50 Hedged item: Unrecognized firm commitments



Excerpt from ASC 815-20

>>> Hedging Instruments in Fair Value Hedges Involving Foreign Exchange Risk

25-58 A derivative instrument or a nonderivative **financial instrument** that may give rise to a foreign currency transaction gain or loss under Topic 830 can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in Subtopic 815-25 if all the fair value hedge conditions in this Section and the conditions in paragraph 815-20-25-30 are met.

25-59 The carrying basis for a nonderivative financial instrument that gives rise to a foreign currency transaction gain or loss under Subtopic 830-20 is not addressed by this Subtopic.

25-60 An entity may designate an intra-entity loan or other payable as the hedging instrument in a foreign currency fair value hedge of an unrecognized firm commitment and qualify for hedge accounting in the consolidated financial statements. That designation is consistent with the ability under paragraphs 815-20-25-58 through 25-59 to designate nonderivative instruments as hedging instruments in foreign currency fair value hedges of firm commitments. However, hedge accounting in the consolidated financial statements shall only be applied if the member of the consolidated entity that is the counterparty to the intra-entity loan has entered into a third-party contract that offsets the foreign exchange exposure of that entity's intra-entity loan receivable. That is, the requirement in paragraphs 815-20-25-28 through 25-29 that an intra-entity derivative instrument designated as a hedging instrument in a foreign currency fair value hedge be offset by a third-party contract would also apply to intra-entity nonderivative instruments designated as hedging instruments. To remain consistent with the notion that the intra-entity contract is simply a conduit for the third-party exposure, an intra-entity loan designated as a hedging instrument shall be offset by a third-party loan (that is, it shall not be offset by a derivative instrument). Hedge accounting shall be applied in consolidation only to those gains and losses occurring during the period that the offsetting third-party loan is in place.

The definition of firm commitment for foreign currency hedges is used in the same manner as for other fair value hedges. An unrecognized FCD firm commitment (or specific portion thereof) is eligible to be a hedged item in a fair value hedge of foreign currency exposure if its price is expressed in a specified amount of currency. For additional discussion of whether a transaction meets the definition of a firm commitment, see section 7.3.20. [815-20 Glossary]

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



Question 11.4.10

Can an entity hedge future interest payments of FCD debt as an unrecognized firm commitment in a fair value hedge?



Excerpt from ASC 815-20

>>>> Foreign-Currency Denominated Interest Payments

55-35 An entity may not treat foreign-currency-denominated fixed-rate interest coupon payments arising from an issuance of foreign-currency-denominated fixed-rate debt as an unrecognized firm commitment that may be designated as a hedged item in a foreign currency fair value hedge. (See paragraph 815-20-25-23.) The foreign-currency exposure of the future interest payments would not meet this Subtopic's definition of an unrecognized firm commitment because the obligation is recognized on the balance sheet—that is, the carrying amount of the foreign-currency-denominated fixed-rate debt incorporates the entity's obligation to make those future interest payments as well as the repayment of principal. However, those fixed-rate interest payments could be designated as the hedged transaction in a cash flow hedge.

55-36 Those fixed-rate interest payments might arise as follows. An entity whose functional currency is the U.S. dollar issues fixed-rate debt denominated in a foreign currency. The debt has a fixed interest coupon that is payable semiannually in that foreign currency. The entity wishes to lock in, in U.S. dollar functional currency terms, the future interest expense that will result from the debt and enters into a derivative instrument to hedge the foreign currency risk of the fixed foreign-currency-denominated interest coupon payments. For example, the entity may enter into a foreign currency swap to receive an amount of the foreign currency required to satisfy the interest coupon obligation in exchange for U.S. dollars at each coupon date, or, alternatively, it may enter into a strip of foreign currency forward contracts that provide for receipt of an amount of foreign currency required to satisfy the interest coupon obligation in exchange for the payment of U.S. dollars at each coupon date.

55-37 This guidance also applies to dual-currency bonds that provide for repayment of principal in the functional currency and periodic fixed-rate interest payments denominated in a foreign currency. Subtopic 830-20 applies to dual-

currency bonds and requires the present value of the interest payments denominated in a foreign currency to be remeasured and the transaction gain or loss recognized in earnings. Thus, those fixed-rate interest payments on a dual-currency bond could be designated as the hedged transaction in a cash flow hedge of foreign exchange risk.

Interpretive response: No. Future interest payments on existing FCD debt do not meet the definition of an unrecognized firm commitment because the obligation is recognized on the balance sheet. Therefore, the coupon payments cannot be hedged in a foreign currency fair value hedge. However, the fixed-rate interest payments may be designated as the hedged transaction in a **cash flow hedge**. [815-20-55-35 – 55-36]

This guidance also applies to a dual-currency bond, which is a bond in which principal and interest payments are denominated in different currencies. [815-20-55-37]



Question 11.4.20

If a commitment to sell is based on the market price at the time of shipment, can a portion of the price of each unit to be sold be designated as the hedged item in a fair value hedge?

Interpretive response: No. The definition of a firm commitment states, among other things, that there must be a fixed price. If the price is the market price at the time of shipment, it is not fixed until the time of shipment and therefore would not qualify as a firm commitment. Therefore, it cannot be designated as the hedged item in a fair value hedge.



Example 11.4.10

Commitment to sell at fair value – hedging a portion of the price of each unit

ABC Corp. is a manufacturing company. Its functional currency is the US dollar. ABC enters into a contract with a foreign customer to sell 10,000 units of product each month. The price of the product is denominated in a foreign currency and is determined as the market price on the date of shipment. There are significant economic penalties resulting from breaking the contract.

Historically, the price of the product has ranged from 80 to 90 euros (€) per unit. ABC wishes to hedge the currency exposure as a hedge of a firm commitment and has proposed hedging the first €50 on each of its fixed quantity of units to be sold. This means ABC's hedging transaction is designed to protect ABC on currency exposure on €50 per unit.

ABC contends that sales below €50 per unit are remote, as that term is used in Topic 450 (contingencies). Therefore, effectively at least €500,000 (10,000 units × €50 per unit) is fixed.

ABC cannot designate the first €50 on each unit sold as the hedged item in a fair value hedge. The definition of a firm commitment is not met because the price is the market price at the time of shipment; therefore, it is not fixed until the time of shipment.

Foreign currency cash flow hedge as an alternative

However, the transaction can be structured as a cash flow hedge if ABC's transaction meets the requirements for a forecasted transaction. To be able to designate the forecasted sales as the hedged item in a cash flow hedge, ABC should be able to support that the specified currency amount of sales is probable.

ABC determined it is probable that it will sell 10,000 units and the sales price will be €80 per unit. Therefore, the foreign currency hedge may cover sales up to €800,000 (10,000 units × €80 per unit).

11.4.60 Hedging instrument: Nonderivative financial instrument

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



Question 11.4.30

Can a nonderivative financial instrument be used to hedge an unrecognized firm commitment?

Interpretive response: Yes, as long as the nonderivative financial instrument gives rise to foreign currency transaction gains or losses under Topic 830 – i.e. the nonderivative instrument must be remeasured to the entity's functional currency at the spot rate through earnings. [815-20-25-58]

An instrument reported at fair value cannot be a hedging instrument. Therefore, a financial instrument for which an entity elects the fair value option under Topic 825 cannot be a hedging instrument because it does not give rise to a foreign currency transaction gain or loss.



Question 11.4.40

In the consolidated financial statements, can an intercompany nonderivative financial instrument be used to hedge an unrecognized firm commitment?

Interpretive response: It depends. An intercompany FCD nonderivative financial instrument (e.g. intercompany borrowing or receivable) can be a hedging instrument in a foreign currency fair value hedge in the consolidated financial statements if: [815-20-25-60]

- the nonderivative instrument gives rise to foreign currency transaction gains or losses; and
- the counterparty to the intercompany instrument has entered into an unrelated third-party nonderivative financial instrument that offsets the foreign currency exposure acquired from the entity that has the firm commitment.

Subtopic 815-20's Example 17 below illustrates these concepts.

The requirement to enter into an offsetting instrument with a third party in this situation is also a requirement when the hedging instrument is an internal derivative, rather than a nonderivative, as explained in section 11.4.70.

FASB Example: Nonderivative hedging instrument designated in a fair value hedge of an unrecognized firm commitment



Excerpt from ASC 815-20

>> Example 17: Designation of an Intra-Entity Loan or Other Payable as the Hedging Instrument in a Fair Value Hedge of an Unrecognized Firm Commitment

55-167 This Example illustrates the application of paragraph 815-20-25-60.

55-168 A parent entity (Parent A) with the U.S. dollar (USD) as both its functional currency and reporting currency has a subsidiary with a Euro (EUR) functional currency (Subsidiary B). Subsidiary B enters into an unrecognized firm commitment with a third party that will result in Japanese yen (JPY) cash inflows. Concurrent with Subsidiary B entering into the firmly committed contract, Parent A extends a loan to Subsidiary B denominated in JPY, which is funded by a third-party, JPY-denominated borrowing by Parent A. Subsidiary B wishes to designate its JPY-denominated intra-entity loan payable as the hedging instrument in consolidated financial statements in a fair value hedge of foreign currency exposure related to its JPY-denominated unrecognized firm commitment to a third party.

55-169 In accordance with paragraph 830-20-35-1, at each balance sheet date, Subsidiary B's JPY-denominated intra-entity loan payable would be remeasured from the foreign currency (JPY) into Subsidiary B's functional currency (EUR) at the current EUR/JPY spot rate. Similarly, Parent A's intra-entity JPY-denominated receivable and its third-party JPY-denominated loan payable are remeasured from the foreign currency (JPY) into Parent A's functional currency (USD) at the current USD/JPY spot rate. The transaction gains or losses that are generated from remeasurement into functional currency are recorded in net income. If Subsidiary B designates its JPY-denominated intra-entity loan payable as the hedging instrument in consolidated financial statements, the transaction gains and losses related to the intra-entity loan payable would offset the change in fair value of the firm commitment attributable to changes in foreign exchange rates in the consolidated income statement.

55-170 In this Example, Subsidiary B's JPY-denominated intra-entity payable may be designated as a fair value hedge of the foreign exchange exposure arising from the third-party JPY-denominated firm commitment. Parent A has in place a third-party JPY-denominated borrowing that offsets the exposure of its JPY-denominated intra-entity receivable from Subsidiary B during the period the intra-entity loan receives hedge accounting.



Question 11.4.50

What are the practical implications of using a nonderivative instrument to hedge an unrecognized firm commitment?

Interpretive response: In contrast to a derivative hedging instrument whose gain or loss is measured by reference to changes in total fair value, the gain or loss on a nonderivative hedging instrument is measured by reference to changes in spot exchange rates under Topic 830. [830-20-35-1 – 35-2]

Therefore, an entity should understand the potential accounting results and differences in choosing the hedging instrument when hedging the foreign currency exposure of a firm commitment. See the KPMG observation in section 11.5.20 relating to calculating the fair value of a hedged unrecognized firm commitment.

11.4.70 Hedging instrument: Internal derivatives



Excerpt from ASC 815-20

20 Glossary

Internal Derivative – A foreign currency derivative instrument that has been entered into with another member of a consolidated group (such as a treasury center).

Intra-entity Derivative – A derivative instrument contract between two members of a consolidated group.

>> Hedged Items and Transactions Involving Foreign Exchange Risk

25-31 However, a subsidiary may enter into an intra-entity hedging instrument with the parent entity, and that contract can be a hedging instrument in the consolidated financial statements if the parent entity enters into an offsetting contract (pursuant to paragraph 815-20-25-52 for the appropriate hedging relationship) with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the subsidiary that initiated the hedge.

25-32 If a subsidiary has the same functional currency as the parent entity or other member of the consolidated group, the parent entity or that other member of the consolidated group may, subject to certain restrictions, enter

into a derivative instrument or nonderivative instrument that is designated as the hedging instrument in a hedge of that subsidiary's foreign exchange risk in consolidated financial statements.

>> Hedging Instruments in Hedges of Foreign Exchange Risk

25-51A The guidance on hedging instruments in hedges of foreign exchange risk is organized as follows:

- a. Intra-entity derivatives
- b. Hedging instruments in fair value hedges involving foreign exchange risk
- c. Internal derivatives as hedging instruments in cash flow hedges of foreign exchange risk
- d. Hedging instruments in net investment hedges.

>>> Intra-Entity Derivatives

25-52 A foreign currency derivative instrument that has been entered into with another member of a consolidated group can be a hedging instrument in any of the following hedging relationships only if that other member of the consolidated group has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge:

- a. A fair value hedge
- b. A cash flow hedge of a recognized foreign-currency-denominated asset or liability
- c. A net investment hedge in the consolidated financial statements.

25-53 Paragraph 815-20-25-46A states that there is no requirement in this Subtopic that the operating unit with the interest rate, market price, or credit risk exposure be a party to the hedging instrument and provides related guidance.

25-54 An intra-entity derivative can be designated as a hedging instrument in consolidated financial statements if condition (a) is met and either condition (b) or (c) is met:

- a. The hedged risk is either of the following:
 1. The risk of changes in fair value or cash flows attributable to changes in a foreign currency exchange rate
 2. The foreign exchange risk for a net investment in a foreign operation.
- b. In a fair value hedge or in a cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment hedge in the consolidated financial statements the counterparty (that is, the other member of the consolidated group) has entered into a contract with an unrelated third party that offsets the intra-entity derivative completely, thereby hedging the exposure it acquired from issuing the intra-entity derivative to the affiliate that designated the hedge.
- c. In a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment the counterparty has entered into a derivative instrument with an unrelated third party to offset the exposure that results from that **internal derivative** or, if the conditions in paragraphs 815-20-25-62 through 25-63 are met, entered into derivative instruments with unrelated third parties that would offset, on a net basis

for each foreign currency, the foreign exchange risk arising from multiple internal derivative instruments.

25-55 The designation of intra-entity derivatives as hedging instruments for hedges of foreign exchange risk enables entities to continue using a central treasury function for derivative instruments with third parties and still comply with the requirement in paragraph 815-20-25-30(a) that the operating unit with the foreign currency exposure be a party to the hedging instrument.

Topic 815 makes a distinction between intra-entity derivatives and internal derivatives. While both derivatives are between members of a consolidated group, the definition of internal derivative is used for foreign currency derivatives. For purposes of this chapter, both intra-entity and internal derivatives are referred to as internal derivatives.

An internal derivative can be designated as a hedging instrument in a fair value hedge of a FCD recognized asset or liability. However, an internal derivative cannot be considered a derivative hedging instrument in the consolidated financial statements unless the risk acquired through the internal derivative has been offset with an unrelated third-party derivative contract.

Internal derivatives do not offset foreign currency exposure on a consolidated basis. Instead, they merely transfer the exposure from one party to another and may alter the form of the exposure if the functional currencies of the two entities are different. Unless an internal derivative is offset by a contract that transfers the exposure to an unrelated third party, the consolidated exposure has not been offset.

Generally, for an internal derivative to qualify as a hedging instrument in the consolidated financial statements, it has to be offset by an unrelated third-party contract on an individual basis. Topic 815 permits a limited exception to offset the net foreign currency exposure of internal derivatives used in a treasury center with an unrelated third party for certain **cash flow hedges** (see section 11.6.70). [815-20-25-52]



Example 11.4.20

Internal derivative with no offsetting third-party derivative contract

Subsidiary has the euro (€) as its functional currency and is exposed to \$/€ currency fluctuations on a \$1,000,000 debt security. Subsidiary enters into a foreign currency forward contract with Parent to sell \$1,000,000 in three months to hedge the impact of foreign currency fluctuations on the debt security over the next three months. Subsidiary designates the forward as a fair value hedge.

The forward contract eliminates Subsidiary's foreign currency risk. However, because the forward contract is an internal derivative, it does not offset the foreign currency exposure on a consolidated basis. It merely transfers the exposure so that Parent now has a \$/€ currency exposure.

In the consolidated financial statements, the internal derivative cannot be accounted for as a hedging instrument because it does not reduce the variability of functional currency equivalent fair value on a consolidated basis. In consolidation, the internal derivative is eliminated and Subsidiary's original exposure to foreign currency fluctuations exposure continues to exist.

In contrast, the internal derivative can qualify as a derivative hedging instrument in Subsidiary's stand-alone financial statements. If Subsidiary accounts for the internal derivative using hedge accounting for purposes of its stand-alone financial statements and Parent does not enter into an offsetting contract with a third party, Parent will need to eliminate the hedge accounting entries made at the subsidiary level when preparing the consolidated financial statements.



Example 11.4.30

Internal derivative with offsetting third-party derivative contract

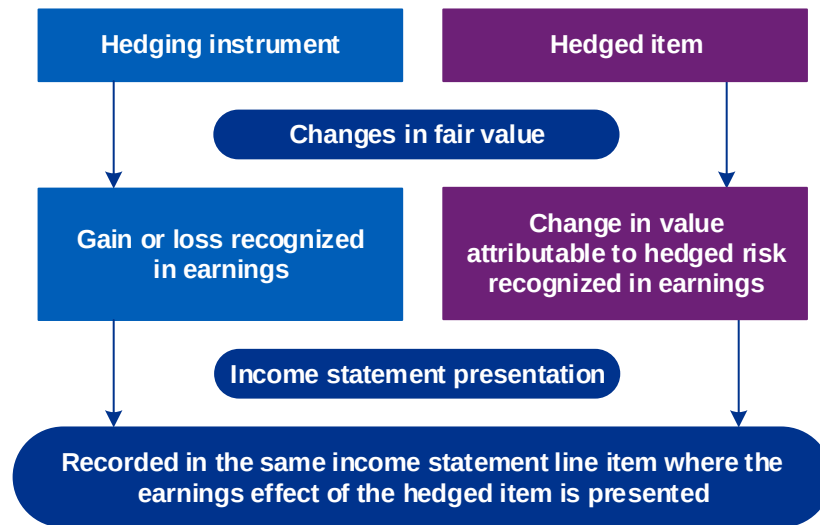
Assume the same facts as in Example 11.4.20 except that Parent enters into a foreign currency forward contract with an unrelated third party to offset the exposure it acquires from entering into the internal derivative with Subsidiary. Specifically, Parent enters into a foreign currency forward contract to sell US dollars with an unrelated third party and documents that the unrelated third-party contract has been entered into to offset the specific contract entered into with Subsidiary.

Parent has offset the exposure acquired from Subsidiary and on a consolidated basis has eliminated its exposure to the variability in the functional currency equivalent fair value of the US dollar security. Therefore, fair value hedge accounting at the subsidiary level carries forward into the consolidated financial statements as long as the hedge documentation is maintained at both the subsidiary and parent levels linking the hedged exposure with the unrelated third-party derivative contract. In Parent's stand-alone financial statements before consolidation, the internal derivative and the unrelated third-party derivative contract are accounted for as speculative derivative instruments because hedge accounting is not permitted when a derivative instrument is used to offset the risks arising from another derivative instrument.

11.5 Accounting for foreign currency fair value hedges

11.5.10 Overview

The accounting for foreign currency fair value hedges is the same as it is for all other fair value hedges (see chapter 8). The following shows the general accounting and presentation for a highly effective fair value hedge (not including excluded components).



In general, the fair value foreign currency hedge accounting model comprises the following.

Derivative hedging instrument	Recognized at fair value on the balance sheet with changes in fair value recognized in earnings, other than amounts related to excluded components. For additional discussion of excluded components, see section 8.2.20.
Nonderivative hedging instrument	Foreign currency transaction gains or losses under Topic 830 reported in earnings. The foreign currency transaction gain or loss is determined as the change in functional currency cash flows attributable to the change in spot exchange rates between the functional currency and the currency in which the hedging instrument is denominated.
Hedged item	FCD assets or liabilities are remeasured to functional currency based on spot exchange rates through earnings. If multiple risks are being hedged, the carrying amount of the hedged item is adjusted for each of the risks (discussed below).

Hedges of multiple risks

In addition to hedging only foreign currency risk, an entity can hedge the combination of foreign currency risk and other risks (see section 6.3.80). For example, to mitigate the earnings volatility caused by entering into a foreign currency fair value hedging relationship for a recognized interest-bearing financial asset or liability, an entity could hedge the combination of foreign currency risk and the benchmark interest rate risk.

Hedging the change in fair value attributable to changes in both the benchmark interest rate and foreign currency exchange rate of a recognized FCD financial

asset or liability requires a two-step approach to adjust the basis of the hedged item.

Step 1

The hedged item is adjusted through earnings for the change in fair value attributable to a change in the foreign benchmark interest rate.

Step 2

The basis-adjusted (for changes in foreign benchmark interest rates) FCD asset or liability is remeasured to the functional currency at the spot rate through earnings.

If an entity excludes the cross-currency basis spread from its assessment of **hedge effectiveness** (see section 13.2.70), the above approach effectively eliminates any difference that will be reflected in earnings related to the volatility in the cross-currency basis spread that is included in the measurement of the hedging instrument. For additional discussion about the accounting for the excluded component, see section 8.2.20.

**Observation****Hedging variable-rate FCD instruments**

If an entity is hedging the foreign currency risk of a variable-rate FCD instrument and no components are excluded from the assessment of hedge effectiveness, there may be volatility in earnings for the fair value hedging model due to spot-forward differences or currency basis spreads.

Earnings volatility can be reduced if an entity excludes the spot-forward difference or currency basis spreads from its assessment of hedge effectiveness and elects to recognize the initial value of the excluded component using an amortization approach. For additional discussion of excluded components, see section 8.2.20.

11.5.20 Changes involving foreign currency risk

**Excerpt from ASC 815-25****>> Changes Involving Foreign Exchange Risk**

35-15 Gains and losses on a qualifying foreign currency fair value hedge shall be accounted for as specified in Section 815-25-40 and paragraphs 815-25-35-1 through 35-10.

35-16 If a nonderivative instrument qualifies as a hedging instrument under paragraph 815-20-25-58, the gain or loss on the nonderivative hedging instrument attributable to foreign currency risk shall be the foreign currency transaction gain or loss as determined under Subtopic 830-20. The foreign currency transaction gain or loss on a hedging instrument shall be determined, consistent with paragraph 830-20-35-1, as the increase or decrease in functional currency cash flows attributable to the change in spot exchange

rates between the functional currency and the currency in which the hedging instrument is denominated. That foreign currency transaction gain or loss shall be recognized currently in earnings along with the change in the carrying amount of the hedged firm commitment.

35-17 Paragraph Not Used

35-18 Remeasurement of hedged foreign-currency-denominated assets and liabilities is based on the guidance in Subtopic 830-20, which requires remeasurement based on spot exchange rates, regardless of whether a fair value hedging relationship exists.



Observation

Calculating the fair value of a hedged unrecognized firm commitment

How an entity calculates the changes in fair value related to foreign currency risk when the hedged item is an unrecognized firm commitment depends on the nature of the hedging instrument.

Hedging instrument is a derivative forward contract

If the hedging instrument is a derivative forward contract, an entity would not have volatility in the income statement if the changes in fair value of the hedged item are based on forward foreign currency exchange rates. Otherwise, if the spot exchange rate were used to calculate the change in fair value of the firm commitment due to changes in the foreign currency exchange rates, there would be volatility in earnings. The volatility is because the change in fair value of the derivative hedging instrument (which is calculated based on forward rates) would not equal the change in the hedged firm commitment (which is based on spot exchange rates).

Hedging instrument is a nonderivative financial instrument

When a FCD nonderivative financial instrument is the hedging instrument, an entity would not have volatility in the income statement if the change in the fair value of the hedged item is based on spot rates. Otherwise, if the forward exchange rate were used to calculate the change in fair value of the firm commitment due to changes in foreign currency exchange rates, there would be volatility in earnings. The volatility is because the change in the nonderivative hedging instrument (which is calculated based on spot rates) would not equal the change in the hedged firm commitment (which is based on forward rates).



Question 11.5.10

What model will result in less earnings volatility when hedging only the foreign currency exposure of a recognized financial asset or liability?

Interpretive response: It depends.

If an entity is hedging a recognized FCD monetary financial asset or liability, the assessment of effectiveness of the fair value hedging relationship due to changes in foreign currency rates is affected by the interaction of Topics 815 and 830.

Topic 830 requires such assets and liabilities to be remeasured to functional currency based on spot exchange rates. Therefore, the adjustment of these assets and liabilities for changes in fair value due to changes in foreign currency exchange rates is limited to the changes based on spot rates; however the change in fair value of the derivative hedging instrument is based on forward rates. If an entity does not exclude any components from its assessment of hedge effectiveness, there will be earnings volatility for the spot-forward rate difference. [830-20-35-1 – 35-2]

Cash flow hedges. If an entity does not exclude any components from its assessment of hedge effectiveness and wants less earnings volatility, it may elect to use the foreign currency cash flow hedging model.



Question 11.5.20

Is a partial-term fair value hedge of foreign currency risk permitted?

Interpretive response: It depends.

- **If effectiveness is based on changes in the spot rates** of the hedging instrument, an entity is permitted to enter into a partial-term fair value hedge of foreign currency risk. Therefore, it does not need to hedge all of the foreign currency exposure throughout the life of the hedged item. This is because if the effectiveness of the hedging relationship is based solely on changes in spot rates, it is not affected by the maturity date of the hedging instrument or the hedged item. If an entity excludes the time value of option and forward points (spot-forward difference) from its assessment of hedge effectiveness, the excluded component should be accounted for using either the mark-to-market approach or the amortization approach (see section 8.2.20).
- **If effectiveness is based on changes in the forward rates** of the hedging instrument, an entity is not permitted to enter into a partial-term fair value hedge of foreign currency risk. We do not believe the guidance in paragraph 815-25-35-13B that permits partial-term hedges of interest rate risk (or interest rate risk and foreign currency risk) permits an entity to enter into a partial-term hedge of only foreign currency risk when effectiveness is based on forward rates.



Example 11.5.10

Partial-term foreign currency fair value hedge

If a US dollar functional currency entity has a 1,000,000 yen (¥) receivable with a maturity of 60 days, it may enter into a forward contract to pay yen and receive

US dollars to hedge the risk of changes in fair value of that receivable due to changes in the ¥/\$ exchange rate.

If the effectiveness of the hedge is assessed based only on changes in the spot rate of the hedging instrument, the maturity of the forward contract can be at the end or at any point during those 60 days because the entity need not hedge all of the foreign currency exposure throughout the hedged item's life. The excluded component should be accounted for using either the mark-to-market approach or the amortization approach (see section 8.2.20).



Question 11.5.30

If a cross-currency interest rate swap is used to hedge only foreign currency risk, what can be excluded from hedge effectiveness?

Background: An entity is permitted to exclude certain items from its assessment of hedge effectiveness including: [\[815-20-25-82\]](#)

- for forward or future contracts, the change in fair value of the contract related to the spot-forward difference; and
- the portion of the change in fair value of a currency swap attributable to the cross-currency basis spread.

Entities often use either a fixed-for-fixed or a floating-for-floating cross-currency interest rate swap to hedge their exposure to foreign currency risk. For further discussion on cross-currency interest rate swaps, see section 6.6.20, and for the accounting for the cross-currency basis spread as an excluded component, see section 8.2.20.

Interpretive response: We believe an entity may exclude the entire spot-forward difference from its assessment of hedge effectiveness when using either a fixed-for-fixed or a floating-for-floating cross-currency interest rate swap to hedge its exposure to foreign currency risk.

We believe the guidance for **net investment hedges** in which only foreign currency risk is hedged may be considered by analogy. An entity is permitted to use a fixed-for-fixed or a floating-for-floating cross-currency interest rate swap for a net investment hedge but is not permitted to use a fixed-for-floating interest rate swap. See chapter 12 for additional information on net investment hedges. [\[815-25-25-67 – 25-68A\]](#)

An entity is not permitted to use a compound derivative that has multiple underlyings as a hedging instrument in a net investment hedge. A fixed-for-fixed or a floating-for-floating cross-currency interest rate swap is not a compound derivative because foreign currency rate changes primarily affect changes in its fair value. These types of derivatives are economically similar to foreign currency forward contracts. Therefore, similar to forward contracts, we believe an entity may exclude the entire spot-forward difference from the assessment of hedge effectiveness.

11.5.30 Examples of foreign currency fair value hedges

This section contains three examples illustrating the application of the foreign currency fair value hedging principles to the following hedging relationships.

- Fair value hedge of a firm FCD purchase commitment with a forward contract (Example 11.5.20);
- Fair value hedge of a FCD AFS debt security with a forward contract (Example 11.5.30); and
- Fair value hedge of a firm commitment denominated in a foreign currency with a forward to purchase a different currency (Subtopic 815-25's Example 10).

Each of the examples assumes that all criteria for hedge accounting, including all required documentation, have been met at the onset of the hedging relationship and at each period end.



Example 11.5.20

Fair value hedge of a firm FCD purchase commitment with a forward contract

ABC Corp's functional currency is the US dollar (\$). On October 1, Year 1, ABC enters into a firm commitment to purchase equipment for delivery on March 31, Year 2 in pounds sterling (£). The price of the equipment is fixed at £10,000 with payment due on delivery.

Also on October 1, Year 1, ABC enters into a foreign currency forward contract to buy £10,000 on March 31, Year 2. ABC will exchange \$11,000 for £10,000 on that date (forward rate \$1.10 per £1).

ABC designates the foreign currency forward contract as a hedge of its risk of changes in the fair value of the firm commitment resulting from changes in the \$/£ exchange rate. This hedging strategy should enable the equipment to be recorded at \$11,000 (the forward price inherent in the foreign currency forward contract) at the time of purchase regardless of the then prevailing spot exchange rate.

Spot rates, forward rates and fair value of the foreign currency forward contract are as follows.

Date	Spot \$/£	Forward \$/£	Fair value	Change in fair value
October 1, Year 1	£1 = \$1.00	£1 = \$1.10	\$ -	N/A
December 31, Year 1	£1 = \$1.50	£1 = \$1.40	2,857 ¹	\$ 2,857
March 31, Year 2	£1 = \$1.15	N/A	500	(2,357)

Note:

1. The fair value is determined using the change in forward rates ($1.40 - 1.10 \times £10,000$) discounted at an appropriate rate.

Hedge effectiveness. ABC assesses hedge effectiveness by comparing the overall changes in fair value of the forward contract to the changes in fair value

of the firm commitment measured by reference to changes in the \$/£ forward exchange rates. Changes in the fair value of the foreign currency forward contract related to changes in the £ forward price are expected to be 100% effective in offsetting the changes in fair value of the firm commitment due to changes in the \$/£ forward exchange rate; this is because both are denominated in the same currency and have the same terms. It is assumed that the hedge is highly effective at inception and throughout the term.

Journal entries

ABC makes a memorandum entry on October 1, Year 1 to document the existence of the hedging relationship. There is no entry for the foreign currency forward contract because the contract is at market rates (i.e. fair value is zero).

Journal entries – December 31, Year 1

	Debit	Credit
Depreciation expense ¹	2,857	
Firm commitment		2,857
<i>To record change in fair value of foreign currency firm commitment.</i>		
Forward contract	2,857	
Depreciation expense		2,857
<i>To record change in fair value of foreign currency forward contract.</i>		
Note: 1. The change in fair value of the foreign currency firm commitment is recorded in the same income statement line item that is used to present the earnings effect of the hedged equipment (depreciation expense).		

Journal entries – March 31, Year 2

	Debit	Credit
Firm commitment	2,357	
Depreciation expense		2,357
<i>To record change in fair value of foreign currency firm commitment.</i>		
Depreciation expense	2,357	
Forward contract		2,357
<i>To record change in fair value of foreign currency forward contract.</i>		
Equipment	11,500	
Cash		11,500
<i>To record purchase of equipment from UK supplier at March 31, Year 2 spot rate (£1 = \$1.15).</i>		
Cash	500	

	Debit	Credit
Forward contract <i>To record settlement of foreign currency forward contract.</i>		500
Firm commitment Equipment <i>To adjust carrying amount of the equipment to reflect hedge of firm commitment.</i>	500	500

ABC's hedging objective was to lock in the purchase price of the equipment at the US dollar price based on the £ forward rate on October 1, Year 1. During the period the hedge was in place, the US dollar weakened against pound sterling. Without any hedge, the equipment would have cost \$11,500 (£10,000 at the spot exchange rate of £1 = \$1.15). However, with the hedge, ABC limits its net cash outflow to \$11,000. The equipment is also recorded at \$11,000.



Example 11.5.30

Fair value hedge of a FCD AFS debt security with a forward contract

ABC Corp.'s functional currency is the US dollar (\$). On April 1, Year 1, ABC purchases a debt security for 1,000,000 pounds sterling (£) and classifies it as an AFS security.

To hedge the fair value of its investment in the debt security against adverse changes in the \$/£ exchange rate, on April 1, Year 1 ABC purchases a forward contract to sell £1,000,000 on June 30. ABC designates the forward as a hedge of its risk of changes in fair value of its AFS debt security (for £1,000,000) resulting from changes in the \$/£ exchange rate between April 1 and June 30.

ABC determines that the change in fair value of the derivative is highly effective at offsetting changes in fair value of the hedged AFS debt securities. ABC elects to exclude the spot-forward difference for the effectiveness assessment and account for the excluded component using the mark-to-market approach.

Bond prices, foreign currency exchange rates and fair value of ABC's investment are as follows.

Date	Value in £	Spot \$/£	Value in \$
April 1	£1,000,000	£1 = \$1.00	\$1,000,000
June 30	1,050,000	£1 = \$0.90	945,000

The change in fair value of the bond is attributable to both changes in the exchange rates and market prices. The following are the changes attributable to each.

Date	Total change in bond fair value USD	Fair value change due to exchange rates	Fair value change due to changes in market price of bond
June 30	\$(55,000)	\$(100,000) ¹	\$45,000 ²
Notes:			
1. £1,000,000 × (\$1.00 - \$0.90).			
2. £50,000 increase in value (£1,050,000 - £1,000,000) converted at the spot rate on June 30 (\$0.90).			

The foreign currency exchange rates and fair value of the forward contracts are as follows.

Date	Spot \$/£	Forward rate \$/£	Fair value of forward contract
April 1	£1 = \$1.00	£1 = \$0.95	N/A
June 30	£1 = \$0.90	N/A	\$50,000 ¹
Note:			
1. £1,000,000 × (\$0.95 - \$0.90).			

Journal entries – April 1, Year 1

	Debit	Credit
Investment in AFS security	1,000,000	
Cash		1,000,000
<i>To record purchase of AFS debt security at spot rate of £1 = \$1.00.</i>		

Journal entries – June 30, Year 1

	Debit	Credit
Forward contract	100,000	
Gains/losses on AFS security		100,000
<i>To record change in fair value of forward contract due to changes in spot rate in same line item as hedged item.</i>		
Gains/losses on AFS security	50,000	
Forward contract		50,000
<i>To record mark-to-market on excluded component (spot-forward difference).</i>		
Gains/losses on AFS security	100,000	
Investment in AFS security		100,000
<i>To record change in fair value of AFS debt security attributable to changes in exchange rates.</i>		

	<i>Debit</i>	<i>Credit</i>
Investment in AFS security	45,000	
Other comprehensive income		45,000
<i>To record change in fair value of AFS debt security attributable to risk not being hedged.</i>		
Cash	50,000	
Forward contract		50,000
<i>To record settlement of forward contract.</i>		

FASB Example: Firm commitment denominated in foreign currency with a forward to purchase a different currency



Excerpt from ASC 815-25

>> Example 10: Fair Value Hedge of a Firm Commitment Denominated in a Foreign Currency with a Forward to Purchase a Different Currency

55-62 This Example illustrates application of the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 to a fair value hedge of a **firm commitment** to purchase an asset for a price denominated in a foreign currency. In this Example, the hedging instrument and the firm commitment are denominated in different foreign currencies. Consequently, although the hedge is highly effective at achieving offsetting changes in fair value, the hedge is not perfectly effective, and there will be an earnings effect. (The entity in the Example could have designed a perfectly effective hedge by using a hedging instrument denominated in the same foreign currency as the firm commitment with terms that match the appropriate terms in the firm commitment.) For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-63 Entity MNO's functional currency is the U.S. dollar (USD). On February 3, 20X7, Entity MNO enters into a firm commitment to purchase a machine for delivery on May 1, 20X7. The price of the machine will be 270,000 Swiss francs (CHF 270,000). Also on February 3, 20X7, Entity MNO enters into a forward contract to purchase 240,000 Euros (EUR 240,000) on May 1, 20X7. Entity MNO will pay USD 0.6125 per EUR 1 (a total of USD 147,000), which is the current forward rate for an exchange on May 1, 20X7. Entity MNO designates the forward contract as a hedge of its risk of changes in the fair value of the firm commitment resulting from changes in the USD–CHF forward exchange rate.

55-64 Entity MNO will assess effectiveness by comparing the overall changes in the fair value of the forward contract to the changes in fair value in USD of

the firm commitment due to changes in USD–CHF forward exchange rates. Entity MNO expects the forward contract to be highly effective as a hedge because all of the following conditions exist:

- EUR 240,000 is approximately equal to CHF 270,000 at the May 1, 20X1, forward exchange rate in effect on February 3, 20X7.
- Settlement of the forward contract and the firm commitment will occur on the same date.
- In recent years, changes in the value in USD of EUR over three-month periods have been highly correlated with changes in the value in USD of CHF over those same periods.

55-65 Although the hedging relationship has been determined to be highly effective at achieving offsetting changes in fair value, the hedge will not be perfectly effective and the difference between changes in the USD equivalent of EUR 240,000 (the notional amount of the forward contract) and changes in the USD equivalent of CHF 270,000 (the amount to be paid for the machine) will affect earnings. The difference between the **spot rate** and the forward exchange rate is not excluded from the assessment of hedge effectiveness because changes in the fair value of the firm commitment are being measured using forward exchange rates. Therefore, the entire change in the fair value of the hedging instrument will be presented in earnings in the same income statement line item as the earnings effect of the hedged item. If the hedged item were a foreign-currency-denominated available-for-sale debt security instead of a firm commitment, Topic 830 would have required its carrying value to be measured using the spot exchange rate. In that case, the spot-forward difference would have been recognized currently in earnings in the same income statement line item as the earnings effect of the hedged item if it was included in the assessment of effectiveness. The spot-forward difference also may be excluded from the assessment of effectiveness and accounted for through either an amortization approach or a mark-to-market approach in accordance with paragraph 815-20-25-83A or paragraph 815-20-25-83B.

55-66 The forward exchange rates in effect on certain key dates are assumed to be as follows.

Date	USD-EUR Forward Exchange Rate for Settlement on 5/1/X7	USD-CHF Forward Exchange Rate for Settlement on 5/1/X7
Inception of the hedge—2/3/X7	USD 0.6125 = EUR 1	USD 0.5454 = CHF 1
Quarter end—3/31/X7	USD 0.5983 = EUR 1	USD 0.5317 = CHF 1
Machine purchase—5/1/X7	USD 0.5777 = EUR 1	USD 0.5137 = CHF 1

55-67 The USD equivalent and changes in the USD equivalent of the forward contract and the firm commitment, the changes in fair value of the forward contract and the firm commitment, and the earnings effect of the hedge on those same key dates are shown in the following table. A 6 percent discount rate is used in this Example.

11. Hedging foreign currency exposures

	2/3/X7		3/31/X7		5/1/x7	
Forward contract						
USD-EUR forward exchange rate for settlement on May 1, 20X7	USD	0.61	USD	0.60	USD	0.58
Units of currency (EUR)		x 240,000		x 240,000		x 240,000
Forward price of EUR 240,000 in USD		147,000		143,592		138,648
Contract price in USD		(147,000)		(147,000)		(147,000)
Difference	USD	-	USD	(3,408.00)	USD	(8,352.00)
Fair value (present value of the difference)	USD	-	USD	(3,391.00)	USD	(8,352.00)
Change in fair value during the period			USD	(3,391.00)	USD	(4,961.00)
Firm commitment						
USD-CHF forward exchange rate for settlement on May 1, 20X7	USD	0.55	USD	0.53	USD	0.51
Units of currency (CHF)		x 270,000		x 270,000		x 270,000
Forward price of CHF 270,000 in USD		(147,258)		(143,559)		(138,699)
Initial forward price in USD		147,258		147,258		147,258
Difference	USD	-	USD	3,699.00	USD	8,559.00
Fair value (present value of the difference)	USD	-	USD	3,681.00	USD	8,559.00
Change in fair value during the period			USD	3,681.00	USD	4,878.00
Difference between changes in fair values of the forward contract denominated in EUR and the firm commitment denominated in CHF						
			USD	290.00	USD	(83.00)

55-68 This Subtopic requires that Entity MNO recognize currently in earnings all changes in fair values of the forward contract. Because Entity MNO is hedging the risk of changes in fair value of the firm commitment attributable to changes in the forward exchange rates, this Subtopic also requires recognizing those changes currently in earnings. Section 815-20-45 requires that those changes be presented in earnings in the same income statement line item as the earnings effect of the hedged item.

55-69 On May 1, 20X7, Entity MNO fulfills the firm commitment to purchase the machine and settles the forward contract. The entries illustrating fair value hedge accounting for the hedging relationship and the purchase of the machine are summarized in the following table.

11. Hedging foreign currency exposures

	Debit (Credit)				
	Cash	Firm Commitment	Forward Contract	Machine	Earnings
March 31, 20X7					
Recognize change in fair value of firm commitment		USD 3,681			USD (3,861)
Recognize change in fair value of forward contract			USD (3,391)		3,391
					(290)
April 30, 20X7					
Recognize change in fair value of firm commitment		4,878			(4,878)
Recognize change in fair value of forward contract			(4,961)		4,961
					83
May 1, 20X7					
Recognize settlement of forward contract	USD (8,352)		8,352		
Recognize purchase of machine	(138,699)	(8,559)		USD 147,258	
Total	USD (147,051)	USD -	USD -	USD 147,258	USD (207)

55-70 To simplify this Example and focus on the effects of the hedging relationship, other amounts that would be involved in the purchase of the machine by Entity MNO (for example, shipping costs and installation costs) have been ignored.

55-71 The effect of the hedge is to recognize the machine at its price in CHF (CHF 270,000) translated at the forward rate in effect at the inception of the hedge (USD 0.5454 per CHF 1).

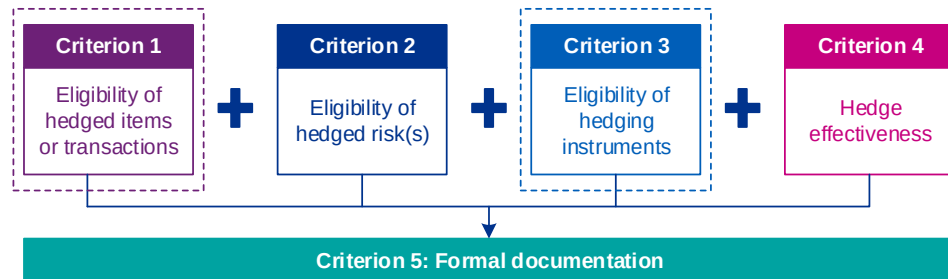
11.6 Specific qualifying criteria for foreign currency cash flow hedges

11.6.10 Overview

To qualify for foreign currency cash flow hedge accounting, a hedging relationship must meet the following qualifying criteria.

General hedging requirements	Chapter 6
Qualifying criteria for all cash flow hedges	Chapter 9 However, the criteria in paragraph 815-20-25-15(c) (which requires that the transaction be with a party external to the entity) does not have to be met.
General qualifying criteria for all foreign currency hedges	Section 11.3
Specific qualifying criteria for foreign currency cash flow hedges	Section 11.6

This section discusses the specific qualifying criteria for foreign currency cash flow hedges related to the eligibility of hedged transactions and hedging instruments.



Topic 815 permits foreign currency cash flow hedges of FCD forecasted transactions (including forecasted intercompany transactions), unrecognized firm commitments and recognized assets and liabilities. Only a derivative may be designated as the hedging instrument in a foreign currency cash flow hedge.

Criterion 1: Items eligible for cash flow hedges of foreign currency risk	Criterion 3: Hedging instruments eligible for cash flow hedges of foreign currency risk
Forecasted transaction (including an intercompany forecasted transaction) (section 11.6.30)	Derivative
Unrecognized firm commitments (section 11.6.40)	Derivative

Criterion 1: Items eligible for cash flow hedges of foreign currency risk

Recognized asset or liability
(section 11.6.50)

Criterion 3: Hedging instruments eligible for cash flow hedges of foreign currency risk

Derivative

Hedged items continue to be subject to other applicable US GAAP, including for assessing impairment.

11.6.20 Eligibility of hedged transactions and hedging instruments in a cash flow hedge of foreign currency risk



Excerpt from ASC 815-20

>>> Items and Transactions in Cash Flow Hedges of Foreign Exchange Risk

25-38 The conditions in the following paragraph relate to a derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with any of the following:

- a. A forecasted transaction (for example, a forecasted export sale to an unaffiliated entity with the price to be denominated in a foreign currency)
- b. A recognized asset or liability
- c. An unrecognized firm commitment
- d. A forecasted intra-entity transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary).

25-39 A hedging relationship of the type described in the preceding paragraph qualifies for hedge accounting if all the following criteria are met:

- a. The criteria in paragraph 815-20-25-30(a) through (b) are met.
- b. All of the cash flow hedge criteria in this Section otherwise are met, except for the criterion in paragraph 815-20-25-15(c) that requires that the forecasted transaction be with a party external to the reporting entity.
- c. If the hedged transaction is a group of individual forecasted foreign-currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.
- d. If the hedged item is a recognized foreign-currency-denominated asset or liability, all the variability in the hedged item's functional-currency-equivalent cash flows shall be eliminated by the effect of the hedge.

Hedged transaction. A foreign currency cash flow hedge is designed to hedge the foreign currency exposure to variability in functional currency equivalent cash flows generated by a hedged transaction. This exposure to cash flows

generated by the following transactions can be hedged in foreign currency cash flow hedges: [815-20-25-38]

- forecasted transaction, including an intercompany forecasted transaction (section 11.6.30);
- unrecognized firm commitment (section 11.6.40); and
- recognized asset or liability (section 11.6.50).

Hedging instruments. Only a derivative may be designated as the hedging instrument in a foreign currency cash flow hedge.

Topic 815 allows internal derivatives to be designated as hedging instruments for cash hedges of foreign exchange risk if certain conditions are met; for further discussion, see section 11.6.60.

11.6.30 Hedged transaction: Forecasted FCD transaction

The cash flows associated with a forecasted FCD transaction can be hedged in a cash flow hedge (but not a fair value hedge). The forecasted transaction may be with an unrelated or a related party (e.g. an intercompany transaction).

This section also discusses items related to when the following forecasted transactions are the hedged transactions:

- forecasted intercompany transaction; and
- forecasted sales or purchases on credit.



Question 11.6.10

Can a group of forecasted transactions be hedged in a single cash flow hedge?

Interpretive response: Yes. A group of similar forecasted transactions can be hedged as one transaction. However, the group cannot include both forecasted foreign currency inflows and outflows. An entity that forecasts sales and purchases in the same foreign currency cannot net the forecasted sales and purchases and hedge the net foreign currency exposure. The entity has to separately hedge the forecasted sales and the forecasted purchases. [815-20-25-39(c)]

Although an entity is not permitted to hedge the net foreign currency exposure, it can hedge a gross exposure (that equals the net exposure) and qualify for hedge accounting.



Example 11.6.10

Forecasted cash inflows and outflows in foreign currency

ABC Corp. has a US dollar functional currency and forecasts that it will (1) receive €1,000,000 (related to sales of its product) on May 15, Year 1 and (2)

pay €700,000 (related to purchases of inventory) on that day. Therefore, ABC has a net receive position of €300,000.

ABC is not permitted to designate that net position as the hedged transaction because it includes forecasted inflows and outflows. Instead, it may hedge the foreign currency risk related to the forecasted receipt of €300,000 (related to sales of its products) on May 15, Year 1 if all of the requirements for a cash flow hedge are met.



Question 11.6.20

Can the foreign currency exposure in a forecasted acquisition of a FCD debt security or forecasted issuance of FCD debt be hedged?

Interpretive response: No. The foreign currency exposure associated with the forecasted issuance of FCD debt cannot be hedged as a forecasted transaction because it does not affect earnings. The change in the functional currency equivalent proceeds an entity will receive on issuance of debt does not affect earnings because changes in exchange rates from hedge inception to the borrowing date will only affect the initial measurement of the liability. Similar reasoning applies to a forecasted investment in a FCD debt security.



Question 11.6.30

Can the foreign currency exposure in forecasted earnings of a foreign subsidiary be hedged?

Interpretive response: No. An entity is not permitted to designate forecasted earnings of a foreign subsidiary as a hedged transaction in a foreign currency cash flow hedge because hedges of future earnings are not permitted. However, an entity may designate the net investment in a foreign operation as the hedged item. For additional discussion of **net investment hedges**, see chapter 12. [FAS 133.BC485]

Forecasted intercompany transaction

Hedging a forecasted intercompany transaction is permitted because when an intercompany transaction denominated in a currency other than an entity's functional currency is remeasured under Topic 830 it affects consolidated earnings. Therefore, a forecasted intercompany transaction presents an exposure to foreign currency risk. [815-20-25-28 – 25-29]



Question 11.6.40

Can forecasted intercompany dividends be hedged?

Interpretive response: No. Forecasted intercompany dividends either in foreign or functional currency cannot be hedged as a forecasted transaction because intercompany dividends do not affect earnings. A hedge of forecasted intercompany dividends expected to be paid from future earnings is a hedge of those future earnings. Hedges of future earnings are not permitted.

[FAS 133.BC485]

However, once FCD dividends are declared by the subsidiary and recognized as dividends receivable/payable by the parent/subsidiary, they can be hedged as recognized FCD assets/liabilities for changes in foreign currency exchange rates.



Question 11.6.50

Can an intercompany FCD transaction be hedged for overall changes in fair value or cash flows?

Interpretive response: No. An intercompany FCD transaction cannot be hedged for overall changes in fair value or cash flows (e.g. price risk), interest rate or credit risk because these risks do not affect consolidated earnings. The exposure to these risks of one party to the contract will be offset by the opposite exposure of the other party to the contract within a consolidated group. Therefore, any potential earnings exposure will be eliminated in consolidation.

However, from the perspective of a subsidiary's stand-alone financial statements, any of the previously mentioned risks (that is, interest rate or credit risk), as well as foreign currency risk, presents exposure to that subsidiary's earnings and therefore are eligible for hedge accounting solely for purposes of the subsidiary's stand-alone financial statements.

Forecasted purchases or sales on credit**Excerpt from ASC 815-20****>>> Sale or Purchase on Credit as a Hedged Item Involving Foreign Exchange Risk**

25-34 The provisions of this Section (including paragraph 815-20-25-28) that permit a recognized foreign-currency-denominated asset or liability to be the hedged item in a fair value or cash flow hedge of foreign currency exposure also pertain to a recognized foreign-currency-denominated receivable or payable that results from a hedged forecasted foreign-currency-denominated

sale or purchase on credit. Specifically, an entity may choose to designate either of the following:

- a. A single cash flow hedge that encompasses the variability of functional currency cash flows attributable to foreign exchange risk related to the settlement of the foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit
- b. Both of the following separate hedges:
 1. A cash flow hedge of the variability of functional currency cash flows attributable to foreign exchange risk related to a forecasted foreign-currency-denominated sale or purchase on credit
 2. A foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable.

25-35 If two separate hedges are designated, the cash flow hedge would terminate (that is, be dedesignated) when the hedged sale or purchase occurs and the foreign-currency-denominated receivable or payable is recognized.

25-36 The use of the same foreign currency derivative instrument for both the cash flow hedge and the fair value hedge is not prohibited.

An entity can designate a cash flow hedge of the variability of functional currency-equivalent cash flows attributable to foreign currency risk related to a forecasted FCD sale or purchase on credit. In a forecasted FCD purchase or sale on credit, an entity can choose to hedge foreign currency risk to the date:

- the purchase or sale will occur; or
- the FCD payable or receivable will be settled.

If an entity chooses to hedge the risk to the date the payable or receivable is settled, it may use the same derivative instrument and designate either a single cash flow hedge or two separate hedges. [815-20-25-34]

- **Single cash flow hedge with a dual purpose.** This alternative hedges the foreign currency risk related to both the forecasted purchase or sale and settlement of the FCD payable or receivable resulting from the forecasted purchase or sale. [815-20-25-34(a), 815-30-35-9]
- **Two separate hedges with the same hedging instrument.** The first hedge is a cash flow hedge that hedges the foreign currency risk related to the forecasted purchase or sale. The first hedge is dedesignated when the purchase or sale occurs. The second hedge is a fair value hedge of the resulting payable or receivable. [815-20-25-34(b) – 25-36]

Generally, entities use a single cash flow hedge with a dual purpose to avoid operational issues associated with using two separate hedges.



Example 11.6.20

Forecasted purchase in foreign currency

ABC Corp.'s functional currency is the US dollar. It forecasts that it will purchase equipment from a supplier in Mexico for 100 Mexican pesos in six

months. It anticipates purchasing the equipment on credit and settling the payable three months after purchase.

Single cash flow hedge with a dual purpose

To hedge the foreign currency risk inherent in this transaction for the hedge term of nine months, ABC uses as the hedging instrument a forward contract that matures in nine months (i.e. when it anticipates settling the payable). This one instrument hedges the variability of functional currency cash flows attributable to foreign currency risk related to the settlement of the FCD payable resulting from a forecasted purchase on credit.

Two separate hedges with the same hedging instrument

To hedge the foreign currency risk inherent in this transaction, ABC establishes a cash flow hedge by using a forward contract that matures in nine months to hedge any foreign currency risk related to the forecasted purchase of equipment. It also establishes a fair value hedge when the payable is recognized with the same forward contract to hedge any change in the fair value of the resulting liability due to foreign currency exchange rate fluctuations.

In this transaction, ABC dedesignates the cash flow hedge when it purchases the equipment in six months.



Observation

Two separate hedges for a forecasted purchase on credit with the same hedging instrument

For a forecasted FCD purchase or sale on credit, an entity may choose to hedge the foreign currency risk to the date the payable or receivable is settled. An entity may elect to hedge this risk by designating two separate hedges with the same hedging instrument.

Hedge effectiveness. If the entity uses a single hedging instrument and designates two separate hedges, the entity's assessment of hedge effectiveness using forward rates will need to consider the mismatch due to the hedging instrument's fair value being based on a time period to the settlement date, while the change in forecasted cash flows is calculated based on a shorter time period (through the sale or purchase date).

If the entity's assessment of hedge effectiveness uses spot rates, the timing mismatch will not impact hedge effectiveness.



Question 11.6.60

Can an entity apply hedge accounting once the forecasted transaction to purchase a FCD nonfinancial asset has occurred?

Interpretive response: Yes. If an entity has a foreign currency cash flow hedge and is hedging the cash settlement of the forecasted acquisition of a FCD nonfinancial asset (e.g. inventory) and the forecasted transaction occurs, it may

continue to apply hedge accounting. However, the entity no longer has a forecasted transaction. Instead, it has a FCD monetary liability (i.e. payable) that would separately be eligible to be designated as a **fair value hedge** of foreign currency risk or continue to be eligible as a cash flow hedge of foreign currency risk.

11.6.40 Hedged transaction: Unrecognized firm commitments



Excerpt from ASC 815-20

>>>> Foreign Exchange Risk of a Firm Commitment as Hedged Transaction in a Cash Flow Hedge

25-42 The reference in the definition of a forecasted transaction indicating that a forecasted transaction is not a firm commitment focuses on firm commitments that have no variability. The reference does not preclude a cash flow hedge of the variability in functional-currency-equivalent cash flows if the commitment's fixed price is denominated in a foreign currency. Although that definition of a firm commitment requires a fixed price, it permits the fixed price to be denominated in a foreign currency. A firm commitment can expose the parties to variability in their functional-currency-equivalent cash flows. The definition of a forecasted transaction also indicates that the transaction or event will occur at the prevailing market price. From the perspective of the hedged risk (foreign exchange risk), the translation of the foreign currency proceeds from the sale of the nonfinancial assets will occur at the prevailing market price (that is, current exchange rate). Example 14 (see paragraph 815-20-55-136) illustrates the application of this guidance.

>> Example 14: Hedging a Firm Commitment or Fixed-Price Agreement Denominated in a Foreign Currency

55-136 The following Cases illustrate hedging foreign exchange risk under the cash flow hedging model as discussed in paragraph 815-20-25-42 and others:

- a. Firm commitment (Case A)
- b. Fixed-price agreement (Case B).

>>> Case A: Firm Commitment

55-137 On January 1, an entity enters into an agreement to sell 1,000 tons of a nonfinancial asset to an unrelated party on June 30. The agreement meets the definition of a firm commitment. The firm commitment is denominated in the buyer's functional currency, which is not the seller's functional currency. Accordingly, the firm commitment exposes the seller to foreign currency risk. The seller may hedge the foreign currency exposure arising from the firm commitment under the fair value hedging model.

55-138 The seller may hedge its exposure to foreign currency risk under the cash flow hedging model even though the agreement meets the definition of a firm commitment. Accordingly, the seller may hedge the foreign currency

exposure arising from the firm commitment to sell 1,000 tons of the nonfinancial asset under the cash flow hedging model, even though the seller has previously hedged its foreign currency exposure arising from another similar firm commitment under the fair value hedging model.

>>> Case B: Fixed-Price Agreement

55-139 On January 1, an entity enters into an agreement to sell 1,000 tons of a nonfinancial asset to an unrelated party on June 30. Although the agreement in this Case does not meet the definition of a firm commitment, the seller's assessment of the observable facts and circumstances is that performance under the agreement is probable. The agreement is denominated in the buyer's functional currency, which is not the seller's functional currency. Accordingly, the foreign-currency-denominated fixed-price agreement exposes the seller to foreign currency risk.

55-140 If the agreement does not meet the definition of a firm commitment, but contains a fixed foreign-currency-denominated price, the seller may not hedge the foreign currency risk relating to the agreement to sell the nonfinancial asset under the fair value hedging model because the agreement is not a recognized asset, a recognized liability, or a firm commitment, which are the only items that can be designated as the hedged item in a fair value hedge. However, the seller may hedge the foreign currency risk relating to the agreement under the cash flow hedging model. The agreement is by definition a forecasted transaction because the sale of the nonfinancial assets will occur at the prevailing market price, that is, the fixed foreign-currency-denominated market price converted into the seller's functional currency at the prevailing exchange rate when the transaction occurs. Therefore, because the agreement includes a fixed foreign-currency-denominated price, the agreement exposes the seller to variability in the functional-currency-equivalent cash flows. Accordingly, the seller may not hedge the foreign currency risk relating to the agreement to sell 1,000 tons of the nonfinancial asset under the fair value hedging model but may hedge the foreign currency risk under the cash flow hedging model.

An unrecognized FCD firm commitment (or specific portion thereof) is eligible to be a hedged transaction in a cash flow hedge of foreign currency exposure if its price is expressed in a specified amount of currency. It does not matter whether that currency is the entity's functional currency or a foreign currency as long as the commitment exposes the entity to variability in its functional currency equivalent cash flows. [\[815-20 Glossary\]](#)

The reference in the definition of a forecasted transaction indicating that a forecasted transaction is not a firm commitment focuses on firm commitments that have no variability. The reference does not preclude a cash flow hedge of the variability in functional currency equivalent cash flows when the commitment's price is denominated in a foreign currency. [\[815-20 Glossary, 815-20-25-42\]](#)



Question 11.6.70

Can an unrecognized FCD commitment with a related party be hedged?

Interpretive response: Yes. FCD commitments with related parties may qualify as forecasted transactions in a cash flow hedge because:

- the criteria for forecasted transactions do not include a criterion that the contract be with an unrelated party (see Question 9.3.40); and
- the intercompany or related party commitment exposes an entity to variability in functional currency equivalent cash flows that could affect reported earnings.

A related party can be another entity within the entity's consolidated group (e.g. a subsidiary-to-subsidiary firm commitment). Alternatively, it can be with another entity that is not within the entity's consolidated group but is nonetheless related to the entity.

However, a commitment with a related party cannot be the hedged item in a **fair value hedge** because the definition of a firm commitment requires that the commitment be with an unrelated party (see section 7.3.20).



Question 11.6.80

Can a commitment to sell in the future based on the market price at the time of shipment be hedged in a cash flow hedge?

Interpretive response: Yes. An entity may hedge the foreign currency risk related to a commitment to sell a nonfinancial asset that is denominated in the buyer's functional currency, which is not the seller's functional currency, under the cash flow hedge model.

The agreement is by definition a forecasted transaction because the sale of the nonfinancial asset will occur at the prevailing market price. Therefore, because the agreement includes a fixed foreign currency denominated price, the agreement exposes the entity to variability in the functional currency equivalent cash flows. Therefore, the entity may hedge the foreign currency risk under the cash flow hedge model [815-20-25-42, 55-139 – 55-140]

Example 11.4.10 is an example of a commitment to sell at fair value.

11.6.50 Hedged transaction: Recognized assets and liabilities



Excerpt from ASC 815-20

>>> Items and Transactions in Cash Flow Hedges of Foreign Exchange Risk

25-39 A hedging relationship of the type described in the preceding paragraph qualifies for hedge accounting if all the following criteria are met: ...

- d. If the hedged item is a recognized foreign-currency-denominated asset or liability, all the variability in the hedged item's functional-currency-equivalent cash flows shall be eliminated by the effect of the hedge.

25-40 For purposes of item (d) in the preceding paragraph, an entity shall not specifically exclude a risk from the hedge that will affect the variability in cash flows. For example, a cash flow hedge cannot be used with a variable-rate foreign-currency-denominated asset or liability and a derivative instrument based solely on changes in exchange rates because the derivative instrument does not eliminate all the variability in the functional currency cash flows. As long as no element of risk that affects the variability in foreign-currency-equivalent cash flows has been specifically excluded from a foreign currency cash flow hedge and the hedging instrument is highly effective at providing the necessary offset in the variability of all cash flows, a less-than-perfect hedge would meet the requirement in (d) in the preceding paragraph. That criterion does not require that the derivative instrument used to hedge the foreign currency exposure of the forecasted foreign-currency-equivalent cash flows associated with a recognized asset or liability be perfectly effective, rather it is intended to ensure that the hedging relationship is highly effective at offsetting all risks that impact the variability of cash flows.

25-41 If all of the variability of the functional-currency-equivalent cash flows is eliminated as a result of the hedge (as required by paragraph 815-20-25-39(d)), an entity can use cash flow hedge accounting to hedge the variability in the functional-currency-equivalent cash flows associated with any of the following:

- a. All of the payments of both principal and interest of a foreign-currency-denominated asset or liability
- b. All of the payments of principal of a foreign-currency-denominated asset or liability
- c. All or a fixed portion of selected payments of either principal or interest of a foreign-currency-denominated asset or liability
- d. Selected payments of both principal and interest of a foreign-currency-denominated asset or liability (for example, principal and interest payments on December 31, 20X1, and December 31, 20X3).

The cash flows associated with a FCD recognized asset or liability can be hedged in a foreign currency cash flow hedge if the hedge eliminates all of the variability in the functional currency equivalent cash flows. [\[815-20-25-39\(d\)\]](#)

An entity can designate all or part of the cash flows of a FCD recognized asset or liability as a hedged transaction. Specifically, for either fixed- or variable-rate

assets or liabilities, an entity is permitted to hedge the variability in functional currency equivalent cash flows for the following: [815-20-25-41]

- all payments of both principal and interest;
- all payments of principal only;
- all or a fixed portion of selected payments of either principal or interest; and
- selected payments of both principal and interest.

When a cash flow hedge will not eliminate all of a hedged transaction's variability, the entity can designate the asset or liability as the hedged item in a foreign currency **fair value hedge** if all of the criteria for the hedge are met (see section 11.4).

See section 11.7.40 for an example of a foreign currency cash flow hedge of portions of a FCD financial asset or liability as the hedged transaction (Subtopic 815-20's Example 15).



Question 11.6.90

Does the requirement that all variability in cash flows be eliminated mean that the hedging instrument needs to be perfectly effective?

Interpretive response: No. The requirement to eliminate all variability in cash flows is not intended to require that the hedging instrument be perfectly effective. Rather, this requirement is intended to ensure that the hedging relationship is highly effective at offsetting all risks that affect the variability of cash flows. Therefore, as long as no element of risk from a hedge that will affect the variability in cash flows has been specifically excluded from the hedge, a less than perfect (but highly effective) hedge meets the requirement to eliminate all variability in cash flows. [815-20-25-40]

Subtopic 815-20's Example 13 (reproduced in this section) includes three different fact patterns to illustrate whether all variability in a hedged transaction's functional currency equivalent cash flows are eliminated by the effect of the hedging instrument when the hedging instrument is not perfectly effective.



Example 11.6.30

Applying the requirement to eliminate variability in all cash flows

Non-interest bearing assets and liabilities

ABC Corp. has a non-interest bearing FCD asset (e.g. an account receivable). ABC wants to hedge the foreign currency risk with a forward currency contract. Because this asset is non-interest bearing, all of the variability in its functional currency equivalent cash flows is attributable to foreign currency exchange rate changes.

Therefore, all of the variability will be eliminated by the forward currency contract, meaning the asset is eligible for a foreign currency cash flow hedge. The same result would apply to a non-interest bearing liability, such as an account payable.

Fixed-rate interest bearing assets and liabilities

ABC has a fixed-rate yen-denominated loan and wants to hedge the foreign currency risk with a forward currency contract. Because the yen interest payments are fixed and the forward currency contract eliminates the remaining variability in the loan's functional currency equivalent cash flows, the loan is eligible for a foreign currency cash flow hedge.

Variable-rate interest bearing assets and liabilities

ABC has a variable-rate yen-denominated loan. ABC wants to hedge the foreign currency risk for both the principal and interest. For a hedge in this example to be a foreign currency cash flow hedge, the hedging instrument needs to offset the variability in cash flows for both foreign currency risk and interest rate risk. ABC may use a floating-to-fixed cross-currency interest rate swap to hedge the foreign exchange and interest rate risks. ABC is not able to use a forward contract because it only eliminates the variability due to foreign currency exchange rates.

Alternatively, ABC may designate as the hedged transaction the present value of the principal amount of the variable-rate yen-denominated loan. ABC may use a forward contract because it eliminates all of the hedged transaction's variability. This is because the interest payment component of the loan, whose variability is not eliminated, is not part of the designated hedged transaction.



Question 11.6.100

May the fixed-rate interest payments denominated in a foreign currency in a dual-currency bond be designated as the hedged transaction?

Interpretive response: Yes, such interest payments may be designated as the hedged transaction in a cash flow hedge of foreign currency risk. Topic 830 applies to dual-currency bonds and requires the present value of the interest payments denominated in a foreign currency to be remeasured and the transaction gain or loss recognized in earnings. Therefore, those fixed-rate interest payments on a dual-currency bond could be designated as the hedged transaction in a cash flow hedge of foreign currency risk.



Example 11.6.40

Hedging fixed-rate interest payments in a dual-currency bond

ABC Corp., whose functional currency is the US dollar, issues dual-currency bonds that provide for repayment of principal in US dollars and periodic fixed-

rate interest payments denominated in a foreign currency. ABC wishes to lock in the US dollar functional currency future interest expense.

To hedge the foreign currency risk of the fixed FCD interest coupon payments, ABC enters into a series of foreign currency forward contracts to receive an amount of the foreign currency required to satisfy the coupon obligation in exchange for US dollars at each coupon date. The fixed-rate interest payments on the dual-currency bond could be designated as the hedged transaction in a cash flow hedge of foreign currency risk.

FASB Example: Eliminating all variability in cash flows



Excerpt from ASC 815-20

>> Example 13: Eliminating All Variability in Cash Flows

55-132 The following Cases illustrate the application of paragraph 815-20-25-39(d) regarding whether all the variability in a hedged item's functional-currency-equivalent cash flows are eliminated by the effect of the hedge:

- a. Difference in optionality (Case A)
- b. Difference in reset dates (Case B)
- c. Difference in notional amounts (Case C).

>>> Case A: Difference in Optionality

55-133 An entity has issued a fixed-rate foreign-currency-denominated debt obligation that is callable (that is, by that entity) and desires to hedge its foreign currency exposure related to that obligation with a fixed-to-fixed cross-currency swap. A fixed-to-fixed currency swap could be used to hedge the fixed-rate foreign-currency-denominated debt instrument that is callable even though the swap does not contain a mirror-image call option as long as the terms of the swap and the debt instrument are such that they would be highly effective at providing offsetting cash flows and as long as it was probable that the debt instrument would not be called and would remain outstanding.

>>> Case B: Difference in Reset Dates

55-134 An entity has issued a variable-rate foreign-currency-denominated debt obligation and desires to hedge its foreign currency exposure related to that obligation. The entity uses a variable-to-fixed cross-currency interest rate swap in which it receives the same foreign currency based on the variable rate index contained in the debt obligation and pays a fixed amount in its functional currency. If the swap would otherwise meet this Subtopic's definition of providing high effectiveness in hedging the foreign currency exposure of the debt instrument, but there is a one day difference between the reset dates in the debt obligation and the swap (that is, the one day difference in reset dates results in the hedge being highly effective, but not perfectly effective), the variable-to-fixed cross-currency interest rate swap could be used to hedge the variable-rate foreign-currency-denominated debt instrument even though there is a one-day difference between the reset dates or a slight difference in the

notional amounts in the debt instrument and the swap. This would be true as long as the difference in reset dates or notional amounts is not significant enough to cause the hedge to fail to be highly effective at providing offsetting cash flows.

>>> Case C: Difference in Notional Amounts

55-135 This Case involves the same facts as in Case B, except that there is no difference in the reset dates. However, there is a slight difference in the notional amount of the swap and the hedged item. If the swap would otherwise meet this Subtopic's definition of providing high effectiveness in hedging the foreign currency exposure of the debt instrument, paragraph 815-20-25-39(d) does not preclude the swap from qualifying for hedge accounting simply because the notional amounts do not exactly match. The mismatch attributable to the slight difference in the notional amount of the swap and the hedged item could be eliminated by designating only a portion of the contract with the larger notional amount as either the hedging instrument or hedged item, as appropriate.

11.6.60 Hedging instrument: Internal derivatives



Excerpt from ASC 815-20

>>> Intra-Entity Derivatives

25-52 A foreign currency derivative instrument that has been entered into with another member of a consolidated group can be a hedging instrument in any of the following hedging relationships only if that other member of the consolidated group has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge:

- a. A fair value hedge
- b. A cash flow hedge of a recognized foreign-currency-denominated asset or liability
- c. A net investment hedge in the consolidated financial statements.

25-53 Paragraph 815-20-25-46A states that there is no requirement in this Subtopic that the operating unit with the interest rate, market price, or credit risk exposure be a party to the hedging instrument and provides related guidance.

25-54 An intra-entity derivative can be designated as a hedging instrument in consolidated financial statements if condition (a) is met and either condition (b) or (c) is met:

- a. The hedged risk is either of the following:
 1. The risk of changes in fair value or cash flows attributable to changes in a foreign currency exchange rate
 2. The foreign exchange risk for a net investment in a foreign operation.

- b. In a fair value hedge or in a cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment hedge in the consolidated financial statements the counterparty (that is, the other member of the consolidated group) has entered into a contract with an unrelated third party that offsets the intra-entity derivative completely, thereby hedging the exposure it acquired from issuing the intra-entity derivative to the affiliate that designated the hedge.
- c. In a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment the counterparty has entered into a derivative instrument with an unrelated third party to offset the exposure that results from that **internal derivative** or, if the conditions in paragraphs 815-20-25-62 through 25-63 are met, entered into derivative instruments with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative instruments.

25-55 The designation of intra-entity derivatives as hedging instruments for hedges of foreign exchange risk enables entities to continue using a central treasury function for derivative instruments with third parties and still comply with the requirement in paragraph 815-20-25-30(a) that the operating unit with the foreign currency exposure be a party to the hedging instrument.

As noted in section 11.4.70, Topic 815 makes a distinction between intra-entity derivatives and internal derivatives. While both derivatives are between members of a consolidated group, the term internal derivative is used for foreign currency derivatives entered into between entities within a consolidated group. For purposes of this chapter, both intra-entity and internal derivatives are referred to as internal derivatives.

An internal derivative can be designated as a hedging instrument in a cash flow hedge of a FCD recognized asset or liability, a forecasted borrowing, purchase or sale, or an unrecognized firm commitment.

However, an internal derivative cannot be considered a derivative hedging instrument in consolidated financial statements unless the risk acquired through the internal derivative has been offset with an unrelated third-party derivative contract. This is because internal derivatives do not offset foreign currency exposure on a consolidated basis. Instead, they merely transfer the exposure from one party to another and may alter the form of the exposure if the functional currencies of the two entities are different. Unless an internal derivative is offset by a contract that transfers the exposure to an unrelated third party, the consolidated exposure has not been offset. [815-20-25-52, 25-54]

Generally, for an internal derivative to qualify as a hedging instrument in the consolidated financial statements, it has to be offset by an unrelated third-party contract on an individual basis. As described in section 11.6.70, Topic 815 permits a limited exception that cash flow hedges of a forecasted borrowing, purchase or sale, or an unrecognized firm commitment can be hedged on a net basis with contracts entered into with unrelated third parties. [815-20-25-52, 25-54(c)]

**Example 11.6.50****Hedging the net exposure from internal derivatives**

Finance Co.'s functional currency is the US dollar. As the parent entity, it acts as the central treasury function for all entities within its consolidated group, including London Co. and Tokyo Co. London's functional currency is the pound sterling (£). Tokyo's functional currency is the yen (¥).

London has a forecasted transaction in which it expects to receive \$100 in three months. To hedge this exposure, it enters into a foreign currency forward contract with Finance to sell \$100 and receive £75 in three months. Tokyo has a forecasted transaction in which it will pay \$150 in three months. To hedge its exposure, it enters into a foreign currency forward contract with Finance to buy \$150 and pay ¥15,000 in three months.

As a result of these internal derivative contracts, Finance has a net position to pay £75 and receive ¥15,000 in three months and therefore has an exposure to both fluctuations in the \$/£ exchange rate and the \$/¥ exchange rate. Finance offsets these two exposures by entering into two foreign currency forward contracts with Bank, an unrelated third party, to buy £75 for \$100 and to sell ¥15,000 for \$150 in three months.

London and Tokyo can apply cash flow hedge accounting in their stand-alone financial statements. London and Tokyo have foreign currency exposure as a result of the forecasted transactions and have entered into the hedging transaction with their parent. A derivative instrument used in a cash flow hedge of a forecasted transaction may be between a parent and subsidiary. [\[815-20-25-30\(a\), 815-20-25-61\]](#)

Finance cannot apply cash flow hedge accounting in its stand-alone financial statements. The risks acquired from the subsidiaries by Finance were acquired in the form of derivative instruments. The internal derivatives entered into by Finance with London and Tokyo will be remeasured at fair value through earnings. Items that are recorded at fair value with adjustments recognized currently through earnings are not permitted to be designated as hedged transactions (see section 6.5.70). The derivative contract entered into with Bank to offset the risks acquired in the internal derivatives with the subsidiaries will be accounted for as speculative (i.e. mark-to-market). The changes in the fair value of all three of these derivative contracts will offset in earnings.

The consolidated group may apply cash flow hedge accounting. Finance entered into two derivatives with an unrelated third party (Bank) to offset the exposures that resulted from the internal derivatives. [\[815-20-25-61\(b\)\(1\)\]](#)

11.6.70 Limitation on internal derivatives as hedging instruments: Hedging on a net basis



Excerpt from ASC 815-20

>>> Internal Derivatives as Hedging Instruments in Cash Flow Hedges of Foreign Exchange Risk

25-61 An internal derivative can be a hedging instrument in a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment in the consolidated financial statements only if both of the following conditions are satisfied:

- a. From the perspective of the member of the consolidated group using the derivative instrument as a hedging instrument (the hedging affiliate), the criteria for foreign currency cash flow hedge accounting otherwise specified in this Section are satisfied.
- b. The member of the consolidated group not using the derivative instrument as a hedging instrument (the issuing affiliate) either:
 1. Enters into a derivative instrument with an unrelated third party to offset the exposure that results from that internal derivative
 2. If the conditions in paragraphs 815-20-25-62 through 25-63 are met, enters into derivative instruments with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative instruments. In complying with this guidance the issuing affiliate could enter into a third-party position with neither leg of the third-party position being the issuing affiliate's functional currency to offset its exposure if the amount of the respective currencies of each leg are equivalent with respect to each other based on forward exchange rates.

25-62 If an issuing affiliate chooses to offset exposure arising from multiple internal derivatives on an aggregate or net basis, the derivative instruments issued to hedging affiliates shall qualify as cash flow hedges in the consolidated financial statements only if all of the following conditions are satisfied:

- a. The issuing affiliate enters into a derivative instrument with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivatives.
- b. The derivative instrument with the unrelated third party generates equal or closely approximating gains and losses when compared with the aggregate or net losses and gains generated by the derivative instruments issued to affiliates.
- c. Internal derivatives that are not designated as hedging instruments are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative instrument. Nonderivative contracts shall not be used as hedging instruments to offset exposures arising from internal derivatives.
- d. Foreign currency exposure that is offset by a single net third-party contract arises from internal derivatives that mature within the same 31-day period and that involve the same currency exposure as the net third-party

derivative instrument. The offsetting net third-party derivative instrument related to that group of contracts shall meet all of the following criteria:

1. It offsets the aggregate or net exposure to that currency.
 2. It matures within the same 31-day period.
 3. It is entered into within three business days after the designation of the internal derivatives as hedging instruments.
- e. The issuing affiliate meets both of the following conditions:
1. It tracks the exposure that it acquires from each hedging affiliate.
 2. It maintains documentation supporting linkage of each internal derivative and the offsetting aggregate or net derivative instrument with an unrelated third party.
- f. The issuing affiliate does not alter or terminate the offsetting derivative instrument with an unrelated third party unless the hedging affiliate initiates that action.

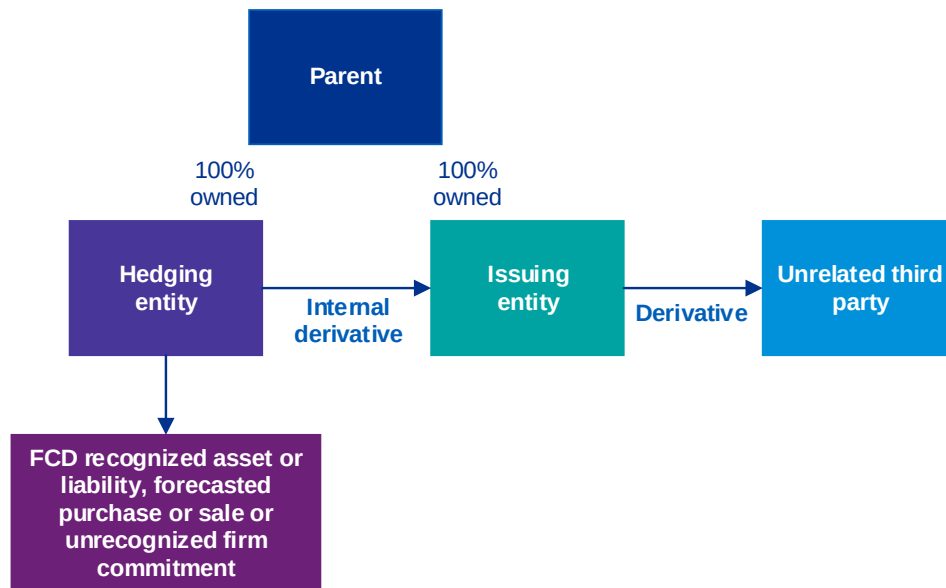
25-63 If the issuing affiliate alters or terminates any offsetting third-party derivative (which should be rare), the hedging affiliate shall prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative instrument.

25-64 A member of a consolidated group cannot meet the offsetting criteria by offsetting exposures arising from multiple internal derivative contracts on a net basis for foreign currency cash flow exposures related to recognized foreign-currency-denominated assets or liabilities. That prohibition includes situations in which a recognized foreign-currency-denominated asset or liability in a fair value hedge or cash flow hedge results from the occurrence of a specifically identified forecasted transaction initially designated as a cash flow hedge.

25-65 A qualifying foreign currency cash flow hedge shall be accounted for as specified in Subtopic 815-30.

Foreign currency risk of multiple internal derivatives can be hedged on a net basis with contracts entered into by the issuing entity with unrelated third parties if certain conditions are met. This type of hedge is permitted only for a cash flow hedge associated with a forecasted borrowing, purchase or sale or an unrecognized firm commitment.

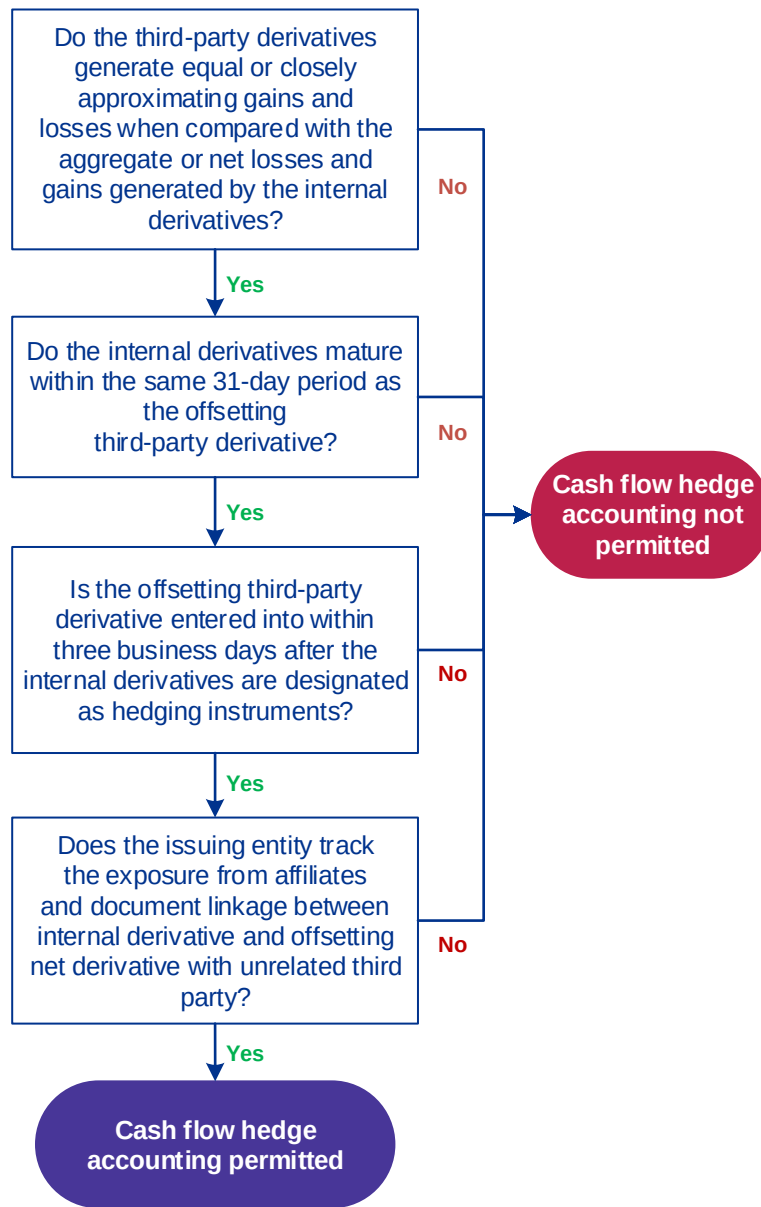
The issuing entity is the member of the consolidated group that is not using the derivative as a hedging instrument. The entities that may be involved when internal derivatives are used are illustrated in the following diagram.



The ability to offset risk on a net basis is intended to accommodate the practice used by many organizations that manage risk on a centralized basis using a treasury center function. The entity with the foreign currency risk to be hedged enters into an internal derivative with the treasury center and designates the internal derivative as the hedging instrument. The treasury center then offsets the risk exposure it receives through the internal derivative by entering into a derivative with a third party for the net exposure. To apply hedge accounting at the consolidated group, a derivative needs to be entered into with a third party for the net exposure.

Neither leg of the derivative with the third party is required to be in the issuing entity's functional currency (see Question 11.6.110). [\[815-20-25-61, 25-62\]](#)

If the issuing entity enters into offsetting third-party derivative contracts on an aggregate or net basis for each currency, the following additional requirements need to be met.



An issuing entity may not alter or terminate the offsetting third-party derivative unless the hedging entity initiates the action. If the issuing entity alters or terminates the offsetting instrument with a third party, hedge accounting would prospectively cease for the internal derivatives that are offset by the third-party derivative. [815-20-25-63]



Observation

Internal derivatives used for different hedging relationship

Treasury centers that issue internal derivatives need to segregate those internal derivatives issued for foreign currency fair value, net investment and recognized asset or liability cash flow hedges (which are not permitted to be aggregated or netted) from internal derivatives issued for cash flow hedges of forecasted transactions or unrecognized firm commitments (which can be aggregated or netted).

This segregation creates system and tracking issues for a treasury center that issues internal derivatives for various hedging purposes. It will require the treasury center to know the hedging relationship that the entity is establishing with the internal derivative.



Question 11.6.110

Can the treasury center enter into a third-party derivative with neither leg being its functional currency?

Interpretive response: Yes. To achieve hedge accounting on a consolidated basis, a treasury center can aggregate or net foreign currency exposures from multiple internal derivatives and enter into one third-party derivative contract to offset those exposures. The legs of the third-party contract do not need to be denominated in the treasury center's functional currency. In other words, the treasury center does not need to enter into two derivatives, each of which has the center's functional currency as one of its legs.

Subtopic 815-20's Example 18 (reproduced below) provides an example of a subsidiary offsetting its exposure on a net basis. [\[815-20-25-61\(b\)\(2\)\]](#)



Excerpt from ASC 815-20

>> Example 18: Offsetting a Subsidiary's Exposure on a Net Basis

55-171 This Example illustrates the application of paragraph 815-20-25-61(b)(2) in offsetting a subsidiary's exposure on a net basis in which neither leg of the third-party position is in the treasury center's functional currency.

55-172 If a U.S. dollar (USD) functional currency treasury center was short 390 Euros (EUR) and long 40,684.80 yen (JPY) after netting its exposures obtained from **internal derivatives** and the forward exchange rate between EUR and JPY was EUR 1.00 = JPY 104.32, then the treasury center could enter into a third-party receive EUR 390, pay JPY 40,684.80 contract to offset the exposures. In contrast, if the treasury center was short EUR 390 and long JPY

51,000, then the treasury center would need to enter into 2 third-party contracts with the receive leg of the second third-party position being the treasury center's functional currency. For example, the treasury center could enter into a third-party receive EUR 390, pay JPY 40,684.80 contract to offset the EUR exposure and partially offset the JPY exposure. It would then need to enter into a receive functional currency, pay JPY contract to hedge the remainder of its JPY exposure.



Question 11.6.120

How does an entity determine if third-party derivatives generate closely approximating gains/losses compared with the net gains/losses generated by the internal derivatives?

Background: When internal derivatives are offset on a net basis by third-party derivatives, those derivatives must generate closely approximating gains and losses when compared with the net gains and losses generated by the internal derivatives. [815-20-25-62(b)]

Interpretive response: Topic 815 does not specify how to determine whether third-party derivatives generate closely approximating gains and losses when compared with the net gains and losses generated by the internal derivatives. However, we believe this requirement is much more stringent than the 80%–125% range used to test if a hedge is highly effective.



Question 11.6.130

Can internal derivatives that are not designated as hedging instruments be included in determining the foreign currency exposure to be offset on a net basis?

Interpretive response: No. Internal derivatives that are not designated as hedging instruments are excluded from the determination of the foreign currency exposure to be offset on a net basis. We believe an entity, through the treasury center, is permitted to decide which internal derivatives will be designated as a hedging instrument and the level or amount of the offsetting contract it enters into with an unrelated third party. [815-20-25-62(c)]

For example, an entity can decide the level of foreign currency exposure it wants to hedge (or not hedge) by identifying which internal derivatives are to be offset with a third-party derivative and designated as hedging instruments for consolidated financial statement purposes. Even if an internal derivative is not designated as a hedging instrument for the consolidated financial statements, a hedging entity may still be able to apply hedge accounting for that derivative in its stand-alone financial statements.

The approach of deciding the level or amount of the offsetting contract appears simple, but if a large number of internal derivatives exist, applying of this approach could become very complex.



Question 11.6.140

Does the linkage between each internal derivative and the offsetting third-party derivative have to be documented at the third-party derivative's initiation?

Interpretive response: Yes, we believe the treasury center is required to document the linkage of each internal derivative and the offsetting net third-party derivative when it enters into the offsetting third-party derivative.



Question 11.6.150

Can the provisions for netting foreign currency risks be used to offset exposures to FCD assets or liabilities or net investment hedges?

Interpretive response: No. The provisions for aggregating or netting foreign currency risk cannot be used to offset exposures arising from internal derivatives related to recognized FCD assets or liabilities or net investment hedges. [815-20-25-64]



Question 11.6.160

If a forecasted transaction or firm commitment is being hedged using an internal derivative, what is the effect when the transaction or firm commitment occurs?

Interpretive response: As noted in Question 11.6.110, for cash flow hedges of forecasted transactions and unrecognized firm commitments, a treasury center may designate an internal derivative as the hedging instrument and offset it on an aggregate or net basis with an unrelated third-party derivative.

There may be instances in which the designated internal derivative has not yet matured when the hedged transaction occurs and becomes a recognized asset or liability. At the point a forecasted transaction or firm commitment occurs, the designated internal derivative that the treasury center aggregated or netted (for purposes of entering into third-party derivative contracts) no longer qualifies for hedge accounting in the consolidated financial statements. Therefore, the internal derivative cannot be used to hedge the newly recognized asset or liability.

Additionally, the treasury center would have to update the hedge documentation that links the third-party derivative to the aggregate or net

remaining internal derivatives. If the conditions for netting foreign currency risks in paragraphs 815-20-25-61 and 25-62 were initially met, the remaining internal derivatives from this linked hedging relationship can continue to receive hedge accounting in the consolidated financial statements.

If a hedging entity modifies the internal derivative (resulting in a dedesignation) or dedesignates the hedging relationship, the treasury center has to reassess compliance with the requirements in paragraphs 815-20-25-61 and 25-62 for hedging the entity's internal derivatives on a net basis. The treasury center also has to update the hedging documentation that links the third-party derivative to the aggregate or net internal derivatives being hedged.

The treasury center can enter into a third-party derivative to offset the effect for the changed internal derivative and rebalance the offsetting hedging relationship to 100%. Alternatively, it could redesignate the excess portion of the third-party derivative to another hedging relationship or leave the existing third-party derivative alone and have a speculative position on that portion of the third-party derivative.



Question 11.6.170

What is the effect of an issuing entity altering or modifying an offsetting third-party derivative?



Excerpt from ASC 815-30

> Alterations or Terminations of Offsetting Third-Party Derivative Instruments

40-7 Paragraph 815-20-25-62 provides guidance on **internal derivatives** as hedging instruments in cash flow hedges of foreign exchange risk. Paragraph 815-20-25-63 states that, if an issuing affiliate alters or terminates any offsetting third-party derivative instrument (which should be rare), the hedging affiliate prospectively shall cease hedge accounting for the internal derivatives that are offset by that third-party derivative instrument.

Interpretive response: If an issuing entity alters or modifies a third-party derivative that is being used to offset the exposure it receives through the internal derivative, the hedging entity discontinues hedge accounting for the internal derivative prospectively. Topic 815 indicates that instances in which the issuing affiliate alters or terminates the offsetting third-party derivative should be rare. [815-30-40-7]

FASB Example: Hedging on a net basis

The following FASB example illustrates the appropriate accounting for an internal derivative that has been offset on a net basis by a third-party derivative.



Excerpt from ASC 815-30

>> Example 19: Hedge Accounting in the Consolidated Financial Statements Applied to Internal Derivatives That Are Offset on a Net Basis by Third-Party Contracts

55-113 This Example illustrates the application of paragraphs 815-20-25-61 through 25-63, specifically, the mechanism for offsetting risks assumed by a Treasury Center using **internal derivatives** on a net basis with third-party contracts. This Example does not demonstrate the computation of fair values and as such makes certain simplifying assumptions.

55-114 Entity XYZ is a U.S. entity with the U.S. dollar (USD) as both its functional currency and its reporting currency. Entity XYZ has three subsidiaries: Subsidiary A is located in Germany and has the Euro (EUR) as its functional currency, Subsidiary B is located in Japan and has the Japanese yen (JPY) as its functional currency, and Subsidiary C is located in the United Kingdom and has the pound sterling (GBP) as its functional currency. Entity XYZ uses its Treasury Center to manage foreign exchange risk on a centralized basis. Foreign exchange risk assumed by Subsidiaries A, B, and C through transactions with external third parties is transferred to the Treasury Center via internal contracts. The Treasury Center then offsets that exposure to foreign currency risk via third-party contracts. To the extent possible, the Treasury Center offsets exposure to each individual currency on a net basis with third-party contracts.

55-115 On January 1, Subsidiaries A, B, and C decide that various foreign-currency-denominated forecasted transactions with external third parties for purchases and sales of various goods are probable. Also on January 1, Subsidiaries A, B, and C enter into internal foreign currency forward contracts with the Treasury Center to hedge the foreign exchange risk of those transactions with respect to their individual functional currencies. The Treasury Center has the same functional currency as the parent entity (USD).

55-116 Subsidiaries A, B, and C have the following foreign currency exposures and enter into the following internal contracts with the Treasury Center.

Subsidiary	Functional Currency	Forecasted Exposures	Expected Transaction Date	Internal Contracts with Treasury Center	
				Currency Received	Currency Paid
A (German)	EUR	JPY payable 12,000	Jun 1	JPY 12,000	EUR 115 ^(a)
		GBP receivable 50	Jun 1	EUR 80 ^(a)	GBP 50
B (Japanese)	JPY	USD payable 100	Jun 15	USD 100	JPY 10,160 ^(a)
		EUR receivable 100	Jun 15	JPY 10,432 ^(a)	EUR 100
C (UK)	GBP	USD receivable 330	Jun 30	GBP 201 ^(a)	USD 330

(a) Computed based on forward exchange rates as of January 1.

55-117 Subsidiaries A, B, and C designate the internal contracts with the Treasury Center as cash flow hedges of their foreign currency forecasted

purchases and sales. Those internal contracts may be designated as hedging instruments in the consolidated financial statements if the requirements of this Subtopic are met. From the subsidiaries' perspectives, the requirements of paragraph 815-20-25-61 for foreign currency cash flow hedge accounting are satisfied as follows:

- a. From the perspective of the hedging affiliate, the hedging relationship must meet the requirements of paragraphs 815-20-25-30 and 815-20-25-39 through 25-41 for cash flow hedge accounting. Subsidiaries A, B, and C meet those requirements. In each hedging relationship, the forecasted transaction being hedged is denominated in a currency other than the subsidiary's functional currency, and the individual subsidiary that has the foreign currency exposure relative to its functional currency is a party to the hedging instrument. In addition, the criteria in Section 815-20-25 are met. Specifically, each subsidiary prepares formal documentation of the hedging relationships, including the date on which the forecasted transactions are expected to occur and the amount of foreign currency being hedged. The forecasted transactions being hedged are specifically identified, are probable of occurring, and are transactions with external third parties that create cash flow exposure that would affect reported earnings. Each subsidiary also documents its expectation of high effectiveness based on the internal derivatives designated as hedging instruments.
- b. The affiliate that issues the hedge must offset the internal derivative either individually or on a net basis. The Treasury Center determines that it will offset the exposure arising from the internal derivatives with Subsidiaries A, B, and C on a net basis with third-party contracts. Each currency for which a net exposure exists at the Treasury Center is offset by a third-party contract based on that currency.

55-118 To determine the net currency exposure arising from the internal contracts with Subsidiaries A, B, and C, the Treasury Center performs the following analysis.

Subsidiary Perspective—Internal Contracts with the Treasury Center

Subsidiary	Contract with Treasury Center	Currency Received (Currency Paid)			
		EUR	JPY	GBP	USD
A (German)	Internal Contract 1	(115)	12,000		
	Internal Contract 2	80		(50)	
B (Japanese)	Internal Contract 3		(10,160)		100
	Internal Contract 4	(100)	10,432		
C (UK)	Internal Contract 5			201	(330)
Net exposure		(135)	12,272	151	(230)

Treasury Center Perspective—Internal Contracts with the Subsidiaries

Subsidiary	Contract with Treasury Center	Currency Received (Currency Paid)			
		EUR	JPY	GBP	USD
A (German)	Internal Contract 1	115	(12,000)		
	Internal Contract 2	(80)		50	
B (Japanese)	Internal Contract 3		10,160		(100)
	Internal Contract 4	100	(10,432)		

C (UK)	Internal Contract 5			(201)	330
Net exposure		135	(12,272)	(151)	230

55-119 For Subsidiaries A, B, and C to designate the internal contracts as hedging instruments in the consolidated financial statements, the Treasury Center must meet certain required criteria outlined in paragraphs 815-20-25-62 through 25-63 in determining how it will offset exposure arising from multiple internal derivatives that it has issued. Based on a determination that those requirements are satisfied (see the following paragraph, the Treasury Center determines the net exposure in each currency with respect to USD (its functional currency). The Treasury Center determines that it will enter into the following three third-party foreign currency forward contracts. The Treasury Center enters into the contracts on January 1. The contracts mature on June 30.

Treasury Center's Contracts with Unrelated Third Parties				
	Currency Brought (Currency Sold)			
	EUR	JPY	BP	USD
Third-Party Contract 1	(135)			138 ^(a)
Third-Party Contract 2		12,272		(121) ^(a)
Third-Party Contract 3			151	(247) ^(a)
Net exposure	(135)	12,272	151	(230)

(a) Computed based on forward exchange rates as of January 1.

55-120 From the Treasury Center's perspective, the required criteria in paragraphs 815-20-25-62 through 25-63 are satisfied as follows:

- The issuing affiliate enters into a derivative instrument with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivatives, and the derivative instrument with the unrelated third party generates equal or closely approximating gains and losses when compared with the aggregate or net losses and gains generated by the derivative instruments issued to affiliates. The Treasury Center enters into third-party derivative instruments to offset the exposure of each foreign currency on a net basis. The Treasury Center offsets 100 percent of the net exposure to each currency; that is, the Treasury Center does not selectively keep any portion of that exposure. In this Example, the Treasury Center's third-party contracts generate losses that are equal to the losses on internal contracts designated as hedging instruments by Subsidiaries A, B, and C (see analysis beginning in the following paragraph).
- Internal derivatives that are not designated as hedging instruments and all nonderivative instruments are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative instrument. The Treasury Center does not include in the determination of net exposure any internal derivatives not designated as hedging instruments or any nonderivative instruments.
- Foreign currency exposure that is offset by a single net third-party contract arises from internal derivatives that involve the same currency and that mature within the same 31-day period. The offsetting net third-party derivative instrument related to that group of contracts must offset the aggregate or net exposure to that currency, must mature within the same

31-day period, and must be entered into within 3 business days after the designation of the internal derivatives as hedging instruments. The Treasury Center's third-party net contracts involve the same currency (that is, not a tandem currency) as the net exposure arising from the internal derivatives issued to Subsidiaries A, B, and C. The Treasury Center's third-party derivative instruments mature within the same 31-day period as the internal contracts that involve currencies that are offset on a net basis. In this Example, for simplicity, all internal contracts and third-party derivative instruments are entered into on the same date.

- d. The issuing affiliate tracks the exposure that it acquires from each hedging affiliate and maintains documentation supporting linkage of each derivative instrument and the offsetting aggregate or net derivative instrument with an unrelated third party. The Treasury Center maintains documentation supporting linkage of third-party contracts and internal contracts throughout the hedge period.
- e. The issuing affiliate does not alter or terminate the offsetting derivative instrument with an unrelated third party unless the hedging affiliate initiates that action. If the issuing affiliate does alter or terminate the offsetting third-party derivative (which should be rare), the hedging affiliate must prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative. Based on Entity XYZ's policy, the Treasury Center may not alter or terminate the offsetting derivative instrument with an unrelated third party unless the hedging affiliate initiates that action.
- f. If an internal derivative that is included in determining the foreign currency exposure on a net basis is modified or dedesignated as a hedging instrument, compliance must be reassessed. For simplicity, this Example does not involve a modification or dedesignation of an internal derivative.

55-121 At the end of the quarter, each subsidiary determines the functional currency gains and losses for each contract with the Treasury Center.

Subsidiary	Contract with Treasury Center	Beginning of Period Functional Currency Amount Receive (Pay)	End of Period Functional Currency Amount Receive (Pay)	Functional Currency Gain (Loss)	US Dollar Gain (Loss)
		(a)	(a)	(b)	(c)
A (German)	Internal Contract 1	(115)	(115)	-	-
	Internal Contract 2	80	83	(3)	(3)
B (Japanese)	Internal Contract 3	(10,160)	(10,738)	578	5
	Internal Contract 4	10,432	10,421	11	-
C (UK)	Internal Contract 5	201	204	(3)	(5)
Net USD Gain (Loss)					(3)

a. Computed based on forward exchange rates as of January 1 and March 31.

b. For simplicity, functional currency gains or losses are not discounted in this Example.

c. Functional currency gains and losses converted to USD based on current spot rates.

55-122 At the end of the quarter, the Treasury Center determines its gains or losses on third-party contracts.

Contract with Third Party	Beginning of Period USD Amount Receive (Pay) ^(a)	End of Period USD Amount Receive (Pay) ^(a)	USD Gain (Loss) ^(b)
Third-Party Contract 1	138	131	7
Third-Party Contract 2	(121)	(114)	(7)
Third-Party Contract 3	(247)	(244)	(3)
Net USD Gain (Loss)			(3)

a. Computed based on forward exchange rates as of January 1 and March 31.

b. For simplicity, gains or losses are not discounted in this Example.

55-123 Journal Entries at March 31 (Note: All journal entries are in USD.)

Subsidiaries' Journal Entries

German Subsidiary A

There is no entry for Contract 1 because the USD gain or loss is zero.

Other comprehensive income	\$ 3	
Derivative liability		\$ 3
To record the loss on Internal Contract 2.		

Japanese Subsidiary B

Derivative asset	\$ 5	
Other comprehensive income		\$ 5
To record the gain on Contract 3.		

There is no entry for Internal Contract 4 because the USD gain or loss is zero.

UK Subsidiary C

Other comprehensive income	\$ 5	
Derivative liability		\$ 5
To record the loss on Internal Contract 5.		

Treasury Center's Journal Entries

Journal Entries for Internal Contracts with Subsidiaries

There is no entry for Internal Contract 1 because the USD gain or loss is zero.

Derivative asset	\$ 3	
Earnings		\$ 3
To record the gain on Internal Contract 2 with German Subsidiary A.		

Earnings	\$ 5	
Derivative liability		\$ 5
To record the gain on Internal Contract 3 with Japanese Subsidiary B.		

There is no entry for Internal Contract 4 because the USD gain or loss is zero.

Derivative asset	\$ 5	
Earnings		\$ 5

To record the gain on Internal Contract 5 with UK Subsidiary C.

Journal Entries for Third-Party Contracts

Derivative asset	\$ 7	
Earnings		\$ 7
To record the gain on Third-Party Contract 1.		
Earnings	\$ 7	
Derivative liability		\$ 7
To record the loss on Third-Party Contract 2.		
Earnings	\$ 3	
Derivative liability		\$ 3
To record the loss on Third-Party Contract 3.		

Results in Consolidation

Derivative asset	\$ 7	
Other comprehensive income	\$ 3	
Derivative liability		\$ 10

11.7 Accounting for foreign currency cash flow hedges

11.7.10 Overview



Excerpt from ASC 815-30

> Subsequent Recognition and Measurement of Gains and Losses on Hedging Instrument

35-3 When the relationship between the hedged item and hedging instrument is highly effective at achieving offsetting changes in cash flows attributable to the hedged risk, an entity shall record in **other comprehensive income** the entire change in the fair value of the designated hedging instrument that is included in the assessment of hedge effectiveness. More specifically, a qualifying **cash flow hedge** shall be accounted for as follows: ...

- An entity's defined risk management strategy for a particular hedging relationship may exclude a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in paragraphs 815-20-25-81 through 25-83B). That excluded component of the gain or loss shall be recognized in earnings either through an amortization approach in accordance with paragraph 815-20-25-83A or through a mark-to-market approach in accordance with paragraph 815-20-25-83B. Under either approach, the amount recognized in earnings for an excluded component shall be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A. For example, if the effectiveness of a hedging relationship with an option is assessed based on changes in the option's intrinsic value, the changes in

the option's **time value** would be excluded from the assessment of hedge effectiveness and either may be recognized in earnings through an amortization approach in accordance with paragraph 815-20-25-83A or currently in earnings in accordance with paragraph 815-20-25-83B.

- b. Amounts in accumulated other comprehensive income related to the derivative designated as a hedging instrument included in the assessment of hedge effectiveness are reclassified to earnings in the same period or periods during which the hedged forecasted transaction affects earnings in accordance with paragraphs 815-30-35-38 through 35-41 and presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A. The balance in accumulated other comprehensive income associated with the hedged **transaction** shall be the cumulative gain or loss on the derivative instrument from inception of the hedge less all of the following:
 1. Subparagraph superseded by Accounting Standards Update No. 2017-12.
 - 1a. The derivative instrument's gains or losses previously reclassified from accumulated other comprehensive income into earnings pursuant to paragraphs 815-30-35-38 through 35-41.
 - 1b. The cumulative amount amortized to earnings related to excluded components accounted for through an amortization approach in accordance with paragraph 815-20-25-83A.
 - 1c. The cumulative change in fair value of an excluded component for which changes in fair value are recorded currently in earnings in accordance with paragraph 815-20-25-83B.
 2. Subparagraph superseded by Accounting Standards Update No. 2017-12.

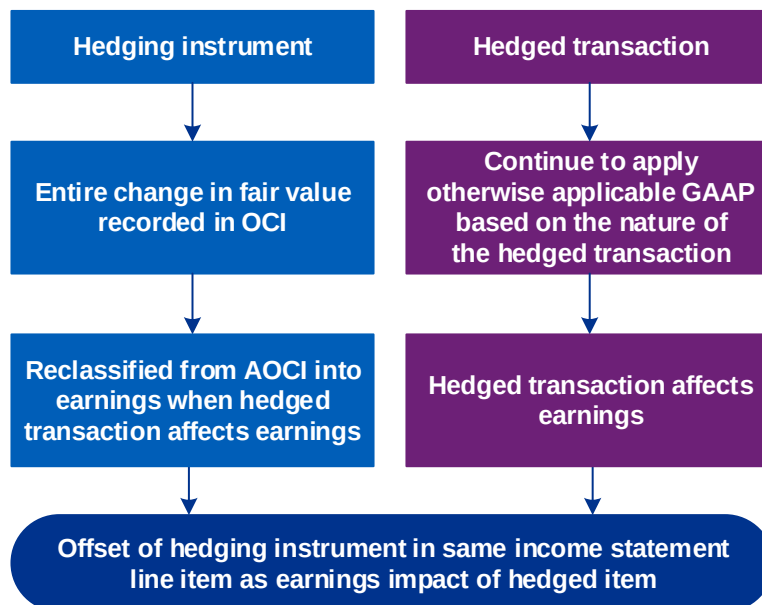
If hedge accounting has not been applied to a cash flow hedging relationship in a previous effectiveness assessment period because the entity's retrospective evaluation indicated that the relationship had not been highly effective in achieving offsetting changes in cash flows in that period, the cumulative gain or loss on the derivative referenced in (b) would exclude the gains or losses occurring during that period. That situation may arise if the entity had previously determined, for example, under a regression analysis or other appropriate statistical analysis approach used for prospective assessments of hedge effectiveness, that there was an expectation in which the hedging relationship would be highly effective in future periods. Consequently, the hedging relationship continued even though hedge accounting was not permitted for a specific previous effectiveness assessment period.

- d. If a non-option-based contract is the hedging instrument in a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 830-20-35-1, an amount that will both offset the related transaction gain or loss arising from that remeasurement and adjust earnings for that period's allocable portion of the initial spot-forward difference associated with the hedging instrument (cost to the purchaser or income to the seller of the hedging instrument) shall be reclassified each period from other comprehensive income to earnings if the assessment of effectiveness is based on total changes in the non-option-based instrument's cash flows. If an option

contract is used as the hedging instrument in a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 830-20-35-1 to provide only one-sided offset against the hedged **foreign exchange risk**, an amount shall be reclassified each period to or from other comprehensive income with respect to the changes in the **underlying** that result in a change in the hedging option's intrinsic value. In addition, if the assessment of effectiveness is based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in **fair value**—its entire gain or loss), an amount that adjusts earnings for the amortization of the cost of the option on a rational basis shall be reclassified each period from other comprehensive income to earnings. This guidance is limited to foreign currency hedging relationships because of their unique attributes and is an exception for foreign currency hedging relationships.

35-6 Remeasurement of the hedged foreign-currency-denominated assets and liabilities is based on the guidance in Topic 830, which requires remeasurement based on spot exchange rates, regardless of whether a cash flow hedging relationship exists.

The accounting for foreign currency cash flow hedges is the same as for all other cash flow hedges (see chapter 10). The following shows the general accounting and presentation for a highly effective cash flow hedge (not including excluded components).



Derivative hedging instrument	Recognized at fair value on the balance sheet with changes in fair value recognized in OCI, other than amounts related to excluded components. For a discussion of excluded components, see section 10.2.20. The amount in AOCI is reclassified into earnings in the same periods during which the hedged transaction affects earnings.
Hedged transaction	FCD monetary assets or liabilities are remeasured to the functional currency based on spot exchange rates through earnings. Therefore, the adjustment for these instruments for changes in foreign currency exchange rates is limited to changes based on spot rates.

The general cash flow hedging model requires amounts in AOCI to be reclassified into earnings in the same period(s) during which the forecasted transaction affects earnings. Such guidance also applies for cash flow hedges of forecasted FCD intercompany transactions. However, the period of reclassification may be different for stand-alone versus consolidated financial statements (see Question 11.7.10).

The following topics specific to accounting for foreign currency cash flow hedges are discussed in this section:

- hedges of recognized FCD assets and liabilities (section 11.7.20); and
- forecasted purchases or sales on credit (section 11.7.30).



Question 11.7.10

When are amounts in AOCI reclassified into earnings in a hedge of a forecasted intercompany transaction?

Interpretive response: The general cash flow hedging model requires amounts in AOCI to be reclassified into earnings in the same period(s) during which the forecasted transaction affects earnings.

If a subsidiary is hedging the functional currency equivalent cash flows of a forecasted FCD intercompany transaction, the subsidiary reclassifies any amounts in AOCI into earnings in the same period or periods during which its forecasted transaction affects earnings for its stand-alone financial statements. However, when the subsidiary is consolidated with other entities, any amounts in AOCI are not reclassified into earnings unless and until the forecasted transaction affects the consolidated earnings. An entity that hedges forecasted FCD intercompany transactions under the cash flow hedge model needs to track these differences.

Subtopic 815-30's Example 14 illustrates the reclassification of amounts from AOCI.



Excerpt from ASC 815-30

>> Example 14: Reclassifying Amounts from a Cash Flow Hedge of a Forecasted Foreign-Currency-Denominated Intra-Entity Sale

55-86 This Example illustrates the application of paragraphs 815-20-25-30 and 815-20-25-39 through 25-41. This Example has the following assumptions:

- a. Parent A is a multinational corporation that has the U.S. dollar (USD) as its functional currency.
- b. Parent A has the following two subsidiaries:
 1. Subsidiary B, which has the Euro (EUR) as its functional currency
 2. Subsidiary C, which has the Japanese yen (JPY) as its functional currency.
- c. Subsidiary B manufactures a product and has a forecasted sale of the product to Subsidiary C that will be transacted in JPY.

55-87 Eventually, Subsidiary C will sell the product to an unrelated third party in JPY. Subsidiary B enters into a forward contract with an unrelated third party to hedge the cash flow exposure of its forecasted intra-entity sale in JPY to changes in the EUR-JPY exchange rate.

55-88 The transaction in this Example meets the hedge criteria of paragraphs 815-20-25-30 and 815-20-25-39 through 25-41, which permits a derivative instrument to be designated as a hedge of the foreign currency exposure of variability in the functional-currency-equivalent cash flows associated with a forecasted intra-entity foreign-currency-denominated transaction if certain criteria are met. Specifically, the operating unit having the foreign currency exposure (Subsidiary B) is a party to the hedging instrument; the hedged transaction is denominated in JPY, which is a currency other than Subsidiary B's functional currency; and all other applicable criteria in Section 815-20-25 are satisfied.

55-89 Subsidiary B measures the derivative instrument at fair value and records the gain or loss on the derivative instrument in accumulated other comprehensive income. In the consolidated financial statements, the amount in other comprehensive income representing the gain or loss on a derivative instrument designated in a cash flow hedge of a forecasted foreign-currency-denominated intra-entity sale should be reclassified into earnings in the period that the revenue from the sale of the manufactured product to an unrelated third party is recognized and presented in earnings in the same income statement line item as the earnings effect of the hedged item. The reclassification into earnings in the consolidated financial statements should occur when the forecasted sale affects the earnings of Parent A. Because the consolidated earnings of Parent A will not be affected until the sale of the product by Subsidiary C to the unrelated third party occurs, the reclassification of the amount of derivative gain or loss from other comprehensive income into earnings in the consolidated financial statements should occur upon the sale by Subsidiary C to an unrelated third party.

55-90 This guidance is relevant only with respect to the consolidated financial statements. In Subsidiary B's separate entity financial statements, the reclassification of the amount of the derivative instrument gain or loss from other comprehensive income into earnings should occur in the period the forecasted intra-entity sale is recorded because Subsidiary B's earnings are affected by the change in the EUR-JPY exchange rate when the sale to Subsidiary C occurs.



Question 11.7.20

How are gains and losses on a hedging instrument recognized if an entity assesses effectiveness on an after-tax basis?



Excerpt from ASC 815-30

> Subsequent Recognition and Measurement of Gains and Losses on Hedging Instrument

35-5 If an entity has designated and documented that it will assess effectiveness and measure hedge results of a cash flow hedge of foreign currency risk on an after-tax basis as permitted by paragraph 815-20-25-3(b)(2)(vi), the portion of the gain or loss on the hedging instrument that exceeded the loss or gain on the hedged item shall be included as an offset to the related tax effects in the period in which those tax effects are recognized.

Interpretive response: If an entity assesses effectiveness on an after-tax basis, the portion of the gain or loss on the hedging instrument that exceeds the loss or gain on the hedged item is included as an offset to the related tax effect in the period in which the tax effects are recognized.



Question 11.7.30

Is a partial-term cash flow hedge of foreign currency risk permitted?

Interpretive response: It depends.

If effectiveness is based on changes in the spot rates of the hedging instrument, an entity is permitted to enter into a partial-term cash flow hedge of foreign currency risk. Therefore, an entity does not need to hedge all of the foreign currency exposure throughout the life of the hedged item.

Because the effectiveness is based on changes in the spot value, any changes in the time value of the hedging instrument would be recognized in earnings

immediately (if the mark-to-market approach is elected) or amortized into earnings (if the amortization approach is elected).



Example 11.7.10

Different maturities for hedged item and hedging instrument

A US dollar functional currency entity expects to sell a product in 60 days for 1,000,000 yen (¥). It enters into a forward contract to pay yen and receive US dollars to hedge the risk of changes in cash flows of that sale due to changes in the ¥/\$ exchange rate.

If the effectiveness of the hedge is assessed based only on changes in the spot value of the hedging instrument, the maturity of the forward contract can be at the end or at any point during those 60 days. The excluded component should be accounted for using either the mark-to-market approach or the amortization approach (see section 10.2.20).

Similarly, if the effectiveness of the hedge is assessed based on changes in total cash flows of the hedging instrument, the maturity of the forward contract can be at the end or at any point during those 60 days. Before such relationship is entered into, the entity needs to consider the effect on its assessment of hedge effectiveness due to the timing of the expected cash flows on the forecasted transaction versus the timing of the cash flows for the forward contract.

11.7.20 Recognized FCD assets and liabilities



Excerpt from ASC 815-30

> Subsequent Recognition and Measurement of Gains and Losses on Hedging Instrument

35-3 When the relationship between the hedged item and hedging instrument is highly effective at achieving offsetting changes in cash flows attributable to the hedged risk, an entity shall record in **other comprehensive income** the entire change in the fair value of the designated hedging instrument that is included in the assessment of hedge effectiveness. More specifically, a qualifying cash flow hedge shall be accounted for as follows: ...

- d. If a non-option-based contract is the hedging instrument in a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 830-20-35-1, an amount that will both offset the related transaction gain or loss arising from that remeasurement and adjust earnings for that period's allocable portion of the initial spot-forward difference associated with the hedging instrument (cost to the purchaser or income to the seller of the hedging

instrument) shall be reclassified each period from other comprehensive income to earnings if the assessment of effectiveness is based on total changes in the non-option-based instrument's cash flows. If an option contract is used as the hedging instrument in a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 830-20-35-1 to provide only one-sided offset against the hedged **foreign exchange risk**, an amount shall be reclassified each period to or from other comprehensive income with respect to the changes in the **underlying** that result in a change in the hedging option's intrinsic value. In addition, if the assessment of effectiveness is based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in **fair value**—its entire gain or loss), an amount that adjusts earnings for the amortization of the cost of the option on a rational basis shall be reclassified each period from other comprehensive income to earnings. This guidance is limited to foreign currency hedging relationships because of their unique attributes and is an exception for foreign currency hedging relationships.

Hedging recognized FCD monetary assets and liabilities is affected by the interaction of Topic 815 and Topic 830. Topic 830 requires recognized FCD monetary assets and liabilities to be remeasured to the functional currency based on the spot exchange rate through earnings; therefore, the adjustment of these recognized assets and liabilities for foreign exchange rates is limited to the changes based on spot rates. A derivative used to hedge the foreign currency risk (such as a foreign currency forward contract) on the FCD monetary assets and liabilities is recognized on the balance sheet at fair value. If the cash flow hedge is highly effective, the change in fair value of the derivative is recognized in OCI while the remeasurement gain/loss of the monetary assets and liabilities is recognized in earnings. This would result in earnings volatility.

Therefore, an exception to the general hedging guidance was provided for cash flow hedges of recognized FCD assets and liabilities when an entity assesses effectiveness based on total changes in the hedging instrument's cash flows. The FASB decided to permit this exception because it believes it is consistent with its general principle of providing special hedge accounting to mitigate the effects in earnings of different existing measurement criteria for FCD transactions.

The following table describes this exception, which may not be applied by analogy to other hedging relationships.

Hedging instrument	Assessment of hedge effectiveness	Amount to be reclassified from AOCI into earnings
Non-option contract	Based on total changes in cash flows of the non-option contract	— Gain or loss to offset transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates. — Portion of cost attributable to spot-forward difference

11. Hedging foreign currency exposures

		amortized in earnings using the interest method.
Option contract	Based on total changes in cash flows of the option contract	— Gain or loss to offset transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates limited to the change in the underlying that results in a change in the option contract's intrinsic value. — Portion of cost of the option amortized in earnings on a rational basis.

The following table describes the reclassification from AOCI into earnings if the assessment of hedge effectiveness is not based on the hedging instrument's total change in cash flows.

Hedging instrument	Assessment of hedge effectiveness	Amount to be reclassified from AOCI into earnings
Non-option contract	Spot-forward difference excluded from assessment of hedge effectiveness	— Gain or loss to offset transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates. — As discussed in section 10.2.20, an entity can recognize the initial value of the excluded component in earnings using either: — Amortization approach. A systematic and rational method over the life of the hedging instrument; or — Mark-to-market approach. A method that recognizes all fair value changes of the excluded component currently in earnings
Option contract	Based on changes in intrinsic value of the option contract	— Gain or loss to offset transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates limited to the change in the underlying that results in a change in the option contract's intrinsic value — As discussed in section 10.2.20, an entity can recognize the initial value of the excluded component in earnings using either:

		– Amortization approach. A systematic and rational method over the life of the hedging instrument; or – Mark-to-market approach. A method that recognizes all fair value changes of the excluded component currently in earnings

The initial spot-forward difference for a forward contract or the premium paid for an option contract represents the cost to the purchaser or income to the seller of the hedging instrument.



Question 11.7.40

For non-option contracts, how are amounts reclassified from AOCI when hedge effectiveness is based on a hedging instrument's total change in cash flows?

Interpretive response: If a non-option contract is the hedging instrument, two reclassifications from AOCI are required when hedge effectiveness is based on the hedging instrument's total change in cash flows.

- First, an amount is reclassified from AOCI each period to offset the transaction gain or loss arising from the Topic 830 remeasurement of the FCD asset or liability at the spot exchange rate.
- Second, an amount is reclassified from AOCI each period representing the cost attributable to the spot-forward difference of the hedging derivative.

The cash flow hedging model for recognized FCD assets and liabilities requires use of the interest method at the inception of the hedging relationship to determine the amount of cost or income to be ascribed to each period of the hedging relationship when the hedging instrument is a non-option contract.

Example 18 in Subtopic 815-30 (reproduced in this section) illustrates a method of ascribing the amount of cost or income to each period using a pro rata method based on the number of days in the hedging relationship. Such method is based on the daily interest implicit in the forward contract. This is done by dividing the forward-to-spot premium or discount by the number of days in the non-option contract. The amount of daily interest is recognized for the number of days in the period.



Question 11.7.50

For option contracts, how are amounts reclassified from AOCI when hedge effectiveness is based on a hedging instrument's total change in cash flows?

Interpretive response: If the hedging instrument is a currency option-based derivative and effectiveness is based on the total change in cash flows, an amount is reclassified each period to or from AOCI with respect to the changes in the underlying that result in a change in the hedging option's intrinsic value. Intrinsic value is based on the spot rate of the underlying.

In-the-money option

When the option is in the money, this change parallels the guidance in Topic 830 that requires the recognized asset or liability to be remeasured using the spot rate. If the option's exercise price is in the money at the beginning and end of the period, and the notional amount of the option and the balance of the hedged asset or liability match, this reclassification would fully offset the Topic 830 transaction gain or loss.

Out-of-the-money option

If the option's exercise price is out of the money at the end of the period, any amounts previously reclassified from AOCI when the option was in the money are reclassified to AOCI.

The cost of the currency option is amortized to earnings on a rational basis. The amortization method is used at the inception of the hedging relationship to determine the amount of cost or income to be ascribed to each period of the hedging relationship. In our experience, most entities use a straight-line amortization method for simplicity. The amount of daily cost is recognized for the number of days in the period.

If the assessment of effectiveness is not based on the total change in cash flows of an option contract, an amount is reclassified each period to or from AOCI with respect to the changes in the underlying that result in a change in the hedging option's intrinsic value. However, the changes in the option's time value are recognized in earnings using either an amortization approach or a mark-to-market approach.

11.7.30 Forecasted purchases and sales on credit



Excerpt from ASC 815-30

> Application to Single Cash Flow Hedge of a Forecasted Sales or Purchase on Credit for Foreign Exchange Risk

35-9 For a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of a foreign-currency-denominated receivable or

payable resulting from a forecasted sale or purchase on credit, the guidance in paragraph 815-30-35-3 is applied as follows:

- a. The gain or loss on the derivative instrument that is included in the assessment of hedge effectiveness is reported in other comprehensive income during the period before the forecasted purchase or sale.
- b. The functional currency interest rate implicit in the hedging relationship as a result of entering into the forward contract is used to determine the amount of cost or income to be ascribed to each period of the hedging relationship. The cash flow hedging model for recognized foreign-currency-denominated assets and liabilities requires use of the interest method at the inception of the hedging relationship to determine the amount of cost or income to be ascribed to each relevant period of the hedging relationship. However, for simplicity, in hedging relationships in which the hedged item is a short-term non-interest-bearing account receivable or account payable, the amount of cost or income to be ascribed each period can also be determined using a pro rata method based on the number of days or months of the hedging relationship. In addition, in a short-term single cash flow hedging relationship that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of a foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit, the amount of cost or income to be ascribed each period can also be determined using a pro rata method or a method that uses two foreign currency forward exchange rates. The first foreign currency forward exchange rate would be based on the maturity date of the forecasted purchase or sale transaction. The second foreign currency forward exchange rate would be based on the settlement date of the resulting account receivable or account payable.
- c. For forecasted sales on credit, the amount of cost or income ascribed to each forecasted period is reclassified from other comprehensive income to earnings on the date of the sale. For forecasted purchases on credit, the amount of cost or income ascribed to each forecasted period is reclassified from other comprehensive income to earnings in the same period or periods during which the asset acquired affects earnings. The reclassification from other comprehensive income to earnings of the amount of cost or income ascribed to each forecasted period is based on the guidance in paragraphs 815-30-35-38 through 35-41.
- d. The income or cost ascribed to each period encompassed within the periods of the recognized foreign-currency-denominated receivable or payable is reclassified from other comprehensive income to earnings at the end of each reporting period.

As discussed in section 11.6.30, an entity can designate a single cash flow hedge that encompasses the variability of functional currency equivalent cash flows attributable to foreign currency risk related to settlement of the FCD receivable or payable resulting from a forecasted sale or purchase on credit.

The accounting from the time the hedge is designated to the time the receivable or payable is cash settled, can be summarized as follows.

Forecast period (before sale/purchase date)	— The gain or loss on the hedging instrument included in the assessment of effectiveness is reported in OCI during the period before the purchase or sale date of a forecasted foreign currency transaction. — The spot-forward premium or discount, or option premium is used to determine the amount of cost or income to be ascribed to each period of the hedging relationship. The amount to be ascribed each period can be determined using a pro rata method based on the number of days in the hedging relationship.
On the sale/purchase date	— For forecasted sales on credit, the amount of cost or income ascribed to the forecasted period to the date of sale is reclassified from AOCI into earnings on the date of the sale. — For forecasted purchases on credit, the amount of cost or income ascribed to the forecasted period is reclassified from AOCI into earnings in the same period(s) during which the asset acquired affects earnings.
After sale/purchase date (during life of FCD receivable/ payable)	— The income or cost ascribed to each period encompassed during the periods of the recognized FCD receivable or payable that results from the forecasted sale or purchase is reclassified from AOCI into earnings at the end of each reporting period. — During the period in which the FCD receivable or payable is recognized, an amount that will offset the related transaction gain or loss arising from remeasurement of the receivable or payable under Topic 830 must be reclassified from AOCI each period if the hedging instrument is a forward-based contract. If the hedging instrument is an option-based contract, any gain or loss to offset the transaction gain or loss from remeasuring the asset/liability to functional currency based on spot rates limited to the changes in the underlying that result in a change in the option's intrinsic value must be reclassified to or from AOCI each period.

The following FASB example illustrates these accounting requirements.



Excerpt from ASC 815-30

>> Example 18: Cash Flow Hedge of Forecasted Purchase or Sale on Credit

55-106 This Example illustrates the application of paragraphs 815-30-35-9 and 815-20-25-34 through 25-36, which permit an entity to designate a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of a

foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit.

55-107 This Example has the following assumptions:

- Entity A, a U.S. dollar (USD) functional currency entity, forecasts the purchase of inventory on credit for FC 100,000 in 182 days with settlement of the payable in 227 days. The purchase will occur July 15 on credit; the resulting payable will settle August 29.
- Entity A enters into a forward contract to purchase FC 100,000 in 227 days at the forward rate of USD .6614 = FC 1.
- Entity A designates a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of the foreign-currency-denominated payable resulting from the forecasted purchase on credit.
- After the initial quantitative effectiveness test, Entity A elects to assess effectiveness on a quantitative basis based on forward rates.

55-108 Exchange rates are as follows.

Period	Spot	8/29 Forward	7/15 Forward
1/14	0.6575	0.6614	0.6605
3/31	0.6757	0.6793	
6/30	0.6689	0.6734	
7/15	0.6761	0.6767	
8/29	0.6798	0.6798	

55-109 Entity A would record the following journal entries.

	Debit (Credit)					Accum. Other Comprehensive Income
	Cash	Inventory	Forward Contract	Accounts Payable	Earnings	
Inception 1/14	-	-	-	-	-	-
March 31 entry (76 days):						
Mark forward to fair value			\$ 1,703			\$ (1,703)
June 30 entry (91 days):						
Mark forward to fair value			(526)			526
July 15 entries (15 days):						
Inventory purchase		\$ 67,610		\$ (67,610)		
August 29 entries (45 days):						
Mark forward to fair value			663			(663)
Functional currency transaction loss on payable				(370)	\$ 370	
Adjustment for paragraph 815-30- 35-3(d)—offset the functional currency transaction loss					(370)	370
Adjustment for paragraph 815-30- 35-3(d)—effect of					78	(78)

11. Hedging foreign currency exposures

hedge (based on implicit interest rate; see paragraph 815-30-55-112)						
Settlement of payable	\$ (67,980)			67,980		
Settlement of forward	1,840		(1,840)			
	<u>\$ (66,140)</u>	<u>\$ 67,610</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 78</u>	<u>\$ (1,548)</u>

55-110 Upon sale of the inventory, Entity A would record cost of goods sold of \$67,610 and reclassify \$1,548 from other comprehensive income to earnings to achieve a net cost of goods sold of \$66,062. The effect of the hedge would result in a net cost to Entity A of \$66,140 for the purchase of the inventory.

55-111 The amount of the adjustment under paragraph 815-30-35-3(d) is that amount needed to ensure that a net amount in earnings reflects the effect of the hedge through each reporting period up to and including the final settlement of the payable.

55-112 The amount of cost or income to be ascribed to each period is calculated as follows.

Daily interest rate implicit in the hedging relationship as a result of the forward contract: \$65,750 PV, \$66,140 FV, 227n, $i = 0.0026053\%$

1/14	\$65,750	
3/31	65,880	\$130
6/30	66,036	156
7/15	66,062	26
8/29	66,140	78
		<u>\$390</u>

Method using two foreign currency forward exchange rates:

From 1/14 to 7/15	
7/15 Forward Rate .6605	
\$66,050 – \$65,750 =	\$ 300
From 7/16 to 8/29	
8/29 Forward Rate .6614	
\$66,140 – \$66,050 =	90
	<u>\$ 390</u>

Pro rata method:

From 1/14 to 7/15:	
\$390 × 182/227 =	\$ 313
From 7/16 to 8/29:	
\$390 × 45/227	77
	<u>\$ 390</u>

11.7.40 Examples of foreign currency cash flow value hedges

This section contains seven examples illustrating the application of the foreign currency cash flow hedging principles to the following hedging relationships.

- Cash flow hedge of variable-rate FCD debt with a variable to fixed cross-currency interest rate swap (variable-to-fixed scenario) (Example 11.7.20)
- Cash flow hedge of a forecasted FCD purchase with a forward contract (Example 11.7.30)
- Cash flow hedge of recognized FCD payable with a forward contract (Example 11.7.40)
- Single cash flow hedge with a foreign currency purchased option (Example 11.7.50)
- Cash flow hedge of foreign currency exposure in a royalty arrangement (Subtopic 815-30's Example 11);
- Cash flow hedge of a fixed-rate FCD loan eliminating variability in the functional currency equivalent cash flows (fixed-to-fixed scenario) (Subtopic 815-30's Example 13);
- Portions of a FCD financial asset or liability as hedged item (Subtopic 815-20's Example 15).

Each of the examples assumes that all criteria for hedge accounting, including all required documentation, have been met at the onset of the hedging relationship and at each period end.



Example 11.7.20

Cash flow hedge of variable-rate FCD debt with a variable to fixed cross-currency interest rate swap (variable-to-fixed scenario)

ABC Corp.'s functional currency is the US dollar. On January 1, Year 1, ABC borrows 100,000 euro (€) at a variable rate of Euribor plus 50 bps. The debt is due on December 31, Year 1. Also on January 1, Year 1, ABC enters into a variable-to-fixed cross-currency interest rate swap (cross-currency swap) in which it will receive Euribor plus 50 bps on €100,000 and pay fixed US dollars at 6.373% on \$102,000.

The swap matures on December 31, Year 1. There will be a final exchange of principal at maturity of the cross-currency swap (ABC will receive €100,000 and pay \$102,000). The debt and the cross-currency swap will pay interest quarterly on March 31, June 30, September 30 and December 31.

ABC designates the cross-currency swap as a cash flow hedge of the euro debt for changes in the functional currency equivalent cash flows due to the variable interest payments and changes in foreign currency exchange rates (\$/€).

Hedge effectiveness. ABC assesses hedge effectiveness using the hypothetical derivative method. Because the critical terms of the hedged item and cross-currency swap match (notional amount of debt, interest indices, settlement date, rate reset and maturity dates), the terms of the hypothetical cross-currency swap match the actual cross-currency swap. Therefore, ABC concludes that the hedge is highly effective. On an ongoing basis, ABC will

ascertain and document that the critical terms of the cross-currency swap and the debt have not changed, including that there have been no adverse developments concerning the risk of default by the counterparty to the cross-currency swap or its own nonperformance risk, therefore not causing a different conclusion about hedge effectiveness.

The spot exchange rate for \$/€, flat Euribor swap rate, and US LIBOR rate over the life of the hedge are as follows.

	January 1	March 31	June 30	September 30	December 31
Spot rate (\$/€)	1.0200	1.0723	1.0723	1.1273	1.1851
Euribor swap rate	5.160%	5.151%	5.040%	4.854%	4.480%
US LIBOR	6.000%	5.500%	6.000%	6.500%	7.000%

The remeasurement at spot of the debt and the fair value and changes in fair value of the cross-currency swap, are shown in the following table.

	January 1	March 31	June 30	September 30	December 31
Spot rate	1.0200	1.0723	1.0723	1.1273	1.1851
Debt at spot (in \$) ¹	\$(102,000)	\$(107,230)	\$(107,230)	\$(112,730)	\$(118,510)
Change in period	-	(5,230)	-	(5,500)	(5,780)
Fair value of swap	-	4,911	5,287	10,905	16,510
Change in period	-	4,911	376	5,618	5,605
Note:					
1. €100,000 × spot rate.					

The income statement effect of the debt and the cross-currency swap are as follows for each quarter ended period.

	March 31	June 30	September 30	December 31
Interest expense ¹ (in €)	€(1,415)	€(1,413)	€(1,385)	€(1,339)
Interest expense ² (in \$)	\$(1,517)	\$(1,515)	\$(1,561)	\$(1,587)
Swap interest settlement	(108)	(110)	(64)	(38)
Net interest expense ³	\$(1,625)	\$(1,625)	\$(1,625)	\$(1,625)
Notes:				

	March 31	June 30	September 30	December 31
1.	Based on Euribor plus 50bps on €100,000. For example, interest for the period ended March 31 is $(5.160\% + 50 \text{ bps}) \div 100 \times \frac{1}{4} \times €100,000 = €1,415$.			
2.	For simplicity, the variable euro interest expense is remeasured into the functional currency (\$) at the spot exchange rate at the end of the quarter.			
3.	Interest expense + swap interest settlement.			

Journal entries – January 1, Year 1

ABC makes a memorandum entry on January 1, Year 1 to document the existence of the hedging relationship. There is no entry for the cross-currency swap because the contract is at market rates (i.e. fair value is zero).

	Debit	Credit
Cash	102,000	
Debt obligation		102,000
<i>To record €100,000 debt at spot rate of €1 = \$1.02.</i>		

Journal entries – March 31, Year 1

	Debit	Credit
Interest expense	1,517	
Cash		1,517
<i>To record interest payment on euro debt at Euribor plus 50 bps. Remeasured at period end spot rates for simplicity.</i>		
Other income/expense	5,230	
Debt obligation		5,230
<i>To record spot remeasurement of debt to functional currency.</i>		
Interest expense	108	
Cash		108
<i>To record net interest cash payment on cross-currency swap.</i>		
Cross-currency swap	4,911	
OCI		4,911
<i>To record change in fair value of cross-currency swap.</i>		
AOCI	5,230	
Other income/expense		5,230
<i>To reclassify amount out of AOCI to offset spot remeasurement loss on debt obligation.</i>		

Journal entries – June 30, Year 1

	<i>Debit</i>	<i>Credit</i>
Interest expense	1,515	
Cash		1,515
<i>To record interest payment on euro debt at Euribor plus 50 bps. Remeasured at period end spot rates for simplicity.</i>		
Interest expense	110	
Cash		110
<i>To record net interest cash payment on cross-currency swap.</i>		
Cross-currency swap	376	
OCI		376
<i>To record change in fair value of cross-currency swap.</i>		

Journal entries – September 31, Year 1

	<i>Debit</i>	<i>Credit</i>
Interest expense	1,561	
Cash		1,561
<i>To record interest payment on euro debt at Euribor plus 50 bps. Remeasured at period end spot rates for simplicity.</i>		
Other income/expense	5,500	
Debt obligation		5,500
<i>To record spot remeasurement of debt to functional currency.</i>		
Interest expense	64	
Cash		64
<i>To record net interest cash payment on cross-currency swap.</i>		
Cross-currency swap	5,618	
OCI		5,618
<i>To record change in fair value of cross-currency swap.</i>		
AOCI	5,500	
Other income/expense		5,500
<i>To reclassify amount out of AOCI to offset spot remeasurement loss on debt obligation.</i>		

Journal entries – December 31, Year 1

	<i>Debit</i>	<i>Credit</i>
Interest expense	1,587	
Cash		1,587
<i>To record interest payment on euro debt at Euribor plus 50 bps. Remeasured at period end spot rates for simplicity.</i>		
Other income/expense	5,780	
Debt obligation		5,780
<i>To record spot remeasurement of debt to functional currency.</i>		
Interest expense	38	
Cash		38
<i>To record net interest cash payment on cross-currency swap.</i>		
Cross-currency swap	5,605	
OCI		5,605
<i>To record change in fair value of cross-currency swap.</i>		
AOCI	5,780	
Other income/expense		5,780
<i>To reclassify amount out of AOCI to offset spot remeasurement loss on debt obligation.</i>		
Cash	16,510	
Cross-currency swap ¹		16,510
<i>To record cash receipt on settlement of notional exchange of cross-currency swap.</i>		
Debt obligation	118,510	
Cash		118,510
<i>To record payment of €100,000 debt on maturity at spot rate of €1 = \$1.1851.</i>		
Note:		
1. Receive \$118,510 ($€100,000 \times \text{spot rate of } €1 = \$1.1851$) and pay \$102,000.		

By using a cross-currency swap, ABC eliminates its foreign exchange and interest rate risk by locking in a forward rate on €100,000 at €1 = \$1.02. This enables ABC to effectively settle its euro-denominated debt for a fixed US dollar amount (\$102,000). ABC's net cash payment at maturity of the debt is \$102,000 (\$118,510 - gain on the swap of \$16,510).

ABC also converts the variable Euribor interest payments into a fixed US dollar amount based on 6.373% of \$102,000, thereby hedging its exposure to changes in interest rates. As a result, the interest expense on the €100,000

debt, adjusted for the period swap interest settlement, totals \$1,625 each quarter.



Example 11.7.30

Cash flow hedge of a forecasted FCD purchase with a forward contract

ABC Corp.'s functional currency is the US dollar. On January 14, Year 1 ABC forecasts the purchase of inventory on credit for 100,000 Swiss francs (CHF). The purchase is expected to occur July 15, Year 1. ABC enters into a foreign currency forward contract to purchase CHF100,000 at \$0.6614 = CHF1. ABC designates a cash flow hedge of the functional currency equivalent cash flows from the date the purchase is forecasted to be probable through the purchase date.

Hedge effectiveness. ABC expects this hedging relationship to be perfectly effective since the critical terms of the forecasted transaction match the foreign currency forward contract. On an ongoing basis, ABC will ascertain and document that the critical terms of the forward contract and the forecasted purchase have not changed, including that there have been no adverse developments concerning the risk of default by the counterparty to the forward contract or its own nonperformance risk, therefore not causing a different conclusion about hedge effectiveness.

The spot and forward exchange rates for \$/CHF over the life of the hedge are as follows.

	Spot rate	July 15 forward rate
January 14	0.6575	0.6614
March 31	0.6757	0.6793
June 30	0.6689	0.6734
July 15	0.6761	N/A

Journal entries – January 14, Year 1

ABC makes a memorandum entry on January 14, Year 1 to document the existence of the hedging relationship. There is no entry for the foreign currency forward because the contract is at market rates (i.e. fair value is zero).

Journal entries – March 31, Year 1

	Debit	Credit
Forward contract ¹	1,703	
OCI		1,703
<i>To record change in fair value of foreign currency forward contract.</i>		
Note:		

	Debit	Credit
1. CHF100,000 × (change in forward rates (0.6793 - 0.6614)) = \$1,790 discounted to March 31 at an appropriate rate.		

Journal entries – June 30, Year 1

	Debit	Credit
OCI ¹	526	
Forward contract		526
<i>To record change in fair value of foreign currency forward contract.</i>		
Note:		
1. Current quarter fair value of \$1,177 - prior quarter fair value of \$1,703. Current quarter fair value is calculated as CHF100,000 × (change in forward rates (0.6734 - 0.6614)) = \$1,200 discounted to June 30 at an appropriate rate.		

Journal entries – July 15, Year 1

	Debit	Credit
Inventory	67,610	
Accounts payable		67,610
<i>To record purchase of inventory at spot rate of CHF1 = \$0.6761.</i>		
Forward contract ¹	293	
OCI		293
<i>To record change in fair value of foreign currency forward contract.</i>		
Cash	1,470	
Forward contract		1,470
<i>To record payment received by ABC to settle gain on foreign currency forward contract.</i>		
Note:		
1. Current quarter fair value of \$1,470 - prior quarter fair value of \$1,177. Current quarter fair value is calculated as CHF100,000 × (change in forward rates (0.6761 - 0.6614)) = \$1,470.		

ABC recorded inventory of \$67,610 (based on the July 15, Year 1 spot rate). The amount at July 15, Year 1 in AOCI of \$1,470 will remain in AOCI until the inventory is sold. At that time, it will be reclassified to cost of sales resulting in a net cost of \$66,140, which is equivalent to the forward rate of \$0.6614 = CHF1 that ABC locked in at January 14, Year 1.

**Example 11.7.40****Cash flow hedge of recognized FCD payable with a forward contract**

ABC Corp.'s functional currency is the US dollar. On January 1, Year 1 ABC purchases inventory on credit for 100,000 Swiss francs (CHF). The payment is due April 30, Year 1. ABC enters into a forward contract to purchase CHF100,000 at CHF1 = \$0.6614. ABC designates a cash flow hedge of the functional currency equivalent cash flows through the payment date of April 30, Year 1.

Hedge effectiveness. ABC expects this hedging relationship to be perfectly effective because the critical terms of the FCD payable match the foreign currency forward contract. ABC assesses effectiveness by verifying and documenting that the critical terms have not changed during the review period.

ABC will recognize the spot-forward premium (cost) of \$390 on the forward contract based on the implicit interest rate of the forward contract recognized on a pro rata basis over the hedging relationship.

The spot and forward rates for \$/CHF over the life of the hedge are as follows.

	Spot rate	April 30 forward rate
January 1	0.6575	0.6614
March 31	0.6757	0.6793
April 30	0.6761	N/A

Journal entries – January 1, Year 1

ABC makes a memorandum entry on January 1, Year 1 to document the existence of the hedging relationship. There is no entry for the foreign currency forward because the contract is at market rates (i.e. fair value is zero).

	Debit	Credit
Inventory	65,750	
Accounts payable		65,750
<i>To record purchase of inventory at spot rate of CHF1 = \$0.6565</i>		

Journal entries – March 31, Year 1

	Debit	Credit
Other income/expense ¹	1,820	
Accounts payable		1,820
<i>To record spot remeasurement of accounts payable to functional currency.</i>		
Forward contract ²	1,780	
OCI		1,780

11. Hedging foreign currency exposures

	Debit	Credit
<i>To record change in fair value of foreign currency forward contract.</i>		
AOCI	1,820	
Other income/expense		1,820
<i>To reclassify amount out of AOCI to offset spot remeasurement adjustment.</i>		
Other income/expense ³	292	
AOCI		292
<i>To reclassify portion of forward premium on foreign currency forward contract attributable to hedging period (rounded).</i>		
Notes:		
1. CHF100,000 × (change in spot rates (0.6757 - 0.6575)).		
2. CHF100,000 × (change in forward rates (0.6793 - 0.6614)) = \$1,790 discounted to March 31 at an appropriate rate.		
3. \$390 premium × 90/120 days.		

Journal entries – April 30, Year 1

	Debit	Credit
Other income/expense ¹	40	
Accounts payable		40
<i>To record spot remeasurement of accounts payable to functional currency.</i>		
OCI ²	310	
Forward		310
<i>To record change in fair value of foreign currency forward contract.</i>		
AOCI	40	
Other income/expense		40
<i>To reclassify amount out of AOCI to offset spot remeasurement adjustment.</i>		
Other income/expense ³	98	
AOCI		98
<i>To reclassify portion of forward premium on foreign currency forward contract attributable to the hedging period (rounded).</i>		
Cash	1,470	
Forward contract		1,470
<i>To record payment received by ABC to settle gain on foreign currency forward contract.</i>		

	<i>Debit</i>	<i>Credit</i>
Accounts payable	67,610	
Cash		67,610
<i>To record payment of FCD payable at spot rate.</i>		
Notes:		
1. CHF100,000 × (change in spot rates (0.6761 - 0.6757)).		
2. April 30 fair value of \$1,470 - March 31 fair value of \$1,780 = \$310.		
3. \$390 premium × 30/120 days.		

ABC is able to lock in its functional currency payable at the January 1, Year 1 forward rate of CHF1 = \$0.6614. It initially records the CHF100,000 payable at \$65,750 and settles it on April 30, Year 1 at the spot rate of CHF1 = \$0.6761 (\$67,610). This amount is offset by a \$1,470 gain on the forward contract.

Absent the forward contract, ABC would have realized a foreign exchange loss of \$1,860 on the CHF100,000 payable. The difference of \$390 (\$1,860 - \$1,470) represents the spot-forward premium incurred by ABC.



Example 11.7.50

Single cash flow hedge with a foreign currency purchased option

ABC Corp.'s functional currency is the US dollar. On December 31, Year 1, ABC forecasts the sale of inventory on credit for 10,000,000 Australian dollars (A\$) on February 15, Year 2 with settlement of the receivable on April 15, Year 2.

ABC purchases a foreign currency European style put option that gives it the right to sell A\$10,000,000 on April 15, Year 2, for \$5,000,000. The terms of the purchased put option are as follows.

Contract amount	A\$10,000,000
Expiration date	April 15, Year 2
Put option strike price	A\$2 = \$1
Spot rate	A\$2 = \$1
Premium	\$20,000

Because the option is purchased at the money, the premium on December 31, Year 1 reflects the option's time value only. The option can be exercised only on its expiration date. It is designated as a single cash flow hedge that encompasses the variability of functional currency equivalent cash flows attributable to foreign currency exchange risk related to:

- forecasted sale of inventory on credit on February 15, Year 2; and
- settlement of the resulting FCD receivable on April 15, Year 2.

ABC defines its foreign currency risk as being in one direction because it wishes to preserve its functional currency equivalent cash flows when the

exchange rate increases above A\$2.00 = \$1 – that is, the option will be exercised if the A\$/ \$ rate increases above the strike price of A\$2.00 = \$1. Specifically, as the functional currency equivalent cash flows of \$5,000,000 decrease, the pay-off amount of the option will compensate ABC for the difference.

ABC ascertains that the conditions in paragraph 815-20-25-129 have been met such that the hedging relationship is considered perfectly effective (see section 13.7.20).

The assumed spot exchange rates and fair value of the option are as follows.

	Spot rate (A\$/ \$)	Fair value	Change in fair value
December 31, Year 1	2.00	\$ 20,000	\$ -
January 31, Year 1	2.10	253,095	233,095
February 15, Year 2	2.05	133,951	(119,144)
March 31, Year 2	1.90	3,000	(130,951)
April 15, Year 2	2.30	652,174	649,174

Journal entries – December 31, Year 1

	Debit	Credit
Purchased put option	20,000	
Cash		20,000
<i>To record purchase of put option at fair value.</i>		

Journal entries – January 31, Year 2

	Debit	Credit
Purchased put option	233,095	
OCI		233,095
<i>To record change in fair value of put option.</i>		

Journal entries – February 15, Year 2

	Debit	Credit
OCI	119,144	
Purchased put option		119,144
<i>To record change in fair value of put option.</i>		
Accounts receivable	4,878,049	
Revenue		4,878,049
<i>To record sale of inventory on credit at spot rate of A\$2.05 = \$1 (rounded).</i>		
AOCI ¹	121,951	

11. Hedging foreign currency exposures

	Debit	Credit
Revenue <i>To reclassify amount out of AOCI for portion of change in fair value of put option to effectively lock in the hedge level (rounded).</i>		121,951
Revenue ² AOCI <i>To reclassify portion of put option premium attributable to forecast period (rounded).</i>	8,762	8,762
Notes: 1. $(\$10,000,000 \div \$2.00) - (\$10,000,000 \div \$2.05)$. 2. Put option premium of $\$20,000 \times (46 \text{ day forecast period} \div 105 \text{ day option term})$.		

Journal entries – March 31, Year 2

	Debit	Credit
OCI Purchased put option <i>To record change in fair value of put option.</i>	130,951	130,951
Accounts receivable ¹ Other income/expense <i>To record spot remeasurement of accounts receivable to functional currency (rounded).</i>	385,109	385,109
Other income/expense ² AOCI <i>To reclassify amount out of AOCI for portion of change in fair value of put option to offset spot remeasurement adjustment. Amount limited to defined hedge exchange rate of $\\$2.00 = \\$1$ (rounded).</i>	121,951	121,951
Other income/expense ³ AOCI <i>To reclassify portion of put option premium attributable to period of recognized receivable (rounded).</i>	8,381	8,381
Notes: 1. $(\$10,000,000 \div \$1.90) - (\$10,000,000 \div \$2.05)$. 2. $(\$10,000,000 \div \$2.05) - (\$10,000,000 \div \$2.00)$. This amount is limited to the defined hedged exchange rate of $\$2.00 = \$1$ because ABC is only hedging against an increase in the rate – i.e. if the rate exceeds $\$2.00$. Because the exchange rate changes from $\$2.05 = \$1$ to $\$1.90 = \$1$, this adjustment only offsets the movement from $\$2.05$ to $\$2.00$ per $\$1$. 3. Put option premium of $\$20,000 \times (44 \text{ days} \div 105 \text{ day option term})$.		

Journal entries – April 15, Year 2

	<i>Debit</i>	<i>Credit</i>
Purchased put option	649,174	
OCI		649,174
<i>To record change in fair value of put option.</i>		
Other income/expense ¹	915,332	
Accounts receivable		915,332
<i>To record spot remeasurement of accounts receivable to functional currency (rounded).</i>		
AOCI ²	652,174	
Other income/expense		652,174
<i>To reclassify amount out of AOCI for portion of change in fair value of put option to offset spot remeasurement adjustment.</i>		
Other income/expense ³	2,857	
AOCI		2,857
<i>To reclassify portion of put option premium attributable to period of recognized receivable (rounded).</i>		
Cash	4,347,826	
Accounts receivable		4,347,826
<i>To record settlement of FCD receivable at spot rate of A\$2.30 = \$1.</i>		
Cash	652,174	
Purchased put option		652,174
<i>To record cash receipt on exercise of put option by ABC.</i>		
Notes:		
1. $(\$10,000,000 \div \$2.30) - (\$10,000,000 \div \$1.90)$.		
2. $(\$10,000,000 \div \$2.30) - (\$10,000,000 \div \$2.00)$. This amount is limited to the increase above the defined hedged exchange rate of $\$2.00 = \$1$ because ABC is only hedging against an increase in the rate. Even though the rate changed from $\$1.90 = \$1$ to $\$2.30 = \$1$, the change in the fair value of the put option that is considered effective is the change from $\$2.00$ to $\$2.30$ per $\$1$.		
3. Put option premium of $\$20,000 \times (15 \text{ days} \div 105 \text{ day option term})$.		

A single cash flow hedge of a forecasted sale on credit hedges two items: the forecasted sale until the date of sale, and the FCD receivable until settlement. Therefore, the gain or loss on the put option is recognized in revenue during the forecast period and in other income/expense when the FCD receivable is outstanding.

Upon sale of the inventory, ABC records revenue of \$4,878,049 (based on the February 15, Year 1 spot rate) and reclassifies \$121,951 from AOCI to revenue,

resulting in net revenue on this sale of \$5,000,000. Part of the option premium of \$20,000 attributable to the forecasted period is also recognized in earnings at this time.

The net effect in ABC's income statement for this sale in Australian dollars, collection of the Australian dollar-denominated receivable and related hedging option is \$4,980,000. This amount is based on the put option's exchange rate of A\$2.00 = \$1, which fixes the functional currency amount of the A\$10,000,000 sale and collection at \$5,000,000 less the option's premium of \$20,000. ABC is not exposed to the increase in the A\$/ \$ exchange rate above A\$2.00 = \$1 because it effectively hedged its exposure.



Excerpt from ASC 815-30

>> Example 11: Cash Flow Hedge of the Foreign Currency Exposure in a Royalty Arrangement

55-67 This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to a hedging relationship involving a single hedging derivative and three separate forecasted transactions. The three transactions occur on three separate dates, but the payment on receivables related to all three occurs on the same date. The settlement of the hedging derivative will occur on the date the receivable is paid. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-68 Entity DEF's functional currency is the U.S. dollar (USD). Entity ZYX's functional currency is the euro (EUR). Effective January 1, 20X1, Entity DEF enters into a royalty agreement with Entity ZYX that gives Entity ZYX the right to use Entity DEF's technology in manufacturing Product X. On April 30, 20X1, Entity ZYX will pay Entity DEF a royalty of EUR 1 million for each unit of Product X sold by that date. Entity DEF expects Entity ZYX to sell one unit of Product X on January 31, one on February 28, and one on March 31. The forecasted royalty is probable because Entity ZYX has identified a demand for Product X and no other supplier has the capacity to fill that demand.

55-69 Also on January 1, 20X1, Entity DEF enters into a forward contract to sell EUR 3 million on April 30, 20X1, for a price equal to the forward price of USD 0.6057 per EUR. Entity DEF designates the forward contract as a hedge of the risk of changes in its functional-currency-equivalent cash flows attributable to changes in the EUR-USD exchange rates related to the forecasted receipt of EUR 3 million from the royalty agreement. The spot price and forward price of EUR at January 1, 20X1, and the USD equivalent of EUR 3 million at those prices are assumed to be as follows.

Prices at January 1, 20X1	USD per EUR		USD Equivalent of EUR 3 Million	
Spot price	USD	0.6019	USD	1,805,700
4-month forward price		0.6057		1,817,100

55-70 Entity DEF will exclude from its assessment of effectiveness the portion of the fair value of the forward contract attributable to the spot-forward difference (the difference between the spot exchange rate and the forward exchange rate). Entity DEF elects to recognize changes in that portion of the derivative instrument's fair value currently in earnings in accordance with paragraph 815-20-25-83B. Entity DEF will estimate the cash flows on the forecasted transactions based on the current spot exchange rate and will discount that amount. Thus, Entity DEF will assess effectiveness by comparing the following amounts:

- a. Changes in the fair value of the forward contract attributable to changes in the USD spot price of EUR
- b. Changes in the present value of the forecasted cash flows based on the current spot exchange rate.

55-71 Those two changes will exactly offset because the currency and the notional amount of the forward contract match the currency and the total of the expected foreign currency amounts of the forecasted transactions. Thus, if Entity DEF dedesignates a proportion of the forward contract each time a royalty is recognized (as described in the following paragraph), the hedging relationship will meet the highly effective criterion.

55-72 As each royalty is recognized, Entity DEF recognizes a receivable and royalty income. The forecasted transaction (the recognition of royalty income) has occurred. The receivable is an asset, not a forecasted transaction, and would separately be eligible to be designated as a fair value hedge of **foreign exchange risk** or continue to be eligible as a cash flow hedge of foreign exchange risk. Consequently, if the variability of the functional currency cash flows related to the royalty receivable is not being hedged, Entity DEF will dedesignate a proportion of the hedging instrument in the original hedging relationship with respect to the proportion of the forward contract corresponding to the recognized royalty. As the royalty is recognized in earnings and each proportion of the derivative instrument is dedesignated, the related derivative instrument gain or loss in accumulated other comprehensive income is reclassified into earnings and presented in the same income statement line item as the earnings effect of the hedged item. After that date, any gain or loss on the dedesignated proportion of the derivative instrument and any transaction loss or gain on the royalty receivable will be recognized in earnings and may substantially offset each other.

55-73 Subtopic 830-20 requires immediate recognition in earnings of any foreign currency transaction gain or loss on a foreign-currency-denominated receivable that is not designated as a hedging instrument. Therefore, the effect of changes in spot prices on the royalty receivable must be recognized immediately in earnings.

55-74 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.

	USD per EUR			
	Spot Price		Forward Price for Settlement on 4/30/X1	
January 1	USD	0.6019	USD	0.6057
January 31		0.5970		0.6000

11. Hedging foreign currency exposures

February 28	0.5909	0.5926
March 31	0.5847	0.5855
April 30	0.5729	0.5729

55-75 The changes in fair value of the forward contract that are recognized each month in earnings and other comprehensive income are shown in the following table. Amounts reclassified from accumulated other comprehensive income to earnings and amounts excluded from the assessment of hedge effectiveness are presented in the same income statement line item as the earnings effect of the hedged item. The fair value of the forward is the present value of the difference between the USD to be received on the forward (USD 1,817,100) and the USD equivalent of EUR 3 million based on the current forward rate. A 6 percent discount rate is used in this Example.

	Debit (Credit)		
	Forward Contract	Earnings	Other Comprehensive Income
Fair value on January 1	\$ -		
Period ended January 31:			
Change in spot-forward difference	2,364	\$ (2,364)	
Change in fair value of dedesignated proportion	-	-	
Change in fair value of designated proportion	14,482		\$ (14,482)
Reclassification of gain	-	(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	-	(10,891)	10,891
Fair value on February 28	38,909		
Period ended March 31:			
Change in spot-forward difference	2,718	(2,718)	
Change in fair value of dedesignated proportion	12,448	(12,448)	
Change in fair value of designated proportion	6,223		(6,223)
Reclassification of gain	-	(17,114)	17,114
Fair value on March 31	60,298		
Period ended April 30:			
Change in spot-forward difference	2,445	(2,445)	
Change in fair value of dedesignated proportion	35,657	(35,657)	
Change in fair value of designated proportion	-		-
Fair value on April 30	\$ 98,400		
Cumulative effect		\$ (98,400)	-

55-76 The effect on earnings of the royalty agreement and hedging relationship illustrated in this Example is summarized by month in the following table.

Period Ended	Amounts Recognized in Earnings Related to					Total Amount Reported in Earnings
	Receivable		Forward Contract			
	USD Equivalent of EUR 1 Million Royalty	Foreign Currency Transaction Gain (Loss)	Amount Attributable to the Dedesignated Proportion	Reclassifications from Other Comprehensive Income	Amount Attributable to the Difference between the Spot and Forward rates	
January 31	\$ 597,000	\$ -	\$ -	\$ 4,827	\$ 2,364	\$ 604,191
February 28	590,900	(6,100)	6,063	10,891	3,873	605,627
March 31	584,700	(12,400)	12,458	17,104	2,718	604,580
April 30	-	(35,400)	35,657	-	2,445	2,702
	<u>\$ 1,772,600</u>	<u>\$ (53,900)</u>	<u>\$ 54,178</u>	<u>\$ 38,822</u>	<u>\$ 11,400</u>	<u>\$ 1,817,100</u>
				<u>\$98,400</u>		



Excerpt from ASC 815-30

>> Example 13: Cash Flow Hedge of a Fixed-Rate Foreign-Currency-Denominated Loan Eliminating Variability in the Functional-Currency-Equivalent Cash Flows (Fixed-to-Fixed Scenario)

55-81 This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to accounting for a cash flow hedge of a fixed-rate foreign-currency-denominated debt in which all of the variability in the functional-currency-equivalent cash flows are eliminated by the effect of the hedge.

55-82 On July 1, 20X1, Entity DEF, a U.S. dollar (USD) functional currency entity, issues a zero-coupon debt instrument with a notional amount of FC 154,766.79 for FC 96,098.00. The interest rate implicit in the debt is 10 percent. The debt will mature on June 30, 20X6. Entity DEF enters into a forward contract to buy FC 154,766.79 in 5 years at the forward rate of 1.090148194 (USD 168,718.74) and designates the forward contract as a hedge of the variability of the USD functional currency equivalent cash flows on the debt. Because the currency, notional amount, and maturity of the debt and the forward contract match, the entity concludes that the hedging relationship will achieve perfect offset. The USD interest rate implicit in the forward contract is 11.028 percent. The market data, period end balances, and journal entries from cash flow hedge accounting are as follows.

Period	Spot Rate USD/ Functional Currency	Forward Rate USD/ Functional Currency	Forward Rate Difference	Foreign Currency Present Value	USD Spot Amounts	USD Debt (@11.028%)	Fair Value Forward USD
0	1.040604383	1.090148194	0	\$ 96,098.00	\$100,000.00	\$100,000.00	\$ -
1	1.1	1.184985966	0.094837771	105,707.80	116,278.58	111.028.04	9,327.97

11. Hedging foreign currency exposures

2	1.1	1.163142906	0.072994712	116,278.58	127,906.44	123,272.25	8,041.09
3	1.1	1.141702484	0.051554290	127,906.44	140,697.08	136,866.76	6,360.72
4	1.1	1.120657277	0.030509083	140,697.08	154,766.79	151,960.48	4,215.89
5	1.1	1.1	0.009851806	154,766.79	170,243.47	168,718.74	1,524.73
					Other Comprehensive Income	Interest Expense	Transaction Loss
7/1/20X1	Borrow money	Cash	Forward	Debt			
6/30/20X2	Accrue interest on debt	\$ 100,000.00		\$(100,000.00)			
6/30/20X2	Mark debt to spot			(10,570.78)		\$ 10,570.78	
6/30/20X2	Mark forward to fair value			(5,707.80)			\$ (5,707.80)
6/30/20X2	Balances		\$ 9,327.97		\$ (4,077.43)	457.26	(5,707.80)
6/30/20X2		100,000.00	9,327.97	(116,278.58)	(4,077.43)	11,028.04	-
6/30/20X3	Accrue interest on debt			(11,627.86)		11,627.86	
6/30/20X3	Mark forward to fair value		(1,286.88)		670.53	616.35	
6/30/20X3	Balances	100,000.00	8,041.08	(127,906.44)	(3,406.90)	23,272.25	
6/30/20X4	Accrue interest on debt			(12,790.64)		12,790.64	-
6/30/20X4	Mark forward to fair value		(1,680.37)		876.50	803.87	
6/30/20X4	Balances	100,000.00	6,360.71	(140,697.08)	(2,530.40)	36,866.76	
6/30/20X5	Accrue interest on debt			(14,069.71)		14,069.71	
6/30/20X5	Mark forward to fair value		(2,144.94)		1,120.83	1,024.01	
6/30/20X5	Balances	100,000.00	4,215.98	(154,766.79)	(1,409.57)	51,960.48	
6/30/20X6	Accrue interest on debt			(15,476.68)		15,476.68	
6/30/20X6	Mark forward to fair value		(2,691.15)		1,409.57	1,281.58	
6/30/20X6	Balances	\$ 100,000.00	\$ 1,524.72	\$(170,243.47)	\$ -	\$ 68,718.74	-

55-83 Following are journal entries at inception of the loan and at the end of the first year.

7/1/20X1		Debit	Credit
Cash		\$ 100,000.00	
Functional currency debt at spot			\$ 100,000.00
To record FC borrowing in USD.			
6/30/20X2		Debit	Credit
Interest expense		\$ 10,570.78	
Debt			\$ 10,570.78
To accrue interest. Period and spot rate used for simplicity.			
Transaction loss		\$ 5,707.80	
Debt			\$ 5,707.80
To record a transaction loss on the debt.			
Derivative asset		\$ 9,327.97	
Other comprehensive income			\$ 9,327.97
To record a derivative instrument at fair value and record the gain on the derivative in other comprehensive income.			
Other comprehensive income		\$ 5,250.54	
Interest expense		457.26	
Transaction gain/loss			\$ 5,707.80

To reclassify an amount out of accumulated other comprehensive income to do both of the following:

- a. To increase interest expense to the USD yield of 11.028 percent.
- b. To offset the transaction loss on the debt.

55-84 Journal entries for the remaining four years are not displayed.

55-85 This Example would also be relevant for a non-interest-bearing foreign-currency-denominated receivable or payable instrument. An amount based on the rate implicit in the forward contract would be reported in earnings each period. Given the short maturities of many receivables and payables, the amount reported in earnings each period may be small.



Excerpt from ASC 815-20

>> Example 15: Portions of a Foreign-Currency-Denominated Financial Asset or Liability as Hedged Item

55-141 The following Cases illustrate the application of paragraph 815-20-25-41 to fixed-rate and variable-rate foreign-currency-denominated debt:

- a. Foreign-currency-denominated fixed-rate debt (Case A)
- b. Foreign-currency-denominated variable-rate debt (Case B).

55-142 Specifically, for each of the eight situations presented collectively in Cases A (see paragraph 815-20-55-143) and B (see paragraph 815-20-55-153), an entity can use cash flow hedge accounting to hedge the variability in the specific principal repayments, interest cash flows, or both by applying the guidance in paragraph 815-30-35-3(d) to the specifically identified hedged cash flows. Only an amount that would offset the transaction gain or loss arising from the remeasurement of a hedged cash flow would be reclassified each period from other comprehensive income to earnings. Also, the change in the fair value of the forward points (time value) attributable to the hedged future cash flows would be reported in other comprehensive income, while the change in the fair value of the forward points (time value) attributable to the unhedged future cash flows would be reported in earnings.

>>> Case A: Foreign-Currency-Denominated Fixed-Rate Debt

55-143 Entity ABC, a U.S. dollar (USD) functional entity, issues a five-year foreign-currency-denominated fixed-rate debt obligation that requires interest payments and partial principal payments annually in the foreign currency with the remaining principal due at the end of five years (maturity) in the foreign currency. More specifically, Entity ABC issues an FC 45 million debt obligation on December 31, 20X0, with FC 5 million due on December 31 of each of the next 4 years and FC 25 million due on December 31, 20X5. Interest payments at 10 percent are paid annually.

55-144 In this Case, Entity ABC can use cash flow hedge accounting to hedge the variability in its functional-currency-equivalent cash flows associated with any of the following:

- All of the payments of both principal and interest of the debt
- All of the payments of principal of the debt
- All or a fixed portion of selected payments of either principal or interest of the debt (such as either principal or interest payments on December 31, 2001, and December 31, 2003)
- Selected payments of both principal and interest of the debt (such as principal and interest payments on December 31, 2001, and December 31, 2003).

55-145 For instance, Entity ABC could use a receive-fixed-rate, pay-fixed rate cross-currency interest rate swap or a series of forward contracts to eliminate variability attributable to foreign exchange rates.

55-146 The following illustrates the second option, hedging the variability in all principal cash flows attributable to foreign exchange risk.

55-147 Entity ABC enters into the following five forward contracts to hedge all principal cash flows:

- Forward contract to purchase FC 5,000 on December 31, 20X1, at a forward rate of 1.05061019
- Forward contract to purchase FC 5,000 on December 31, 20X2, at a forward rate of 1.06061601
- Forward contract to purchase FC 5,000 on December 31, 20X3, at a forward rate of 1.07066924
- Forward contract to purchase FC 5,000 on December 31, 20X4, at a forward rate of 1.08076989
- Forward contract to purchase FC 25,000 December 31, 20X5, at a forward rate of 1.090871.

55-148 Exchange rates are as follows.

Period	Spot	12/31/X1 Forward	12/31/X2 Forward	12/31/X3 Forward	12/31/X4 Forward	12/31/X5 Forward
12/31/X0	1.04060438	1.05061019	1.06061601	1.07066924	1.08076989	1.090871
12/31/X1	1.1		1.12125604	1.14271548	1.16448149	1.18655697
12/31/X2	1.1			1.12125604	1.14272548	1.16448149
12/31/X3	1.1				1.12125604	1.14272548
12/31/X4	1.1					1.12125604
12/31/X5	1.1					

55-149 Entity ABC would make the following journal entries.

	Debit (Credit)				Accum. Other Comprehensive Income
	Cash	Forward Contracts	Note Payable	Income or Expense	
Inception 12/31/X0	46,827		(46,827)		
December 31, 20X1 entries:					
Repayment of principal	(5,500)		5,203	297	
Payment of interest	(4,950)			4,950	

11. Hedging foreign currency exposures

Transaction loss on note payable			(2,376)	2,376	
Fair value of forward contract #1		247			(247)
Settlement of forward #1	247	(247)			
Offset \$247 of loss on principal (\$50 related to cost of hedge remains in earnings)				(247)	247
	Debit (Credit)				
	Cash	Forward Contracts	Note Payable	Income or Expense	Accum. Other Comprehensive Income
Fair value of forward contracts #2-5 (based on 6% discount rate)		2,853			(2,853)
Paragraph 815-30-35-3(d) adjustment—offset the transaction loss related to principal				(1,734)	1,734
Paragraph 815-30-35-3(d) adjustment—effect of hedge				396	(396)
December 31, 20X2 entries:					
Repayment of principal	(5,500)		5,203	297	
Payment of interest	(4,400)			4,400	
Fair value of forward contract #2		(89)			89
Settlement of forward #2	197	(197)			
Offset \$197 of loss on principal (\$100 related to cost of hedge remains in earnings)				(197)	197
Fair value of forward contracts #3-5 (based on 6% discount rate)		(507)			507
Paragraph 815-30-35-3(d) adjustment—effect of hedge				299	(299)
Change in time value related to principal goes to other comprehensive income or change in time value related to interest goes to earnings ^(a)			297	(180)	(117)
December 31, 20X3 entries:					
Repayment of principal	(5,500)		5,203	297	
Payment of interest	(3,850)			(3,850)	
Fair value of forward contract #3		(92)			92
Settlement of forward #3	147	(147)			
Offset \$147 of loss on principal (\$150 related to cost of hedge remains in earnings)				(147)	147
Fair value of forward contracts #4-5 (based on 6% discount rate)		(477)			477
Paragraph 815-30-35-3(d) adjustment—effect of hedge				202	(202)
Change in time value related to principal goes to other comprehensive income or change in time value related to interest goes to earnings			297	(168)	(129)
December 31, 20X4 entries:					
Repayment of principal	(5,500)		5,203	297	
Payment of interest	(3,300)			3,300	

11. Hedging foreign currency exposures

Fair value of forward contract #4		(95)			95
Settlement of forward #4	96	(96)			
Offset \$96 of loss on principal (\$201 related to cost of hedge remains in earnings)				(96)	96
Fair value of forward contract #5 (based on 6% discount rate)		(437)			437
Paragraph 815-30-35-3(d) adjustment—effect of hedge				104	(104)
			Debit (Credit)		
	Cash	Forward Contracts	Note Payable	Income or Expense	Accum. Other Comprehensive Income
Change in time value related to principal goes to other comprehensive income or change in time value related to interest goes to earnings			297	(154)	(143)
December 31, 20X5 entries:					
Repayment of principal	(27,500)		26,015	1,485	
Payment of interest	(2,750)			2,750	
Fair value of forward contract #5		(488)			488
Settlement of forward #5	228	(228)			
Offset \$228 of loss on principal				(228)	228
Paragraph 815-30-35-3(d) adjustment—effect of hedge			1,485	(1,001)	(484)
Change in time value related to principal goes to other comprehensive income or change in time value related to interest goes to earnings				(140)	(140)
	(21,008)	-	-	(b)	-

- a. The entry recording the \$297 gain for the period ended December 31, 20X2, results from the spot exchange rate remaining unchanged from December 31, 20X1, and one less period remaining on the loan payable. The \$117 principal portion of the gain goes to other comprehensive income because only principal is being hedged. The \$180 interest portion of the gain goes to earnings because interest is not being hedged.
- b. See Schedule 3 (paragraph 815-20-55-152) for income or expense for each period.

55-150 The following schedules support the preceding entries.

Schedule 1	Foreign Currency	Functional Currency at 12/31/X0 Spot Rate (1)	Functional Currency at Current Spot Rate (2)	Transaction Gain or Loss	(2) – (1)	Change in Time Value
12/31/X0						
Principal	30,976 ^(a)	32,234				
Interest	14,024 ^(a)	14,593				
Loan value	45,000	46,827				
12/31/X1						
Principal	29,192	30,377	32,111	1,734		
Interest	10,808	11,247	11,889	642		
Loan value	40,000	41,624	44,000			
12/31/X2						
Principal	27,222	28,328	29,945		1,617	117 = (1,734 – 1,617)
Interest	7,778	8,093	8,555		462	180 = (642 – 462)
Loan value	35,000	36,421	38,500			
12/31/X3						

11. Hedging foreign currency exposures

Principal	25,048	26,065	27,553	1,488	129 = (1,617 – 1,488)
Interest	4,952	5,153	5,447	294	168 = (462 – 294)
Loan value	30,000	31,218	33,000		
12/31/X4					
Principal	22,649	23,568	24,913	1,345	143
Interest	2,351	2,447	2,586	140	154
Loan value	25,000	26,015	27,500		

12/31/X5 (before final principal payment is made)

Schedule 1	Foreign Currency	Functional Currency at 12/31/X0 Spot Rate (1)	Functional Currency at Current Spot Rate (2)	Transaction Gain or Loss	(2) – (1)	Change in Time Value
Principal	25,000	26,015	27,500		1,485	(140)
Interest	-	-	-			140
Loan value	25,000	26,015	27,500			

(a) The value ascribed to the principal portion was determined by discounting the future principal payments at an annual rate of 10% compounded quarterly. The value ascribed to the interest portion was determined by discounting future quarterly interest accruals at an annual rate of 10%.

55-151 Schedule 2 provides the amount of cost attributed to each period for each forward contract. Each period's cost is determined based on applying the interest method to each forward contract.

Schedule 2	Forward Contract #1	Forward Contract #2	Forward Contract #3	Forward Contract #4	Forward Contract #5	Total
12/31/X1	\$ 50.03	\$ 49.79	\$ 49.63	\$ 49.50	\$ 246.61	\$ 445.56
12/31/X2		50.27	50.11	49.97	248.95	399.30
12/31/X3			50.59	50.44	251.31	352.34
12/31/X4				50.92	253.69	304.61
12/31/X5					256.11	256.11
Total	\$ 50.03	\$ 100.06	\$ 150.33	\$ 200.83	\$1,256.67	\$1,757.92

55-152 Schedule 3 provides a breakdown for each year-end reporting period.

Schedule 3
12/31/X1

\$ 4,950	Interest expense
446	Cost of hedge (396 + (297 – 247))
642	Transaction loss related to unhedged interest (2,376 – 1,734)
\$ 6,038	Total expense

12/31/X2

\$ 4,400	Interest expense
399	Cost of hedge (299 + (297 – 197))
(180)	Time value related to unhedged interest
\$ 4,619	Total expense

12/31/X3

\$ 3,850	Interest expense
352	Cost of hedge (202 + (297 – 147))

(168)	Time value related to unhedged interest
<u>\$ 4,034</u>	Total expense

12/31/X4

\$ 3,300	Interest expense
305	Cost of hedge (104 + (297 – 96))
(154)	Time value related to unhedged interest
<u>\$ 3,451</u>	Total expense

12/31/X5

\$ 2,750	Interest expense
256	Cost of hedge (1,485 – (1,001 + 228))
(140)	Time value related to unhedged interest
<u>\$ 2,866</u>	Total expense

>>> Case B: Foreign-Currency-Denominated Variable-Rate Debt

55-153 Entity XYZ, a U.S. dollar (USD) functional entity issues a five-year foreign-currency-denominated variable-rate debt obligation that requires interest payments and partial principal payments annually in the foreign currency with the remaining principal due at the end of five years (maturity) in the foreign currency. More specifically, Entity XYZ issues an FC 45 million debt obligation on December 31, 20X0, with FC 5 million due on December 31 of each of the next 4 years and FC 25 million due on December 31, 20X5. Interest payments are paid annually based on LIBOR.

55-154 In this Case the guidance in paragraph 815-20-25-41 provides that Entity XYZ can use cash flow hedge accounting to hedge the variability in its functional-currency-equivalent cash flows associated with any the following:

- All of the payments of both principal and interest of the debt
- All of the payments of principal of the debt
- All or a fixed portion of selected payments of either principal or interest of the debt
- Selected payments of both principal and interest of the debt (such as principal and interest payments on December 31, 2001, and December 31, 2003).

55-155 An entity could use a receive-variable-rate, pay-fixed-rate cross-currency interest rate swap to eliminate variability attributable to interest rates and foreign exchange rates. In cash flow hedges of recognized foreign-currency-denominated assets and liabilities, the entity must assess whether the changes in cash flows attributable to the risk being hedged are expected to offset at the inception of the hedging relationship and on an ongoing basis. In a manner similar to that described beginning in paragraph 815-30-35-25, the entity would assess the effectiveness of the hedge using the hypothetical derivative method. After the initial quantitative assessment of hedge effectiveness, the entity may elect to assess hedge effectiveness on a qualitative or quantitative basis.

12. Net investment hedges

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12.1 How the standard works

Throughout this chapter, FCD means foreign currency denominated.

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

When the comprehensive hedge accounting model in Topic 815 was developed, the FASB did not reconsider the accounting for foreign currency translation. As a result, the FASB decided to continue to permit hedge accounting for net investment hedges, including that these hedging relationships would continue to be subject to only certain hedging criteria.

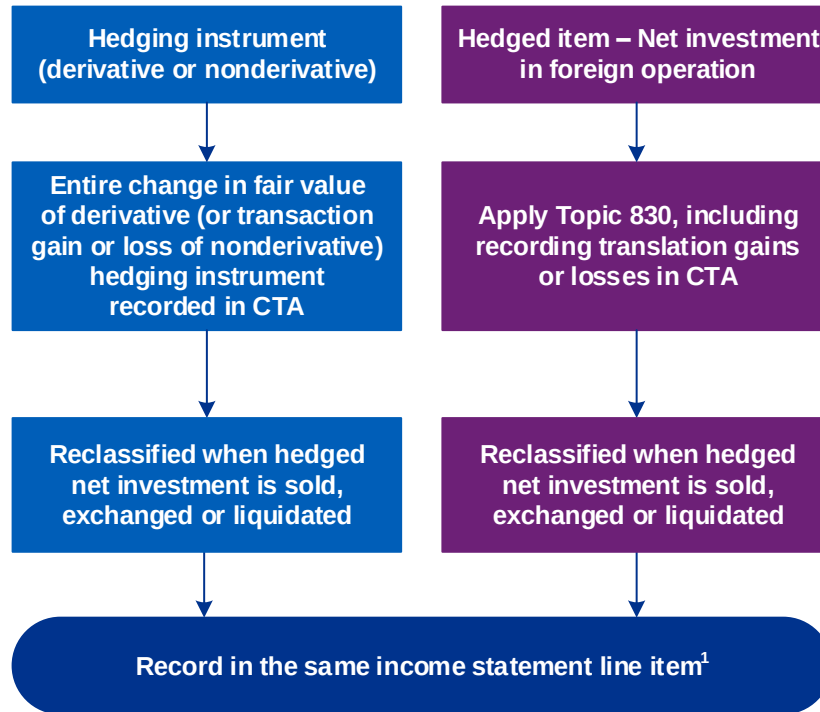
Net investment hedges are subject only to the following hedging criteria.

General qualifying criteria for all foreign currency hedges (Section 11.3)	— Hedging instrument. The entity with the foreign currency exposure needs to be a party to the hedging instrument (section 11.3.20). — Hedged item or transaction. The hedged net investment needs to be denominated in a currency other than the entity's functional currency (section 11.3.30).
Hedge effectiveness (Section 12.4)	— The hedging instrument must be both designated and effective as an economic hedge of the net investment. — The entity assesses effectiveness at least quarterly and whenever financial statements or earnings are reported.
Formal documentation (Section 6.9)	The entity formally documents the hedging relationship.

In general, the net investment hedge accounting model works as follows.

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

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



Note:

1. In certain situations, a portion of the translation gain or loss should be reclassified from CTA to noncontrolling interest (see section 12.5.20).



Observation**

Optional expedients available in Topic 848

The guidance in this chapter does not consider the optional expedients that may be available in Topic 848 (reference rate reform) for hedging relationships that reference LIBOR or a reference rate that is expected to be discontinued. See 'Optional expedients available in Topic 848' in chapter 6 for discussion of expedients to hedge accounting that are not specific to a particular type of hedging relationship.

12.2 Qualifying criteria for net investment hedges

12.2.10 Overview

The objective of a net investment hedge is to reduce or eliminate the exposure to foreign currency risk of a net investment in a foreign operation.

A net investment in a foreign operation includes incorporated and unincorporated business structures such as subsidiaries, divisions, branches, joint ventures, consolidated variable interest entities and equity method investments.

Topic 830 (foreign currency matters) provides accounting guidance on foreign currency transactions and the translation of financial statements. Before the comprehensive hedge accounting model in Topic 815 was established, the foreign currency accounting guidance permitted hedge accounting for net investments and practice in this area was well-established. When the comprehensive hedge accounting model was developed, the FASB did not reconsider the accounting for foreign currency translation. As a result, the FASB decided to continue to permit hedge accounting for net investment hedges, including that these hedging relationships would only be subject to certain hedging criteria. [\[FAS 133.BC475–478\]](#)

Designation of a net investment in a foreign operation as a hedged item is permitted even though it is considered the same as designating a group of dissimilar assets and liabilities as the hedged item, which is not permitted for a **fair value hedge** or **cash flow hedge**.

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

- The operating unit with the foreign currency exposure needs to be a party to the hedging instrument (see section 11.3.20). [\[815-20-25-30\(a\)\]](#)
- The hedged net investment needs to be denominated in a currency other than the entity's functional currency (see section 11.3.30). [\[815-20-25-30\(b\)\]](#)
- The entity needs to formally document the hedging relationship. The documentation requirements for net investment hedges are the same as those for other hedging relationships (see section 6.9). [\[815-20-25-3\(b\)\]](#)
- The entity needs to assess effectiveness at least quarterly and whenever financial statements or earnings are reported (see sections 12.2.20 and 12.4). [\[815-35-35-27\]](#)
- The hedging instrument must be designated and effective as an economic hedge of the net investment (see section 12.4). [\[815-20-25-26\(e\), 830-20-35-3\]](#)

As highlighted above, the operating unit that has the foreign currency exposure must be a party to the hedging instrument. However, as explained in section 11.3.20, another member of the consolidated group that has the same functional currency as the operating unit may instead be a party to the hedging instrument if there is no intervening subsidiary with a different functional currency. [\[815-20-25-23, 25-24, 25-30\(a\)\]](#)



Question 12.2.10

Can foreign currency risk related to a forecasted equity method investment be hedged?

Background: ABC Corp.'s functional currency is the US dollar. ABC anticipates acquiring a 35% equity interest in a Korean car manufacturer. ABC has signed a purchase contract and has publicly announced the terms of the acquisition, which include a fixed price of 10 billion Korean won (₩). The expected consummation date is July 1, Year 1.

Once it is acquired, ABC will account for the investment using the equity method. ABC forecasts that ₩500 million of net income will be earned related to the investment in the year after the acquisition.

Scenario 1: ABC wants to hedge the foreign currency risk related to the forecasted purchase of the equity method investee

Interpretive response: No. As explained in section 6.5.20, cash flow hedges of transactions relating to investments accounted for by the equity method are not permitted. Because ABC will account for the investment using the equity method, it cannot designate the forecasted transaction as the hedged item in a cash flow hedge. [815-20-25-43(b)(1)]

Scenario 2: ABC wants to hedge the foreign currency risk related to forecasted earnings of the investment after the acquisition

Interpretive response: No. Although ABC may designate the recognized equity method investee as the hedged item in a net investment of a foreign operation, forecasted earnings cannot be hedged. This is because net income represents the netting of many dissimilar transactions, rather than a series of individual but similar transactions sharing the same risk exposure. Additionally, dividends from an equity method investment may not be designated as the hedged item. [FAS 133.BC485, 815-20-25-39(c)]



Example 12.2.10

Hedging a foreign net investment with a FCD liability of another subsidiary

Parent's functional currency is the US dollar. Parent has two subsidiaries: Sub NZ in New Zealand and Sub J in Japan. The functional currency of Sub J is its local currency (Japanese yen).

Scenario 1: Sub NZ's functional currency is its local currency (NZ dollar)

Sub NZ issues yen-denominated notes. Parent is not permitted to designate the yen-denominated notes issued by Sub NZ as the hedging instrument in a hedge of its net investment in Sub J. This is because Sub NZ is not part of the operating unit that has the foreign currency exposure and Sub NZ has a functional currency different from that of the Parent.

Scenario 2: Sub NZ's functional currency is the US dollar

Sub NZ issues yen-denominated notes and Parent designates those notes payable as the hedging instrument in its hedge of its net investment in Sub J. This is permissible because Sub NZ has the same functional currency as Parent and there are no intervening subsidiaries with a different functional currency.

On a consolidated basis, Parent translates Sub J's financial statements from its functional currency into US dollars. Any foreign currency translation gains or losses are recorded in CTA in AOCI.

In its stand-alone financial statements, Sub NZ's yen-denominated notes are remeasured at spot through earnings to its functional currency (the US dollar) at period-end because the hedging relationship and related hedge accounting exist only in the context of Parent's consolidated financial statements.

However, if Sub NZ's yen-denominated notes are effective at hedging the exchange gains or losses arising on translation of Sub J's financial statements from yen to US dollars, the gain or loss in Sub NZ's stand-alone financial statements related to remeasuring the yen-denominated notes to US dollars is reclassified in consolidation to CTA in AOCI (i.e. in Parent's consolidated financial statements).

12.2.20 Redesignation of the hedged item



Excerpt from Subtopic 815-35

> Redesignation

35-27 If an entity documents that the effectiveness of its hedge of the net investment in a foreign operation will be assessed based on the beginning balance of its net investment and the entity's net investment changes during the year, the entity shall consider the need to redesignate the hedging relationship (to indicate what the hedging instrument is and what numerical portion of the current net investment is the hedged portion) whenever financial statements or earnings are reported, and at least every three months. An entity is not required to redesignate the hedging relationship more frequently even when a significant transaction (for example, a dividend) occurs during the interim period. Example 1 (see paragraph 815-35-55-1) illustrates the application of this guidance.

Determining the amount of the net investment to hedge presents a challenge because the net investment balance is constantly changing as the foreign operation generates profits and losses. In practice, an entity designates the beginning balance (or a specified amount of it) as the hedged item (see Question 12.2.20). [\[815-35-35-27\]](#)

An entity is required to consider the need to prospectively redesignate the hedging relationship whenever financial statements or earnings are reported, and at least every three months. [\[815-35-35-27\]](#)

An entity is not required to redesignate the hedging relationship more frequently even when a significant transaction (e.g. a dividend or additional

investment) occurs during the interim period. However, an entity may wish to do so to avoid volatility in the CTA in AOCI related to the net investment. [815-35-35-27]

This is because when the beginning balance of the net investment is designated as the hedged item, the hedging instrument is also designated based on that beginning balance (see Question 12.2.20). However, the ending balance of the net investment is translated in consolidation. As a result, when significant transactions occur during the interim period and the hedge is not redesignated, the translation of the net investment's ending balance (which is recorded in CTA in AOCI) may not be exactly offset by the remeasurement of the hedging instrument that is recognized in CTA in AOCI. Redesignating the hedging relationship more frequently may reduce the volatility resulting from this lack of offset. [815-35-35-27]



Question 12.2.20

Can the ending or average balance be designated as the hedged item in a net investment hedge?

Interpretive response: No. We believe using the ending or average balance would be equivalent to hedging the foreign currency exposure associated with the future earnings (loss) of a foreign operation. As discussed in Question 12.2.10, it is not permitted to hedge the future earnings of a foreign operation.

Instead, we believe an entity should assess the effectiveness of the hedging relationship based on the beginning balance of the net investment.

An entity that expects its net investment in a foreign operation to decrease during the quarter may want to consider redesignating the hedged amount at the beginning of each month to mitigate the amount of volatility that would otherwise be included in the CTA in AOCI. This may be preferable if the entity expects significant decreases during a quarter.

FASB Example: Frequency of designation of hedged net investment

Subtopic 815-35's Example 1 (paragraph 815-35-35-1) illustrates assessing the effectiveness of a hedge of the foreign currency exposure of a net investment when the balance changes.

- In the first scenario (paragraph 815-35-55-1(a)), the entity could enter into an additional forward contract to hedge the net investment balance exceeding the original forward contract's notional amount.
- In both scenarios (paragraphs 815-35-55-1(a) and 55-1(b)), the full change in the fair value of the foreign currency forward contract would be recorded in the CTA in AOCI for the quarter then ended.



Excerpt from Subtopic 815-35

>> Example 1: Frequency of Designation of Hedged Net Investment

55-1 This Example illustrates the application of paragraph 815-35-35-27. Assume that an entity enters into a foreign currency forward contract that has a **notional amount** equal to the beginning balance of its investment in a foreign operation (for example, 100,000 foreign currency units [FC]). This foreign currency forward contract is immediately designated as a hedge of the entire beginning balance of the net investment at the inception of the hedge. As the net investment changes, the entity would periodically assess the original hedging relationship and decide whether it needs to remove (that is, dedesignate) that original relationship and designate a new hedging relationship for the following assessment period. The following presents one method of such redesignation in those circumstances in which the entity chooses not to obtain a new **derivative instrument**:

- a. If the net investment had increased (for example, to FC 120,000), the entire forward contract would be designated prospectively as hedging only a portion of the beginning balance of the net investment in that foreign operation. The hedged portion would be the ratio of the net investment at the inception of the hedge to the net investment at the beginning of the new assessment period (for example, five-sixths of the FC 120,000).
- b. If the net investment had decreased (for example, to FC 90,000), only a proportion of the forward contract would be designated prospectively as hedging the entire beginning balance of the net investment in that foreign operation. The proportion of the forward contract designated prospectively as the hedging instrument would be the ratio of the net investment at the beginning of the new assessment period to the net investment at the inception of the hedge (for example, nine-tenths of the forward contract). The proportion of the forward contract not designated prospectively as the hedging instrument in the net investment hedge could be designated as a hedging instrument in a different hedging relationship or simply reported at **fair value** with its gain or loss after the dedesignation date recognized currently in earnings pursuant to paragraph 815-20-35-1(a).

12.3 Hedging instruments

12.3.10 Overview



Excerpt from Subtopic 815-20

>>> Hedging Instruments in Net Investment Hedges

25-66 A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Subtopic 830-20

can be designated as hedging the foreign currency exposure of a net investment in a foreign operation provided the conditions in paragraph 815-20-25-30 are met. A nonderivative financial instrument that is reported at fair value does not give rise to a foreign currency transaction gain or loss under Subtopic 830-20 and, thus, cannot be designated as hedging the foreign currency exposure of a net investment in a foreign operation.

>>>> Foreign-Currency-Denominated Debt Instrument as both Hedging Instrument and Hedged Item

55-38 A foreign-currency-denominated debt instrument that is designated as the hedging instrument in a net investment hedge may also be designated as the hedged item in a fair value hedge of **interest rate risk**. The two hedging relationships address separate risk types that are permitted to be hedged individually under this Subtopic. Example 10 (see paragraph 815-20-55-127) illustrates this circumstance.

An entity may designate a derivative instrument or a FCD nonderivative financial liability as a hedge of the foreign currency exposure inherent in a net investment in a foreign operation, consistent with Topic 830 (foreign currency matters). [\[815-20-25-66\]](#)

To be used as a hedging instrument, a FCD nonderivative is required to be a financial liability that gives rise to a foreign currency transaction gain or loss under Topic 830. A FCD nonderivative that is reported at fair value (e.g. an instrument to which an entity has chosen to apply the fair value option under Topic 825 (financial instruments)) cannot be used as a hedging instrument because it does not give rise to a foreign currency transaction gain or loss under Topic 830. [\[815-20-25-66\]](#)

A FCD fixed-rate debt instrument designated as the hedging instrument in a net investment hedge may also be designated as the hedged item in a fair value hedge of interest rate risk. The two hedging relationships address separate types of risk, which can be hedged individually.

As a result of applying fair value hedge accounting, the debt's carrying amount will be adjusted to reflect changes in its FCD fair value attributable to interest rate risk. As a result, the notional amount of the debt designated to hedge the net investment amount will change over time, which may cause an entity to adjust the amount of the hedged net investment as discussed in section 12.2.20. For an example of using a FCD fixed-rate debt instrument as a hedging instrument and a hedged item in a fair value hedge of interest rate risk, see Subtopic 815-20's Example 10 (reproduced in this section). [\[815-20-55-38, 55-129\]](#)

Cross-currency interest rate swaps that have either two fixed-rate legs or two variable-rate legs are eligible as hedging instruments. However, Topic 815 prohibits using compound derivatives as hedging instruments. As a result, cross-currency interest rate swaps with one fixed-rate and one variable-rate are not eligible as hedging instruments. Topic 815 also prohibits using a combination of hedging instruments (i.e. a single synthetic instrument) as a hedging instrument. For further discussion, see section 12.3.40. [\[815-20-25-67 – 25-68\]](#)

The hedging instrument's gain or loss included in the effectiveness assessment is reported in CTA, consistent with the accounting for the net investment. [\[815-35-35-1 – 35-2\]](#)



Question 12.3.10

Does the use of proceeds affect whether a FCD nonderivative debt obligation can be used as the hedging instrument in a net investment hedge?

Background: Parent's functional currency is the US dollar. Parent has a UK subsidiary and its functional currency is the pound sterling. Parent issues a debt obligation denominated in pound sterling to a third party and uses the proceeds to finance its US operations. Parent did not elect the fair value option for the debt obligation.

Interpretive response: No. A FCD nonderivative financial liability is eligible to be used as the hedging instrument in a hedge of a net investment in a foreign operation without regard to how the proceeds are used, provided it gives rise to a transaction gain or loss under Topic 830.

Because Parent's debt obligation is denominated in pound sterling, its remeasurement each period to the Parent's functional currency (US dollar) will give rise to a transaction gain or loss. As a result, Parent may designate the debt obligation as a hedging instrument in a net investment hedge of its net investment in the UK subsidiary. [\[815-20-25-66\]](#)



Question 12.3.20

Can FCD variable-rate debt that is the hedging instrument in a net investment hedge be the hedged item in a cash flow hedge of interest rate risk?

Interpretive response: Yes, we believe a FCD variable-rate debt instrument may be designated as the hedging instrument in a net investment hedge and also be the hedged item in a cash flow hedge of interest rate risk.

The cash flow hedge accounting model does not result in adjusting the notional amount of the debt, so the quarterly redesignation (discussed in section 12.2.20) would focus on changes of the net investment balance in assessing the prospective hedged amount.

FASB Example: FCD debt instrument as both hedging instrument and hedged item



Excerpt from Subtopic 815-20

>> Example 10: Foreign-Currency-Denominated Debt Instrument as both Hedging Instrument and Hedged Item

55-127 This Example illustrates the application of paragraph 815-20-55-38.

55-128 A U.S. parent entity (Parent A) with a U.S. dollar (USD) functional currency has a German subsidiary that has the Euro (EUR) as its functional currency. On January 1, 2001, Parent A issues a five-year, fixed-rate EUR-denominated debt instrument and designates that EUR-denominated debt instrument as a hedge of its net investment in the German subsidiary. On the same date, Parent A enters into a five-year EUR-denominated receive-fixed, pay-Euribor-interest rate swap. Parent A designates the interest rate swap as a hedge of the foreign-currency-denominated fair value of the fixed-rate EUR-denominated debt instrument attributable to changes in Euribor interest rates, which is considered the benchmark interest rate for a hedge of the EUR-denominated fair value of that instrument.

55-129 As permitted by paragraph 815-20-55-38, Parent A may designate the EUR-denominated debt instrument as a hedge of its net investment in the German subsidiary and also as the hedged item in a fair value hedge of the debt instrument's foreign-currency-denominated fair value attributable to changes in the designated benchmark interest rate. As a result of applying fair value hedge accounting, the debt's carrying amount will be adjusted to reflect changes in its foreign-currency-denominated fair value attributable to interest rate risk. The notional amount of the debt that is designated as the hedging instrument in the net investment hedge will change over time such that it may not match the notional amount of the hedged net investment. The entity then applies the net investment hedge guidance in Subtopic 815-35 and the fair value hedge guidance in Subtopic 815-25. As discussed in paragraphs 815-35-35-13 through 35-14, because the notional amount of the nonderivative instrument designated as a hedge of the net investment does not match the portion of the net investment designated as being hedged, hedge effectiveness is assessed by comparing the following two values:

- a. The foreign currency transaction gain or loss based on the spot rate change (after tax effects, if appropriate) of that nonderivative hedging instrument
- b. The transaction gain or loss based on the spot rate change (after tax effects, if appropriate) that would result from the appropriate hypothetical nonderivative instrument that has a notional amount that matches the portion of the net investment being hedged. The hypothetical nonderivative instrument also would have a maturity that matches the maturity of the actual nonderivative instrument designated as the net investment hedge.

12.3.20 Counterparty to hedging instrument

A derivative or nonderivative hedging instrument can be with either an unrelated third party or with a related party.

However, an internal derivative cannot be considered a hedging instrument in the consolidated financial statements unless the risk acquired through the internal derivative has been offset with an unrelated third-party derivative contract. That is, the counterparty to the internal derivative (usually a treasury center) is required to enter into an offsetting contract with a third party.

This is because internal derivatives do not offset foreign currency exposure on a consolidated basis. Instead, they merely transfer the exposure from one party to another and may alter the form of the exposure if the functional currencies of the two entities are different. Unless an internal derivative is offset by a contract that transfers the exposure to an unrelated third party, the consolidated exposure has not been offset.

Similarly, an intercompany FCD liability cannot be considered a hedging instrument in the consolidated financial statements unless the counterparty to the FCD liability has entered into an unrelated third-party nonderivative financial instrument that offsets the foreign currency exposure. This requirement is the same as the requirement when using a FCD nonderivative as the hedging instrument to hedge the risk of changes in fair value attributable to changes in a foreign currency exchange rate associated with an unrecognized firm commitment. For further discussion, see section 11.4.60, including Question 11.4.40.

12.3.30 Tandem currency hedges



Excerpt from Subtopic 815-20

>>> Hedging Instruments in Net Investment Hedges

25-69 To designate a derivative instrument as a hedge of a net investment, an entity shall have an expectation that the derivative instrument will be effective as an economic hedge of foreign exchange risk associated with the hedged net investment. Accordingly, if any difference in **notional amount**, currencies, or underlyings is present, the entity shall establish an expectation that the actual derivative instrument designated as the hedging instrument will be effective as an economic hedge.

25-70 For example, if an entity designates a derivative instrument that has an underlying exchange rate involving a currency other than the functional currency of the net investment, that exchange rate shall be expected to move in tandem with the exchange rate between the functional currency of the hedged net investment and the investor's functional currency. Use of a currency different from the exposed currency is not limited to cases in which it is not practical or feasible to hedge in the exposed currency if all other qualifying criteria are met.

As discussed in section 11.3.40 (tandem or cross-currency hedging), an entity is not required to use a derivative instrument denominated in the same foreign currency as the hedged item. Instead, a hedging transaction can involve 'tandem' currencies – i.e. currencies from two different countries that are highly correlated. This is permitted as long as the hedging relationship is expected to be effective as an economic hedge. [815-20-25-33, 815-35-25-69 – 25-70]

See Subtopic 815-20's Example 10 (reproduced in section 12.3.10) for an example of a tandem currency hedge.

12.3.40 Ineligible hedging instruments



Excerpt from Subtopic 815-20

>> Instruments Specifically Ineligible for Designation as Hedging Instruments

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

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

Topic 815 prohibits using a compound derivative or a combined hedging instrument (i.e. a single synthetic instrument) as a hedging instrument. [815-20-25-71(d)]

Compound derivatives



Excerpt from Subtopic 815-20

>>> Hedging Instruments in Net Investment Hedges

25-67 Hedging instruments that are eligible for designation in a net investment hedge include, among others, both of the following:

- a. A receive-variable-rate, pay-variable-rate cross-currency interest rate swap, provided both of the following conditions are met:

1. The interest rates are based on the same currencies contained in the swap.
 2. Both legs of the swap have the same repricing intervals and dates.
- b. A receive-fixed-rate, pay-fixed-rate cross-currency interest rate swap. A cross-currency interest rate swap that has two fixed legs is not a compound derivative instrument and, therefore, is not subject to the criteria in (a).

25-68 A cross-currency interest rate swap that has either two variable legs or two fixed legs has a fair value that is primarily driven by changes in foreign exchange rates rather than changes in interest rates. Therefore, foreign exchange risk, rather than interest rate risk, is the dominant risk exposure in such a swap.

25-68A Under the guidance in paragraph 815-20-25-71(d)(1), a cross-currency interest rate swap with one fixed-rate leg and one floating-rate leg cannot be designated as the hedging instrument in a net investment hedge.

An entity may not use a compound derivative that has multiple underlyings – one based on foreign currency risk and one or more not based on foreign currency risk (e.g. interest rate index, Standard & Poor's 500) – as the hedging instrument in a net investment hedge. [815-20-25-71(d)(1)]

Topic 815 provides the following guidance regarding whether different types of cross-currency interest rate swaps may be used as hedging instruments in a net investment hedge.

Two variable legs or two fixed legs

[815-20-25-67, 25-68]

A receive-variable, pay-variable cross-currency interest rate swap can be designated as the hedging instrument in a net investment hedge if:

- the interest rates are based on the same currencies contained in the swap; and
- both legs of the swap have the same repricing intervals and dates.

A receive-fixed, pay-fixed cross-currency interest rate swap is not a compound derivative and may be designated as the hedging instrument in a net investment hedge. This type of derivative reacts very similarly to a foreign currency forward contract.

These cross-currency interest rate swaps may be used because their fair value is primarily driven by changes in foreign exchange rates rather than changes in interest rates. Therefore, foreign currency risk – rather than interest rate risk – is the dominant risk exposure in such swaps.

One fixed and one variable leg

[815-20-25-68A]

A cross-currency interest rate swap with one fixed-rate leg and one variable-rate leg may not be designated as the hedging instrument in a net investment hedge.

Synthetic hedging instruments



Excerpt from Subtopic 815-20

>>> Synthetic Foreign Currency Borrowing Ineligible as a Hedging Instrument

55-49 A debt instrument denominated in the investor's functional currency and a cross-currency interest rate swap cannot be accounted for as synthetically created foreign-currency-denominated debt to be designated as a hedge of the entity's net investment in a foreign operation.

55-50 For example, a parent entity that has the U.S. dollar (USD) as its functional and reporting currency has a net investment in a Japanese yen- (JPY-) functional-currency subsidiary. The parent borrows in euros (EUR) on a fixed-rate basis and simultaneously enters into a receive-EUR, pay-Japanese yen currency swap (for all interest and principal payments) to synthetically convert the borrowing into a yen-denominated borrowing. The parent entity cannot designate the EUR-denominated borrowing and the currency swap in combination as a hedging instrument for its net investment in the JPY-functional-currency subsidiary.

55-51 An approach that would involve measuring a derivative instrument and a cash instrument as a single unit at the current **spot rate** (which is used in the translation of the hedged net investment) violates the requirements of Subtopic 830-20 for translation of foreign-currency-denominated borrowings at the spot rate relevant to the currency of the borrowing. It also violates the requirements of Subtopic 815-10 for measurement of all derivative instruments at fair value. Accordingly, combining the EUR-denominated borrowing and the currency swap for designation as a single hedging instrument—a JPY-denominated borrowing—in a net investment hedge is not permitted.

55-52 In contrast, an entity could designate a foreign currency derivative instrument and a foreign-currency-denominated cash instrument individually as hedging different portions of its net investment in a foreign operation provided the derivative instrument and the cash instrument each individually qualified as a hedging instrument.

55-53 For example, a JPY-USD forward contract and a JPY-denominated cash instrument could each be designated as the hedging instrument in a hedge of different portions of the net investment in a JPY-functional-currency subsidiary (that is, two separate hedging relationships would be designated).

Topic 815 prohibits considering a separate derivative and a nonderivative financial instrument as a combined hedging instrument (i.e. single synthetic instrument) for hedge accounting purposes. [815-20-25-71(d)(2), 55-49]

This approach is prohibited because it would result in measuring a derivative and a financial instrument as a single unit at the current spot rate (synthetic accounting). This violates the requirements of Topic 830 for remeasurement of FCD debt at the spot rate relevant to the currency of the borrowing. It also violates the requirements of Topic 815 to measure all derivatives at fair value. [815-20-55-51]

However, an entity may designate a foreign currency derivative and a FCD nonderivative financial liability individually as hedging instruments that are hedging different portions of its net investment in a foreign operation. This is permitted if each of the instruments qualifies individually as a hedging instrument. [815-20-55-52]



Example 12.3.10

Eligibility of financial instruments as hedging instruments

The following example is based on paragraphs 815-20-55-50 and 55-3.

Parent has the US dollar as both its functional currency and its reporting currency. It has a net investment in a Japanese subsidiary (Sub J), which has Japanese yen as its functional currency.

Scenario 1: Synthetic fixed-rate, yen-denominated borrowing

Parent has both of the following financial instruments:

- fixed-rate, euro-denominated debt; and
- receive-euros, pay-yen currency swap (for all interest and principal payments on the euro-denominated debt).

As a result of the combination of these financial instruments, Parent has synthetically converted its borrowing into a fixed-rate, yen-denominated borrowing.

Parent is not permitted to designate the synthetic fixed-rate, yen-denominated borrowing as a hedging instrument for its net investment in Sub J.

Scenario 2: Separate forward contract and yen-denominated financial liability

Parent has both of the following:

- yen-US dollar forward contract; and
- yen-denominated nonderivative financial liability.

Each of these financial instruments could be designated as the hedging instrument in a hedge of different portions of the net investment in Sub J (i.e. two separate hedging relationships would be designated), as long as each qualifies individually as a hedging instrument.

12.4 Assessing effectiveness

12.4.10 Overview



Excerpt from Subtopic 815-35

> Assessing Hedge Effectiveness and Measuring Hedge Results

35-4 If a derivative instrument is used as the hedging instrument, an entity may assess the effectiveness of a net investment hedge using either a method based on changes in spot exchange rates (as specified in paragraphs 815-35-35-5 through 35-15) or a method based on changes in forward exchange rates (as specified in paragraphs 815-35-35-17 through 35-26). This guidance can also be applied to purchased options used as hedging instruments in a net investment hedge. However, an entity shall consistently use the same method for all its net investment hedges in which the hedging instrument is a derivative instrument; use of the spot method for some net investment hedges and the forward method for other net investment hedges is not permitted. An entity may change the method that it chooses to assess the effectiveness of its net investment hedges in accordance with paragraphs 815-20-55-55 through 55-56A.

35-4A Hedge effectiveness shall be assessed on a quantitative basis at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(01) unless one of the exceptions in that paragraph applies. Subsequent assessments of hedge effectiveness may be performed either on a quantitative basis or on a qualitative basis in accordance with paragraphs 815-20-35-2 through 35-2F.

To designate a derivative or FCD nonderivative as a hedging instrument in a net investment hedge, the relationship must be expected to be – and actually be – effective as an economic hedge of foreign currency risk associated with the hedged net investment. The entity is required to assess effectiveness of a net investment hedge at least quarterly and whenever financial statements or earnings are reported. [815-20-25-26(e), 815-35-35-27]

At inception, an entity is required to assess effectiveness quantitatively, unless the conditions that will result in perfect effectiveness are met (see sections 12.4.20 and 12.4.30). [815-20-25-3(b)(2)(iv), 815-35-35-5, 35-12]

Subsequently, an entity may assess effectiveness quantitatively, or qualitatively if certain conditions are met. See Questions 13.2.50 regarding whether a quantitative or qualitative method is used when the conditions that will result in perfect effectiveness are met; and section 13.5 for a discussion of the qualitative method. [815-35-35-4A]

Depending on the hedging instrument, an entity may assess effectiveness on a quantitative basis using a method based on either changes in spot exchange rates (the spot method) or changes in forward exchange rates (the forward method). [815-35-35-4]

The following table summarizes these methods as relevant for the categories of hedging instruments.

Hedging instrument category	Effectiveness assessment method(s)
Derivative instrument E.g. a cross-currency interest rate swap, a foreign currency forward contract, purchased option	- Spot method (i.e. intrinsic value method for purchased options) - Forward method (i.e. total value for purchased options) - While either method is appropriate, the same method is required to be

	used for all net investment hedges using derivative hedging instruments. [815-35-35-4]
Nonderivative financial instrument E.g. FCD debt obligation	Spot method [815-35-35-14]

Topic 815 permits hedging foreign currency risk on an after-tax basis, provided that the documentation of the hedge at inception indicated that the assessment of effectiveness will be on an after-tax basis (rather than on a pre-tax basis). [815-20-25-3(b)(2)(vi)]

If an entity has elected to hedge foreign currency risk on an after-tax basis, it must adjust the notional amount of its hedging instrument appropriately to reflect the effect of tax rates. In that case, the hypothetical derivative contract used to assess effectiveness when a hedging relationship is not perfectly effective should have a notional amount that has been appropriately adjusted (pursuant to the documentation at inception) to reflect the effect of the after-tax approach. [815-35-35-26]



Question 12.4.10

Does a change in tax rates affect effectiveness when it is assessed on an after-tax basis?

Interpretive response: Yes. When effectiveness is assessed on an after-tax basis, the notional amount of the hedging instrument must be adjusted to appropriately reflect the effect of tax rates. If tax rates change, the notional amount of a hedging instrument that would result in perfect effectiveness is affected by the change in tax rates.

As a result, if an entity has a hedging relationship that is perfectly effective and tax rates change, the hedging relationship will no longer be perfectly effective unless the entity redesignates the hedging relationship taking into consideration the effect of the changed tax rates.



Example 12.4.10

Adjusting the notional of the hedging instrument when hedging on an after-tax basis

Parent's functional currency is the US dollar. Parent has a wholly owned subsidiary, Sub, whose functional currency is the euro (€). As of January 1, Year 1, Parent has a net investment in Sub of €100 million.

Parent asserts indefinite reinvestment of Sub's foreign earnings and therefore does not provide deferred taxes on its outside basis difference. It does provide deferred taxes on the derivative's unrealized gains and losses because those amounts are not taxable or deductible until realized.

When designating its hedging relationship as of January 1, Year 1, Parent considered its enacted tax rate of 21% and designated a forward contract with a notional amount of €126.6 million [$€100 \text{ million} \div (1 - 21\%)$] to perfectly offset (on an after-tax basis) the foreign currency changes in its €100 million net investment in Sub.

12.4.20 Spot method

An entity may elect to assess effectiveness based on spot rates when the hedging instrument is a derivative. Additionally, this method is used when the hedging instrument is a FCD nonderivative.

Derivative hedging instrument



Excerpt from Subtopic 815-35

>>> Hedging Instrument Is a Derivative Instrument

35-5 The change in the **fair value** of the derivative instrument attributable to changes in the difference between the forward rate and **spot rate** would be excluded from the assessment of hedge effectiveness if all of the following conditions are met:

- The **notional amount** of the derivative instrument designated as a hedge of a net investment in a foreign operation matches (that is, equals) the portion of the net investment designated as being hedged.
- The derivative instrument's underlying exchange rate is the exchange rate between the functional currency of the hedged net investment and the investor's functional currency.
- When the hedging derivative instrument is a cross-currency interest rate swap, it is eligible for designation in a net investment hedge in accordance with paragraph 815-20-25-67.

In that circumstance, the hedging relationship would be considered perfectly effective, and no quantitative effectiveness assessment is required at hedge inception. (See paragraph 815-20-25-3(b)(2)(iv)(01).)

35-5A An entity shall recognize in earnings the initial value of the component excluded from the assessment of effectiveness using a systematic and rational method over the life of the hedging instrument. Any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method shall be recognized in the same manner as a translation adjustment (that is, reported in the cumulative translation adjustment section of other comprehensive income).

35-5B An entity alternatively may elect to record changes in the fair value of the excluded component currently in earnings. This election shall be applied consistently to similar hedges in accordance with paragraph 815-20-25-81.

35-6 The interest accrual (periodic cash settlement) components of qualifying receive-variable-rate, pay-variable-rate and receive-fixed rate, pay-fixed-rate cross-currency interest rate swaps shall also be reported directly in earnings.

35-7 The change in fair value of the derivative instrument attributable to changes in the spot rate shall be reported in the same manner as a translation adjustment (that is, reported in the cumulative translation adjustment section of other comprehensive income).

35-8 The spot-to-spot changes in value reported in the cumulative translation adjustment section of other comprehensive income shall not be discounted.

35-9 The hedging relationship would not be considered perfectly effective, and the guidance in paragraph 815-35-35-10 shall be applied if any of the following conditions exist:

- a. The notional amount of the derivative instrument does not match the portion of the net investment designated as being hedged.
- b. The derivative instrument's underlying exchange rate is not the exchange rate between the functional currency of the hedged net investment and the investor's functional currency.
- c. When the hedging derivative instrument is a cross-currency interest rate swap eligible for designation in a net investment hedge in accordance with paragraph 815-20-25-67, both legs are not based on comparable interest rate curves (for example, pay foreign currency based on the three-month London Interbank Offered Rate [LIBOR], receive functional currency based on three-month commercial paper rates).

35-10 If any of the conditions in paragraph 815-35-35-9 exist, the change in fair value of the hypothetical derivative instrument that does not incorporate those differences shall be compared with the change in fair value of the actual derivative instrument in assessing hedge effectiveness.

35-11 The hypothetical derivative instrument used to assess hedge effectiveness also shall have a maturity and repricing and payment frequencies for any interim payments that match the maturity and repricing and payment frequencies for any interim payments of the actual derivative instrument designated as the hedging instrument in the net investment hedge.

When a derivative instrument is designated as the hedging instrument in a net investment hedge under the spot method, an entity may assume the hedging relationship is perfectly effective if certain conditions are met.

Conditions that will result in perfect effectiveness [815-35-35-5, 35-9]	— The notional amount¹ of the derivative hedging instrument matches (i.e. equals) the portion of the net investment designated as being hedged. — The derivative's underlying exchange rate is the exchange rate between the functional currency of the hedged net investment and the investor's functional currency. — When using the spot method, a non-zero fair value derivative designated as a hedging instrument may be assumed to not affect hedge effectiveness. This approach is consistent with the guidance in 815-35-35-17A to 35-18 regarding net investment hedging relationships that are considered perfectly effective. That is, those paragraphs do not require the derivative hedging instrument to have a zero fair value at hedge designation for the relationship to be perfectly effective.² — If the derivative is a qualifying receive-variable, pay-variable cross-currency interest rate swap, both legs are based on comparable interest rate curves.³
How effectiveness is assessed if the conditions that will result in perfect effectiveness are not met [815-35-35-10 – 35-11]	— If the conditions that will result in perfect effectiveness (above) are <i>not</i> met, an entity must perform initial and subsequent hedge effectiveness assessments using the hypothetical derivative method (see section 13.7.30). — Under this method, the following are compared: — the change in fair value of the actual hedging instrument; and — the change in fair value of a PEH derivative.⁴
Notes: 1. The notional amount is adjusted to reflect the effect of tax rates if effectiveness is assessed and hedge results are measured on an after-tax basis. [815-35-35-26] 2. As discussed in Question 12.4.100, a non-zero fair value due to the derivative hedging instrument being off-market at designation creates some complexity when determining the value of the excluded component (such as when an entity changes from the forward method to the spot method). When an amortization approach is used to recognize the excluded component, any systematic and rational approach that results in the off-market nature being reduced to zero at the end of the hedging relationship generally is acceptable. Nonetheless, an approach designed specifically to take advantage of structuring opportunities to achieve a desired accounting result would not meet the spirit of a systematic and rational approach. 3. See Question 12.4.40 regarding what interest rate curves are considered 'comparable'. 4. The PEH derivative is one that meets conditions for the relationship to be perfectly effective and also has a maturity date, repricing dates and payment frequencies for any interim payments that match the actual derivative hedging instrument. [815-35-35-10 – 35-11]	

Topic 815 permits an entity to exclude forward points of a forward contract (i.e. the spot-forward difference) or time value of an option from its effectiveness assessments when using a derivative as the hedging instrument in a net investment hedge (see also section 13.2.70). In these situations, an entity recognizes the initial value of the excluded component in earnings using either an amortization approach or a mark-to-market approach. [815-35-35-5A – 35-5B]

- **Amortization approach.** The initial value of the excluded component is amortized into earnings using a systematic and rational method over the life of the hedging instrument. The difference between the amortized amount and the change in the excluded component's fair value is recognized in CTA for the period.
- **Mark-to-market approach.** The entire change in fair value of the excluded component is immediately recognized in earnings.

The interest accrual/periodic cash settlement components of qualifying cross-currency interest rate swaps (i.e. the periodic amortization in a cross-currency interest rate swap whose terms are at-market) are reported directly in earnings. [815-35-35-6]

When a hedging relationship is effective as an economic hedge, the change in fair value of the derivative hedging instrument attributable to changes in the spot rate is reported in the same manner as a translation adjustment (i.e. reported in CTA in AOCI). The spot-to-spot changes in value reported in CTA in AOCI should not be discounted. [815-35-35-7 – 35-8]



Question 12.4.20

Can the cross-currency basis spread be an excluded component when a cross-currency interest rate swap is used in a net investment hedge?

Interpretive response: No. While an entity is permitted to exclude the portion of the change in fair value of a currency swap attributable to a cross-currency basis spread in a cash flow or fair value hedge, it cannot be the excluded component for a net investment hedge. [815-20-25-82]

For a cross-currency interest rate swap used in a net investment hedge, only the change in the fair value of the derivative instrument attributable to changes in the difference between the forward rate and the spot rate (spot-forward difference) can be excluded from the assessment of hedge effectiveness. [815-35-35-5]



Question 12.4.30

Where is the effect of the excluded components presented in earnings?

Interpretive response: For net investment hedges, Topic 815 does not specify a required presentation in earnings for excluded components. [815-20-45-1C]

For **fair value** and **cash flow** hedges, Topic 815 requires that excluded components be presented in the same income statement line item in which the earnings effect of the hedged item is presented.

However, the FASB decided not to provide similar guidance for **net investment hedges**. This is because amounts in CTA related to a hedged net investment are not reclassified into earnings until the hedged net investment is sold,

exchanged or liquidated (see section 12.5.20). In contrast, the initial value of the excluded component is recognized in earnings over the life of the hedging instrument (using either an amortization or mark-to-market approach). As a result, requiring the excluded components to be presented together with the earnings effect of the hedged item could result in presentation in an income statement line item such as 'gain or loss on sale of subsidiary' even when that subsidiary has not or will not be sold. [ASU 2017-12.BC131]

Regardless of whether the entity chooses the amortization or mark-to-market approach, we believe an entity should develop a policy for income statement line item presentation for excluded components and apply that policy consistently for all applicable net investment hedges.

For example, many entities present the excluded component for net investment hedges in interest expense.

Nonderivative hedging instrument



Excerpt from Subtopic 815-35

>>> Hedging Instrument Is Not a Derivative Instrument

35-12 The translation gain or loss determined under Subtopic 830-30 by reference to the spot exchange rate between the transaction currency of the debt and the functional currency of the investor (after tax effects, if appropriate) shall be reported in the same manner as the translation adjustment associated with the hedged net investment (that is, reported in the cumulative translation adjustment section of other comprehensive income) if both of the following conditions are met:

- a. The notional amount of the nonderivative instrument matches the portion of the net investment designated as being hedged.
- b. The nonderivative instrument is denominated in the functional currency of the hedged net investment.

In that circumstance, the hedging relationship would be considered perfectly effective, and no prospective quantitative effectiveness assessment is required at hedge inception (see paragraph 815-20-25-3(b)(2)(iv)(01)).

35-13 The hedging relationship would not be perfectly effective if either of the following conditions is met:

- a. The notional amount of the nonderivative instrument does not match the portion of the net investment designated as being hedged.
- b. The nonderivative instrument is denominated in a currency other than the functional currency of the hedged net investment.

35-14 Effectiveness shall be assessed by comparing the following two values:

- a. The foreign currency transaction gain or loss based on the spot rate change (after tax effects, if appropriate) of that nonderivative instrument
- b. The transaction gain or loss based on the spot rate change (after tax effects, if appropriate) that would result from the appropriate hypothetical nonderivative instrument that does not incorporate those differences. The

hypothetical nonderivative instrument shall also have a maturity that matches the maturity of the actual nonderivative instrument designated as the net investment hedge.

When a nonderivative instrument is designated as the hedging instrument in a net investment hedge under the spot method, an entity may assume the hedging relationship is perfectly effective if certain conditions are met.

Conditions that will result in perfect effectiveness [815-35-35-12 – 35-13]	— The principal amount¹ of the nonderivative instrument matches the portion of the net investment designated as being hedged. — The nonderivative instrument is denominated in the functional currency of the hedged net investment.
How effectiveness is assessed if the conditions that will result in perfect effectiveness are not met [815-35-35-14]	— If the conditions that will result in perfect effectiveness (above) are <i>not</i> met, an entity must perform initial and subsequent hedge effectiveness assessments by comparing: — the foreign currency transaction gain or loss of the nonderivative instrument based on the spot rate change (after tax effects, if appropriate); and — the transaction gain or loss based on the spot rate change (after tax effects, if appropriate) that would result from the appropriate hypothetical nonderivative instrument that does meet the conditions that would result in perfect effectiveness and also has a maturity that matches the maturity of the actual nonderivative hedging instrument.
Note: 1. The principal amount is adjusted to reflect the effect of tax rates if effectiveness is assessed and hedge results are measured on an after-tax basis. [815-35-35-26]	

When a hedging relationship is effective as an economic hedge, the foreign currency transaction gain or loss upon remeasurement at the spot rate (after tax effects, if appropriate) is reported in the same manner as the translation adjustment associated with the hedged net investment (i.e. in the CTA in AOCI). [815-35-35-12]



Example 12.4.20 Using the spot method when FCD debt is used to hedge a net investment

Parent's functional currency is the US dollar. Parent has a wholly owned subsidiary, Sub, whose functional currency is the euro (€). As of January 1, Year 1, Parent has a net investment of €10,000,000.

Parent also has a €12,000,000 debt obligation that matures on June 30, Year 1. Parent designates €10,000,000 of this debt obligation to hedge its €10,000,000 net investment.

Parent chooses to apply hedge accounting and formally designates and documents the hedging relationship on January 1, Year 1.

The following additional facts are relevant.

- All criteria for hedge accounting have been met.
- Parent assesses effectiveness based on changes in spot rates and on the balance of the net investment at the beginning of the hedging period. Parent believes that because the hedged amount matches the designated proportion of the debt obligation and the debt obligation is denominated in euros, the hedging relationship will provide an economically effective hedge of its net investment in Sub.
- The spot exchange rates for various dates and changes for remeasurement at the spot rate are as follows.

Date	Spot rate	Translation gain/(loss) on €10,000,000 net investment balance ¹	Remeasurement gain/(loss) on €12,000,000 debt balance ²
January 1, Year 1	€1 = \$0.90	\$ -	\$ -
March 31, Year 1	€1 = \$0.95	500,000	(600, 000)
June 30, Year 1	€1 = \$0.85	(1,000,000)	1,200,000
Notes:			
1. €10,000,000 × (Spot exchange rate at respective date - Spot exchange rate at preceding measurement date).			
2. €(12,000,000) × (Spot exchange rate at respective date - Spot exchange rate at preceding measurement date).			

- Parent's net investment in Sub did not change during the hedging relationship – i.e. Sub's operations were break-even during the period.
- On April 1, Year 1, Parent redesignated this hedging relationship to be for the balance of the net investment at April 1, Year 1 of €10,000,000.

For simplicity, this example ignores the effect of commissions and other transaction costs, initial margins and income taxes.

Journal entries – January 1, Year 1

There is a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship.

Journal entries – March 31, Year 1

Parent records the following journal entries as of March 31, Year 1.

	Debit	Credit
Investment in Sub	500,000	
CTA		500,000
<i>To record change in carrying amount of net investment in Sub due to changes in spot exchange rates from January 1 to March 31.</i>		

	Debit	Credit
CTA	500,000	
Transaction gain / loss	100,000	
Debt obligation		600,000
<i>To record remeasurement of FCD debt obligation to Parent's functional currency at March 31 spot rate.¹</i>		
Note:		
1. The total remeasurement of €12,000,000 is recorded as follows.		
— The remeasurement of €10,000,000 of the debt obligation is recorded in CTA in AOCI because it was designated as hedging the corresponding net investment amount. — The remeasurement of €2,000,000 of the debt obligation is recorded as a transaction gain/loss.		

Journal entries – June 30, Year 1

Parent records the following journal entries as of June 30, Year 1.

	Debit	Credit
CTA	1,000,000	
Investment in Sub		1,000,000
<i>To record change in carrying amount of net investment in Sub due to changes in spot exchange rates from April 1 to June 30.</i>		
Debt obligation	1,200,000	
CTA		1,000,000
Transaction gain / loss		200,000
<i>To record remeasurement of FCD debt obligation to Parent's functional currency at June 30 spot rate.¹</i>		
Note:		
1. The total remeasurement of €12,000,000 of the debt obligation is recorded as follows.		
— The remeasurement of €10,000,000 of the debt obligation is recorded in CTA because it was designated as hedging the corresponding net investment amount. — The remeasurement of €2,000,000 of the debt obligation is recorded as a transaction gain/loss.		

Parent was concerned that the dollar would strengthen relative to the euro and designated a euro-denominated debt obligation as a hedge of its net investment.

As a result of entering into this hedge, Parent was able to offset translation gains and losses on its net investment. This was achieved by recording the Topic 830 remeasurement adjustment on the designated portion of the euro-denominated debt obligation (€10,000,000) in CTA in AOCI to offset the translation adjustment.

Without the designation of the euro-denominated debt obligation as a hedging instrument, the remeasurement adjustment for the debt obligation would have been recorded in earnings, creating foreign exchange volatility in Parent's earnings.

The undesignated portion of the debt obligation (€2,000,000) continued to be remeasured at the spot rate through earnings.

12.4.30 Forward method



Excerpt from Subtopic 815-35

>> Method Based on Changes in Forward Exchange Rates

35-17 Under a method based on changes in forward exchange rates, an entity shall report all changes in fair value of the derivative instrument in the same manner as a translation adjustment (that is, reported in the cumulative translation adjustment section of other comprehensive income), including the following amounts:

- a. The time value component of purchased options
- b. The interest accrual/periodic cash settlement components of qualifying receive-variable-rate, pay-variable-rate and receive-fixed-rate, pay-fixed-rate cross-currency interest rate swaps.

>>> Assessment of Effectiveness

35-17A If the notional amount of the derivative instrument designated as a hedge of a net investment in a foreign operation matches (that is, equals) the portion of the net investment designated as being hedged and the derivative instrument's **underlying** relates solely to the foreign exchange rate between the functional currency of the hedged net investment and the investor's functional currency, the hedging relationship would be considered perfectly effective, and no quantitative effectiveness assessment is required at hedge inception (see paragraph 815-20-25-3(b)(2)(iv)(01)).

35-18 However, the hedging relationship would not be considered perfectly effective if any of the following conditions exist:

- a. The notional amount of the derivative instrument does not match the portion of the net investment designated as being hedged.
- b. The derivative instrument's underlying exchange rate is not the exchange rate between the functional currency of the hedged net investment and the investor's functional currency.
- c. When the hedging derivative instrument is a cross-currency interest rate swap eligible for designation in a net investment hedge in accordance with paragraph 815-20-25-67, both legs are not based on comparable interest rate curves (for example, pay foreign currency based on three-month LIBOR, receive functional currency based on three-month commercial paper rates).

35-19 The assessment of hedge effectiveness due to such differences between the hedging derivative instrument and the hedged net investment considers the following:

- a. Different notional amounts. If the notional amount of the derivative instrument designated as a hedge of the net investment does not match the portion of the net investment designated as being hedged, hedge effectiveness shall be assessed by comparing the following two values:
 1. The change in fair value of the actual derivative instrument designated as the hedging instrument
 2. The change in fair value of a hypothetical derivative instrument that has a notional amount that matches the portion of the net investment being hedged and a maturity that matches the maturity of the actual derivative instrument designated as the net investment hedge. See paragraph 815-35-35-26 for situations in which the hedge of a net investment in a foreign operation is hedging foreign currency risk on an after-tax basis, as permitted by paragraph 815-20-25-3(b)(2)(vi).
- b. Different currencies. If the derivative instrument designated as the hedging instrument has an underlying foreign exchange rate that is not the exchange rate between the functional currency of the hedged net investment and the investor's functional currency (a tandem currency hedge), hedge effectiveness shall be assessed by comparing the following two values:
 1. The change in fair value of the actual cross-currency hedging instrument
 2. The change in fair value of a hypothetical derivative instrument that has as its underlying the foreign exchange rate between the functional currency of the hedged net investment and the investor's functional currency and a maturity and repricing and payment frequencies for any interim payments that match the maturity and repricing and payment frequencies for any interim payments of the actual derivative instrument designated as the net investment hedge.
- c. Multiple underlyings. In accordance with paragraph 815-20-25-67(a), the only derivative instruments with multiple underlyings permitted to be designated as a hedge of a net investment are receive-variable-rate, pay-variable-rate cross-currency interest rate swaps that meet certain criteria. Paragraph 815-20-25-67(b) also permits receive-fixed-rate, pay-fixed-rate cross-currency interest rate swaps to be designated as a hedge of a net investment.

35-20 If a receive-variable-rate, pay-variable-rate cross-currency interest rate swap is designated as the hedging instrument in a net investment hedge, hedge effectiveness shall be assessed by comparing the following two values:

- a. The change in fair value of the actual cross-currency interest rate swap designated as the hedging instrument
- b. The change in fair value of a hypothetical receive-variable-rate, pay-variable-rate cross-currency interest rate swap in which the interest rates are based on the same currencies contained in the hypothetical swap and both legs of the hypothetical swap have the same repricing intervals and dates. The hypothetical derivative instrument also shall have a maturity that matches the maturity of the actual cross-currency interest rate swap designated as the net investment hedge.

35-21 If a receive-fixed-rate, pay-fixed-rate cross-currency interest rate swap is designated as the hedging instrument in a net investment hedge, hedge effectiveness shall be assessed by comparing the following two values:

- a. The change in fair value of the actual cross-currency interest rate swap designated as the hedging instrument
- b. The change in fair value of a hypothetical receive-fixed-rate, pay-fixed-rate cross-currency interest rate swap in which the interest rates are based on the same currencies contained in the hypothetical swap. The hypothetical derivative instrument shall also have a maturity that matches the maturity of the actual cross-currency interest rate swap designated as the net investment hedge.

35-26 Paragraph 815-20-25-3(b)(2)(vi) permits hedging foreign currency risk on an after-tax basis, provided that the documentation of the hedge at its inception indicated that the assessment of effectiveness and measurement of hedge results will be on an after-tax basis (rather than on a pretax basis). If an entity has elected to hedge foreign currency risk on an after-tax basis, it shall adjust the notional amount of its derivative instrument appropriately to reflect the effect of tax rates. In that case, the hypothetical derivative instrument used to assess effectiveness shall have a notional amount that has been appropriately adjusted (pursuant to the documentation at inception) to reflect the effect of the after-tax approach.

When a derivative instrument is designated as the hedging instrument in a net investment hedge, an entity may elect to assess effectiveness based on forward rates rather than spot rates.

When using the forward method, an entity may also assume the hedging relationship is perfectly effective if certain conditions are met.

Conditions for applying this method [815-35-35-17 – 35-26]	— The hedging instrument is a derivative.
Conditions that will result in perfect effectiveness¹ [815-35-35-17A – 35-18]	— The notional amount^{2, 3} of the derivative hedging instrument matches (i.e. equals) the portion of the net investment designated as being hedged. — The derivative's underlying relates solely to the foreign exchange rate between the functional currency of the hedged net investment and the investor's functional currency — If the derivative is a qualifying receive-variable, pay-variable cross-currency interest rate swap, both legs are based on comparable interest rate curves.⁴
How effectiveness is assessed if the conditions that will result in perfect	— If the conditions that will result in perfect effectiveness (above) are <i>not</i> met, an entity must perform initial and subsequent hedge effectiveness assessments using the hypothetical derivative method (see section 13.7.30). — Under this method, the following are compared:

effectiveness are not met [815-35-35-19]	— the change in fair value of the actual hedging instrument. — the change in fair value of a PEH derivative. See below for additional guidance for defining the PEH derivative.
Notes: 1. See Question 12.4.50 regarding whether a hedging relationship can be perfectly effective if a derivative hedging instrument has a non-zero fair value at designation. 2. The notional amount is adjusted to reflect the effect of tax rates if effectiveness is assessed and hedge results are measured on an after-tax basis. [815-35-35-26] 3. See Questions 12.4.60 and 12.4.70 regarding whether leverage has effectively increased the notional amount of a cross-currency interest rate swap, resulting in the notional amount of the derivative instrument not matching the hedged portion of the net investment. 4. See Question 12.4.40 regarding what interest rate curves are considered 'comparable'.	

When the hedging relationship does not meet the conditions to be considered perfectly effective, what is compared when assessing effectiveness depends on the cause of the relationship not being perfectly effective. This is shown in the following table. [\[815-35-35-19 – 35-21\]](#)

Different notional amounts [815-35-35-19(a), 35-26]	Compare: — the change in fair value of the actual hedging derivative; and — the change in fair value of a PEH derivative contract that has a notional amount^{1,2} that matches the portion of the net investment being hedged and that has a maturity that matches that of the actual hedging derivative. Notes: 1. The notional amount is adjusted to reflect the effect of tax rates if effectiveness is assessed and hedge results are measured on an after-tax basis. [815-35-35-26] 2. See Questions 12.4.60 and 12.4.70 regarding whether leverage has effectively increased the notional amount of a cross-currency interest rate swap, resulting in the notional amount of the derivative instrument not matching the hedged portion of the net investment.
Different currencies [815-35-35-19(b)]	Compare: — the change in fair value of the actual hedging derivative; and — the change in fair value of a hypothetical derivative contract that has as its underlying the foreign exchange rate between the functional currency of the hedged net investment and the investor's functional currency; and also that has a maturity date, repricing dates and payment frequencies for any interim payments that match the actual hedging derivative. For example, if a cross-currency interest rate swap with two fixed legs is designated as the hedging derivative but the hedge uses a tandem currency, effectiveness would be assessed by comparing:

	— the change in fair value of the actual cross-currency interest rate swap; and — the change in fair value of a hypothetical receive-fixed, pay-fixed cross-currency interest rate swap based on the functional currencies of the hedged net investment and the investor, with the interest rates based on the same currencies contained in the hypothetical swap. The hypothetical derivative must also have a maturity that matches the maturity of the actual hedging derivative.
Cross-currency interest rate swaps with two variable legs (multiple underlyings) [815-35-35-19(c) – 35-20]	The only derivative with multiple underlyings permitted to be designated as a hedge of a net investment is a cross-currency interest rate swap with two variable legs (see section 12.3.40). If a qualifying receive-variable, pay-variable cross-currency interest rate swap is the hedging instrument, compare: — the change in fair value of the actual cross-currency interest rate swap; and — the change in fair value of a hypothetical receive-variable, pay-variable cross-currency interest rate swap. The hypothetical swap should be based on the functional currencies of the hedged net investment and the investor, with the interest rates based on the same currencies and comparable interest rate curves, and both legs of the hypothetical swap having the same repricing intervals and dates. See Question 12.4.40 regarding which interest rate curves are considered comparable.
Cross-currency interest rate swap with two fixed legs [815-35-35-21]	A cross-currency interest rate swap with two fixed legs is not considered a compound derivative (see section 12.3.40). If a qualifying receive-fixed, pay-fixed cross-currency interest rate swap is the hedging instrument, compare: — the change in fair value of the actual cross-currency interest rate swap; and — the change in fair value of a hypothetical receive-fixed, pay-fixed cross-currency interest rate swap in which the interest rates are based on the same currencies contained in the hypothetical swap and that has a maturity that matches the maturity of the actual hedging derivative.

If the hedging relationship has multiple differences (i.e. different notional amounts, currencies and underlyings), effectiveness can be assessed by a single comparison of the actual hedging derivative to the appropriate hypothetical derivative contract that does not incorporate those differences.



Question 12.4.40

What interest rate curves are considered comparable?

Interpretive response: We believe ‘comparable interest rate curves’ means comparable credit quality curves. Therefore, a US dollar LIBOR and euro LIBOR

index would be comparable, whereas the commercial paper rate and a LIBOR index rate reflect different credit quality.



Question 12.4.50

Can a hedging relationship be perfectly effective if a derivative hedging instrument has a non-zero fair value at designation?

Interpretive response: It depends on the approach to assessing effectiveness. We believe there are two acceptable approaches that an entity may take to assess effectiveness if a derivative hedging instrument has a non-zero fair value at hedge designation. An entity should adopt a policy and apply it on a consistent basis for all hedges of net investments in foreign operations.

Approach 1: The non-zero fair value affects hedge effectiveness, similar to the approach for fair value and cash flow hedges

Under this approach, the entity assesses effectiveness by comparing:

- the change in fair value of the actual hedging derivative; and
- the change in fair value of a hypothetical derivative with similar notional amounts, currencies, and underlyings as the hedged net investment. However in constructing the hypothetical derivative, the underlying rates would be the current market rates at the date of designation such that the hypothetical derivative would have a fair value of zero at the date of designation. This approach would be consistent with the required approaches when the fair value of a hedging instrument in a cash flow or fair value hedging relationship is other than zero on the date of hedge designation.

Approach 2: The non-zero fair value does not affect hedge effectiveness

Under this approach, the non-zero fair value is assumed to not affect hedge effectiveness. This approach is consistent with the guidance in 815-35-35-17A to 35-18 regarding net investment hedging relationships that are considered perfectly effective. That is, those paragraphs do not require the derivative hedging instrument to have a zero fair value at hedge designation for the relationship to be perfectly effective.

In our experience, most entities apply Approach 2 in practice, because it is consistent with the general theory that an entity is required to have an expectation that the derivative will be effective as an economic hedge of foreign currency risk associated with the hedged net investment.



Question 12.4.60

What is the effect on a hedging relationship if the interest rates in a qualifying cross-currency interest rate swap are higher than normal market rates and the forward method is used?

Background: When a qualifying cross-currency interest rate swap (having either two variable or two fixed legs) is designated as the hedging derivative in a net investment hedge, sometimes the terms of the swap are such that the coupons in the two currencies may be at levels higher than normal market rates, but the fair value of the swap at inception is still zero.

For example, a US dollar functional currency entity has a euro-denominated foreign operation and wants to hedge its euro (€) net investment using a €/€ pay-fixed, receive-fixed cross-currency interest rate swap for a notional amount of €100 million/\$113 million.

The normal market terms of the swap may have fixed coupons of 1.5% for euro and 2% for US dollar. The entity may decide to increase the coupon on the receive US dollar leg to 2.5%, and have the pay euro leg of the swap adjusted to an amount higher than 1.5% so that the fair value of the swap at inception is still zero.

Interpretive response: When leverage is added to the coupon rates of the cross-currency swap, it effectively increases the notional amount of the swap. If the swap's notional amount matches the portion of the net investment being hedged, it may appear that the swap meets all the criteria outlined for the hedging relationship to be considered perfectly effective.

However, because the leverage has effectively increased the notional amount of the swap, the notional amount of the derivative instrument does not match the portion of the net investment designated as being hedged. As a result, the relationship cannot be considered to be perfectly effective.



Question 12.4.70

Has leverage been added to coupon rates in a qualifying cross-currency interest rate swap that is designated in a hedge after its initial recognition?

Background: As discussed in Question 12.4.60, leverage may be added to the coupon rates of a swap, resulting in a hedging relationship not being perfectly effective due to having notional amounts that do not match.

Interpretive response: No, we generally do not consider leverage to have been added to the coupon rates of the swap if the rates were market rates at the swap's inception and the swap was not subsequently modified. This is even if the swap is later designated as a hedging derivative after market rates had changed.



Example 12.4.30

Using the forward method when using a foreign currency forward to hedge a net investment

Parent's functional currency is the US dollar. Parent has a wholly owned subsidiary, Sub, whose functional currency is the pound sterling (£). As of January 1, Year 1, Parent has a net investment of £10,000,000.

Parent enters into a six-month forward contract to buy USD and sell the foreign currency. The hedging derivative has the following terms.

- Contract amount: £10,000,000
- Trade date: January 1, Year 1
- Maturity date: June 30, Year 1
- Forward contract rate: £1 = \$1.50

The contract is at market, and therefore no cash is exchanged at inception.

Parent chooses to apply hedge accounting and formally designates and documents the hedging relationship on January 1, Year 1.

The following additional facts are relevant.

- All criteria for hedge accounting have been met.
- Parent elects to assess effectiveness based on changes in the forward rates and on the balance of the net investment at the beginning of the hedging period. Accordingly, all changes in the fair value of the forward contract will be reported in CTA in AOCI because the hedged amount matches the notional amount of the forward contract and the underlying currency of the forward matches Sub's functional currency. For the same reasons, Parent believes the foreign currency forward contract will provide an economically effective hedge of its net investment in Sub.
- The spot and forward exchange rates for various dates, along with the fair value and changes in fair value of the forward contract, are as follows.

Date	Spot rate	Forward rate	Fair value ¹	Changes in fair value
January 1, Year 1	£1 = \$1.475	£1 = \$1.50	\$ - ¹	N/A
March 31, Year 1	£1 = \$1.48	£1 = \$1.55	(493,000) ¹	\$(493,000)
June 30, Year 1	£1 = \$1.45	N/A	500,000 ²	993,000
Notes:				
1. Determined using the change in forward rates discounted at an appropriate discount rate.				
2. £10,000,000 × (\$1.50 - \$1.45).				

- Parent's net investment in Sub was \$14,750,000 as of January 1, Year 1 (£10,000,000 × \$1.475 spot exchange rate).
- Parent's net investment in Sub did not change during the hedging relationship (i.e. Sub's operations were break-even during the period).

- On April 1, Year 1, Parent redesignated this hedging relationship to be for the balance of the net investment at April 1, Year 1 of £10,000,000.
- The foreign currency forward contract settles on June 30, Year 1 with Parent receiving \$500,000.

For simplicity, this example ignores the effect of commissions and other transaction costs, initial margins and income taxes.

Journal entries – January 1, Year 1

There is a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship. The financial records of Parent are not otherwise affected as of this date because the forward contract has a fair value of zero at inception.

Journal entries – March 31, Year 1

Parent records the following journal entries as of March 31, Year 1.

	Debit	Credit
Investment in Sub ¹ CTA <i>To record change in carrying amount of net investment in Sub due to changes in spot exchange rates from January 1 to March 31.</i>	50,000	50,000
CTA Forward contract <i>To record change in fair value of foreign currency forward contract.²</i>	493,000	493,000
Notes: 1. £10,000,000 × (\$1.48 - \$1.475). 2. The amount recorded represents the entire change in fair value of the foreign currency forward contract.		

Journal entries – June 30, Year 1

Parent records the following journal entries as of June 30, Year 1.

	Debit	Credit
CTA Investment in Sub ¹ <i>To record change in carrying amount of net investment in Sub due to changes in spot exchange rates from April 1 to June 30.</i>	300,000	300,000
Forward contract CTA <i>To record change in fair value of foreign currency forward contract.²</i>	993,000	993,000
Cash	500,000	

	Debit	Credit
Forward contract		500,000
<i>To record settlement of foreign currency forward contract.</i>		
Notes:		
1. £10,000,000 × (\$1.45 - \$1.48).		
2. The amount recorded represents the entire change in fair value of the foreign currency forward contract.		

Parent was concerned that the dollar would strengthen relative to the pound sterling and entered into a foreign currency forward contract to hedge its net pound sterling investment.

As a result of entering into this hedge, Parent locked in an exchange rate of £1 = \$1.50. Because the spot exchange rate at the end of the hedge period was £1 = \$1.45, the counterparty paid Parent \$500,000 $[(\$1.50 - \$1.45) \times £10,000,000]$.

During the six months ended June 30, Year 1, Parent recorded a change in its net investment in Sub of \$250,000 and an offsetting change in the fair value of the forward contract of \$500,000 in CTA in AOCI.

The change in fair value of the forward contract exceeded the translation loss by \$250,000. This amount represents the spot-forward difference (forward points) $[(\$1.50 \text{ forward rate} - \$1.475 \text{ spot rate at January 1, Year 1}) \times £10,000,000]$.

12.4.40 Changing the effectiveness assessment method

An entity is permitted to change the method it uses to assess effectiveness of its net investment hedges. Guidance for changing effectiveness assessment methods is discussed in section 13.6.40. [815-35-35-4]



Question 12.4.80

Is an entity permitted to change the method it uses to assess effectiveness of a net investment hedge?

Interpretive response: Yes. An entity using a derivative hedging instrument in a net investment hedge may change from the forward method to the spot method or vice versa, provided that the new method is an improved method for assessing effectiveness (see Question 12.4.90). [815-35-35-4]

In addition, the entity is required to use the new method for all of its net investment hedges. Changing methods involves dedesignating existing hedging relationships and redesignating hedging relationships (see Question 12.4.100). [815-20-55-56]

The ability to change methods is not applicable when a nonderivative hedging instrument is used, because only the spot method is applicable to such hedging relationships (see section 12.4.10).



Question 12.4.90

What does an entity consider in changing its method of assessing effectiveness for a net investment hedge?

Interpretive response: When changing the method of assessing effectiveness, an entity should document its justification for the new method being an improved method for assessing effectiveness.

When making the initial change, the entity establishes that the new method is an improved method. Therefore, it is unlikely that the entity could later support the original method as an improved method because this would contradict the original analysis.

For example, an entity that uses the forward method to assess effectiveness and wants to change to the spot method may be able to justify that the spot method is an improved method. This is because:

- its risk management objective is to hedge the changes in the spot exchange rates arising from the translation of its foreign operation(s); and
- it considers the excluded component as a 'cost of the hedge', which should be recognized ratably in earnings over the term of the hedge.

However, if that same entity wishes to change back to the forward method at a later date, it is unlikely that it could justify the change because this would contradict its original justification.



Question 12.4.100

What does an entity consider when it dedesignates and redesignates a net investment hedge?

Interpretive response: If an entity uses a derivative hedging instrument, it is likely that the derivative hedging instrument will have a non-zero fair value (i.e. be off-market) at redesignation. The non-zero fair value of the derivative instrument creates some complexity when determining the value of the excluded component at the time of redesignation.

If an entity changes from the forward method to the spot method, and it elects to subsequently amortize the excluded component (the spot-forward difference) using the amortization approach, it will have to develop an appropriate methodology at the date of redesignation to determine the value of the excluded component (the spot-forward difference) that subsequently is amortized. [815-35-35-5 – 35-5A]

In a February 2018 FASB meeting, the FASB discussed appropriate methodologies for amortizing the excluded component, including the off-market

element of a derivative instrument that could occur at the time of redesignation. The FASB agreed that an appropriate amortization method would not violate the guidance in paragraphs 815-35-35-6 to 35-7, meaning that at the end of the hedging relationship only amounts of the derivative related to the changes in spot exchange rates over the hedge term on the notional amount of the net investment should remain in CTA in AOCI. Therefore any systematic and rational approach that results in the off-market nature of the swap being reduced to zero at the end of the hedging relationship is acceptable.

The FASB further clarified that any approach that is designed specifically to take advantage of structuring opportunities to achieve a desired accounting result does not meet the spirit of a systematic and rational approach. For example, if an entity deliberately enters into an off-market derivative to amortize the off-market amount into interest income to achieve a desired accounting result, the entity would have to use the terms of an at-market derivative to determine the appropriate amortization of the excluded component.

12.4.50 Counterparty credit risk and entity's own nonperformance risk

An entity is required to consider the effects of counterparty credit risk and the entity's own nonperformance risk when assessing hedging relationships.

The potential effect of counterparty credit risk (and an entity's own nonperformance risk) on a net investment hedging relationship's effectiveness as an economic hedge is ignored unless it is no longer probable that the derivative counterparty or the entity itself will *not* default.

However, if non-default by either party is no longer probable, an entity will be required to assess whether the hedging relationship has been and is expected to continue to be effective as an economic hedge. If an entity continues to expect the relationship to be effective as an economic hedge, strong evidence supporting the expectation would be needed.

See further discussion of considerations related to counterparty credit (and an entity's own nonperformance) risk and related to credit risk adjustments determined at a portfolio level in section 13.2.60.

12.5 Accounting for net investment hedges

12.5.10 Overview



Excerpt from Subtopic 815-20

35-1 Paragraph 815-10-35-2 states that the accounting for subsequent changes in the **fair value** (that is, gains or losses) of a **derivative instrument** depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Specifically, subsequent

gains and losses on derivative instruments shall be accounted for as follows:
...

- d. Net investment hedge. The gain or loss on the hedging derivative or nonderivative hedging instrument in a hedge of a net investment in a foreign operation shall be reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment, as provided in paragraph 815-20-25-66. If an entity excludes a portion of the hedging instrument from the assessment of hedge effectiveness in accordance with paragraphs 815-35-35-5 through 35-5B, the initial value of the excluded component shall be recognized in earnings using a systematic and rational method over the life of the hedging instrument. Any difference between the change in fair value of the excluded component and the amounts recognized in earnings under that systematic and rational method shall be recognized in the same manner as a translation adjustment (that is, reported in the cumulative translation adjustment section of other comprehensive income) in accordance with paragraph 815-35-35-5A. An entity also may elect to recognize the excluded component of the gain or loss currently in earnings in accordance with paragraph 815-35-35-5B.

> Income Statement Classification

45-1C For qualifying net investment hedges, an entity shall present in the same income statement line item that is used to present the earnings effect of the hedged net investment those amounts reclassified from accumulated other comprehensive income to earnings. This Subtopic provides no guidance on the required income statement classification of amounts excluded from the assessment of effectiveness in net investment hedges.

45-1D While the Derivatives and Hedging Topic does not specify whether certain income statement line items are either permitted or appropriate, the other hedging-related Subtopics in this Topic do contain specific disclosure requirements for those items. See Section 815-10-50 and Subtopics 815-25, 815-30, and 815-35.

> Statement of Cash Flows

45-2 For guidance on the classification of cash receipts and payments related to hedging activities, see paragraph 230-10-45-27.



Excerpt from Subtopic 815-35

> Overall

35-1 The gain or loss on a hedging **derivative instrument** (or the foreign currency transaction gain or loss on the nonderivative hedging instrument) that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation shall be reported in the same manner as a translation adjustment (that is, reported in the cumulative translation adjustment section of **other comprehensive income**).

35-2 The hedged net investment shall be accounted for consistent with Topic 830. The provisions of Subtopic 815-25 for recognizing the gain or loss on assets designated as being hedged in a **fair value hedge** do not apply to the hedge of a net investment in a foreign operation.

35-3 If an entity has designated and documented that it will assess effectiveness and measure hedge results on an after-tax basis as permitted by paragraph 815-20-25-3(b)(2)(vi), the portion of the gain or loss on the hedging instrument that exceeded the loss or gain on the hedged item shall be included as an offset to the related tax effects in the period in which those tax effects are recognized.

When a net investment is translated into the entity's reporting currency, the effects of translation are recognized in CTA in AOCI. When the net investment is designated in a hedge that is effective as an economic hedge, changes in the fair value of a hedging derivative instrument (or foreign currency transaction gains or losses of a FCD nonderivative hedging instrument) are also recognized in CTA in AOCI (other than excluded components). [815-35-35-1 – 35-2]

When the hedging instrument is a derivative and the spot method is used, an entity excludes forward points (i.e. the spot-forward difference) from its effectiveness assessments. In these situations, an entity recognizes the initial value of the excluded component in earnings using either an amortization approach or a mark-to-market approach. See further discussion in sections 12.4.20 (derivative hedging instruments) and 13.2.70. [815-35-35-5A – 35-5B]

When the forward method is used, changes in the hedging derivative instrument's fair value that are included in CTA in AOCI include the time value component of purchased options or forwards, or the interest accrual/periodic cash settlement components of qualifying cross-currency interest rate swaps. [815-35-35-17]

If an entity elects to assess effectiveness on an after-tax basis, the portion of the gain or loss on the hedging instrument that exceeds the loss or gain on the hedged net investment is included as an offset to the related tax effects in the period in which those tax effects are recognized. [815-35-35-3]

Amounts in CTA in AOCI – including amounts related to excluded components – generally remain in CTA until the hedged foreign entity is sold, exchanged or liquidated (see section 12.5.20). However, amounts in CTA are considered as part of the carrying amount when assessing impairment of a foreign operation if an entity has committed to a plan that will cause the CTA related to the foreign operation to be reclassified into earnings (see section 12.5.30).



Example 12.5.10 Recognizing amounts in CTA

On January 1, Year 1, Parent enters into a six-month foreign currency forward contract to sell FC1,000. This contract is designated as a hedge of the foreign currency exposure in its net investment of Subsidiary. The net investment in Sub balance at January 1, Year 1 is FC1,000.

At March 31, Year 1, the net investment balance has declined to FC800.

For the quarter ended March 31, Year 1, the entire change in fair value of the foreign currency forward contract is reflected in CTA because the entire contract was designated and deemed effective as a hedge of the beginning balance of the net investment.

12.5.20 Subsequent accounting for amounts in CTA



Excerpt from Subtopic 830-30

> Sale or Liquidation of an Investment in a Foreign Entity

40-1 Upon sale or upon complete or substantially complete liquidation of an investment in a **foreign entity**, the amount attributable to that entity and accumulated in the translation adjustment component of equity shall be both:

- a. Removed from the separate component of equity
- b. Reported as part of the gain or loss on sale or liquidation of the investment for the period during which the sale or liquidation occurs.

40-1A A sale shall include:

- a. The loss of a controlling financial interest in an investment in a foreign entity resulting from circumstances contemplated by Subtopic 810-10 (see paragraph 810-10-55-4A for related implementation guidance)
- b. An acquirer obtaining control of an acquiree in which it held an equity interest, accounted for as an equity method investment that is a foreign entity, immediately before the acquisition date in a business combination achieved in stages (see paragraphs 805-10-25-9 through 25-10).

>> Partial Sale of Ownership Interest

40-2 If a **reporting entity** sells part of its ownership interest in an equity method investment that is a foreign entity, a pro rata portion of the accumulated translation adjustment component of equity attributable to that equity method investment shall be recognized in measuring the gain or loss on the sale. If the sale of part of an equity method investment that is a foreign entity results in the loss of significant influence, see paragraphs 323-10-35-37 through 35-39 for guidance on how to account for the pro rata portion of the accumulated translation adjustment component of equity attributable to the remaining investment. For guidance if an entity sells a noncontrolling interest in a consolidated foreign entity, but still retains a controlling financial interest in the foreign entity, see paragraph 810-10-45-23 through 45-24.

40-3 Although partial liquidations by a parent of net assets held within a foreign entity may be considered similar to a sale of part of an ownership interest in the foreign entity if the liquidation proceeds are distributed to the parent, extending pro rata recognition (release of the cumulative translation adjustment into net income) to such partial liquidations would require that their substance be distinguished from ordinary dividends. Such a distinction is neither possible nor desirable. For those partial liquidations, no cumulative translation

adjustment is released into net income until the criteria in paragraph 830-30-40-1 are met.

40-4 Under Subtopic 220-20, a gain or loss on disposal of part or all of a net investment may be recognized in a period other than that in which actual sale or liquidation occurs. Paragraph 830-30-40-1 does not alter the period in which a gain or loss on sale or liquidation is recognized under existing generally accepted accounting principles (GAAP).

Amounts recorded in CTA in AOCI as a result of applying net investment hedge accounting are subsequently accounted for in the same manner as translation adjustments. Those adjustments do not affect reporting currency cash flows until the respective foreign entity is sold, exchanged or liquidated. They can be viewed as unrealized gains or losses; therefore, they are not reported as part of the results of operations – but rather in CTA – until realized on sale, exchange, or liquidation of the foreign entity. [815-35-35-1, 830-30-40-1 – 40-3]

The following table summarizes the accounting for amounts in CTA in AOCI upon sale, exchange or liquidation of a hedged net investment.

Nature of net investment in foreign operation	Accounting for amounts recorded in CTA (including amounts related to the excluded component) upon sale, exchange or liquidation
Consolidated investment	Complete sale or substantial liquidation of investment in foreign entity - Amount recorded in CTA is reported in the income statement as part of the gain or loss on sale or liquidation of the investment. Sale of part of investment in foreign entity Controlling financial interest is retained. Sale is accounted for as an equity transaction with a pro rata portion of CTA related to the interest sold transferred to noncontrolling interest. Controlling financial interest is <i>not</i> retained. Entire amount recorded in CTA related to the investment is reported in the income statement as part of the gain or loss on sale, even if significant influence is retained. Other events leading to loss of control of investment in foreign entity - Entire amount recorded in CTA related to the investment is reported in the income statement as part of the gain or loss if the foreign entity (1) is a business and (2) is not in-substance real estate. Sale of foreign entity's net assets¹ Sale represents complete or substantially complete liquidation. Entire amount recorded in CTA related to the investment is reported in the income statement as part of the gain or loss on sale. Sale does <i>not</i> represent complete or substantially complete liquidation. No amount of CTA is released into earnings.

Nature of net investment in foreign operation	Accounting for amounts recorded in CTA (including amounts related to the excluded component) upon sale, exchange or liquidation
	Exchange of investments in foreign entities — The transaction's specific facts and circumstances must be evaluated to determine the appropriate accounting for the amount recorded in CTA.
Equity method investment	Complete sale or substantial liquidation — Related portion of CTA is reported in the income statement as part of the gain or loss on sale or liquidation of the investment. Sale of part of investment — Pro rata portion of CTA related to the interest sold is reported in the income statement as part of the gain or loss on sale. — If significant influence is not retained after the sale, the pro rata portion of CTA related to the portion of investment that is not sold is offset against the carrying amount of the investment. To the extent the offset results in a carrying amount less than zero (i.e. the remaining CTA balance is a credit amount greater than the cost basis of the investment)), the carrying amount is reduced to zero and the remaining amount is recorded in earnings. Exchange of investments in foreign entities — The transaction's specific facts and circumstances must be evaluated to determine the appropriate accounting for the amount recorded in CTA.
Note: 1. For purposes of this discussion, the concept of net asset groups includes subsidiaries but does not include subsidiaries or net assets that represent in-substance real estate or oil- and gas-producing activities. For guidance on transactions related to subsidiaries or net assets that represent in-substance real estate or oil- and gas-producing activities, see Topics 360 (property, plant and equipment) and 932 (oil and gas), respectively.	

See paragraphs 4.036 to 4.054 in KPMG Handbook, [Foreign currency](#), for additional guidance on the accounting for translation adjustments upon the sale, exchange or liquidation of an investment in a foreign entity, including guidance on how 'substantial liquidation' is interpreted.

12.5.30 Assessing impairment



Excerpt from Subtopic 830-30

>>> Consideration of Cumulative Translation Adjustment in Impairment Tests

45-13 An entity that has committed to a plan that will cause the cumulative translation adjustment for an equity method investment or a consolidated investment in a foreign entity to be reclassified to earnings shall include the cumulative translation adjustment as part of the carrying amount of the investment when evaluating that investment for impairment. The scope of this guidance includes an investment in a foreign entity that is either consolidated by the reporting entity or accounted for by the reporting entity using the equity method. This guidance does not address either of the following:

- a. Whether the cumulative translation adjustment shall be included in the carrying amount of the investment when assessing impairment for an investment in a foreign entity when the reporting entity does not plan to dispose of the investment (that is, the investment or related consolidated assets are held for use)
- b. Planned transactions involving foreign investments that, when consummated, will not cause a reclassification of some amount of the cumulative translation adjustment.

45-14 In both cases, paragraph 830-30-40-1 is clear that no basis exists to include the cumulative translation adjustment in an impairment assessment if that assessment does not contemplate a planned sale or liquidation that will cause reclassification of some amount of the cumulative translation adjustment. (If the reclassification will be a partial amount of the cumulative translation adjustment, this guidance contemplates only the cumulative translation adjustment amount subject to reclassification pursuant to paragraphs 830-30-40-2 through 40-4.)

45-15 An entity shall include the portion of the cumulative translation adjustment that represents a gain or loss from an effective hedge of the net investment in a foreign operation as part of the carrying amount of the investment when evaluating that investment for impairment.

When an entity has committed to a plan to dispose of a hedged foreign operation that will cause the related CTA in AOCI attributable to that operation to be reclassified to earnings, the entity should include the CTA as part of the carrying amount of the investment when evaluating that investment for impairment. This includes the portion of the CTA that resulted from applying hedge accounting. [830-30-45-13 – 45-15]

See paragraph 4.035 in KPMG Handbook, [Foreign currency](#), for additional guidance about accounting for translation adjustments when assessing impairment.

12.5.40 Discontinuing hedge accounting



Excerpt from Subtopic 815-35

> Discontinuing Hedge Accounting

>> Amounts Excluded from the Assessment of Effectiveness under an Amortization Approach

40-1 When applying the guidance in paragraph 815-35-35-5A and a hedge is discontinued, any amounts that have not yet been recognized in earnings shall remain in the cumulative translation adjustment section of accumulated other comprehensive income until the hedged net investment is sold or liquidated in accordance with paragraphs 830-30-40-1 through 40-1A.

Hedge accounting is discontinued prospectively if any one of the following events occurs.

Change in eligibility or critical terms of hedged item (net investment in foreign operation) (section 6.10.20)	— Hedged item no longer meets the eligibility criteria (see section 12.2). — Complete sale or substantial liquidation of foreign operation (see section 12.5.20). — Other events leading to a loss of control of the investment in foreign entity (see section 12.5.20). — Partial sale of investment in foreign operation (see section 12.5.20). — Changes in the net investment balance should be monitored to determine whether the hedging relationship should be redesignated to reflect a revised balance (see section 12.2.20).
Change in eligibility or critical terms of hedging instrument (section 6.10.30)	— Hedging instrument no longer meets the eligibility criteria (see section 12.3). — Hedging instrument expires or is sold, terminated or exercised. — Modification of hedging instrument such that critical terms of the original hedging relationship have changed.
Change in the hedged risk (section 6.10.40)	— Change in the hedged risk. [815-20-55-56]
Change in hedge effectiveness (section 6.10.50)	— Hedging relationship is no longer effective as an economic hedge (see below). — Change in the effectiveness assessment method, including changing from forward method to spot method, or vice versa (see section 12.4.40). [815-20-55-56]
Elective dedesignation	An entity may elect to discontinue the hedging relationship (see sections 12.2.20 and 6.10).

Amounts in CTA in AOCI related to a discontinued hedging relationship – including amounts related to excluded components – remain in CTA until the hedged net investment is sold, exchanged or liquidated (see section 12.5.20). [815-35-35-1, 40-1]

Hedged net investment. When hedge accounting is discontinued, the entity may designate prospectively the previously hedged net investment in a new

hedging relationship with a different hedging instrument as long as the hedging criteria are met for the new relationship (see section 12.2.20).

Hedging instrument. The accounting for the hedging instrument after a hedging relationship is discontinued depends on whether the instrument is a derivative or nonderivative.

- **Derivative hedging instrument.** A derivative hedging instrument that remains outstanding continues to be recorded in the balance sheet at fair value. However, changes in its fair value (including changes in excluded components) are reflected in earnings – rather than CTA – unless it is designated as the hedging instrument in a new cash flow or net investment hedge.
- **Nonderivative hedging instrument.** Foreign currency transaction gains or losses on a FCD nonderivative financial instrument that is no longer designated as a hedging instrument are recognized in earnings – rather than CTA – unless it is designated as the hedging instrument in a new net investment hedge.

Hedging relationship is no longer effective as an economic hedge

If an entity's hedge effectiveness assessment indicates that a hedging relationship is no longer highly effective, the hedging relationship is discontinued prospectively. In that case, generally no changes in the fair value of a derivative hedging instrument (or transaction gains or losses of a nonderivative hedging instrument) are recognized in CTA after the last date on which effectiveness testing indicated the relationship was effective as an economic hedge.



Question 12.5.10

Is hedge accounting applied through the date an event causes a hedging relationship to no longer be effective as an economic hedge?

Background: If in a **fair value hedge** an event or change in circumstances results in the hedging relationship not being retrospectively highly effective for the current period and the date that event or change in circumstances occurred can be identified, the entity must apply fair value hedge accounting through that date (see section 8.5.20). Topic 815 does not contain similar language for cash flow or net investment hedges. [815-25-40-4]

Based on discussions with the FASB staff, we believe **cash flow hedge** accounting should be applied through the date of such an event or change (see Question 10.5.30).

Interpretive response: Yes. We believe that when a hedging relationship was not effective as an economic hedge at the current assessment date, the entity generally should discontinue hedge accounting and should not recognize

changes in the fair value of the hedging derivative (or remeasurement gains or losses of a FCD liability) in CTA in AOCI for that assessment period.

However, if the entity is able to identify the event or change in circumstances that resulted in the hedging relationship being discontinued, the entity must apply hedge accounting up to the date of that event or change in circumstances. All subsequent changes in fair value of the derivative (and remeasurement gains or losses of a FCD liability) that occurred from that date to the current assessment date are reported in earnings.

13. Hedge effectiveness

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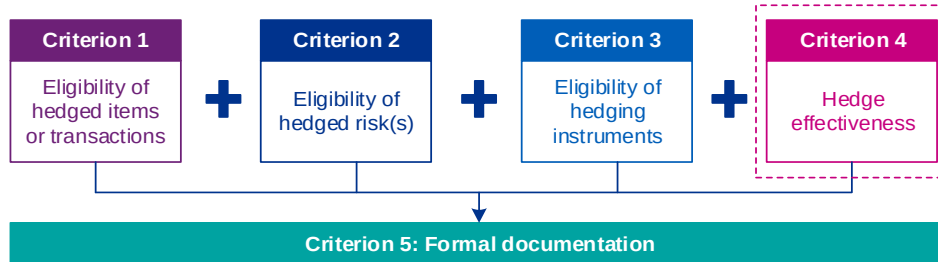
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13.8 Examples of effectiveness assessment methods relevant to various hedging instruments

13.9 Comparison of methods for assessing effectiveness

13.1 How the standard works

Throughout this chapter, PEH means perfectly effective hypothetical (derivative).



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

- For a **prospective** assessment, the entity evaluates whether the hedging relationship is expected to be highly effective.
- For a **retrospective** assessment, the entity evaluates whether the hedging relationship has actually been highly effective.

The following diagram summarizes how effectiveness is assessed.



Quantitative vs qualitative. Topic 815 requires the initial (prospective) assessment to be performed on a quantitative basis unless the hedging relationship meets certain conditions. Subsequent assessments may be performed on a quantitative basis, or on a qualitative basis if certain conditions are met (see section 13.5).

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

- shortcut method (section 13.3);
- critical terms match method (section 13.4); and
- simplified hedge accounting approach, which is available for private companies that are not financial institutions (section 16.2).

An entity is generally required to apply the same method for assessing effectiveness to similar hedging relationships (see section 13.2.80).

This chapter discusses the general requirements for assessing hedge effectiveness and the specific requirements for various assessment methods. It also explains some additional considerations that affect the assessments, including the following.

- **Excluded components.** Improving hedge effectiveness by excluding certain components of the hedging instrument (e.g. the time value of an option) from effectiveness assessments. Excluding a component improves hedge effectiveness when the hedged item's fair value (or hedged transaction's cash flows) is not affected by (or not affected to the same extent as) the component (see section 13.2.70).
- The effects of **counterparty credit risk and the entity's own nonperformance risk** when assessing hedging relationships. These considerations are different, depending on whether the hedging relationship is a cash flow, fair value, or net investment hedge and on the method used for assessing effectiveness (see section 13.2.60).

If a hedge was not highly effective in a period, hedge accounting is not applied for that period. Additionally, if an entity can no longer support its expectation of high effectiveness, hedge accounting is discontinued prospectively (see section 6.10.50).



Observation**

Optional expedients available in Topic 848

The guidance in this chapter does not consider the optional expedients that may be available in Topic 848 (reference rate reform) for hedging relationships that reference LIBOR or a reference rate that is expected to be discontinued. See 'Optional expedients available in Topic 848' in chapter 6 for discussion of expedients to hedge accounting that are not specific to a particular type of hedging relationship, chapter 7 for expedients specific to fair value hedges, and chapter 9 for expedients specific to cash flow hedges.

The key provisions of the optional expedients related to hedge effectiveness are summarized below.

Fair value hedges

An entity may elect to continue to apply the shortcut method for existing fair value hedging relationships without regard to whether the conditions in paragraph 815-20-25-104(d) and 25-104(g) are met. [\[848-40-25-8\]](#)

Changing the designated method of assessing effectiveness for a cash flow hedge

An entity may elect to change the method of assessing hedge effectiveness that was documented at hedge inception for a cash flow hedge if both of the following conditions are met: [\[848-30-25-8\]](#)

- the hedging instrument or forecasted transaction in a hedging relationship references a rate in the scope of Topic 848; and
- the new method of assessing hedge effectiveness is an optional expedient method available in Subtopic 848-50.

Assessment of hedge effectiveness for cash flow hedges

For cash flow hedges for which either the hedged forecasted transaction or the hedging instrument references a rate that is in the scope of Topic 848, an entity

may elect optional expedients to disregard certain of the conditions in Topic 815 when performing initial or subsequent assessment of hedge effectiveness when one of the following methods is used: [848-50-25-4 – 25-10, 848-50-35-4 – 35-9]:

- shortcut method;
- terminal value method;
- simplified hedge accounting for private companies;
- change-in-variable-cash-flows method; and
- hypothetical derivative method.

Additionally, if certain criteria are met, an entity may elect an optional expedient and qualitatively assess cash flow hedges on an ongoing basis after an initial assessment of hedge effectiveness is completed using a method in Topic 815 or an optional expedient in Topic 848. [848-50-35-10, 35-13]

If an entity performs subsequent assessments of hedge effectiveness for a cash flow hedge using a quantitative method, an entity may, when performing that assessment, alter certain of the terms of the hedged forecasted transaction to match the hedging instrument as long as either the hedging instrument or the hedged forecasted transaction reference a rate in the scope of Topic 848. [848-50-35-17(b)]

An entity discontinues the use of the optional expedients described above for assessing subsequent hedge effectiveness for a cash flow hedge and reverts to applying the qualifying criteria and hedge assessment methods in Topic 815 to assess whether hedge accounting may continue for subsequent reporting periods if: [848-50-35-19]

- neither the hedged item nor the hedging instrument reference a rate that is in the scope of Topic 848;
- the guidance in Topic 848 is superseded; or
- an entity elects to stop applying the applicable optional expedient.

Discontinuing the use of an optional expedient to subsequently assess hedge effectiveness (i.e. changing the hedge assessment method) for a cash flow hedge does not automatically result in the dedesignation of the hedging relationship. However, hedge accounting is discontinued prospectively if the hedging relationship does not qualify for hedge accounting when applying a hedge assessment method in Topic 815. [848-50-35-23 – 35-24]

13.2 General requirements for assessing effectiveness

13.2.10 Overview



Excerpt from ASC 815-20

> Hedge Effectiveness

25-73 Sections 815-25-55 and 815-30-55 illustrate some ways in which an entity may assess hedge effectiveness for specific strategies. The Examples are not intended to imply that other reasonable methods are precluded. However, not all possible methods are reasonable or consistent with this

Subtopic. Those Sections also discuss some methods of assessing hedge effectiveness that are not consistent with this Subtopic and thus may not be used.

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-74 This guidance addresses hedge effectiveness criteria applicable to both fair value hedges and cash flow hedges.

25-75 To qualify for hedge accounting, the hedging relationship, both at inception of the hedge and on an ongoing basis, shall be expected to be highly effective in achieving either of the following:

- a. Offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated (if a fair value hedge)
- b. Offsetting cash flows attributable to the hedged risk during the term of the hedge (if a cash flow hedge), except as indicated in paragraph 815-20-25-50.

25-77 There would be a mismatch between the change in fair value or cash flows of the hedging instrument and the change in fair value or cash flows of the hedged item or hedged transaction in any of the following circumstances, among others:

- a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction, to the extent that those bases do not move in tandem
- b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in any of the following:
 1. Notional amounts
 2. Maturities
 3. Quantity
 4. Location (not applicable for hedging relationships in which the variability in cash flows attributable to changes in a contractually specified component is designated as the hedged risk)
 5. Delivery dates.
- c. A change in the counterparty's creditworthiness

25-78 Paragraph 815-20-55-62 discusses basis differences in cash flow hedges of interest rate risk.

Assessing effectiveness means determining the degree to which the change in fair value or cash flows of the hedged item attributable to the risk being hedged has been and is expected to continue to be offset by the change in the fair value or cash flows of the derivative hedging instrument that are included in the assessment of effectiveness. This assessment can be expressed in terms of a percentage of offset and the percentage should be within the range of 80%–125% (see section 13.2.40). [\[815-20-25-75\]](#)

As discussed in section 6.8, hedge accounting is applied only if the hedging relationship is expected to be (and actually is) highly effective. [\[815-20-25-75\]](#)

Fair value hedge	Cash flow hedge
Gains or losses on the derivative hedging instrument that are included in the assessment of effectiveness are expected to be – and actually are – highly effective at offsetting changes in the fair value of the hedged item attributable to the designated hedged risk.	Gains or losses on the derivative hedging instrument that are included in the assessment of effectiveness are expected to be – and actually are – highly effective at offsetting changes in the cash flows of the hedged transaction attributable to the designated hedged risk.

For **net investment hedges**, hedge accounting is applied only if the hedging relationship is effective as an economic hedge (see section 12.4).

Topic 815 does not prescribe methods that must be used for assessing hedge effectiveness. Rather, it requires that the method used be reasonable and consistent with the risk management strategy; this means that the assessment is required to be performed in a manner that is consistent with the documented risk management objective (see section 13.2.30). Moreover, it generally requires an entity to assess effectiveness for similar hedges in a similar manner (see section 13.2.80).

To determine if a hedging relationship is both expected to be (prospectively will be) and actually is (retrospectively has been) highly effective, an entity performs effectiveness assessments both at inception of the hedging relationship and periodically thereafter (at least quarterly). The initial assessment is required to be quantitative, unless certain conditions are met (see Question 13.2.50). The subsequent assessments may be quantitative (see section 13.6) or qualitative if certain conditions are met (see section 13.5).

The assessment process can be complex. For example, an entity is required to consider the effect of counterparty credit risk (its own nonperformance risk) on the hedging relationship (see section 13.2.60). Additionally, an entity must select a period over which to assess effectiveness, which may result in an entity assessing effectiveness more frequently than quarterly (see section 13.2.50). Moreover, there are additional considerations:

- when using **options** as hedging instruments (see section 13.2.90);
- for **fair value hedges** related to prepayment risk under the last-of-layer method (section 13.2.100); and
- for **cash flow hedges** related to time value of money (see section 13.2.110).

Topic 815 streamlines the assessment process for certain hedging relationships by providing three methods that assume a hedging relationship is perfectly effective, each of which has specific criteria that must be met:

- shortcut method (see section 13.3)
- critical terms match method (see section 13.4)
- simplified hedge accounting approach, which is available for private companies that are not financial institutions (see section 16.2).

Topic 815 also permits an entity to exclude some components of the hedging instrument from the effectiveness assessment to increase the likelihood that the hedging relationship will be highly effective (see section 13.2.70).

Hedging relationships that are not perfectly effective

Some hedging relationships are not designed to be perfectly effective but nonetheless can be highly effective. A hedging relationship will not be perfectly effective in any of the following situations – i.e. there will be a mismatch between the change in fair value or cash flows of the hedging instrument and the change in fair value or cash flows of the hedged item or transaction. [815-20-25-77]

Basis difference exists

[815-20-25-77(a)]

A basis difference is a difference between the basis that drives the variability in cash flows of the hedging instrument and the hedged item or hedged transaction; for example, a difference between a contractually specified interest rate in existing variable-rate debt and the index on which cash flows of the variable leg of an interest rate swap are determined. [815-20-25-78, 55-62]

% Interest rate risk. See also section 6.3.40 regarding basis differences in cash flow hedges of interest rate risk.

Other critical terms do not match

[815-20-25-77(b)]

Other critical terms do not match (i.e. the critical terms of the hedging instrument and the hedged item or transaction do not match), including differences in notional amounts, maturities, payment dates, quantity, location, and delivery dates.

Cash flow hedge. The location is not a critical term in a cash flow hedge of a contractually specified component.

Changes in creditworthiness

[815-20-25-77(c)]

See section 13.2.60 regarding consideration of a counterparty's credit risk and the entity's own nonperformance risk.

Fair value hedges. Changes in both counterparty credit risk and an entity's own nonperformance risk affect the measurement of changes in the fair value of the derivative hedging instrument. These changes likely have no offsetting effect on changes in the measurement of the hedged item attributable to the hedged risk.

Additional items affecting the measurement of the hedging instrument

- There are additional items that affect the measurement of the hedging instrument's fair value or cash flows that affect the hedged item or transaction differently (or not at all).
- For example:
 - In a fair value hedge, the effect of credit risk on the measurement of fair value may be different between the hedged item and hedging instrument. For example, in a hedge of the changes in fair value of a recognized fixed-rate liability due to changes in LIBOR (a benchmark interest rate), a collateralized interest rate swap (hedging instrument) could be discounted using the overnight index swap (OIS) rate while the change in the fair value of the liability attributable to LIBOR is discounted using LIBOR.

- The time value of an option, forward points in a forward or futures contract, or cross-currency basis spread in a currency swap affect the fair value of those hedging instruments unless they are excluded components (see section 13.2.70).



Question 13.2.10

Is an entity permitted to deliberately overhedge or underhedge?

Background: An overhedge occurs when the hedging instrument is expected to provide cash flows in excess of the expected cash flows of the forecasted transaction. For example, an entity has a \$1,000,000 investment in a variable-rate (three-month LIBOR) corporate debt security and enters into an interest rate swap to hedge the variability in cash flows attributable to interest receipts due on the debt security, but designates the entirety of a swap contract with a \$1,100,000 notional as the hedging instrument.

An underhedge occurs when the expected cash flows on the hedged transaction exceed the expected cash flows on the derivative hedging instrument. For example, an entity has a \$1,000,000 investment in a variable-rate (three-month LIBOR) corporate debt security and enters into an interest rate swap contract to hedge the variability in cash flows attributable to interest receipts due on the debt security, but the swap contract has a \$900,000 notional.

Interpretive response: Yes. An entity is permitted to deliberately overhedge or underhedge as long as the hedging relationship will still be highly effective.
[815-20-25-75]

Fair value hedge. The effects of a fair value overhedge or underhedge are included in earnings immediately because the entire change in fair value of the hedging instrument included in the assessment of effectiveness is included in earnings.

Cash flow hedge. The effects of a cash flow overhedge or underhedge are initially recognized in OCI. These amounts are recognized when the hedged transaction affects earnings (see section 10.3).

Net investment hedge. The effects of a net investment overhedge or underhedge are initially recognized in CTA within AOCI. These amounts are recognized when the respective foreign entity is sold, exchanged, or liquidated (see section 12.5.20).



Question 13.2.20

How is a hedging relationship affected when a physical (nonfinancial) asset's actual location is different from that of the derivative's underlying?

Interpretive response: Unless the hedged risk is a contractually specified component in a cash flow hedging relationship, an underlying of the hedged item or transaction being in a different location from the underlying of the derivative hedging instrument will cause a mismatch between changes in the fair value or cash flows of the hedged item or transaction and changes in the fair value or cash flows of the derivative hedging instrument. This would preclude the entity from assuming that the hedging relationship is perfectly effective.

This is because an entity is required to incorporate the location as one of a physical (nonfinancial) asset's characteristics, unless the hedged risk is a contractually specified component in a cash flow hedging relationship. Specifically, actual location must be incorporated when measuring changes in the fair value of a physical asset that is the hedged item in a **fair value hedge**, or changes in the expected future cash flows of a forecasted transaction that involves a physical asset in a **cash flow hedge**. [815-20-25-12(e), 25-15(i)(2), 25-77]

For example, if an entity designates a Colombian coffee futures contract as the hedging instrument in a fair value hedge of its coffee inventory that is stored in Brazil, the entity may not assume the hedging relationship will be perfectly effective. This is because of the location difference between the physical asset that is the hedged item and location of the underlying of the hedging instrument.

If the hedged risk is a contractually specified component in a cash flow hedging relationship, Topic 815 does not require an entity to incorporate location as one of a physical (nonfinancial) asset's characteristics. [815-20-25-15(i)(3), 25-77]

FASB examples

The following FASB examples are reproduced below.

Fair value hedges

- Fair value hedge of natural gas inventory with futures contracts (Subtopic 815-25's Example 1). Effectiveness is assessed using the spot method and is affected by a location difference.
- Fair value hedge of tire inventory with a forward contract (Subtopic 815-25's Example 2). Effectiveness is assessed using the spot method and is affected by a basis difference.
- Fair value hedge of growing wheat with futures contracts (Subtopic 815-25's Example 3). Effectiveness is affected by the futures contract being for grown, harvested wheat while the inventory is not grown (or harvested).

Cash flow hedges

- Effectiveness of cash flow hedge with a basis swap (Subtopic 815-30's Example 2). Effectiveness is affected by timing differences between the hedging instrument and forecasted transactions.



Excerpt from ASC 815-25

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

55-1 This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a **fair value hedge** of natural gas inventory with futures contracts. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

55-2 Entity A has 20,000 million British thermal units of natural gas stored at its location in West Texas. To hedge the **fair value** exposure of the natural gas, Entity A sells the equivalent of 20,000 million British thermal units of natural gas futures contracts on a national mercantile exchange. The futures contracts prices are based on delivery of natural gas at the Henry Hub gas collection point in Louisiana.

55-3 The price of Entity A's natural gas inventory in West Texas and the price of the natural gas that is the **underlying** for the futures contracts it sold will differ as a result of regional factors (such as location, pipeline transmission costs, and supply and demand). Entity A therefore may not automatically assume that the hedge will be highly effective at achieving offsetting changes in fair value, and it cannot assess effectiveness by looking solely to the change in the price of natural gas delivered to the Henry Hub. The use of a hedging instrument with a different underlying basis than the item or **transaction** being hedged is generally referred to as a cross-hedge. The principles for cross-hedges illustrated in this Example also apply to hedges involving other risks. For example, the effectiveness of a hedge of **interest rate risk** in which one interest rate is used as a surrogate for another interest rate would be evaluated in the same way as the natural gas cross-hedge in this Example.

55-4 Both at inception of the hedge and on an ongoing basis, Entity A might assess the hedge's expected effectiveness on a quantitative basis based on the extent of correlation in recent years for periods similar to the spot prices term of the futures contracts between the spot prices of natural gas in West Texas and at the Henry Hub. If those prices have been and are expected to continue to be highly correlated, Entity A might reasonably expect the changes in the fair value of the futures contracts attributable to changes in the spot price of natural gas at the Henry Hub to be highly effective in offsetting the changes in the fair value of its natural gas inventory. In assessing effectiveness during the term of the hedge, Entity A must take into account actual changes in spot prices in West Texas and at the Henry Hub. The period of time over which correlation of prices should be assessed would be based on management's judgment in the particular circumstance.

55-5 Entity A may not assume that the change in the spot price of natural gas located at Henry Hub, Louisiana, is the same as the change in fair value of its West Texas inventory. The physical hedged item is natural gas in West Texas, not natural gas at the Henry Hub. In identifying the price risk that is being hedged, Entity A also may not assume that its natural gas in West Texas has a Louisiana natural gas component. Use of a price for natural gas located somewhere other than West Texas to assess the effectiveness of a fair value hedge of natural gas in West Texas would be inconsistent with this Subtopic and could result in an assumption that a hedge was highly effective when it was not. If the price of natural gas in West Texas is not readily available, Entity A might use a price for natural gas located elsewhere as a base for estimating the price of natural gas in West Texas. However, that base price must be adjusted to reflect the effects of factors, such as location, transmission costs, and supply and demand, that would cause the price of natural gas in West Texas to differ from the base price.

55-6 Consistent with Entity A's method of assessing whether the hedge is expected to be highly effective, the hedge would not be perfectly effective and there would be a net earnings effect to the extent that the actual change in the fair value of the futures contracts attributable to changes in the spot price of natural gas at the Henry Hub did not offset the actual change in the spot price of natural gas in West Texas per million British thermal units multiplied by 20,000.

55-7 That method excludes the change in the fair value of the futures contracts attributable to changes in the difference between the spot price and the forward price of natural gas at the Henry Hub in assessing effectiveness. The excluded amount would be recognized in earnings through an amortization approach in accordance with paragraph 815-20-25-83A or a mark-to-market approach in accordance with paragraph 815-20-25-83B and presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.



Excerpt from ASC 815-25

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

55-8 This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value hedge of tire inventory with a forward contract. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

55-9 Entity B manufactures tires. The production of those tires incorporates a variety of physical components, of which rubber and steel are the most significant, as well as labor and overhead. Entity B hedges its exposure to changes in the fair value of its inventory of 8,000 steel-belted radial tires by entering into a forward contract to sell rubber at a fixed price.

55-10 Entity B decides to perform subsequent hedge effectiveness assessments on a quantitative basis and bases its assessment on changes in the fair value of the forward contract attributable to changes in the spot price of rubber. To determine whether the forward contract is expected to be highly effective at offsetting the change in fair value of the tire inventory, Entity B could estimate and compare such changes in the fair value of the forward contract and changes in the fair value of the tires (computed as the market price per tire multiplied by 8,000 tires) for different rubber and tire prices. Entity B also should consider the extent to which past changes in the spot prices of rubber and tires have been correlated. Because tires are a nonfinancial asset and rubber is only an ingredient in manufacturing them, Entity B may not assess hedge effectiveness by looking to the change in the fair value of only the rubber component of the steel-belted radial tires (see paragraph 815-20-25-12(e)). Both at inception of the hedge and during its term, Entity B must base its assessment of hedge effectiveness on changes in the market price of steel-belted radial tires and changes in the fair value of the forward contract attributable to changes in the spot price of rubber.

55-11 It is unlikely that this transaction would be highly effective in achieving offsetting changes in fair value. However, if Entity B concludes that the hedge will be highly effective and the hedge otherwise qualifies for hedge accounting, the hedge would have a net earnings effect to the extent that the actual changes in the following amounts did not offset:

- a. The fair value of the forward contract attributable to the change in the spot price of rubber
- b. The market price of steel-belted radials multiplied by the number of tires in inventory.

55-12 Because Entity B bases its assessment of effectiveness on changes in spot prices, the change in the fair value of the forward contract attributable to changes in the difference between the spot and forward price of rubber would be excluded from the assessment of effectiveness, recognized in earnings through an amortization approach in accordance with paragraph 815-20-25-83A or a mark-to-market approach in accordance with paragraph 815-20-25-83B, and presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.



Excerpt from ASC 815-25

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

55-13 This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value hedge of growing wheat with futures contracts. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

55-14 Entity C has a tract of land on which it is growing wheat. Historically, Entity C has harvested at least 40,000 bushels of wheat from that tract of land. Two months before its expected harvest, Entity C sells 2-month futures contracts for 40,000 bushels of wheat, which it wants to designate as a fair value hedge of its growing wheat, rather than as a **cash flow hedge** of the projected sale of the wheat after harvest.

55-15 Even though the futures contracts are for the same type of wheat that Entity C expects to harvest in two months, the futures contracts and hedged wheat have different bases because the futures contracts are based on fully grown, harvested wheat, while the hedged item is unharvested wheat with two months left in its growing cycle. Entity C therefore may not automatically assume that the hedge will be highly effective in achieving offsetting changes in fair value.

55-16 To determine whether the futures contracts are expected to be highly effective in providing offsetting changes in fair value for the growing wheat, Entity C would need to estimate and compare the fair value of its growing wheat and of the futures contracts for different levels of wheat prices. Entity C may not base its estimate of the value of its growing wheat solely on the current price of wheat because that price is for grown, harvested wheat. Entity C might, however, use the current price of harvested wheat together with other relevant factors, such as additional production and harvesting costs and the physical condition of the growing wheat, to estimate the current fair value of its growing wheat crop.

55-17 It is unlikely that wheat futures contracts would be highly effective in offsetting the changes in value of growing wheat.



Excerpt from ASC 815-30

>> Example 2: Effectiveness of Cash Flow Hedge with a Basis Swap

55-9 This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to assessing effectiveness for a cash flow hedge with a basis swap. Assume that the entity elects to perform subsequent hedge effectiveness assessments on a quantitative basis and that all hedge documentation requirements were satisfied at inception.

55-10 Entity H has a 5-year, \$100,000 variable-rate asset and a 7-year, \$150,000 variable-rate liability. The interest on the asset is payable by the counterparty at the end of each month based on the prime rate as of the first of the month. The interest on the liability is payable by Entity H at the end of each month based on **London Interbank Offered Rate (LIBOR)** as of the tenth day of the month (the liability's anniversary date). The reference rates for both the asset and the liability are contractually specified. Entity H enters into a 5-year interest rate swap to pay interest at the prime rate and receive interest at LIBOR at the end of each month based on a **notional amount** of \$100,000. Both rates are determined as of the first of the month. Entity H designates the

interest rate swap as a hedge of 5 years of interest receipts on the \$100,000 variable-rate asset and the first 5 years of interest payments on \$100,000 of the variable-rate liability. The hedged risk is the variability in the contractually specified interest payments received on the asset and paid on the liability. Assume the likelihood of credit default and the likelihood of principal prepayments each is remote.

55-11 Entity H may not automatically assume that the hedge always will be highly effective at achieving offsetting changes in cash flows because the reset date on the receive leg of the interest rate swap differs from the reset date on the corresponding variable-rate liability. Both at hedge inception and on an ongoing basis, Entity H's assessment of expected effectiveness could be based on the extent to which changes in LIBOR have occurred during comparable 10-day periods in the past. Entity H's ongoing assessment of effectiveness would be on a cumulative basis and would incorporate the actual interest rate changes to date. There will be no perfect offset to the extent that the cumulative change in cash flows on the prime leg of the interest rate swap did not offset the cumulative change in expected cash flows on the asset, and the cumulative change in cash flows on the LIBOR leg of the interest rate swap did not offset the change in expected cash flows on the hedged portion of the liability. The terms of the interest rate swap, the asset, and the portion of the liability that is hedged are the same, with the exception of the reset dates on the liability and the receive leg of the interest rate swap. Thus, there will be no perfect offset in the hedging relationship if LIBOR has changed between the first of the month (the reset date for the interest rate swap) and the tenth of the month (the reset date for the liability).

55-12 See Topic 820 (including paragraph 820-10-55-13) for a discussion of expected cash flows.

13.2.20 Timing and nature of prospective and retrospective effectiveness assessments



Excerpt from ASC 815-20

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-79 An entity shall consider hedge effectiveness in two different ways—in prospective considerations and in retrospective evaluations:

- a. Prospective considerations. The entity's expectation that the relationship will be highly effective over future periods in achieving offsetting changes in fair value or cash flows, which is forward looking, must be assessed on a quantitative basis at hedge inception unless one of the exceptions in paragraph 815-20-25-3(b)(2)(iv)(01) is met. Prospective assessments shall be subsequently performed whenever financial statements or earnings are reported and at least every three months. The entity shall elect at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(03) whether to perform subsequent assessments on a quantitative or qualitative basis.

See paragraphs 815-20-35-2A through 35-2F for additional guidance on qualitative assessments of hedge effectiveness. A quantitative assessment can be based on regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. The quantitative prospective assessment of hedge effectiveness shall consider all reasonably possible changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument and the hedged items for the period used to assess whether the requirement for expectation of highly effective offset is satisfied. The quantitative prospective assessment may not be limited only to the likely or expected changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument or the hedged items. Generally, the process of formulating an expectation regarding the effectiveness of a proposed hedging relationship involves a probability-weighted analysis of the possible changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument and the hedged items for the hedge period. Therefore, a probable future change in fair value will be more heavily weighted than a reasonably possible future change. That calculation technique is consistent with the definition of the term **expected cash flow** in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*.

- b. Retrospective evaluations. An assessment of effectiveness may be performed on a quantitative or qualitative basis on the basis of the entity's election at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(03). That assessment shall be performed whenever financial statements or earnings are reported, and at least every three months. See paragraphs 815-20-35-2 through 35-4 for further guidance. At inception of the hedge, an entity electing a dollar-offset approach to perform retrospective evaluations on a quantitative basis may choose either a period-by-period approach or a cumulative approach in designating how effectiveness of a fair value hedge or of a cash flow hedge will be assessed retrospectively under that approach, depending on the nature of the hedge documented in accordance with paragraph 815-20-25-3. For example, an entity may decide that the cumulative approach is generally preferred, yet may wish to use the period-by-period approach in certain circumstances. See paragraphs 815-20-35-5 through 35-6 for further guidance.

25-79A See paragraphs 815-20-25-139 through 25-142 about the timing of hedge effectiveness assessments required by paragraph 815-20-25-79 for a private company that is not a financial institution or a not-for-profit entity (except for a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market).

Topic 815 requires effectiveness assessments to be performed and documented both at inception of a hedging relationship and periodically thereafter. These subsequent effectiveness assessments are also referred to as 'quarterly hedge effectiveness assessments' because they are required to be performed at least quarterly. More specifically, they are required to be

performed whenever financial statements or earnings are reported and at least every three months. [815-20-25-79]

Effectiveness assessments are required to be performed consistently with the initially documented method for assessing effectiveness (see section 6.9).

[815-20-25-79(b), 55-68 – 55-69]

Two types of effectiveness assessments are required to be performed. [815-20-25-79, 35-2]

Description	Frequency	Results
Prospective assessment		
A forward-looking assessment of whether gains or losses on the derivative hedging instrument that are included in the assessment of effectiveness <i>are expected to be</i> highly effective at offsetting changes in the fair value (cash flows) of the hedged item (forecasted transaction). This generally involves a probability-weighted analysis of possible changes and is required to consider all reasonably possible scenarios.	— At hedge inception. — Whenever financial statements or earnings are reported and at least every three months. In practice, this assessment is usually supported by periodic retrospective assessments (see Question 13.2.30).	If this assessment does not support an expectation of high effectiveness, hedge accounting is discontinued prospectively (see section 6.10.50).
Retrospective assessment		
Focuses on actual performance – i.e. whether gains or losses on the derivative hedging instrument that are included in the assessment of effectiveness <i>actually have been</i> highly effective at offsetting changes in the fair value (cash flows) of the hedged item (forecasted transaction). See also section 13.6.20 regarding choosing a cumulative or period-by-period approach when the dollar-offset method is used to assess effectiveness quantitatively.	Whenever financial statements or earnings are reported and at least every three months.	If this assessment demonstrates that the hedge was not highly effective, hedge accounting is not applied for the period being assessed. Additionally, this may result in an entity concluding that the hedging relationship is not expected to be highly effective in the future (prospectively), resulting in the hedging relationship being discontinued (see section 6.10.50).

The initial prospective assessment is required to be quantitative, unless certain conditions are met (see conditions in the table in Question 13.2.50).

Subsequent effectiveness assessments (both prospective and retrospective) may be either qualitative or quantitative, depending on whether certain conditions are met (see conditions in section 13.5.10).

Additionally, there are three assessment methods that assume the hedging relationship is perfectly effective:

- the shortcut method (see section 13.3);
- the critical terms match method (see section 13.4); and
- the simplified hedge accounting approach, which is available for private companies that are not financial institutions (see section 16.2).

If a hedging relationship qualifies for one of these three assessment methods and the entity elects that method, subsequent effectiveness assessments under that method are primarily qualitative in nature.

When the initial effectiveness assessment is required to be quantitative, an entity has until the earliest of several dates to perform and document the initial quantitative effectiveness assessment, the latest of which is three months after hedge designation (see section 6.9.40). [815-20-25-3(b)(2)(iv)(01-02)]

Certain private companies and certain NFPs have additional time to perform and document their initial and subsequent quarterly effectiveness assessments (see chapter 16). [815-20-25-79A]



Question 13.2.30

Is a quarterly hedge effectiveness assessment always performed only quarterly?

Interpretive response: No. Although the periodic effectiveness assessments that are required subsequent to hedge inception are commonly referred to as quarterly hedge effectiveness assessments, they are required to be performed whenever financial statements or earnings are reported and at least every three months. [815-20-25-79]

Further, if the hedging relationship is shorter than three months, the effectiveness assessment is required to be performed to match the hedge period; for example, daily or weekly, such as when a dynamic hedging strategy is used as described in section 13.2.50. In other words, if the hedge period is daily, the effectiveness assessment is required to be performed daily based on daily changes in fair value (cash flows) of the derivative and portfolio of hedged items (forecasted transactions).



Question 13.2.40

May an entity use different methods for its prospective and retrospective effectiveness assessments?

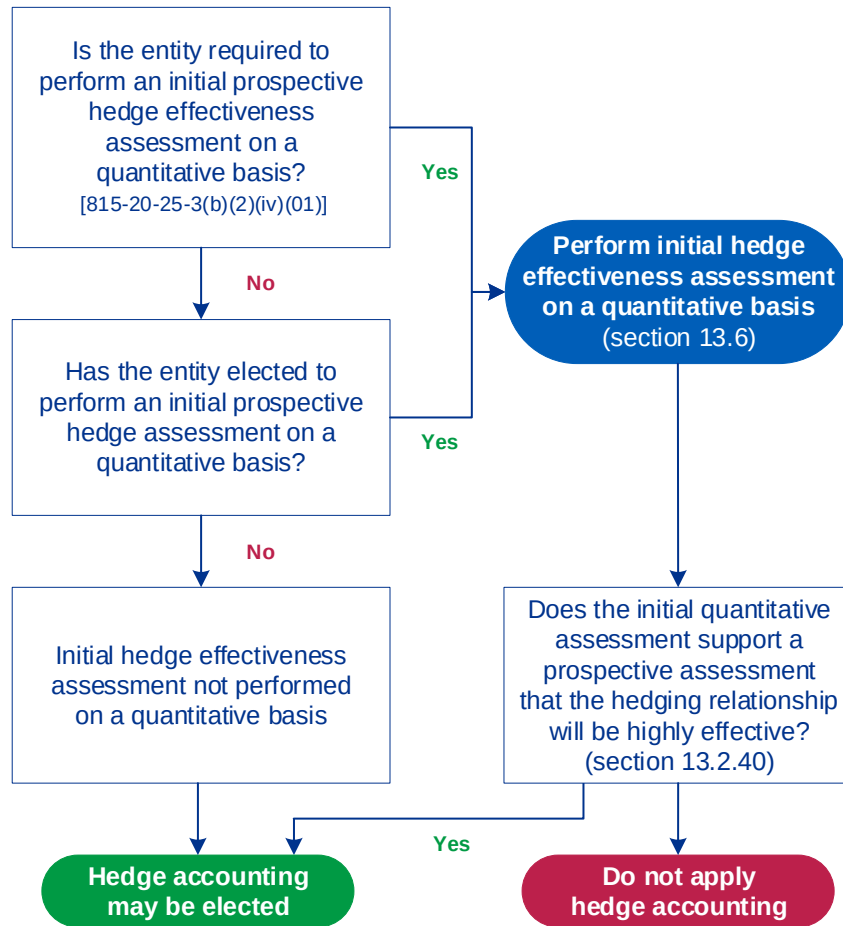
Interpretive response: Yes. Topic 815 permits an entity to use different methods for its prospective and retrospective effectiveness assessments, provided that it documents the different methods in its hedge documentation and consistently uses those methods during the hedge period. [815-20-55-68 – 55-70]

However, in practice, most entities use the same method for both their prospective and retrospective assessments to reduce the administrative burden of applying hedge accounting and because unusual results may occur otherwise. Unusual results include the following.

- If an entity's prospective assessment does not support an expectation that the hedging relationship *will be* highly effective, the hedging relationship must be discontinued even if the entity's retrospective assessment indicates that the hedging relationship was (1) highly effective, and (2) would, if used as the prospective method, support an expectation of high effectiveness.
- If an entity's retrospective assessment indicates that the hedging relationship *was not* highly effective, hedge accounting cannot be applied for the period assessed even if the entity's prospective assessment (1) supports an expectation of high effectiveness, and (2) would have, if used as the retrospective method, indicated that the hedging relationship was highly effective in the period assessed.

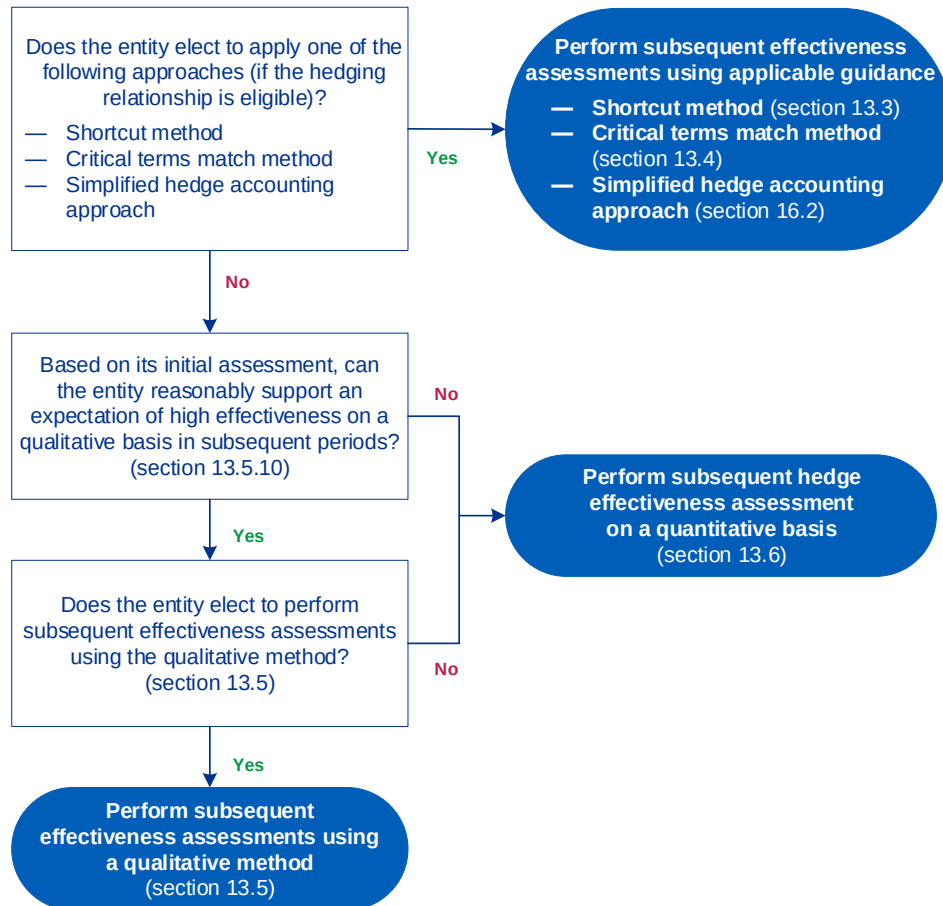
Initial effectiveness assessments

The following flowchart summarizes considerations related to whether an entity performs an initial hedge effectiveness assessment on a quantitative basis.



Subsequent effectiveness assessments

The following flowchart summarizes considerations related to whether an entity performs subsequent effectiveness assessments on a quantitative or qualitative basis.



Question 13.2.50

If an entity is not required to perform an initial prospective assessment on a quantitative basis, on what basis are its subsequent effectiveness assessments performed?

Interpretive response: It depends on the reason the initial prospective assessment is not required to be performed on a quantitative basis.

There are eight situations in which an initial quantitative assessment is not required (see also section 6.9.30 for formal documentation requirements). The following table summarizes those situations. In all cases, the critical terms are required to match. [815-20-25-3(b)(2)(iv)(01)]

Description	Reference
Fair value or cash flow hedges	
(A) Shortcut method: Interest rate swap is used to hedge interest rate risk related to recognized assets or liabilities and certain conditions are met. [815-20-25-102 – 25-117]	Section 13.3
Cash flow hedges	
(B) Critical terms match method¹: A forward or option is used and the critical terms of the hedging instrument and hedged item match. [815-20-25-84 – 25-85, 35-9 – 35-12]	Section 13.4
(C) Terminal value method: A purchased option, net purchased option or zero-cost collar is used and certain conditions are met. [815-20-25-126, 25-129 – 25-129A]	Section 13.7.20
(D) Simplified hedge accounting approach: An interest rate swap is used to hedge interest rate risk of variable-rate borrowings and certain conditions are met. This approach is available to private companies that are not financial institutions. [815-20-25-133 – 25-138]	Section 16.2
(E) Change-in-variable-cash-flows method: An interest rate swap is used to hedge variability in interest receipts or payments and certain conditions are met. [815-30-35-16 – 35-24]	Section 13.7.40
(F) Hypothetical derivative method: A derivative instrument is used to hedge any eligible risk (an interest rate swap is used to hedge variability in interest receipts or payments) and the critical terms of the hedging instrument and hedged transaction match. [815-30-35-25 – 35-29]	Sections 13.7.30 and 13.7.40
Note: 1. We believe the critical terms match method is precluded for fair value hedging relationships in the vast majority of circumstances (see section 13.4.20).	
Net investment hedges	
(G) Changes in spot rate method: Certain conditions are met, depending on whether the hedging instrument is a derivative or a nonderivative. [815-35-35-5, 35-12]	Section 12.4.20
(H) Changes in forward rate method: Certain conditions are met. [815-35-35-17A]	Section 12.4.30

Shortcut method (A), critical terms match method (B), or simplified hedge accounting approach (D)

If the entity is applying one of these methods, it applies the specific guidance applicable to that method. The subsequent effectiveness assessments under these methods are primarily qualitative in nature.

Other situations (C, E to H)

In these situations, Topic 815 indicates that the hedging relationships will be perfectly effective if all conditions are met. However, it does not specify whether the subsequent effectiveness assessments are to be performed using the guidance for quantitative or qualitative assessments. As a result, we believe an entity may choose to perform its quarterly hedge effectiveness assessments on a quantitative or qualitative basis.



Question 13.2.60

Why may an entity elect to perform subsequent assessments on a qualitative – rather than a quantitative – basis?

Background: As discussed in Question 13.2.50, an initial prospective assessment is not required to be performed on a quantitative basis in eight situations. In five of these situations (the ‘other situations’ referenced in Question 13.2.50), Topic 815 does not provide specific guidance regarding subsequent assessments. When an entity has applied one of these other qualitative approaches in its initial effectiveness assessment, we believe it may choose to perform its subsequent hedge effectiveness assessments on a quantitative or qualitative basis.

Interpretive response: In the other situations referenced in Question 13.2.50, the subsequent ongoing assessments will be largely similar regardless of whether an entity documents that it is applying a quantitative or a qualitative assessment as long as the critical terms of the hedging instrument and hedged item or transaction match. However, we believe electing to perform subsequent effectiveness assessments on a qualitative basis – rather than on a quantitative basis – may provide an entity with more flexibility should the critical terms of the hedging relationship cease to match (or other conditions cease to be met, if applicable).

This is because when the critical terms cease to match (or other conditions cease to be met), it may be possible for an entity to revert to performing qualitative assessments after performing a quantitative assessment if it can reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods.

This is explained further in the following table.

Scenario 1: Critical terms continue to match (and other conditions continue to be met, if applicable) throughout the hedging relationship	In this scenario, an entity’s quarterly hedge effectiveness assessment focuses on confirming and documenting the fact that the critical terms continue to match (and other conditions continue to be met, if applicable), whether the assessment is on a quantitative or qualitative basis. Additionally, the entity is required to include in its initial hedge documentation a quantitative method, even if it elects to perform subsequent assessments on a qualitative basis (see discussion of formal documentation in section 6.9.30). This method is required to be the same as that used to support the entity’s initial prospective hedge effectiveness assessment. Further, when an entity will perform its subsequent effectiveness assessments on a quantitative basis, we believe that an entity is not required to perform the actual calculation when the results of the quantitative test are known with mathematical certainty without performing the full calculation (see Question 13.6.80).

Scenario 2: Critical terms cease to match (and/or other conditions cease to be met, if applicable) during the hedging relationship	In this scenario, the subsequent assessment requirements differ depending on whether the entity chose to perform subsequent assessments on a quantitative or qualitative basis. — Quantitative basis. If the entity documented that it will perform quantitative (rather than qualitative) assessments each period, it will be required to perform quantitative assessments in all periods – i.e. dollar-offset or statistical analysis, as selected in the initial documentation. — Qualitative basis. If the entity documented that it will perform qualitative assessments, it is required to use its judgment in determining whether there has been a change in facts and circumstances such that it can no longer assert qualitatively that the hedging relationship was and continues to be highly effective (as discussed in section 13.5.20). We believe the entity would apply judgment when the critical terms of the hedging instrument and hedged item or transaction cease to match. – The entity is permitted to perform a quantitative assessment in any reporting period to validate whether qualitative assessments of hedge effectiveness remain appropriate. [815-20-35-2D] – If the entity was required or elected to perform quantitative effectiveness assessments, it is permitted to revert to qualitative effectiveness assessments if it can reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods (see Question 13.5.50). As a result, an entity may conclude that continued qualitative assessments are appropriate (e.g. if the degree to which the critical terms cease to match is minimal) and/or may perform a quantitative assessment in one period to validate its assertion that continued qualitative assessments are appropriate in future periods.

13.2.30 Aligning effectiveness assessments with the designated hedged risk



Excerpt from ASC 815-20

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-76 If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, either of the following conditions shall be met:

- The increases (or decreases) in the fair value of the hedging instrument are expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item (if a fair value hedge).

- b. The cash inflows (outflows) from the hedging instrument are expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction (if a cash flow hedge).

>>> Hedge Effectiveness When Hedged Exposure Is More Limited Than Hedging Instrument

25-100 An entity may designate as the hedging instrument in a fair value hedge or cash flow hedge a derivative instrument that does not have a limited exposure comparable to the limited exposure of the hedged item to the risk being hedged. However, to make that designation, in accordance with paragraph 815-20-25-75, the entity shall establish that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated. See paragraph 815-20-25-79(a) for additional guidance on prospective considerations of hedge effectiveness in this circumstance.

Effectiveness assessments are required to be performed in a manner that is consistent with the documented risk management objective. That is, when assessing effectiveness, the change in the fair value or cash flows of the hedged item or forecasted transaction should consider only the risks that are being hedged. That change should be compared with the extent of offset provided by the derivative hedging instrument's total change in fair value or cash flows (other than excluded components). [\[815-20-25-75\]](#)

Topic 815 provides flexibility in designating the hedged risk, including that the hedged risk is not always required to be the entire change in the fair value or cash flows of the hedged item or forecasted transaction (see section 6.2.20). Similarly, Topic 815 permits using a variety of hedging instruments (see section 6.6), and permits excluding certain components of the hedging instrument from effectiveness assessments (see section 13.2.70). However, in all cases, an entity is required to select a derivative hedging instrument for which the change in fair value or cash flows (other than excluded components) is expected to be highly effective at offsetting changes in fair value or cash flows attributable to the hedged risk. [\[815-20-25-75\]](#)

The following are examples of designating the hedged risk and selecting a hedging instrument in the context of assessing effectiveness.

Hedged risk is one-sided

For example, an entity may hedge only an increase in the benchmark (or contractually specified) interest rate when hedging existing fixed-rate (or variable-rate) debt.

It may be necessary for the entity to select a hedging instrument that provides one-sided offset when the hedged risk is one-sided to achieve a highly effective hedging relationship. Typically, an option is used because of its one-sided nature. [\[815-20-25-76\]](#)

See also section 13.2.70 regarding excluded components, and section 13.2.90 regarding using options as hedging instruments.

Hedged exposure is limited but hedging instrument's exposure is not	For example, an entity may hedge fixed-rate debt that is prepayable in a fair value hedge with a hedging instrument that does not have a mirror prepayment feature. Or, an entity may hedge variable-rate debt that has a floor of zero on the interest rate in a cash flow hedge with a hedging instrument that does not have a floor. The entity is required to demonstrate that the hedging instrument in each case is expected to be highly effective at offsetting changes in fair value or cash flows attributable to the hedged risk, including consideration of the mismatch of exposures between the hedging instrument and hedged item. [815-20-25-100, 55-193 – 55-197] This type of relationship may be highly effective in some circumstances. For example, an entity enters into a cash flow hedge of variable-rate debt that has a cap on the interest rate with a hedging instrument that does not. Although the effectiveness assessment must consider all reasonably possible changes in cash flows (rather than only likely or expected changes) the assessment involves a probability-weighted analysis. This means that probable changes are more heavily weighted than reasonably possible changes. As a result, if it is unlikely that interest rates will fall below the level in the floor, they will not have a significant effect on the expected cash flows of the hedging instrument and the hedging relationship may be highly (although not perfectly) effective. [815-20-25-79(a), 55-197] See also Subtopic 815-20's Example 22 reproduced below.
Hedged risk is within a range and the hedging instrument is a net purchased option	For example, an entity may wish to hedge against changes in the benchmark (or contractually specified) interest rate on existing fixed-rate (or variable-rate) debt only within a certain range of interest rates. In this situation, the entity may designate as the hedging instrument a combination of options (deemed to be a net purchased option) and assess effectiveness based only on changes in the underlying that cause a change in the intrinsic value of that net purchased option. [815-20-25-130 – 25-131] See section 13.2.70 regarding excluded components, and section 13.2.90 regarding using options as hedging instruments (including Example 13.2.60).

If the hedged risk is basis risk, each leg of the basis swap is required to be linked to a designated item with the same underlying. For a discussion of the special rule for basis swaps, see section 9.5.10. [815-20-25-50 – 25-51]

Examples

The following examples demonstrate effectiveness assessments that are consistent with the documented risk management objective.

- Consistency of effectiveness assessment with documented risk management objective (Example 13.2.10).
- Cesignation if hedged exposure is limited but derivative instrument exposure is not (Subtopic 815-20's Example 22).



Example 13.2.10

Consistency of effectiveness assessment with documented risk management objective

ABC Corp.'s documented hedged risk objective includes hedging only the change in fair value (or cash flows) related to interest payments on debt due to an increase in the benchmark rate above 7%.

Therefore, the change in fair value of the hedged item (or change in cash flows of the forecasted transaction) that is included in the effectiveness assessment is limited to the extent of the change in fair value (or change in cash flows) of the debt resulting from increases in the benchmark interest rate over 7%.



Excerpt from ASC 815-20

>> Example 22: Designation If Hedged Exposure Is Limited but Derivative Instrument Exposure Is Not

55-193 The following Cases illustrate the application of paragraph 815-20-25-100 to situations in which the hedged item or hedged forecasted transaction may have a risk exposure that is limited, but the derivative instrument that the entity desires to designate as a hedging instrument does not have comparable limits:

- a. Fair value hedge (Case A)
- b. Cash flow hedge (Case B).

55-194 For the purposes of both Cases A and B, it is assumed that the shortcut method may not be applied.

>>> Case A: Fair Value Hedge

55-195 Entity A issues 10-year fixed-rate debt that is callable at the end of the fifth year. It decides to convert the interest payments on the bond from fixed-rate to variable-rate by entering into a 10-year receive-fixed, pay-variable interest rate swap. The interest rate swap is not cancelable at the end of the fifth year. From Entity A's perspective, if interest rates increase, there is a gain on the debt (the liability's fair value decreases) and a loss on the swap (fair value either decreases as an asset or increases as a liability). If interest rates decrease, there is a loss on the debt (the liability's fair value increases) and a gain on the swap (fair value either increases as an asset or decreases as a liability). However, during the first five years, if interest rates decrease, the gain on the swap will exceed the loss on the debt because the debt's fair value change will consider the impact of the call feature, which is in the money when interest rates fall below the stated rate on the debt. Entity A wishes to designate the interest rate swap as the hedging instrument in a fair value hedge of interest rate risk of the fixed-rate debt. The conclusions for Case A and Case B are discussed in paragraph 815-20-55-197.

>>> Case B: Cash Flow Hedge

55-196 Entity B issues 10-year, variable-rate debt that reprices based on 6-month LIBOR. The interest rate on the debt is capped at 9 percent. Entity B decides to convert the interest payments on the debt from variable-rate to fixed-rate by entering into a receive-variable, pay-fixed interest rate swap. There is no cap on the variable-rate leg of the interest rate swap. From Entity B's perspective, if interest rates decrease, there will be a cumulative reduction in the expected future cash outflows on the debt and a cumulative reduction in the expected future cash inflows on the swap. If interest rates increase, there will be a cumulative increase in the expected future cash outflows on the debt and a cumulative increase in the expected future cash inflows on the swap. However, if interest rates increase such that the variable rate on the swap would be greater than 9 percent, the cumulative increase in the expected future cash inflows on the swap will exceed the cumulative increase in the expected future cash outflows on the debt because of the interest rate cap on the debt, which is in the money if interest rates increase such that the variable rate on the debt would exceed 9 percent. Entity B wishes to designate the interest rate swap as the hedging instrument in a cash flow hedge of interest rate risk of the variable-rate debt.

55-197 In both Cases A and B, the entity must assess, based on an appropriate methodology, whether the changes in fair value or cash flows of the interest rate swap could be expected to be highly effective in offsetting changes in fair value or cash flows of the debt attributable to interest rate risk taking into account the effect of the embedded call option (Case A) or the effect of the interest rate cap (Case B). As required by paragraph 815-20-25-6, the effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. Therefore, if the options in Cases A and B are expected to be out of the money based on a probability-weighted analysis of the range of possible changes in interest rates, then those options would be expected to have a minimal effect on changes in fair value or cash flows of the debt, and the hedging relationships could meet the requirement for an expectation of high effectiveness. In the case of a fair value hedge of callable debt discussed in Case A, in accordance with paragraph 815-20-25-6B, Entity A may assess hedge effectiveness on the basis of whether the debt will be called at the end of the fifth year because of expected changes in benchmark interest rates, but not because of other factors potentially affecting the exercise of the call feature. Entity A intends to assess hedge effectiveness on this basis.

13.2.40 Meaning of 'highly effective'

Entities commonly think of a highly effective hedging relationship from an economic point of view – i.e. whether the derivative provides the desired risk management effect. Often, that view is consistent with Topic 815's notion that high effectiveness is achieved when the changes in the fair value or cash flows of a derivative hedging instrument are highly effective at offsetting changes in the fair value or cash flows of the hedged item or hedged transaction attributable to the hedged risk. However, the distinction between an effective economic hedge and a hedge that is permitted under Topic 815 is significant

because hedge accounting is permitted only if the specific criterion of high effectiveness and other eligibility criteria are met.

Hedge effectiveness is measured using the following formula.

$$\frac{\text{Absolute value of change in fair value or cash flows of hedging instrument (other than excluded components)}}{\text{Absolute value of change in fair value or cash flows of hedged item or transaction due to hedged risk}} = \text{Percentage of offset}$$

To be highly effective, should be within the range of 80%–125% (see Question 13.2.70)



Question 13.2.70 Does Topic 815 define highly effective?

Interpretive response: No. Topic 815 does not define ‘highly effective’.

When the term was initially introduced in FASB Statement No. 133 (now Topic 815), the FASB intended it to have essentially the same meaning as the notion of ‘high correlation’ used in FASB Statement No. 80 (futures contracts). As a result, we believe that ‘highly effective’ describes a relationship in which the change in the fair value or cash flows of the derivative hedging instrument is within 80% to 125% of the opposite change in the fair value or cash flows of the hedged item or cash flows attributable to the hedged risk.

Additionally, the FASB has acknowledged that practice has interpreted highly effective to mean an 80%–125% offset. [\[ASU 2017-12.BC165\]](#)



Example 13.2.20 Calculations of effectiveness

The following scenarios show how the extent of effectiveness of a hedging relationship is computed.

	Increase (decrease)
Scenario 1: Fair value hedge – 80% effective	
Change in fair value of derivative hedging instrument included in the assessment of effectiveness	\$80
Change in fair value of hedged item attributable to the hedged risk	\$(100)
Effectiveness ¹	80%
Scenario 2: Scenario 1: Fair value hedge – 125% effective	
Change in fair value of derivative hedging instrument included in the assessment of effectiveness	\$100
Change in fair value of hedged item attributable to the hedged risk	\$(80)

	Increase (decrease)
Effectiveness ¹	125%
Scenario 3: Cash flow hedge – 80% effective	
Change in cash flows of derivative hedging instrument included in the assessment of effectiveness	\$80
Change in cash flows of hedged transaction item attributable to the hedged risk	\$(100)
Effectiveness ¹	80%
Scenario 4: Cash flow hedge – 125% effective	
Change in cash flows of derivative hedging instrument included in the assessment of effectiveness	\$100
Change in cash flows of hedged transaction item attributable to the hedged risk	\$(80)
Effectiveness ¹	125%
Note: 1. Calculated as: – Absolute value of the change in fair value (or cash flows) of derivative hedging instrument included in the assessment of effectiveness ÷ – Absolute value of the change in fair value of hedged item (or cash flows of hedged transaction) attributable to the hedged risk	

13.2.50 Determining the period for assessing effectiveness



Excerpt from ASC 815-20

>>> Hedge Effectiveness during Designated Hedge Period

25-101 It is inappropriate under this Subtopic for an entity to designate a derivative instrument as the hedging instrument if the entity expects that the derivative instrument will not be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated, unless the entity has documented undertaking a dynamic hedging strategy in which it has committed itself to an ongoing repositioning strategy for its hedging relationship.

It is not appropriate for an entity to designate a derivative as the hedging instrument when it expects that the derivative will not be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk *during the period over which effectiveness will be assessed*. [815-20-25-101]

However, an entity is not required to assess effectiveness using an assessment period that is as long as the term of the hedging instrument. Instead, an entity may undertake a dynamic hedging strategy in which it commits itself to an ongoing repositioning strategy for its hedging relationship and to an assessment period that is shorter than the term of the hedging instrument. When an entity does this, effectiveness is expected over that assessment period. [815-20-25-101]

The following are examples of dynamic hedging strategies.

Delta-neutral dynamic hedging strategy

In a delta-neutral dynamic hedging strategy for a **fair value hedge**, an entity may commit to constant monitoring of the ratio of changes in the option's price to changes in the price of the hedged item (referred to as the option's delta).

As the ratio changes, the entity rebalances the portfolio of options (i.e. buy or sell options) so that the change in the fair value of all of the options held can be expected to counterbalance or offset the next change in the value of the hedged item.

In this situation, the hedging instrument is constantly being changed and the assessment of effectiveness considers only the change in fair value to the next rebalancing date.

See also Question 6.10.60 regarding whether a rebalancing of hedging derivatives when such a strategy is used requires discontinuation of the hedging relationship.

Tailing strategy

In a tailing strategy with futures contracts in a **cash flow hedge**, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures contracts do not distort the results of the hedge.

To assess the offset of cash flows, an entity could include the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

In this situation, an entity is required to document that it is undertaking a dynamic hedging strategy in which it commits itself to an ongoing repositioning strategy for the hedging relationship and believes it is probable that the forecasted transactions will occur. [815-20-25-121]

See also section 13.2.110 for a discussion of the time value of money and Question 6.10.60 regarding whether a rebalancing of hedging derivatives when such a strategy is used requires discontinuation of the hedging relationship.

Additionally, Topic 815 does not prescribe the historical period that should be used when assessing whether a hedging instrument is expected to be (or has been) highly effective at offsetting the hedged risk (see Question 13.2.80).



Question 13.2.80

How does an entity determine the historical period when initially assessing hedge effectiveness?

Interpretive response: Regardless of the technique used to assess hedge effectiveness, we believe an entity should document the historical relationship between changes in fair values of the hedged item (or cash flows of the forecasted transaction) and changes in the fair value (or cash flows) of the derivative hedging instrument over an appropriate period.

Judgment is required in determining the appropriate period to be used. However, an entity should consider that the objective of the prospective effectiveness assessment is to conclude that the hedging relationship is expected to be highly effective. As a result, an entity should consider a historical period for which the potential changes are reasonably expected to reflect those expected over the documented hedge period.

For example, if an entity is considering a two-year foreign currency hedging relationship involving US dollars and euros (€), its prospective effectiveness assessment should not be limited to changes in the \$/€ exchange rate for the last month. The changes for the last month may not be indicative of the potential changes in the exchange rate that are reasonably expected to occur over the next two years.

Once an entity has initially assessed hedge effectiveness, the historical period to be used when performing subsequent effectiveness assessments depends on the method used to assess effectiveness. For discussion of the information to be used when performing quantitative effectiveness assessments using dollar-offset method and regression analysis, see sections 13.6.20 and 13.6.30, respectively.

Special criterion for fair value hedges only



Excerpt from ASC 815-20

> > Hedge Effectiveness Criterion Applicable to Fair Value Hedges Only

25-118 In documenting its risk management strategy for a fair value hedge, an entity may specify an intent to consider the possible changes (that is, not limited to the likely or expected changes) in value of the hedging derivative instrument and the hedged item only over a shorter period than the derivative instrument's remaining life in formulating its expectation that the hedging relationship will be highly effective in achieving offsetting changes in fair value for the risk being hedged. The entity does not need to contemplate the offsetting effect for the entire term of the hedging instrument.

When designating a fair value hedging relationship, an entity can specify an intent to consider changes in the values of the hedging instrument and hedged item over a period shorter than the hedging instrument's remaining life when

assessing effectiveness. To do so, the entity needs to consider the possible changes in these values, not only the likely or expected changes. Therefore, the entity does not need to contemplate the offsetting effect of the derivative hedging instrument for the entire term of the hedging instrument and/or hedging relationship. [815-20-25-118]

This approach may be useful when a hedged item's risk exposure is limited, but the risk exposure of the hedging derivative is not. Subtopic 815-20's

Example 22 (reproduced in section 13.2.30) demonstrates a situation in which an entity hedges 10-year debt that is callable after five years with a 10-year interest rate swap that is not cancelable. In that situation, an entity may choose to assess effectiveness by considering the possible changes in the fair value of the derivative hedging instrument for a period shorter than the derivative's life, such as the next three months.

%↑ Interest rate risk. Alternatively, an entity may choose to use a partial-term hedging strategy when the hedged risk is interest rate risk or a combination of interest rate risk and foreign currency risk, which is discussed in section 7.3.80. Under this strategy, an entity measures the change in the hedged item's fair value attributable to interest rate risk using an assumed term that reflects only the designated cash flows and assumes that the principal payment occurs at the end of the hedge term. This strategy may result in a hedge that is more likely to be highly effective, as explained in Question 7.3.210.

FASB Example: Hedge effectiveness horizon in a fair value hedge when effectiveness is assessed on a quantitative basis



Excerpt from ASC 815-20

>> Example 25: Hedge Effectiveness Horizon in a Fair Value Hedge When Effectiveness Is Assessed on a Quantitative Basis

55-204 This Example illustrates the application of paragraph 815-20-25-118. Under the guidance in that paragraph, if a derivative instrument with a five-year term is designated as the hedging instrument in a fair value hedge of a financial asset that also has a five-year term, an entity may base its expectation that the hedging relationship will be highly effective in achieving offsetting changes in fair value for the risk being hedged by considering the possible changes in value occurring only over a shorter period than the life of the derivative instrument, such as over only the first three months of the derivative instrument's five-year life. For example, an entity may specify, in documenting its risk management strategy, that every three months it will do both of the following:

- a. It will assess the effectiveness of the existing hedging relationship for the past three-month period.
- b. It intends to consider possible changes in value of the hedging derivative and the hedged item over the next three months in deciding whether it has

an expectation that the hedging relationship will continue to be highly effective at achieving offsetting changes in fair value.

13.2.60 Considering counterparty credit risk and entity's own non-performance risk



Excerpt from ASC 815-20

>>> Consideration of Counterparty Credit Risk

25-122 For a cash flow hedge, an entity shall consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative instrument that require the counterparty to make payments to the entity. Paragraph 815-20-35-14 states that, for an entity to conclude on an ongoing basis that a cash flow hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows, the entity shall not ignore whether it will collect the payments it would be owed under the contractual provisions of the derivative instrument. See paragraphs 815-20-35-14 through 35-18 for further guidance.

> Possibility of Default by the Counterparty to Hedging Derivative

35-14 For an entity to conclude on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows, the entity shall not ignore whether it will collect the payments it would be owed under the contractual provisions of the derivative instrument. In complying with the requirements of paragraph 815-20-25-75(b), the entity shall assess the possibility of whether the counterparty to the derivative instrument will default by failing to make any contractually required payments to the entity as scheduled in the derivative instrument. In making that assessment, the entity shall also consider the effect of any related collateralization or financial guarantees. The entity shall be aware of the counterparty's creditworthiness (and changes therein) in determining the fair value of the derivative instrument. Although a change in the counterparty's creditworthiness would not necessarily indicate that the counterparty would default on its obligations, such a change shall warrant further evaluation.

35-15 If the likelihood that the counterparty will not default ceases to be probable, an entity would be unable to conclude that the hedging relationship in a cash flow hedge is expected to be highly effective in achieving offsetting cash flows.

35-16 In contrast, a change in the creditworthiness of the derivative instrument's counterparty in a fair value hedge would have an immediate effect because that change in creditworthiness would affect the change in the derivative instrument's fair value, which would immediately affect both of the following:

- a. The assessment of whether the relationship qualifies for hedge accounting

- b. The amount of mismatch between the change in the fair value of the hedging instrument and the hedged item attributable to the hedged risk recognized in earnings under fair value hedge accounting.

35-18 Paragraph 815-20-25-103 states that, in applying the shortcut method, an entity shall consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity. That paragraph explains that implicit in the criteria for the shortcut method is the requirement that a basis exist for concluding on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair values or cash flows.

Topic 815 – in combination with Topic 820 (fair value) – requires an entity to consider the effects of counterparty credit risk and the entity's own nonperformance risk when assessing the effectiveness of hedging relationships. These considerations are different for fair value versus cash flow hedges, and also differ depending on the effectiveness assessment method, as follows.

Fair value hedge
[815-20-35-16, 35-18]

- Changes in both counterparty credit risk and an entity's own nonperformance risk affect the measurement of changes in the fair value of the derivative hedging instrument. These changes likely have no offsetting effect on changes in the measurement of the hedged item attributable to the hedged risk.
- As a result, changes in counterparty credit risk and the entity's own nonperformance risk will result in a hedge not being perfectly effective and such changes have an immediate effect on the assessment of effectiveness.
- However, if the shortcut method is used (see section 13.3), the potential effect of these differences on the hedging relationship's effectiveness is ignored unless it is no longer probable that the derivative counterparty or the entity itself will not default. If non-default by either party is no longer probable, the shortcut method is required to be discontinued.

Cash flow hedge
[815-20-25-122, 35-14 – 35-15]

- Changes in both counterparty credit risk and an entity's own nonperformance risk affect the measurement of changes in the fair value of the derivative hedging instrument – and therefore the derivative gains or losses recognized in OCI.
- The effectiveness assessment may also be affected by changes in counterparty credit risk and an entity's own nonperformance risk even if effectiveness is not assessed based on a method that uses the derivative hedging instrument's fair value change.
- The potential effect on the hedging relationship's effectiveness of these changes is ignored. However, if it is no longer probable that the derivative counterparty or the entity itself will not default, an entity will be unable to conclude that the hedging relationship is expected to be

	highly effective and will therefore be required to discontinue the hedging relationship. — In addition, an entity is required to consider the credit risk of the counterparty to the hedged transaction to determine the likelihood that it will occur, particularly if the hedged transaction involves payments under a contractual obligation.
Net investment hedge	— An entity is required to consider the effects of counterparty credit risk and the entity's own nonperformance risk when assessing hedging relationships. — Changes in both counterparty credit risk and an entity's own nonperformance risk affect the measurement of changes in the fair value of a derivative hedging instrument, and therefore the derivative gains or losses recognized in CTA within AOCI. — The potential effect of these differences on a net investment hedging relationship's effectiveness as an economic hedge is ignored unless it is no longer probable that the derivative counterparty or the entity itself will not default. If the forward method is used and meets the conditions to be perfectly effective, the total changes in the fair value of the derivative instrument are included in CTA within AOCI. — However, if non-default by either party is no longer probable, an entity will be required to assess whether the hedging relationship has been and is expected to continue to be effective as an economic hedge. If an entity continues to expect the relationship to be effective as an economic hedge, strong evidence supporting the expectation would be needed.

See also KPMG Handbook, [Fair value measurement](#), including:

- Section O, Application issues: Derivatives and hedging, including Question O70, which provides additional information about whether (and how) the requirements to include counterparty credit risk and an entity's own nonperformance risk in measuring the fair values of derivative instruments affect hedging relationships.
- Question C70, which addresses how to consider the existence of a separate arrangement (such as a master netting agreement or credit support agreement) that mitigates credit risk exposure in the event of default when measuring the fair value of a financial instrument.



Question 13.2.90

If a hedging instrument is in a liability (asset) position, can changes in counterparty creditworthiness (its own nonperformance risk) be ignored?

Interpretive response: No. Changes in a derivative hedging instrument's underlying can cause it to move into an asset position before its settlement or maturity. As a result, an entity must consider the effect that changes in the counterparty's credit risk would have on the hedging relationship if the derivative were to move into an asset position. If the current likelihood of counterparty default would cause the entity to discontinue a cash flow hedge (or a fair value hedge for which the shortcut method is used) for which the hedging instrument is in an asset position, the entity typically should discontinue the hedging relationship even if the hedging derivative is in a liability position. That is, the possibility that a change in the underlying could cause the derivative to move into an asset position before settlement or maturity typically would cause the hedging relationship to be not highly effective on a prospective basis.

Similarly, an entity cannot ignore the effect of its own nonperformance risk if a derivative hedging instrument is in an asset position. Because the derivative could move into a liability position before its settlement or maturity, an entity must consider the effect its own nonperformance risk would have on the hedging relationship in the same way that the entity must consider the counterparty's credit risk when the derivative is in a liability position.

See also KPMG Handbook, [Fair value measurement](#), including Section O, Application issues: Derivatives and hedging. In particular, see Question O20, which provides information about how credit valuation adjustments (CVA) for counterparty credit risk and debit valuation adjustments (DVA) for an entity's own nonperformance risk are determined in measuring derivatives at fair value.

Consideration of credit risk adjustments determined at a portfolio level for hedging instruments

Derivative instruments are measured on the balance sheet at fair value. The fair values of derivative instruments are typically determined on an individual basis. However, if certain conditions are met, an entity is permitted to measure the fair value of a group of financial assets and liabilities based on a price that would be received to sell or paid to transfer the net risk position (referred to as a 'portfolio measurement exception'). [\[820-10-35-18D – 35-18E\]](#)

If an entity has a group of derivative assets and liabilities with a particular counterparty and applies the portfolio measurement exception to that counterparty's credit risk, the effect on the entity's net exposure to the credit risk of that counterparty (or on the counterparty's net exposure to the entity's own nonperformance risk) may result in a portfolio-level credit risk adjustment when measuring fair value to be recognized on the entity's balance sheet.

Even though the credit risk adjustment may be determined at a portfolio level under the portfolio measurement exception, hedge effectiveness is assessed on an individual hedging relationship basis. This means that an entity is required to consider the effect of counterparty credit risk (or its own nonperformance risk) on each individual hedging relationship when assessing hedge effectiveness. As a result, it may be necessary to allocate a portfolio-level credit risk adjustment to individual hedging relationships, as explained in Questions 13.2.90 and 13.2.100.

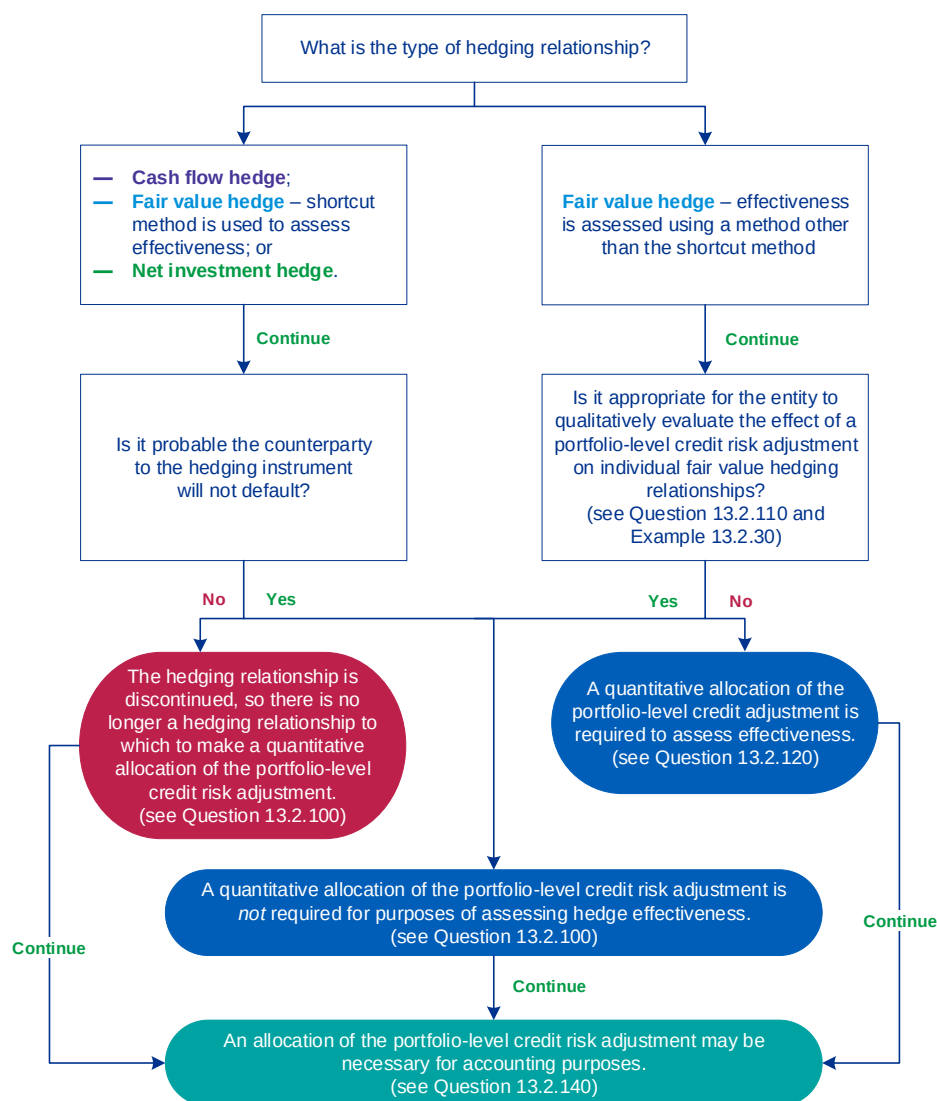
Because the effect of a portfolio-level credit risk adjustment is part of an entity's effectiveness assessments, an entity needs to determine the adjustment as frequently as it performs the hedge effectiveness assessments (whether daily, weekly, monthly, quarterly or other frequency).

Additionally, an entity may be required to allocate a portfolio-level credit risk adjustment to individual hedging derivatives to properly account for the derivatives, even if such an allocation is not necessary for assessing effectiveness (see Question 13.2.140).

See also KPMG Handbook, [Fair value measurement](#). In particular, see:

- Section L, Portfolio measurement exception, which addresses the circumstances under which it is appropriate to apply the portfolio measurement exception and related issues.
- Section O, Application issues: Derivatives and hedging, including Question O70, which discusses how the requirements to include counterparty credit risk and an entity's own nonperformance risk in measuring the fair values of derivative instruments affect hedging relationships.

The flowchart below summarizes considerations when evaluating whether a portfolio-level credit risk adjustment (that results from applying the portfolio measurement exception when measuring the fair value to be recognized on the balance sheet for a group of derivatives) is required to be allocated to individual derivative instruments either for purposes of assessing effectiveness of hedging relationships or for other purposes.



Question 13.2.100

Must an entity allocate a portfolio-level credit risk adjustment to individual hedging relationships when assessing effectiveness?

Interpretive response: Generally, yes. When assessing hedge effectiveness, an entity generally is required to determine the individual credit risk adjustments to arrive at the fair values of the individual hedging derivatives or the appropriate credit risk adjustment for a group of derivatives that have been designated together as the hedging instrument in a single hedging relationship.

However, it may not be necessary to make such an allocation, depending on the type of hedging relationship and the method used to assess effectiveness, as explained in the following table.

Fair value and cash flow hedges – shortcut method [815-20-35-18]	Under the shortcut method, a hedge is assumed to be perfectly effective – with changes in fair value of the hedging derivative serving as a proxy for changes in the fair value of the hedged item – when it is probable that the interest rate swap’s counterparty or the entity itself will not default. In this situation, an entity may conclude that the hedging relationship is highly effective without allocating the portfolio-level credit risk adjustment. If it is <i>not</i> probable that the counterparty or the entity itself will not default, the shortcut method is required to be discontinued and there is no longer a hedging relationship to which to make an allocation.
Fair value hedges – long-haul methods [815-20-35-16]	For all fair value hedges other than those using the shortcut method, changes in the fair value of a derivative – including those related to counterparty credit risk and an entity’s own nonperformance risk – have an immediate effect on the assessment of effectiveness. Normally, this results in a requirement to allocate a portfolio-level credit risk adjustment to the individual hedging instruments. However, in some situations, it may be possible for an entity to qualitatively evaluate whether it is necessary to allocate the portfolio-level credit risk adjustment to individual fair value hedging relationships (see Question 13.2.110).
Cash flow hedges – all methods other than shortcut [815-20-25-122, 35-14 – 35-15]	An entity is permitted to ignore the effects of changes in both counterparty credit risk and an entity’s own nonperformance risk for a cash flow hedge if it is probable that the counterparty to the derivative instrument and the entity itself will not default. In this situation, an entity may conclude that the hedging relationship is highly effective without performing an allocation of the portfolio-level credit risk adjustment. Additionally, if it is <i>not</i> probable that the counterparty or the entity itself will not default, an entity will be unable to conclude that the hedging relationship is expected to be highly effective and must discontinue the hedge. If the hedge is discontinued, there is no longer a hedging relationship in which to make an allocation.
Net investment hedges	An entity is permitted to ignore the effects of changes in both counterparty credit risk and an entity’s own nonperformance risk for a net investment hedge if it is probable that the counterparty to the derivative instrument and the entity itself will not default. In this situation, an entity may conclude that the hedging relationship is effective as an economic hedge without performing an allocation of the portfolio-level credit risk adjustment. If it is <i>not</i> probable that the counterparty or the entity itself will not default, an entity will frequently conclude that the hedging relationship is no longer expected to be effective as an economic hedge and discontinue the hedge. If the hedge is discontinued, there is no longer a hedging relationship in which to make an allocation. If the entity concludes that the hedging relationship continues to be expected to be effective as an economic hedge, the entity is required to allocate the portfolio-level credit risk adjustment to the individual hedging relationships when assessing effectiveness.



Question 13.2.110

Under what circumstances may an entity qualitatively evaluate the effect of a portfolio-level credit risk adjustment on individual fair value hedging relationships?

Interpretive response: The SEC staff will not object to using a qualitative analysis to conclude that it is not necessary to allocate the portfolio-level credit risk adjustment to the individual **fair value hedging relationships** when assessing effectiveness, provided the qualitative analysis results in a reasonable conclusion, based on the specific facts and circumstances.

An entity should use reasonable judgment in performing a qualitative analysis. A conclusion that it is probable that the counterparty and the entity itself will not default is not, in isolation, a sufficient qualitative analysis. Instead, the qualitative analysis should consider all relevant facts and circumstances, including:

- the size of the portfolio-level credit risk adjustment;
- the hedging relationships' degree of effectiveness without considering the portfolio-level credit risk adjustment;
- the creditworthiness of the counterparty and the entity itself;
- the probability of default by either party; and
- the method used to assess effectiveness.

Further, if an entity is unable to conclude it is probable that the counterparty or the entity itself will *not* default, a solely qualitative analysis is not appropriate. Additionally, if the shortcut method is used to assess effectiveness, the hedging relationship is required to be discontinued.

When a reasonable conclusion that the hedging relationships, including derivative instruments subject to the portfolio-level credit risk adjustment, would be highly effective cannot be reached solely through a qualitative analysis, a quantitative analysis is necessary.



Example 13.2.30

Qualitative analysis of whether allocation of portfolio-level credit risk adjustment is required

ABC Corp. applies the portfolio measurement exception to its derivative assets and liabilities with DEF Counterparty and applies the portfolio measurement exception to DEF's credit risk, resulting in a portfolio-level credit risk adjustment.

The net position of ABC's derivative instruments with DEF is a \$10 billion liability position and the portfolio-level credit risk adjustment is \$1 million. The derivative instruments are part of fair value hedging relationships for which ABC uses regression analysis (a long-haul method) for assessing effectiveness.

Both ABC and DEF are AA-rated and the likelihood of either party not defaulting is deemed probable.

Other causes of the relationship not being perfectly effective are minimal, such that the hedging relationships are at least 95% effective without consideration of the portfolio-level credit risk adjustment.

Based on these facts, ABC may conclude that a qualitative analysis is sufficient for determining an allocation of the portfolio-level credit adjustment when assessing effectiveness.

However, ABC may be required to allocate the portfolio-level credit adjustment for reasons other than assessing effectiveness, as explained in Question 13.2.140.



Question 13.2.120

What methods may be used to quantitatively allocate a portfolio-level credit risk adjustment to individual fair value hedging relationships?

Interpretive response: When measuring the fair values of individual hedging instruments to assess effectiveness, we believe an entity should adopt a reasonable and consistently applied methodology for allocating credit risk adjustments determined at a portfolio level to individual derivative instruments.

In our experience, the following allocation methods generally are used for credit risk adjustments.

- **Relative fair value method.** The portfolio-level credit risk adjustment is allocated to the individual instruments in the portfolio based on their relative fair values. There are two methods that are used in practice.
 - Allocate the adjustment to all instruments in the portfolio based on their relative fair values.
 - Allocate the adjustment only to those instruments that are in the same position (asset or liability) as the net position with the counterparty, based on their relative fair values. For example, if the net position is an asset, the portfolio-level credit risk adjustment is allocated only to the financial assets in the portfolio based on their relative fair values.
- **Relative credit adjustment method.** The portfolio-level credit risk adjustment is allocated to the individual instruments in the portfolio based on their relative stand-alone credit risk adjustments. Applying this method requires the entity to calculate the credit risk adjustment both on a gross basis (assuming that the portfolio measurement exception is not applied) and on a net basis.

The appropriate allocation method is affected by the fair value hierarchy of the financial instruments within the portfolio (see Question 13.2.130).

See also KPMG Handbook, [Fair value measurement](#). In particular, see:

- Section L, Portfolio measurement exception, including Question L60, which addresses allocations of a net portfolio basis adjustment to individual financial assets and liabilities that make up the portfolio.

- Section O, Application issues: Derivatives and hedging, including Question O70, which discusses how the requirements to include counterparty credit risk and an entity's own nonperformance risk in measuring the fair values of derivative instruments affect hedging relationships.



Question 13.2.130

How does a financial instrument's level in the fair value hierarchy affect allocation of a portfolio-level credit risk adjustment to individual hedging relationships?

Interpretive response: We understand from conversations with the FASB staff that they believe the fair value allocated to financial instruments within the portfolio categorized in Level 1 of the fair value hierarchy should be determined using the instrument price times the quantity (i.e. $P \times Q$), which is consistent with the guidance in Topic 820 for Level 1 inputs. The FASB staff indicated that the net portfolio measurement exception allows an entity to estimate the fair value of financial instruments at levels different from the unit of account prescribed by other Topics, but does not provide an exception to the other conclusions and concepts of fair value measurement under Topic 820.

We believe this guidance is unlikely to apply in many circumstances because the portfolios to which portfolio-level credit risk adjustments would apply frequently do not contain Level 1 derivative instruments.

See also KPMG Handbook, [Fair value measurement](#), including Question L60, which addresses allocations of a net portfolio basis adjustment to individual financial assets and liabilities that make up the portfolio.



Question 13.2.140

Could an entity be required to quantitatively allocate a portfolio-level credit risk adjustment for reasons other than assessing effectiveness?

Interpretive response: Yes. Even if an entity is not required to quantitatively allocate a portfolio-level credit risk adjustment to the individual derivative assets and liabilities within the group for which the portfolio measurement exception is applied when assessing effectiveness (see Questions 13.2.90 and 13.2.100), such an allocation frequently is necessary for other purposes.

The following are examples of when a quantitative allocation might be necessary for reasons other than assessing effectiveness.

Derivatives in the group are used in fair value, cash flow and net investment hedging relationships	It is necessary to allocate a portfolio-level credit risk adjustment to the individual hedging instruments. This is because the change in fair value of a hedging instrument in a fair value hedge is recorded immediately in earnings while the change in a cash flow or net investment hedge is recorded in OCI (or CTA in AOCI).
Derivatives in the group are used in fair value hedges of different types of risk	If the changes in fair value of the derivatives in the group are recorded in different income statement line items, it is necessary to allocate a portfolio-level credit risk adjustment between income statement line items.
Derivatives in the group are used in fair value hedges that use the shortcut method– basis adjustments	— When the shortcut method is used to assess effectiveness for a fair value hedge of interest rate risk, the change in fair value of the hedging instrument is used as a proxy for the change in fair value of the hedged item (i.e. the basis adjustment). — It may be necessary to allocate a portfolio-level credit risk adjustment to determine the hedged item's amortized cost basis (which includes the basis adjustment) for purposes of applying other applicable GAAP, including impairment (see section 8.3.30).
Derivatives in the group are used in cash flow hedges of different types of risk and/or to hedge forecasted transactions that affect earnings in different periods	— In these situations, it is necessary to allocate a portfolio-level credit risk adjustment to the individual hedging instruments. This is because the net derivative gain or loss is reclassified from AOCI into earnings when the hedged transaction affects earnings and is presented in the same line item as the effect of the hedged transaction (see section 10.3). — If the hedged risk varies for the derivatives in the group, the income statement line items in which the allocated credit risk should be recorded when reclassified into earnings may vary. — If the timing of the hedged transaction affecting earnings varies, the timing of reclassifications from AOCI will also vary. — Additionally, certain other circumstances also may result in reclassifying amounts from AOCI, as discussed in section 10.4.

13.2.70 Excluded components



Excerpt from ASC 815-20

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-82 In defining how hedge effectiveness will be assessed, an entity shall specify whether it will include in that assessment all of the gain or loss on a hedging instrument. An entity may exclude all or a part of the hedging instrument's time value from the assessment of hedge effectiveness, as follows:

- a. If the effectiveness of a hedge with an option is assessed based on changes in the option's intrinsic value, the change in the time value of the option would be excluded from the assessment of hedge effectiveness.
- b. If the effectiveness of a hedge with an option is assessed based on changes in the option's minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract shall be excluded from the assessment of hedge effectiveness.
- c. An entity may exclude any of the following components of the change in an option's time value from the assessment of hedge effectiveness:
 1. The portion of the change in time value attributable to the passage of time (theta)
 2. The portion of the change in time value attributable to changes due to volatility (vega)
 3. The portion of the change in time value attributable to changes due to interest rates (rho).
- d. If the effectiveness of a hedge with a forward contract or futures contract is assessed based on changes in fair value attributable to changes in spot prices, the change in the fair value of the contract related to the changes in the difference between the spot price and the forward or futures price shall be excluded from the assessment of hedge effectiveness.
- e. An entity may exclude the portion of the change in fair value of a currency swap attributable to a cross-currency basis spread.

25-83 No other components of a gain or loss on the designated hedging instrument shall be excluded from the assessment of hedge effectiveness nor shall an entity exclude any aspect of a change in an option's value from the assessment of hedge effectiveness that is not one of the permissible components of the change in an option's time value. For example, an entity shall not exclude from the assessment of hedge effectiveness the portion of the change in time value attributable to changes in other market variables (that is, other than rho and vega).

>>> Components of Option Time Value

55-57 This guidance discusses implementation of paragraph 815-20-25-82.

55-58 Some entities may wish to assess hedge effectiveness based on the change in an option's value excluding a certain aspect of the change in the option's time value. For example, some entities may wish to exclude the change in time value attributable to the passage of time (theta) from the

assessment of hedge effectiveness, while assessing hedge effectiveness based on the remaining components of changes in an option's value. As an illustration, if out-of-the-money options are designated as hedging instruments, changes in value of the option are primarily driven by the change, if any, in the value of the underlying (delta). If the price of the underlying asset changes, in effective hedging strategies involving out-of-the-money options, the hedge gain or loss due to delta would offset the change in value of the hedged item; however, if the price of the underlying does not change, there is no change in fair value attributable to changes in delta. In that case, the only change in the option's value is attributable to the passage of time (theta), or to changes in other market variables such as volatilities or interest rates. Accordingly, for those hedging relationships to qualify for hedge accounting, an entity may need to exclude the change in value attributable to theta from the assessment of hedge effectiveness.

55-59 Other entities may wish to exclude changes in time value attributable to certain market variables—volatility (vega) or interest rates (rho)—from the assessment of hedge effectiveness. An entity may wish to exclude changes in time value attributable to volatility (vega) from the assessment of hedge effectiveness because the fair value measurement of the hedged item does not incorporate a measure of implied volatility.

55-60 Similarly, an entity may seek to exclude changes in time value attributable to interest rates (rho) from the assessment of hedge effectiveness. For example, in a foreign currency hedge involving a country in which interest rates are volatile, a substantial portion of the change in value of the option may be attributable to fluctuations in those interest rates, while the fair value of the hedged item is not affected correspondingly. Accordingly, for these hedging relationships to qualify for hedge accounting, an entity may need to exclude the change in value attributable to the relevant market variable from the assessment of hedge effectiveness.

55-61 In summary, the exclusion of a certain aspect of the change in an option's time value from the assessment of hedge effectiveness is driven by the fact that, in certain circumstances, the measurement of changes in fair value of the hedged item or changes in the cash flows of the hedged transaction does not depend on or incorporate that aspect. Option valuation models are capable of isolating the various aspects of changes in an option's time value.

Topic 815 permits entities to exclude some components of a derivative hedging instrument's changes in fair value (i.e. cash flows) from the effectiveness assessment. [\[815-20-25-82 – 25-83\]](#)

Hedge effectiveness is improved by excluding a component when the hedged item's fair value (or hedged transaction's cash flows) is not affected by (or not affected to the same extent as) the component. As a result, the ability to exclude certain components from effectiveness assessments is important because it improves effectiveness, which increases the likelihood of being able to apply hedge accounting. [\[815-20-55-57 – 55-61\]](#)

Including all gains and losses on the derivative hedging instrument may result in reduced levels of effectiveness if the fair value or cash flows of the hedged

item or transaction is not affected by (or to the same extent as) the excluded components (e.g. time value).

The following table provides examples of components of a hedging instrument's fair value or cash flows that may be excluded from the effectiveness assessment. [815-20-25-82]

Hedging instrument	Excluded component
Cash flow, fair value and net investment hedges	
Options	Excluded component depends on the method used to assess effectiveness. — Changes in intrinsic value. All changes in time value or changes in time value attributable to either passage of time (rho), volatility (theta) or interest rates (vega) may be excluded. — Changes in minimum value (i.e. intrinsic value after the effect of discounting). Volatility value may be excluded.
Forward or futures contract	Spot-forward difference – i.e. the difference between the spot price and the forward or futures price (referred to as forward points). This method is referred to as the spot method.
Cash flow and fair value hedges	
Currency swap	Cross-currency basis spread – this represents a charge to convert one currency to another; its initial cost is embedded in the coupon payments that an entity has agreed to pay the counterparty.

For additional considerations when using options (or combinations of options) as a hedging instrument, see section 13.2.90.

No components (or portions of components) other than those specified in Topic 815 may be excluded. [815-20-25-83]



Example 13.2.40

Effect of time value on hedge effectiveness

ABC Corp. purchases wheat to be used in its production of cereal. ABC enters into a firm commitment to purchase wheat in six months at a fixed price from DEF; this purchase is considered a 'normal' purchase.

ABC is concerned that the price of wheat will fall during the coming months. A decline in wheat prices would decrease the value of the purchase commitment. This is because ABC will be required to pay the fixed price in the firm commitment even if the market value for the wheat is less than that six months from now.

To hedge this exposure, ABC enters into a futures contract, which settles net in cash, to sell wheat in six months at a fixed price. If the price of wheat decreases, the fair value of the futures contract will increase while the fair value of the firm commitment will decrease. Conversely, if the price of wheat

increases, the fair value of the futures contract will decrease while the fair value of the firm commitment will increase.

ABC will assess the effectiveness of this hedging relationship by comparing the changes in the fair value of the firm commitment to purchase wheat to changes in the entire fair value of the wheat futures contract – i.e. time value is *not* an excluded component). Including all gains and losses of the derivative hedging instrument improves effectiveness if the time value element of the futures contract changes in amounts similar to (but in amounts opposite from) the time value of the firm commitment.

In contrast, if ABC was hedging the fair value of its wheat inventory, the time value element of the wheat futures contract would likely reduce the effectiveness of the hedging relationship. This is because there is no time value associated with the fair value of recognized inventory.



Question 13.2.150

Are there circumstances where the time value does not affect the assessment of effectiveness even though it is not considered an excluded component?

Interpretive response: Yes, but only when the terminal value method is used.

When the hedging instrument is a purchased option or combination of options resulting in a net purchased option or zero-cost collar, generally the option's premium (time value) does not offset hedged changes in cash flows. This generally results in the time value affecting the hedging relationship's effectiveness unless time value is excluded from the assessment.

However, the time value component does not affect hedge effectiveness when the terminal value method is used, even though time value is not an excluded component under that approach (see section 13.7.20). This is because the terminal value method focuses on the option's terminal value (i.e. the expected pay-off at its maturity date) in determining whether the hedging relationship is expected to be highly effective.

Recognizing excluded components



Excerpt from ASC 815-20

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-83A For fair value and cash flow hedges, the initial value of the component excluded from the assessment of effectiveness shall be recognized in earnings using a systematic and rational method over the life of the hedging instrument. Any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method

shall be recognized in other comprehensive income. Example 31 beginning in paragraph 815-20-55-235 illustrates this approach for a cash flow hedge in which the hedging instrument is an option and the entire time value is excluded from the assessment of effectiveness.

25-83B For fair value and cash flow hedges, an entity alternatively may elect to record changes in the fair value of the excluded component currently in earnings. This election shall be applied consistently to similar hedges in accordance with paragraph 815-20-25-81 and shall be disclosed in accordance with paragraph 815-10-50-4EEEE.

> Income Statement Classification

45-1A For qualifying fair value and cash flow hedges, an entity shall present both of the following in earnings in the same income statement line item that is used to present the earnings effect of the hedged item:

- a. The change in the fair value of the hedging instrument that is included in the assessment of hedge effectiveness
- b. Amounts excluded from the assessment of hedge effectiveness in accordance with paragraphs 815-20-25-83A through 25-83B.

See paragraphs 815-20-55-79W through 55-79AD for related implementation guidance.

45-1B For cash flow hedges in which the hedged forecasted transaction is probable of not occurring in accordance with paragraph 815-30-40-5, this Subtopic provides no guidance on the required income statement classification of amounts reclassified from accumulated other comprehensive income to earnings.

45-1D While the Derivatives and Hedging Topic does not specify whether certain income statement line items are either permitted or appropriate, the other hedging-related Subtopics in this Topic do contain specific disclosure requirements for those items. See Section 815-10-50 and Subtopics 815-25, 815-30, and 815-35..

If an entity has excluded components from its assessment of hedge effectiveness, it can recognize the initial value of the excluded components in earnings using either of the following approaches. [\[815-20-25-83A – 25-83B\]](#)

- **Amortization approach.** A systematic and rational method over the life of the hedging instrument.
- **Mark-to-market approach.** A method that recognizes all fair value changes of the excluded components currently in earnings.

When using the amortization approach, any difference between the change in fair value of the excluded component and the amounts recognized in earnings are included in AOCI (or CTA in AOCI). This election is applied consistently to similar hedges, as discussed in section 13.2.80. If an entity elects the mark-to-market approach, that election is disclosed. [\[815-10-50-4EEEE, 815-20-25-83A – 25-83B\]](#)

An entity presents amounts related to excluded components that are recognized in earnings in the same income statement line item that is used to present the earnings effect of the hedged item. [\[815-20-45-1A\]](#)



Question 13.2.160

What is a systematic and rational method to recognize an excluded component?

Interpretive response: The FASB did not prescribe a specific methodology to satisfy the requirement that the excluded component be recognized in earnings using a systematic and rational method over the life of the hedging instrument.

However, one method that an entity may consider to be systematic and rational is the straight-line method. [815-20-55-237]

Additionally, the FASB noted that, similar to forward points (or the spot-forward difference), cross-currency basis spreads reduce to zero by the time the derivative matures. In the FASB's view, recognizing the cross-currency basis spread in earnings through the swap accrual is a systematic and rational method for recognizing the cost of the cross-currency basis spread in earnings. [ASU 2017-12.BC162–BC163]

When an entity elects to consider a cross-currency basis spread as an excluded component and to recognize it through the swap accrual (an amortization approach), the change in fair value of the swap attributable to the cross-currency basis spread incorporated in the discount rates used to value the swap is included in AOCI. It is not necessary to manually amortize any amounts when their effect on the swap discounting reverses to zero in AOCI because the swap matures. [ASU 2017-12.BC164]



Question 13.2.170

Under the amortization approach, is the excluded component recognized when the hedged transaction affects earnings?

Interpretive response: Not necessarily. The excluded component can be viewed as the 'cost of the hedge'. The amortization approach allows that cost to be recognized over the term of the hedging relationship and could be viewed as smoothing the effect of the excluded component in earnings. However, if the forecasted transaction(s) will only affect earnings at the end of the hedging relationship, the excluded component (cost of the hedge) will be recognized earlier than when the hedged item actually affects earnings.

For example, an entity purchases an option to hedge its price exposure on the anticipated sale of a nonfinancial item and decides to exclude the time value from the assessment of hedge effectiveness. In that case, the effect of time value is recognized over the period of the hedge, which is before the anticipated sales revenue is recognized in earnings.



Question 13.2.180

Is the caplet method acceptable for recognizing the initial value of an excluded component?

Background: The caplet method involves associating the initial fair value of an interest rate cap with each caplet within the rate cap, and reclassifying the amount of each caplet from AOCI to earnings when the respective forecasted interest payment occurs. [\[815-30-35-41B\]](#)

Interpretive response: No. The initial value of excluded components is required to be recognized in earnings using either an amortization approach or the mark-to-market approach, both of which result in the initial fair value of the excluded component being recognized in earnings over the life of the hedging instrument.

In contrast, the caplet method recognizes amounts when the hedged transactions are reported in earnings. This may not occur during each period of the hedging instrument's life. For example, the hedged transaction may be sales that occur in only certain periods or occur after the life of the hedging instrument.

As a result, we believe that the caplet method is not an acceptable method for recognizing the initial value of an excluded component.



Question 13.2.190

How does an entity account for amounts included in AOCI related to an excluded component if hedge accounting is discontinued?

Interpretive response: These amounts should be recognized in earnings consistent with existing guidance for discontinued fair value or cash flow hedges.

Fair value hedges

Any amounts associated with the excluded component remaining in AOCI when a fair value hedge is discontinued are recorded in earnings in the same manner as other components (e.g. the basis adjustment) of the carrying amount of the hedged asset or liability when the hedged item continues to exist. [\[815-25-40-7\]](#)

When the hedged item is derecognized, the amounts remaining in AOCI are recognized in earnings immediately. [\[815-25-40-7\]](#)

For further guidance on the discontinuation of fair value hedge accounting, see section 8.5.10.

Cash flow hedges

Any amounts associated with the excluded component remaining in AOCI when a cash flow hedge is discontinued are recognized in earnings when the hedged transaction affects earnings (see section 10.5.10). [\[815-30-40-6A\]](#)

If the cash flow hedge relates to a forecasted transaction that it is probable will *not* occur (i.e. a missed forecast), any amounts associated with the excluded component remaining in AOCI are recognized currently in earnings. See also section 10.5.20, including Question 10.5.100 related to income statement presentation in such situations.

Net investment hedges

Any amounts remaining in the cumulative translation adjustment (CTA) in AOCI related to a discontinued hedging relationship – including amounts related to excluded components – remain in CTA until the hedged net investment is sold, exchanged or liquidated (see sections 12.5.20 and 12.5.40). For guidance on the income statement presentation of excluded components, see Question 12.4.30. [815-35-35-1(c), 40-1]

Examples

The following are examples that demonstrate the amortization and mark-to-market approaches.

- Option time value excluded from the assessment of effectiveness in a cash flow hedge and recorded in earnings under an amortization approach (Subtopic 815-20's Example 31).
- Comparison of approaches to recognize the excluded component for a cash flow hedge (Example 13.2.50).

See sections 8.2.20 and 10.2.20 for additional examples of approaches to recognize the excluded component for fair value and cash flow hedges, respectively.



Excerpt from Subtopic 815-20

>> Example 31: Option Time Value Excluded from the Assessment of Effectiveness in a Cash Flow Hedge and Recorded in Earnings under an Amortization Approach

55-235 This Example illustrates the application of paragraph 815-20-25-83A.

55-236 On December 31, 20X0, an entity intends to purchase 1,000 barrels of crude oil in December 20X4. The entity decides to hedge changes in the price of the crude oil by purchasing an at-the-money call option on 1,000 barrels of crude oil. The entity purchases the option on December 31, 20X0, with an initial premium of \$9,250, a strike price of \$75, and a maturity date of December 31, 20X4. The entity designates the option as the hedging instrument in a cash flow hedge of a forecasted purchase of crude oil.

55-237 The entity elects to exclude the time value of the option from the assessment of effectiveness in accordance with paragraph 815-20-25-82 and applies the amortization approach for recognizing excluded components in accordance with paragraph 815-20-25-83A. The entity applies a straight-line

amortization method and, based on the initial option premium of \$9,250, the entity determines an annual amortization amount of \$2,313. The entity records all changes in fair value over the term of the derivative in other comprehensive income and records amortization in earnings each period with an offsetting entry to other comprehensive income. The changes in value of the option over the life of the hedging relationship are as follows.

	12/31/20X1	12/31/20X2	12/31/20X3	12/31/20X4
Ending market price of crude oil	\$ 77	\$ 76	\$ 74	\$ 81
Ending fair value of option:				
Time value	7,500	5,500	3,000	-
Intrinsic value	2,000	1,000	-	6,000
Total	\$ 9,500	\$ 6,500	\$ 3,000	\$ 6,000
Change in time value	\$ (1,750)	\$ (2,000)	\$ (2,500)	\$ (3,000)
Change in intrinsic value	2,000	(1,000)	(1,000)	6,000
Total current-period gain (loss) on derivative	\$ 250	\$ (3,000)	\$ (3,500)	\$ 3,000

55-238 On December 31, 20X4, the entity purchases 1,000 barrels of crude oil, and the option expires with an intrinsic value of \$6,000. This amount will remain in accumulated other comprehensive income until the commodity is sold in 20X5. The journal entries over the life of the hedging relationship are as follows.

December 31, 20X0

Derivative asset	\$ 9,250	
Cash		\$ 9,250
To record the derivative asset based on the initial premium.		

December 31, 20X1

Derivative asset	\$ 250	
Other comprehensive income		\$ 250
To record the change in value of the derivative in other comprehensive income.		
Cost of goods sold	\$ 2,313	
Other comprehensive income		\$ 2,313
To record amortization of the excluded amount.		

December 31, 20X2

Other comprehensive income	\$ 3,000	
Derivative asset		\$ 3,000
To record the change in value of the derivative in other comprehensive income.		
Cost of goods sold	\$ 2,313	
Other comprehensive income		\$ 2,313

To record amortization of the excluded amount.

December 31, 20X3

Other comprehensive income	\$ 3,500	
Derivative asset		\$ 3,500

To record the change in value of the derivative in other comprehensive income.

Cost of goods sold	\$ 2,313	
Other comprehensive income		\$ 2,313

To record amortization of the excluded amount.

December 31, 20X4

Derivative asset	\$ 3,000	
Other comprehensive income		\$ 3,000

To record the change in value of the derivative in other comprehensive income.

Cost of goods sold	\$ 2,311 ^(a)	
Other comprehensive income		\$ 2,311 ^(a)

To record amortization of the excluded amount.

July 1, 20X5

Accumulated other comprehensive income	\$ 6,000	
Cost of goods sold		\$ 6,000

Upon sale of commodity, to record intrinsic value to cost of goods sold.

(a) \$2 rounding adjustment



Example 13.2.50

Comparison of approaches to recognize the excluded component for a cash flow hedge

Using the fact pattern in Subtopic 815-20's Example 31, the following shows the effect on earnings if the entity has elected to recognize the change in the excluded component currently in earnings (mark-to-market approach).

	December 31				
	Year 0	Year 1	Year 2	Year 3	Year 4
Ending fair value of the option:					
Time value	\$9,250	\$7,500	\$5,500	\$3,000	\$ -
Intrinsic value	-	2,000	1,000	-	6,000
Total	\$9,250	\$9,500	\$6,500	\$3,000	\$6,000

	December 31				
	Year 0	Year 1	Year 2	Year 3	Year 4
Change in time value		\$(1,750)	\$(2,000)	\$(2,500)	\$(3,000)
Change in intrinsic value		2,000	(1,000)	(1,000)	6,000
Total current-period gain (loss) on derivative		\$ 250	\$(3,000)	\$(3,500)	\$3,000

The following journal entry recognizes the purchase of the derivative.

	Debit	Credit
Derivative asset (option)	9,250	
Cash		9,250
<i>To record derivative asset based on initial premium paid.</i>		

The following journal entry recognizes the change in the fair value of the derivative for Year 1.

	Debit	Credit
Cost of goods sold ¹	1,750	
Derivative asset (option)		1,750
<i>To record change in time value.</i>		
Derivative asset (option) ²	2,000	
AOCI		2,000
<i>To record change in intrinsic value.</i>		
Notes:		
1. Beginning time value of \$9,250 - ending time value of \$7,500.		
2. Beginning intrinsic value of \$0 - ending intrinsic value of \$2,000.		

The following journal entry recognizes the change in the fair value of the derivative for Year 2.

	Debit	Credit
Cost of goods sold ¹	2,000	
Derivative asset (option)		2,000
<i>To record change in time value.</i>		
AOCI ²	1,000	
Derivative asset (option)		1,000
<i>To record change in intrinsic value.</i>		

Notes:

1. Beginning time value of \$7,500 - ending time value of \$5,500.
2. Beginning intrinsic value of \$2,000 - ending intrinsic value of \$1,000.

The following journal entry recognizes the change in the fair value of the derivative for Year 3.

	Debit	Credit
Cost of goods sold ¹	2,500	
Derivative asset (option)		2,500
<i>To record change in time value.</i>		
AOCI ²	1,000	
Derivative asset (option)		1,000
<i>To record change in intrinsic value.</i>		

Notes:

1. Beginning time value of \$5,500 - ending time value of \$3,000.
2. Beginning intrinsic value of \$1,000 - ending intrinsic value of \$0.

The following journal entry recognizes the change in the fair value of the derivative for Year 4.

	Debit	Credit
Cost of goods sold ¹	3,000	
Derivative asset (option)		3,000
<i>To record change in time value.</i>		
Derivative asset (option) ²	6,000	
AOCI		6,000
<i>To record change in intrinsic value.</i>		

Notes:

1. Beginning time value of \$3,000 - ending time value of \$0.
2. Beginning intrinsic value of \$0 - ending intrinsic value of \$6,000.

The following table compares the earnings effect of the excluded component under the two methods:

- amortization approach (Subtopic 815-20's Example 31); and
- mark-to-market approach (KPMG example).

Approach	December 31				Total
	Year 1	Year 2	Year 3	Year 4	
Amortization	\$2,313	\$2,313	\$2,313	\$2,311	\$9,250
Mark-to-market	1,750	2,000	2,500	3,000	9,250
Difference	\$ 563	\$ 313	\$ (187)	\$ (689)	\$ -

13.2.80 Consistency of methods between hedging relationships



Excerpt from ASC 815-20

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-81 This Subtopic does not specify a single method for assessing whether a hedge is expected to be highly effective. The method of assessing effectiveness shall be reasonable. The appropriateness of a given method of assessing hedge effectiveness depends on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, an entity shall assess effectiveness for similar hedges in a similar manner, including whether a component of the gain or loss on a derivative instrument is excluded in assessing effectiveness for similar hedges. Use of different methods for similar hedges shall be justified. The mechanics of isolating the change in **time value of an option** discussed beginning in paragraph 815-20-25-98 also shall be applied consistently.

An entity should assess effectiveness for similar hedges in a similar manner, and is required to justify using different methods for similar hedges. This includes whether a component of a hedging instrument is an excluded component for similar hedges, how the change in time value in an option is isolated, and the method that will be used to recognize excluded components (see section 13.2.70). [815-20-25-81]



Question 13.2.200

Are there situations in which an entity may use different effectiveness assessment methods for similar hedges?

Interpretive response: Yes. Topic 815 permits an entity to use different effectiveness assessment methods when the entity can justify doing so. We believe that judgment may be used when determining whether using different methods is justified. For example, we believe an entity may be justified in using different methods between autonomous business units when those business units individually manage risk.



Question 13.2.210

Must an entity use qualitative effectiveness assessments for all similar hedges?

Interpretive response: No. Topic 815 ordinarily requires an entity to justify using different methods for assessing the effectiveness of similar hedges.

However, the FASB observed that requiring an entity to perform qualitative assessments for all similar hedges may have unintended consequences. Instead, it decided to allow the election to be made on a hedge-by-hedge basis to be consistent with its intent to provide more flexibility and relieve operational burden. As a result, an entity is permitted to elect to perform subsequent qualitative effectiveness assessments on a hedge-by-hedge basis. [815-20-25-81, 35-2B, ASU 2017-12.BC207]

However, an entity still needs to justify using different quantitative methods for similar hedges. Unless using different quantitative methods is justified, an entity is expected to specify in its initial hedge documentation the same quantitative method to be used for assessing effectiveness for similar hedges, both for the initial prospective effectiveness assessment, and in the event that the entity is required to perform a quantitative test subsequently (see Question 13.5.20). [815-20-25-81, 35-2B, ASU 2017-12.BC207]



Question 13.2.220

What effect does ASU 2017-12 have on the requirement to assess effectiveness for similar hedges in a similar manner?



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*:

- i. An entity is not required to apply the guidance in paragraph 815-20-25-81 when comparing hedging relationships executed before and after the date of adoption of the pending content that links to this paragraph for any of the following:
 1. Hedging relationships executed before the date of adoption assessed under the shortcut method for which hedge documentation was not amended as permitted by (e)(5)(ii) above, and hedging relationships executed after the date of adoption assessed under the shortcut method in accordance with paragraphs 815-20-25-117A through 25-117D.
 2. Hedging relationships executed before the date of adoption for which the hedged risk was not amended to a contractually specified component or a contractually specified interest rate as permitted by (e)(6) above, and hedging relationships executed after the date of adoption for which the hedged risk is the variability in cash flows attributable to changes in a contractually specified component or a contractually specified interest rate.

3. Hedging relationships executed before the date of adoption for which the recognition of excluded components was not amended to an amortization approach as permitted by (e)(4) above, and hedging relationships executed after the date of adoption for which an amortization approach is elected in accordance with paragraph 815-20-25-83A.

Interpretive response: Due to operational concerns, the FASB provided relief for entities from the requirement to assess effectiveness for similar hedges in a similar manner. In the situations specified in the following table, an entity is not required to comply with the requirement.

Shortcut method	ASU 2017-12 permits an entity to document a quantitative method to be used if the shortcut method was not or no longer is appropriate (see section 17.4.60). An entity may document a quantitative effectiveness method for new shortcut method hedging relationships executed after the date of adoption of ASU 2017-12 regardless of whether the entity modifies its hedge documentation to include a quantitative effectiveness method for hedges existing at the date of adoption. [815-20-65-3(i)(1), ASU 2017-12.BC261]
Contractually specified component or interest rate	ASU 2017-12 added as a new hedging strategy the ability to designate a contractually specified component or interest rate as the hedged risk in a cash flow hedge (see section 17.4.40). An entity may continue designating the variability in total cash flows as the hedged risk for hedging relationships that existed on the date of adoption, and designate the hedged risk as the variability in the contractually specified component or contractually specified interest rate for hedging relationships executed after the date of adoption. [815-20-65-3(i)(2)]
Method for recognizing excluded components	Before ASU 2017-12, entities were required to use the mark-to-market approach for recognizing excluded components. ASU 2017-12 permits an entity to use the mark-to-market approach or an amortization approach (see section 17.4.50). An entity may continue recognizing excluded components using a mark-to-market approach for hedging relationships that existed on the date of adoption, and elect an amortization approach for hedging relationships executed after the date of adoption. [815-20-65-3(i)(3)]

13.2.90 Additional considerations when using options as the hedging instrument



Excerpt from ASC 815-20

>>> Additional Considerations for Options in Cash Flow Hedges

25-123 When an entity has documented that the effectiveness of a cash flow hedge will be assessed based on changes in the hedging option's intrinsic value pursuant to paragraph 815-20-25-82(a), that assessment (and the related cash flow hedge accounting) shall be performed for all changes in intrinsic value—that is, for all periods of time when the option has an intrinsic value, such as when the underlying is above the strike price of the call option.

25-124 When a purchased option is designated as a hedging instrument in a cash flow hedge, an entity shall not define only limited parameters for the risk exposure designated as being hedged that would include the time value component of that option. An entity cannot arbitrarily exclude some portion of an option's intrinsic value from the hedge effectiveness assessment simply through an articulation of the risk exposure definition. It is inappropriate to assert that only limited risk exposures are being hedged (for example, exposures related only to currency-exchange-rate changes above \$1.65 per pound sterling as illustrated in Example 26 [see paragraph 815-20-55-205]).

25-125 If an option is designated as the hedging instrument in a cash flow hedge, an entity may assess hedge effectiveness based on a measure of the difference, as of the end of the period used for assessing hedge effectiveness, between the strike price and forward price of the underlying, undiscounted. Although assessment of cash flow hedge effectiveness with respect to an option designated as the hedging instrument in a cash flow hedge shall be performed by comparing the changes in present value of the expected future cash flows of the forecasted transaction to the change in fair value of the derivative instrument (aside from any excluded component under paragraph 815-20-25-82), that measure of changes in the expected future cash flows of the forecasted transaction based on forward rates, undiscounted, is not prohibited. With respect to an option designated as the hedging instrument in a cash flow hedge, assessing hedge effectiveness based on a similar measure with respect to the hedging instrument eliminates any difference that the effect of discounting may have on the hedging instrument and the hedged transaction. Pursuant to paragraph 815-20-25-3(b)(2)(iv), entities shall document the measure of intrinsic value that will be used in the assessment of hedge effectiveness. As discussed in paragraph 815-20-25-80, that measure must be used consistently for each period following designation of the hedging relationship.

An entity can exclude time value (or certain portions of time value) from its effectiveness assessments when the hedging instrument is an option (see section 13.2.70).

When time value is excluded, effectiveness is assessed based on the option's intrinsic value. In those situations, effectiveness is assessed during those periods when the option has intrinsic value – such as when the underlying is above the strike price of a call option. [\[815-20-25-123\]](#)

In addition to the considerations in this section, an entity using an option contract, a combination of option contracts, or a combination of an option contract with a non-option derivative as a hedging instrument is required to consider whether the option or combination is a net written option. This is because there is a special rule for written options (see sections 6.7.50 and 6.7.60).



Question 13.2.230

What are the components of an option's value?

Interpretive response: An option's total value at any point in time comprises the following.

Component	Description
Time value	The value of the time to the end of the exercise period, which is affected by volatility of the price of the underlying, the remaining option term, and other economic factors.
Intrinsic value	The amount by which the value of the underlying exceeds (call option) or is less than (put option) an option's strike price. This is commonly characterized by the term 'in the money' or 'out of the money.' In either case, intrinsic value normally can only be a positive amount (i.e. an option cannot have an intrinsic value less than zero from the holder's perspective), even when it is out of the money.

As a result, time value may be viewed as the portion of an option's total value that is not represented by intrinsic value (see Question 13.2.240).



Question 13.2.240

How is the intrinsic value of an option measured?

Interpretive response: The following table presents the methods that market convention considers to be measures of intrinsic value, and whether those methods may be used for fair value, cash flow or net investment hedging relationships that use the intrinsic value method to assess effectiveness – i.e. that exclude time value from the effectiveness assessment.

Method for measuring intrinsic value	Hedging relationships that may use it
The difference between the strike price and the spot price of the underlying asset	Fair value, cash flow or net investment
The present value of the difference between the strike price (i.e. contractual price) and the forward price (i.e. forward rate in the market on the measurement date) of the underlying asset	Fair value or cash flow
The difference between the strike price (i.e. contractual price) and the forward price (i.e. forward rate in the market on the measurement date) of the underlying, <i>undiscounted</i>	Cash flow only [815-20-25-125] This method is available for cash flow hedges due to the greater flexibility provided in measuring the change in value of the hedged cash flow

As part of the overall documentation for each hedging relationship, entities must document the measure of intrinsic value that will be used in the assessment of hedge effectiveness. That measure must be used consistently for each period following designation of the hedging relationship. [815-20-25-125]



Question 13.2.250

How is the intrinsic value of a cap option that involves a series of payments measured?

Background: An entity may purchase an option that involves a series of payments. For example, an entity may purchase an interest rate cap (option) that it designates as the hedging instrument in a cash flow hedge of changes in the cash flows of forecasted interest payments that are attributable to changes in a referenced interest rate when it exceeds a specified level (e.g. 8%).

Interpretive response: Topic 815 does not specify how to measure the intrinsic value of a cap option if the option involves a series of payments. We believe that the following are two acceptable methods.

- Estimate the intrinsic value of the cap assuming the referenced interest rate remains constant for the remaining term of the hedge. In the background example, the intrinsic value for all future periods would be assumed to be 1% if the referenced interest rate is 9% at the valuation date (9% referenced interest rate less 8% specified level in the interest rate cap). Under this method, the effect of the forward yield curve is excluded from the intrinsic value and instead is included in other components (e.g. time value).
- Estimate the intrinsic value of the cap for each period based on the market's expectations of movements in the referenced interest rate using the forward yield curve for that interest period.



Question 13.2.260

How are portions of time value (passage of time, market variables) measured?



Excerpt from ASC 815-20

>>>> Computing Changes in an Option's Time Value

25-98 In computing the changes in an option's time value that would be excluded from the assessment of hedge effectiveness, an entity shall use a technique that appropriately isolates those aspects of the change in time value. Generally, to allocate the total change in an option's time value to its different aspects—the passage of time and the market variables—the change in time value attributable to the first aspect to be isolated is determined by holding all

other aspects constant as of the beginning of the period. Each remaining aspect of the change in time value is then determined in turn in a specified order based on the ending values of the previously isolated aspects.

25-99 Based on that general methodology, if only one aspect of the change in time value is excluded from the assessment of hedge effectiveness (for example, theta), that aspect shall be the first aspect for which the change in time value is computed and would be determined by holding all other parameters constant for the period used for assessing hedge effectiveness. However, if more than one aspect of the change in time value is excluded from the assessment of hedge effectiveness (for example, theta and vega), an entity shall determine the amount of that change in time value by isolating each of those two aspects in turn in a prespecified order (one first, the other second). The second aspect to be isolated would be based on the ending value of the first isolated aspect and the beginning values of the remaining aspects. The portion of the change in time value that is included in the assessment of effectiveness shall be determined by deducting from the total change in time value the portion of the change in time value attributable to excluded components.

Interpretive response: To measure portions of the changes in an option's time value that may be excluded from the effectiveness assessment, an entity uses a technique that appropriately isolates those components of the change in time value. [815-20-25-98]

Generally, to allocate the total change in an option's time value to its different aspects (i.e. the passage of time versus market variables), the change in time value attributable to the first component to be isolated is determined by holding all other components constant as of the beginning of the period. Each remaining component is then determined in turn in a specified order based on the ending values of the previously isolated components. [815-20-25-99]

- **Only one component of the change in time value is excluded.** Using theta as the example component that is excluded, the change in time value for theta is measured first. Its value would be determined by holding all other parameters constant for the period used to assess hedge effectiveness.
- **More than one component is excluded.** Using theta and vega as the example components that are excluded, the entity determines the amount of that change in time value by isolating each of those two components in a pre-specified order (e.g. theta first and vega second). Vega is isolated based on the ending value theta and the beginning values of the remaining components that are not excluded.

The portion of the change in time value that is *not* an excluded component (i.e. the portion that is included in the effectiveness assessment) is determined by deducting from the total change in time value the portion that is attributable to excluded components. [815-20-25-99]



Question 13.2.270

Must an entity assess effectiveness for all periods that the option has intrinsic value?

Interpretive response: Yes. Regardless of the method selected for measuring an option's intrinsic value, the effectiveness assessment (and related hedge accounting) must be performed for all changes in the intrinsic value – i.e. for all periods of time in which the option has an intrinsic value. An entity cannot arbitrarily exclude some portion of the option's intrinsic value from the effectiveness assessment simply through an articulation of the risk exposure definition. See also Subtopic 815-20's Example 26 reproduced below. [815-20-25-124]

However, an entity may be able to use the terminal value method when assessing effectiveness. This approach includes the time value component of the option in the assessment of effectiveness, but focuses on the hedging instrument's terminal value (i.e. the expected pay-off at its maturity date) in determining whether the hedging relationship is expected to be highly effective at achieving offsetting cash flows that are attributable to the hedged risk during the term of the hedge (see section 13.7.20).

FASB Example: Defining the risk exposure for hedging relationships involving an option contract as the hedging instrument



Excerpt from ASC 815-20

>> Example 26: Defining the Risk Exposure for Hedging Relationships Involving an Option Contract as the Hedging Instrument

55-205 This Example illustrates the application of paragraph 815-20-25-124.

55-206 Entity XYZ, a U.S. dollar (USD) functional currency entity forecasts the purchase of goods with the payment denominated in pounds sterling (GBP). To hedge the foreign currency exposure from the forecasted purchase, Entity XYZ purchases an at-the-money call option on GBP. The notional amount of the option equals the forecasted value of goods to be purchased, and the option exercise date is the date the purchase consummates. At inception of the hedging relationship the strike price and the forward market exchange rate for GBP 1 are both USD 1.50. The time value component on the option is USD 0.15 per GBP. The foreign currency option in this Example could be effective as a hedging instrument only if effectiveness for that hedging relationship were based solely on either of the following:

- a. Changes in the option's intrinsic value
- b. Changes in the option's entire fair value.

55-207 As stated in paragraph 815-20-25-124, it is inappropriate to assert that only limited risk exposures are being hedged, such as exposures related only to currency-exchange-rate changes above USD 1.65 per GBP.

Using a net-purchased combination of options as the hedging instrument (assessing effectiveness only when intrinsic value changes)



Excerpt from ASC 815-20

>>>> Hedge Effectiveness of a Net-Purchased Combination of Options

25-130 The guidance in the following paragraph addresses a cash flow hedging relationship that meets both of the following conditions:

- a. A combination of options (deemed to be a net purchased option) is designated as the hedging instrument.
- b. The effectiveness of the hedge is assessed based only on changes in intrinsic value of the hedging instrument (the combination of options).

25-131 The assessment of effectiveness of a cash flow hedging relationship meeting the conditions in the preceding paragraph may be based only on changes in the underlying that cause a change in the intrinsic value of the hedging instrument (the combination of options). Thus, the assessment can exclude ranges of changes in the underlying for which there is no change in the hedging instrument's intrinsic value.

If a combination of options is deemed to be a net-purchased option (see section 6.7.60), it may qualify for hedge accounting even if it offers protection only within various ranges of changes in the underlying – instead of in all ranges of change.

In this situation, effectiveness is assessed based only on changes in the underlying that cause a change in the intrinsic value of the hedging instrument(s). Effectiveness assessment excludes ranges of changes in the underlying for which there is no change in the hedging instrument's intrinsic value. [815-20-25-130 – 25-131]

See Subtopic 815-20's Example 28 reproduced below.



Question 13.2.280

If the hedged risk is changes within a range and time value is an excluded component, how are changes in the underlying that do not cause a change in intrinsic value accounted for?

Interpretive response: When the hedged risk is changes within a range and time value is an excluded component, the effectiveness assessment is based

only on changes in the underlying that cause a change in the intrinsic value of the hedging instrument. Under this method, the changes in the hedging instrument's underlying that occur outside of the various ranges not covered in the hedging strategy are part of the excluded component. The related changes in the fair value of the combination of options for the excluded components are recognized using either the amortization or mark-to-market approach discussed in section 13.2.70.

Cash flow hedges. However, for cash flow hedges we believe an entity may use the terminal value method when assessing effectiveness if the conditions for that approach are met (see section 13.7.20).



Question 13.2.290

If a zero-cost collar has different notional amounts, can the hedged item be different proportions of the same asset referenced in the collar?



Excerpt from ASC 815-20

>>> Different Proportions of the Same Asset as a Hedged Item

25-10 In a hedging relationship in which a collar that is comprised of a purchased option and a written option that have different notional amounts is designated as the hedging instrument and the hedge's effectiveness is assessed based on changes in the collar's intrinsic value, the hedged item may be specified as two different proportions of the same asset referenced in the collar, based on the upper and lower price ranges specified in the two options that make up the collar. That is, the quantities of the asset designated as being hedged may be different based on those price ranges in which the collar's intrinsic value is other than zero. This guidance shall be applied only to collars that are a combination of a single written option and a single purchased option for which the underlying in both options is the same. This guidance shall not be applied by analogy to other derivative instruments designated as hedging instruments. Although the quantities of the asset designated as being hedged may be different based on the upper and lower price ranges in the collar, the actual assets that are the subject of the hedging relationship may not change. The quantities that are designated as hedged for a specific price or rate change shall be specified at the inception of the hedging relationship and shall not be changed unless the hedging relationship is dedesignated and a new hedging relationship is redesignated. Since the hedge's effectiveness is based on changes in the collar's intrinsic value, the assessment of hedge effectiveness shall compare the actual change in intrinsic value of the collar to the change in value of the prespecified quantity of the hedged asset that occurred during the hedge period.

Interpretive response: Yes. If a hedging relationship in which a zero-cost collar that comprises a single purchased option and single written option that have different notional amounts is designated as the hedging instrument, the hedged

item may be specified as two different proportions of the same asset referenced in the collar – based on the upper and lower price ranges specified in the two options that comprise the collar. In this situation, hedge effectiveness is assessed based on changes in the collar’s intrinsic value.

Specifically, the quantities of the forecasted transaction that are designated as being hedged may differ based on the price ranges in which the collar’s intrinsic value is other than zero. This strategy is used when an entity seeks full protection of downside risk while partially paying for this protection by selling some of the upside potential.

See Subtopic 815-20’s Example 9 reproduced below.

We believe this approach may also be used when the notional amounts in the zero-cost collar are the same but the strike prices are different.

Cash flow hedges. We also believe that the terminal value method may be used for cash flow hedges if the conditions for its use are met (see section 13.7.20).

Fair value hedges. We do not believe an entity may designate a series of possible percentages of servicing right assets (prohibition of preset hedge coverage ratios) that each correspond to a specified independent variable, such as an interest rate (see section 7.3.60).

Examples

The following are examples that demonstrate using a net-purchased combination of options as the hedging instrument (assessing effectiveness only when intrinsic value changes).

- Assessing effectiveness with an interest rate cap (Example 13.2.60)
- Effectiveness of a combination of options involving one written option and two purchased options (Subtopic 815-20’s Example 28).
- Definition of hedged item when using a zero-cost collar with different notional amounts (Subtopic 815-20’s Example 9).



Example 13.2.60

Assessing effectiveness with an interest rate cap

ABC Corp. issues floating-rate debt (indexed to three-month LIBOR, a contractually specified component) and wishes to hedge its risk to variability in cash flows due to three-month LIBOR changes when three-month LIBOR is greater than 7%. ABC purchases an interest rate cap with a notional amount equal to the principal of the debt and a strike price of 7% that includes a knock-out provision (a written call) that nullifies the cap when three-month LIBOR reaches 12%.

If the interest rate cap represents a net purchased option (see section 6.7.60), ABC can designate the hedged risk as the risk of variability in cash flows due to changes in a contractually specified component (i.e. three-month LIBOR) when it exceeds 7% but is below 12%.



Excerpt from ASC 815-20

>> Example 28: Effectiveness of a Combination of Options Involving One Written Option and Two Purchased Options

55-212 This Example illustrates the application of paragraph 815-20-25-131.

55-213 Entity JPN is a Japanese subsidiary of a U.S. entity. Entity JPN's functional currency is the Japanese yen (JPY). Entity JPN has forecasted inventory purchases to be paid in U.S. dollars (USD). As a result, Entity JPN is exposed to changes in the JPY-USD exchange rate: its functional currency cash outflows will increase (loss) if JPY weakens versus USD and decrease (gain) if JPY strengthens versus USD.

55-214 Entity JPN would like to hedge the foreign currency exposure related to the forecasted transaction by entering into a combination of foreign-currency-denominated option contracts designated as a single hedging instrument.

55-215 For purposes of this discussion, assume all of the following:

- a. Entity JPN has met the qualifying criteria regarding forecasted transactions eligible for designation as hedged transactions pursuant to paragraph 815-20-25-15 and the options are entered into contemporaneously with the same counterparty and can be transferred independently of each other.
- b. The combination of foreign currency option contracts meets all of the conditions in paragraphs 815-20-25-89 through 25-90 to be considered a net purchased option (that is, considered not to be a net written option subject to the requirements of paragraph 815-20-25-94).

55-216 Entity JPN employs the following hedging strategy:

- a. The forecasted transaction is estimated at USD 150,000,000. The at-the-money forward rate is JPY 120 per USD 1.
- b. Entity JPN's documented hedge objective is to offset the foreign exchange risk to the functional currency equivalent cash flows at levels above JPY 125/USD 1 and in the range from JPY 113/USD 1 to JPY 108/USD 1. In the range JPY 113/USD 1 to JPY 125/USD 1 and at levels below JPY 108/USD 1, Entity JPN chooses not to offset the foreign exchange risk to the functional currency equivalent cash flows.
- c. To implement this hedge objective, Entity JPN enters into all three of the following option contracts and jointly designates them as the hedging instrument:
 1. Option 1. One purchased option that gives Entity JPN the right to purchase USD 150,000,000 at an exchange rate of JPY 125/USD 1. Premium paid: USD 1,536,885.
 2. Option 2. One sold (written) option that, if exercised, obligates Entity JPN to purchase USD 150,000,000 at an exchange rate of JPY 113/USD 1. Premium received: USD 1,536,885.
 3. Option 3. One purchased option that gives Entity JPN the right to sell USD 150,000,000 at an exchange rate of JPY 108/USD 1. Premium paid: USD 737,705.

55-217 The time value of the combination of options is to be excluded from the assessment of effectiveness and, therefore, effectiveness is based only on changes in intrinsic value related to the combination of options.

55-218 The purpose of Option 1 is to protect Entity JPN when the JPY-USD exchange rate increases above JPY 125/USD 1. As the JPY-USD exchange rate increases, Entity JPN will be required to purchase the USD 150,000,000 inventory at a greater JPY-equivalent cost. As the JPY-USD exchange rate increases above JPY 125/USD 1, the intrinsic value of the option increases as the option is increasingly in the money. That increase in the option's intrinsic value is expected to offset the increase in the JPY-equivalent expenditure on the forecasted transaction.

55-219 Entity JPN also writes an option (Option 2) that obligates Entity JPN to purchase USD from the counterparty at an exchange rate of JPY 113/USD 1. The counterparty will exercise the option whenever the JPY-USD exchange rate is below JPY 113/USD 1. As the JPY-USD exchange rate decreases, Entity JPN will be required to purchase the USD 150,000,000 inventory at a lesser JPY-equivalent cost. As the JPY-USD exchange rate decreases below JPY 113/USD 1, Entity JPN's losses related to increases in the intrinsic value of the written option are expected to offset the decrease in the JPY-equivalent expenditure on the forecasted transaction.

55-220 Entity JPN also purchases an option to sell USD (Option 3) for a notional amount equal to the notional of the written option (Option 2) with a strike price of JPY 108/USD 1. Entity JPN will exercise Option 3 whenever the JPY-USD exchange rate is below JPY 108/USD 1. When the exchange rate is below JPY 108/USD 1, although Entity JPN will be obligated to make a payment in relation to Option 2, it will also receive a payment in relation to Option 3. As a result of purchasing Option 3, Entity JPN will be exposed to exchange rate fluctuations on Option 2 only when the exchange rate is between JPY 113/USD 1 and JPY 108/USD 1. Hence, with Options 2 and 3, Entity JPN has effectively limited its hedge offset to changes in cash flows on the forecasted item to levels between JPY 113/USD 1 and JPY 108/USD 1. Changes in the exchange rate below JPY 108/USD 1 result in no change in the intrinsic value of the combination of options because the change in Option 2 offsets the change in Option 3. However, when the exchange rate is below JPY 108/USD 1, the combination of options has an intrinsic value other than zero.

55-221 In summary, potential changes in intrinsic value related to this combination option hedge construct (Options 1, 2, and 3) would limit the hedge offset to corresponding changes in functional currency cash flows on the forecasted transaction only at levels above JPY 125/USD 1 and in the range JPY 108/USD 1 to JPY 113/USD 1, consistent with Entity JPN's documented hedge objective.

55-222 The cash flow hedging relationship in this Example involving a combination of options may be considered effective at offsetting the change in cash flows due to foreign currency exchange rate movements related to the forecasted transaction. Specifically, Entity JPN may assess the effectiveness of the hedge based only on changes in the underlying that cause a change in the intrinsic value of the combination of options. Thus, in that case, Entity JPN would assess effectiveness of the hedge only when the JPY-USD

exchange rate is above JPY 125/USD 1 and between JPY 113/USD 1 and JPY 108/USD 1. Likewise, Entity JPN's assessment would exclude changes in the JPY-USD exchange rate between JPY 113/USD 1 and JPY 125/USD 1 and below JPY 108/USD 1.

55-223 The combination of options used by Entity JPN as a hedging instrument is deemed to be a net purchased option based on the provisions of this Subtopic. Therefore, the hedging relationship avoids being subject to the hedge effectiveness test for written options in paragraph 815-20-25-94.

55-224 In particular, as it relates to paragraph 815-20-25-89(a), the aggregate premium (that is, the time values) for the three options comprising the hedging instrument results in Entity JPN paying a net premium.

55-225 The evaluation of whether a net premium has been received under paragraph 815-20-25-89(a) must include consideration of only the time value components of the options designated as the hedging instrument. That evaluation must not include the intrinsic value, if any, of the options.



Excerpt from ASC 815-20

>> Example 9: Definition of Hedged Item When Using a Zero-Cost Collar with Different Notional Amounts

55-117 The following Example illustrates the application of paragraph 815-20-25-10 to a currency collar.

>>> Case B: Currency Collar

55-123 Entity B forecasts that it will purchase inventory that will cost 100 million foreign currency (FC) units. Entity B's functional currency is the U.S. dollar (USD). To limit the variability in USD-equivalent cash flows associated with changes in the USD-FC exchange rate, Entity B constructs a currency collar as follows:

- a. A purchased call option providing Entity B the right to purchase FC 100 million at an exchange rate of USD 0.885 per FC 1.
- b. A written put option obligating Entity B to purchase FC 50 million at an exchange rate of USD 0.80 per FC 1.

55-124 The purchased call option provides Entity B with protection when the USD-FC exchange rate increases above USD 0.885 per FC 1. The written put option partially offsets the cost of the purchased call option and obligates Entity B to give up some of the foreign currency gain related to the forecasted inventory purchase as the USD-FC exchange rate decreases below USD 0.80 per FC 1. (For both options, the underlying is the same—the USD-FC exchange rate.) Assuming that a net premium was not received for the combination of options and all the other criteria in paragraphs 815-20-25-89 through 25-90 have been met, if Entity B chooses to use the combination of options as a hedging

instrument, it is not required to comply with the provisions contained in paragraph 815-20-25-94 related to written options.

55-125 Entity B would like to designate the combination of options as a hedge of the variability in USD-equivalent cash flows of its forecasted purchase of inventory denominated in FC. Assume Entity B specifies in the hedge effectiveness documentation that the collar's time value would be excluded from the assessment of hedge effectiveness.

55-126 The hedging relationship involving the currency collar designated as a hedge of the effect of fluctuations in the USD-FC exchange rate qualifies for cash flow hedge accounting. In that example, the hedged risk is the risk of changes in USD-equivalent cash flows attributable to foreign currency risk (specifically, the risk of fluctuations in the USD-FC exchange rate). The foreign currency collar is hedging the variability in USD-equivalent cash flows for 100 percent of the forecasted FC 100 million purchase price of inventory for USD-FC exchange rate movements above USD 0.885 per FC 1 and variability in USD-equivalent cash flows for 50 percent of the forecasted FC 100 million purchase price of inventory for USD-FC exchange rate movements below USD 0.80 per FC 1. Cash flow hedge effectiveness will be determined based on changes in the underlying (the USD-FC exchange rate) that cause changes in the collar's intrinsic value (that is, changes below USD 0.80 per FC 1 and above USD 0.885 per FC 1). Because the hedge's effectiveness is based on changes in the collar's intrinsic value, hedge effectiveness must be assessed based on the actual exchange rate changes by comparing the change in intrinsic value of the collar to the change in the specified quantity of the forecasted transaction for those changes in the underlying.

13.2.100 Additional consideration for fair value hedges – prepayment risk under the last-of-layer method



Excerpt from ASC 815-20

>>>> Fair Value Hedges of Interest Rate Risk in Which the Hedged Item Can Be Settled before Its Scheduled Maturity

25-6B An entity may designate a fair value hedge of interest rate risk in which the hedged item is a prepayable instrument in accordance with paragraph 815-20-25-6. The entity may consider only how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity (for example, an entity may consider only how changes in the benchmark interest rate affect an obligor's decision to call a debt instrument when it has the right to do so). The entity need not consider other factors that would affect this decision (for example, credit risk) when assessing hedge effectiveness. Paragraph 815-25-35-13A discusses the measurement of the hedged item.

>>> Consideration of Prepayment Risk Using the Last-of-Layer Method

25-118A In a fair value hedge of interest rate risk designated under the last-of-layer method in accordance with paragraph 815-20-25-12A, an entity may

exclude prepayment risk when measuring the change in fair value of the hedged item attributable to interest rate risk.

An entity is prohibited from hedging prepayment risk (see Question 6.3.20). However, it generally is required to consider prepayment risk when assessing hedge effectiveness and measuring the change in fair value of the hedged item attributable to interest rate risk. Two exceptions and an election apply in some instances to simplify the assessment process regarding prepayment risk.

- **As exceptions.** If an entity uses the following fair value hedges of interest rate risk, it does not consider prepayment risk for assessing hedge effectiveness and measuring the change in fair value of the hedged item:
 - partial-term hedges, when the assumed term ends before (or on) the initial date a financial instrument can be prepaid (see section 7.3.80); and
 - last-of-layer method (see section 7.3.100). [815-20-25-118A]
- **As an election.** Topic 815 allows an entity to consider only the effect of changes in the benchmark interest rate on the decision to prepay a financial instrument. If an entity elects this approach, it does not consider in its assessment of hedge effectiveness how other factors (e.g. credit risk) might affect the decision to prepay the financial instrument. [815-20-25-6B]

For further discussion of hedging interest rate risk on prepayable financial instruments, see section 7.4.10.

13.2.110 Additional consideration for cash flow hedges – time value of money



Excerpt from ASC 815-20

>>> Consideration of the Time Value of Money

25-120 In assessing the effectiveness of a cash flow hedge, an entity generally shall consider the time value of money, especially if the hedging instrument involves periodic cash settlements.

25-121 An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

Because the focus of the effectiveness of a cash flow hedging relationship is on cash flows, the timing of the respective cash flows must be considered in

assessing effectiveness. This is especially important if the hedging instrument involves periodic cash settlements. However, Topic 815 does not prescribe a required method for measuring the changes in the derivative hedging instrument's cash flows or the changes in the hedged transaction's cash flows attributable to the hedged risk. [815-20-25-120]

An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts, which is discussed in section 13.2.50. To assess the offset of cash flows when using this strategy, an entity could include the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument. [815-20-25-121]



Question 13.2.300

How is the timing of cash flows considered in an effectiveness assessment for a cash flow hedge?

Interpretive response: We believe a present value methodology generally should be used to consider the timing of cash flows of both the hedging instrument and the forecasted transaction attributable to the hedged risk. The discount rates to be used when determining the change in cash flows for purposes of assessing effectiveness are summarized as follows.

Rate for discounting derivative hedging instrument's cash flows	Rate for discounting cash flows of the hedged transaction attributable to the hedged risk
Discount rate used to determine the fair value of the instrument.	Discount rate applicable to the cash flows to arrive at fair value (i.e. the relevant curve for those cash flows) as if the cash flows were related to an instrument that has cash flows identical to those of the hedged transaction.

The discount rates may differ between the derivative hedging instrument and the hedged transaction as a result of the timing of the respective cash flows, the credit risk of the counterparty to the derivative, the entity's own nonperformance risk and other relevant factors.

However, because cash flow hedging relationships are focused on the changes in cash flows of the derivative hedging instrument and the hedged transaction, credit risk (or the entity's own nonperformance risk) has no effect on hedge effectiveness under certain assessment methods, as long it is probable that the counterparty to the derivative or the entity will not default.

- **Hypothetical derivative method** (section 13.7.30) **and change-in-variable-cash-flow method** (section 13.7.40). An entity is permitted to use the same credit risk adjustment that is used to determine the fair value of the derivative when measuring the change in the cash flows of the hedged transaction, as long it is probable that the counterparty to the derivative or the entity will not default. As a result, credit risk (or the entity's own

nonperformance risk) and changes therein do not affect hedge effectiveness.

- **Change-in-fair-value method** (section 13.7.40). Even though the same discount rate is used under the change-in-fair-value method when measuring the swap and the present value of the cumulative change in expected cash flows of the hedged transaction, the mechanics of applying this method may cause effectiveness to be affected in periods that creditworthiness changes.

However, if it is *not* probable that an entity will not default, a cash flow hedging relationship should be discontinued (see section 13.2.60).



Question 13.2.310

Is discounting required when the spot method is used?

Interpretive response: No. One exception to Topic 815's guidance that discounting should generally be incorporated when assessing effectiveness is when an entity uses the spot method – i.e. uses a forward contract as the hedging instrument and chooses to exclude the spot-forward difference from the effectiveness assessment.

In these circumstances, the entity chooses one of the following methods.

- **Cash flows are discounted.** The expected cash flows of the derivative hedging instrument and the hedged transaction are discounted to convert them to current amounts based on the date the respective cash flows will actually occur.
- **Cash flows are not discounted.** The expected cash flows of the derivative hedging instrument and the hedged transaction are not discounted because they are both assumed to occur at the reporting date. In effect, a critical terms match approach could be used and perfect effectiveness would result when the other terms, such as notional amount and underlying, are the same.

Under both methods, the excluded component (changes in value of the spot-forward difference) are recognized using either an amortization approach or a mark-to-market approach (see section 13.2.70).

The choice of method for calculating the spot-forward difference is considered an accounting policy election that should be applied consistently to all similar hedging relationships.

These methods are illustrated in Example 13.2.70.



Question 13.2.320

How does discounting affect a hedging relationship when a forward contract does not settle on the date of the forecasted transaction?

Background: As discussed in section 13.2.50, Topic 815 requires that a hedging relationship is expected to be highly effective in achieving offsetting cash flows that are attributable to the hedged risk during the term of the hedging relationship. However, it does not require that the hedging derivative expire or terminate on the same date that the forecasted transaction is expected to occur or that the cash inflows (outflows) from the derivative occur at the same time as the cash outflows (inflows) from the forecasted transaction.

Interpretive response: When the timing of the derivative differs from the timing of the forecasted transaction, the hedging relationship will not be perfectly effective in either of the following situations.

- The entity elects to include the entire change in the cash flows of the derivative hedging instrument in assessing effectiveness rather than excluding the spot-forward difference from the effectiveness assessment (see discussion of excluded components in section 13.2.70).
- The entity elects to discount expected cash flows of the derivative hedging instrument and forecasted transaction (see Question 13.2.310).

When the hedging relationship is not perfectly effective due to timing differences between the derivative and the forecasted transaction, strategies that an entity may implement to improve hedge effectiveness include the following.

- **The hedging relationship is rebalanced.** The entity implements a hedging strategy whereby the derivative instrument will be rebalanced. See discussion of dynamic hedging strategies in section 13.2.50.
- **The notional amounts of the derivative and hedged transaction do not match.** The entity implements a hedging strategy for which the notional amount of the derivative instrument is different from the notional amount of the hedged transaction; however, the changes in cash flows of the derivative instrument offset the changes in cash flows of the forecasted transaction so that the relationship is expected to be highly effective throughout the term of the hedge.

Examples

The following KPMG examples demonstrate the effect of considering time value of money in cash flow hedging relationships.

- Comparison of excluding spot-forward difference – discounted vs. undiscounted (Example 13.2.70).
- Measuring changes in cash flows – discounted vs. undiscounted (Example 13.2.80).



Example 13.2.70

Comparison of excluding spot-forward difference – discounted vs. undiscounted

The following table summarizes the effects of excluding (or including) the spot-forward difference and of discounting (or not discounting) expected cash flows on hedge effectiveness in a forecasted sale of widgets that is expected to occur on a different date than when the hedging derivative settles.

	<u>Case A:</u> Derivative's term is <i>longer</i> than that of forecasted transaction	<u>Case B:</u> Derivative's term is <i>shorter</i> than that of forecasted transaction
Assumptions		
Hedge inception date	July 1, Year 1	July 1, Year 1
Date forecasted sale of widgets is expected to occur and settle in cash	September 30, Year 1	November 30, Year 1
Settlement date for hedging derivative	November 30, Year 1	September 30, Year 1
End of hedge term: earlier of the derivative's or forecasted transaction's settlement date	September 30, Year 1	September 30, Year 1
Scenario 1: Effectiveness is assessed using the forward rate (i.e. no excluded components) and expected cash flows are discounted		
Reasons the hedge will not be perfectly effective:	Differences in forward prices. The forward price of the sale is through September 30 while the forward price of the derivative is through November 30. Discounting the forward prices. There are different discounting periods through the forecasted sale date (three months to September 30) and the derivative's settlement date (five months to November 30).	Differences in forward prices. The forward price of the derivative is through September 30 while the forward price of the sale is through November 30. Discounting the forward prices. There are different discounting periods through the derivative's settlement date (three months to September 30) and the forecasted sale date (five months to November 30).
Scenario 2: Effectiveness is assessed using the spot rate (i.e. spot-forward difference is excluded) and expected cash flows are discounted		
Reasons the hedge will not be perfectly effective:	Discounting the spot prices. There are different discounting periods through the forecasted sale date (three months to September 30) and the	Discounting the spot prices. There are different discounting periods through the derivative's settlement date (three months to September 30)

	Case A: Derivative's term is <i>longer</i> than that of forecasted transaction	Case B: Derivative's term is <i>shorter</i> than that of forecasted transaction
	derivative's settlement date (five months to November 30).	and the forecasted sale date (five months to November 30).

This example summarizes potential effects in a hedging relationship involving a single settlement date for each of the forecasted sale and the hedging derivative. Similar effects occur if an entity designates a derivative with multiple settlements as the hedging instrument in a relationship involving a series of forecasted transactions. That is, differences between the hedging derivative's settlement dates and the dates of the forecasted transactions may cause the relationship to lack perfect effectiveness.



Example 13.2.80

Measuring changes in cash flows – discounted vs. undiscounted

ABC Corp. is a manufacturer with the US dollar as its functional currency. On January 1, Year 1, ABC forecasts the sale of 1,000,000 worth of goods denominated in foreign currency (FC) to a foreign country on August 31, Year 1 (eight months from the date of hedge inception). ABC does not have any firm contracts yet, but based on historical experience and its forecasts, it concludes that these sales are probable.

ABC is exposed to changes in the \$/FC exchange rates and enters into a six-month forward contract to buy US dollars and sell the foreign currency. The hedging derivative has the following terms:

- Contract amount: FC1,000,000;
- Trade date: January 1, Year 1;
- Maturity date: June 30, Year 1; and
- Forward contract rate: FC1 = \$1.20.

ABC chooses to apply hedge accounting and formally designates and documents the hedging relationship on January 1, Year 1. ABC elects to exclude the spot-forward difference and recognize changes in the excluded component using the mark-to-market approach.

The following additional facts are relevant.

- The spot and forward exchange rates for various dates as applicable to the actual hedging derivative are in the following table.

	Spot rate	Forward rate
January 1, Year 1	\$1.11 = FC1	\$1.20 = FC1
March 31, Year 1	\$1.13 = FC1	\$1.23 = FC1
June 30, Year 1	\$1.14 = FC1	-

- The fair value of the actual hedging derivative as of March 31, Year 1 is \$(29,851) – i.e. a liability position to the entity. This is based on changes in forward rates discounted over three months (because it matures on June 30, Year 1) at an assumed discount rate of 2% – i.e. it is the present value of \$30,000 [$FC1,000,000 \times (\$1.20 - \$1.23)$] discounted at 2%.
- The spot and forward exchange rates for various dates as applicable to the hedged forecasted sale are in the following table.

	Spot rate	Forward rate
January 1, Year 1	\$1.11 = FC1	\$1.25 = FC1
March 31, Year 1	\$1.13 = FC1	\$1.28 = FC1
June 30, Year 1	\$1.15 = FC1	-

- On March 31, Year 1, ABC calculates the amounts to be reflected in the financial statements.

Scenario 1: Changes in cash flows due to changes in spot prices are not discounted

In this scenario, the entity does not discount changes in cash flows due to changes in spot prices when assessing hedge effectiveness. The changes in fair value of the forward contract and changes in cash flows of the hedged transaction are as shown in the table below.

	Change in fair value of forward contract gain (loss)	Change in cash flows of the hedged forecasted sale gain (loss)
Total change in fair value	\$(29,851)	\$ -
Change in cash flows due to changes in spot rates	(20,000) ¹	20,000 ²
Change due to spot-forward difference (excluded component recognized in earnings)	(9,851) ³	-
Notes:		
1. $FC1,000,000 \times (\$1.11 - \$1.13)$		
2. $FC1,000,000 \times (\$1.13 - \$1.11)$		
3. $\$(29,851) - \$(20,000)$		

This approach results in perfect effectiveness, as the change in fair value of the forward exchange contract and changes in cash flows of the hedged anticipated sale due to changes in the spot rate will be equal.

Scenario 2: Changes in cash flows due to changes in spot prices are discounted

In this scenario, the entity discounts changes in cash flows due to changes in spot prices when assessing hedge effectiveness.

- The projected cash flows of the forward contract are discounted over three months because it matures on June 30, Year 1. The discount rate is assumed to be 2%.

- The projected cash flows of the anticipated sale are discounted over five months because it is forecasted to occur on August 31, Year 1. The discount rate is assumed to be 2.05%.

The changes in fair value of the forward contract and changes in cash flows of the hedged transaction are shown in the table below.

	Change in fair value of forward contract gain (loss)	Change in cash flows of the hedged forecasted sale gain (loss)
Total change in fair value	\$(29,851)	\$ -
Change in cash flows due to changes in spot rates	(19,900) ¹	19,830 ²
Change due to spot-forward difference (excluded component recognized in earnings)	(9,951) ³	-
Notes:		
1. Present value of \$20,000 [$FC1,000,000 \times (\$1.11 - \$1.13)$] discounted over three months at 2%.		
2. Present value of \$20,000 [$FC1,000,000 \times (\$1.11 - \$1.13)$] discounted over five months at 2.05%.		
3. $\$(29,851) - \$(19,900)$		

This approach results in the hedge not being perfectly effective, as the change in fair value of the forward exchange contract is \$70 different from the change in cash flows of the hedged anticipated sale ($\$19,900 - \$19,830$).

13.3 Shortcut method for interest rate swaps

13.3.10 Overview



Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-102 The conditions for the shortcut method do not determine which hedging relationships qualify for hedge accounting; rather, those conditions determine which hedging relationships qualify for a shortcut version of hedge accounting that assumes perfect hedge effectiveness. If all of the applicable conditions in the list in paragraph 815-20-25-104 are met, an entity may assume perfect effectiveness in a hedging relationship of interest rate risk involving a recognized interest-bearing asset or liability (or a firm commitment arising on the trade [pricing] date to purchase or issue an interest-bearing asset or liability) and an interest rate swap (or a compound hedging instrument composed of an interest rate swap and a mirror-image call or put option as discussed in paragraph 815-20-25-104[e]) provided that, in the case of a firm commitment, the trade date of the asset or liability differs from its settlement

date due to generally established conventions in the marketplace in which the transaction is executed. The shortcut method's application shall be limited to hedging relationships that meet each and every applicable condition. That is, all the conditions applicable to fair value hedges shall be met to apply the shortcut method to a fair value hedge, and all the conditions applicable to cash flow hedges shall be met to apply the shortcut method to a cash flow hedge. A hedging relationship cannot qualify for application of the shortcut method based on an assumption of perfect effectiveness justified by applying other criteria. The verb match is used in the specified conditions in the list to mean *be exactly the same* or *correspond exactly*.

>>>> Application of the Shortcut Method to a Portfolio of Hedged Items

25-116 Portfolio hedging cannot be used to circumvent the application of the shortcut method criteria beginning in paragraph 815-20-25-102 to a fair value hedge of an individual interest-bearing asset or liability. A portfolio of interest-bearing assets or interest-bearing liabilities cannot qualify for the shortcut method if it contains an interest-bearing asset or liability that individually cannot qualify for the shortcut method.

25-117 The fair value hedge requirements of paragraph 815-20-25-12(b)(1) ensure that the individual items in a portfolio share the same risk exposure and have fair value changes attributable to the hedged risk that are expected to respond in a generally proportionate manner to the overall fair value changes of the entire portfolio. That requirement restricts the types of portfolios that can qualify for portfolio hedging; however, it also permits the existence of a mismatch between the change in the fair value of the individual hedged items and the change in the fair value of the hedged portfolio attributable to the hedged risk in portfolios that do qualify. As a result, the assumption of perfect effectiveness required for the shortcut method generally is inappropriate for portfolio hedges of similar assets or liabilities that are not also nearly identical (except for their notional amounts). Application of the shortcut method to portfolios that meet the requirements of paragraph 815-20-25-12(b)(1) is appropriate only if the assets or liabilities in the portfolio meet the same stringent criteria in paragraphs 815-20-25-104(e), 815-20-25-104(g), and 815-20-25-105(a) as required for hedges of individual assets and liabilities.

>>> Applicability of the Shortcut Method

55-71 Given the conditions in paragraph 815-20-25-104, the shortcut method cannot be applied, for example, to any of the following hedging relationships:

- a. Those hedging interest rate risk that involve hedging instruments other than interest rate swaps.
- b. For fair value hedges, those that involve hedged risks other than the risk of changes in fair value attributable to changes in the designated **benchmark interest rate**.
- bb. For cash flow hedges, those that involve hedging relationships in which the contractually specified interest rate of a recognized interest-bearing asset or liability does not match the interest rate index of the variable leg of the interest rate swap.
- c. Those that do not involve a recognized interest-bearing asset or liability.

55-72 Based on (c) in the preceding paragraph, the shortcut method cannot be applied in a cash flow hedge of a forecasted transaction, even if an entity

determines that all critical terms of the hedging instrument and the hedged forecasted transaction are matched.

The shortcut method is an elective method that greatly simplifies the hedge effectiveness assessment for a hedge of interest rate risk. If a hedging relationship meets the criteria for this method, the entity can assume that the hedging relationship is perfectly effective. Therefore, the method simplifies the hedge effectiveness assessment by eliminating the initial and ongoing quantitative aspect of the assessment. [815-20-25-102]

Fair value hedges. For shortcut method fair value hedges, the hedged item's change in fair value attributable to the hedged risk is the inverse of the hedging instrument's change in the fair value. For example, if the hedging instrument's fair value increases by \$100, the entity assumes that the hedged item's change in fair value attributable to the hedged risk has decreased by \$100.

Cash flow hedges. For shortcut method cash flow hedges, an entity records the change in fair value of the hedging instrument in AOCI. An entity accounts for all cash flow hedges in this manner. However, if an entity does not apply the shortcut method, it will need to perform initial and ongoing effectiveness assessments. [815-20-25-102, 35-1(c)]

Criteria for applying shortcut method



The shortcut method applies only to hedges of interest rate risk, and then only if general requirements and specific criteria are met. It is narrow in scope by design and cannot be applied by analogy. Specifically, the SEC staff has indicated that the circumstances in which an entity can apply the shortcut method are limited to those where the specific criteria are met. The staff does not believe the shortcut method criteria have a spirit or principle that an entity can meet without strictly complying with the stated requirements. [815-20-25-102, 2006 AICPA Conf]

The general requirements are discussed in section 13.3.20. The specific criteria are summarized here and discussed in the referenced sections.

General criteria for both fair value hedges and cash flow hedges	
Criterion 1 (section 13.3.30)	Swap's notional amount matches the hedged item's principal amount [815-20-25-104(a)]
Criterion 2 (section 13.3.40)	Swap's fair value at hedge inception is zero [815-20-25-104(b), 25-104(c)]

Criterion 3 (section 13.3.50)	Swap has a consistent formula for computing net settlements each period [815-20-25-104(d)]
Criterion 4 (section 13.3.60)	Hedged item is not prepayable [815-20-25-104(e)]
Criterion 5 (section 13.3.70)	All other terms are typical and do not invalidate assumption of perfect effectiveness [815-20-25-104(g)]

Additional shortcut criteria for fair value hedges (section 13.3.80)

The maturity dates of the swap and hedged item(s) match. [815-20-25-105(a)]
The variable interest rate of the swap has no cap or floor. [815-20-25-105(b)]
The repricing intervals on the swap's variable rate are frequent enough to assume that the variable rate is a market rate. [815-20-25-105(c)]
The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the hedged interest rate. [815-20-25-105(f)]

Additional shortcut criteria for cash flow hedges (section 13.3.90)

All of the hedged transaction's interest payments during the swap's term are hedged, and none of its interest payments beyond the swap's term are hedged. [815-20-25-106(a), 25-106(b)]
Either the swap has no cap or floor, or if the hedged transaction has a cap or floor, the swap has a comparable cap or floor. [815-20-25-106(c)]
The repricing dates of the swap and the hedged transaction match. [815-20-25-106(d)]
The index on which the variable leg of the swap is based matches the contractually specified interest rate designated as the hedged interest rate. [815-20-25-106(g)]

13.3.20 General requirements

There are general requirements regarding the nature of the hedged item or transaction, hedging instrument and hedged risk that must be met before an entity can determine whether a hedging relationship meets the specific criteria to be assessed under the shortcut method.

%↑ Interest rate risk. First, the hedging relationship needs to hedge interest rate risk as follows. [815-20-25-102, 55-71]

Fair value hedge	Cash flow hedge
The hedged risk is a benchmark interest rate.	The hedged risk is the interest rate index contractually specified in the interest-bearing asset or liability.

Additional requirements for the hedged item or transaction and hedging instrument are as follows.

Hedging instrument needs to be:	— a simple interest rate swap without embedded options; or — a compound hedging instrument comprising an interest rate swap and an embedded call or put option that mirrors the call or put option embedded in the hedged item. [815-20-25-102]
Hedged item or transaction needs to be:	— a recognized interest-bearing asset (e.g. a debt instrument classified as AFS); — a recognized interest-bearing liability (e.g. fixed-rate debt issued); or — a firm commitment arising from a difference between the trade date and settlement date relating to a purchase of an interest-bearing asset or issuance of an interest-bearing liability. [815-20-25-102]

For a portfolio of interest-bearing assets or interest-bearing liabilities to qualify for the shortcut method, each asset or liability in the portfolio must individually qualify for the shortcut method. [815-20-25-116]



Question 13.3.10

Can the shortcut method be applied to a hedge of the forecasted issuance or purchase of a financial instrument?

Interpretive response: Generally an entity cannot apply the shortcut method to the hedge of a forecasted purchase of an asset or issuance of a liability – e.g. the variability in interest payments on the forecasted issuance of fixed rate debt. This is because a forecasted purchase is not a recognized interest-bearing asset or interest-bearing liability. This is true even if the critical terms of the interest rate swap match the forecasted purchase or issuance. [815-20-25-102, 55-71, 55-72]

However, an entity could apply the shortcut method to a firm commitment that arises on the trade date if the difference between the trade and settlement dates is due to generally established conventions in the marketplace in which the transaction is executed (see Question 13.3.20). [815-20-25-102]



Question 13.3.20

How does an entity determine whether the trade and settlement dates of a firm commitment differ due to market conventions?

Background: An entity may designate a firm commitment as the hedged item in a shortcut method hedge if: [815-20-25-102]

- the firm commitment arises on the trade date to purchase or issue an interest-bearing asset or liability; and
- the reason for the difference between the trade date of the firm commitment and settlement date of the interest-bearing asset or liability is

due to generally established conventions in the marketplace in which the transaction is executed.

Interpretive response: An entity applies judgment when determining whether the trade and settlement dates of a firm commitment to purchase or issue an interest-bearing asset or liability differ due to established market conventions. It considers the facts and circumstances of the specific transaction and the market in which the transaction is executed.



Example 13.3.10 Debt hedged on trade date

Debt issued and hedged with an interest rate swap

ABC Corp. issues a fixed-rate debt instrument. On the same day, ABC enters into an interest rate swap whereby it will receive a fixed rate and pay a variable rate.

The fixed-rate debt will settle five days after its trade date (i.e. date issued). ABC determines that the reason for the five-day difference between the trade and settlement dates is due to established market conventions. ABC applies the shortcut method.

Fair value hedge designation

Hedged item	Fixed-rate debt issued
Hedging instrument	Receive fixed, pay variable interest rate swap
Hedged risk	Three-month LIBOR

Fair value hedge accounting – shortcut method

Trade date	The interest rate swap and a firm commitment representing the debt that will settle in five days both have fair values of zero.
Trade date to settlement date	ABC applies the shortcut method. Therefore, it records the change in fair value of the interest rate swap and an equal and offsetting change in fair value of the firm commitment in earnings. In addition, ABC adjusts the carrying amount of the interest rate swap to its fair value and adjusts the carrying amount of the firm commitment in an equal and offsetting amount.
Settlement date	ABC recognizes the debt instrument and incorporates the prior carrying amount of the firm commitment into the amount it recognizes.
After settlement date	ABC continues to apply the shortcut method.

What if the debt had a variable interest rate?

If ABC had issued variable-rate debt, it would have been exposed to cash flow variability beginning on the debt's trade date. ABC could have designated the

hedging relationship as a **cash flow hedge** and applied the shortcut method. All changes in the fair value of the interest rate swap would have been recorded in AOCI and are reclassified to earnings as the hedged item affects earnings. On settlement date, ABC would have recognized the variable-rate debt instrument.



Question 13.3.30

Can a lessee or lessor apply the shortcut method to a cash flow hedge of the variability in lease payments of an interest rate indexed operating lease?

Interpretive response: No. Neither the lessee nor the lessor may apply the shortcut method to a **cash flow hedge** of the variability in lease payments for an interest-rate-indexed operating lease. The lease is neither an interest-bearing asset or liability, nor a firm commitment to purchase or issue an interest-bearing asset or liability with a settlement date that differs from its trade date due to established market conventions. [815-20-25-102, 55-71]



Question 13.3.40

Can an entity replace the hedged item or transaction during a shortcut method hedging relationship?

Interpretive response: No. An entity must identify and document the specific hedged item or transaction at the inception of the specific interest-bearing asset or liability. Therefore, an entity is not permitted to replace the hedged item or transaction during the hedging relationship. If the entity derecognizes the hedged item or transaction that was designated in its original hedge documentation, the hedging relationship would be terminated. [815-20-25-3]

The hedge of a firm commitment and subsequent recognition and continued hedge of the related interest-bearing asset or liability is not considered a replacement of the hedged item or transaction.



Question 13.3.50

Are there documentation considerations that are specific to the shortcut method?

Interpretive response: Yes. We believe that at hedge inception, an entity should **formally document** how each of the applicable shortcut criteria are met.

In addition, an entity may want to consider documenting at hedge inception a quantitative method it would use to assess hedge effectiveness if it subsequently determines the shortcut method was not or no longer is appropriate (see section 13.3.110). [815-20-25-117A]



Question 13.3.60

Can the shortcut method be applied when a portion (i.e. a percentage) of an interest-bearing asset or liability is designated as the hedged item or transaction?

Interpretive response: Yes. An entity may designate a portion (i.e. a percentage) of an interest-bearing asset or liability as the hedged item (or interest payments on a portion of the principal amount of an interest-bearing asset or liability as the hedged transaction) in a shortcut method hedge. However, the notional amount of the interest rate swap and the principal amount of the hedged item or transaction must match (see section 13.3.30).
[815-20-25-105(d), 25-106(e)]

For guidance on designating a portion (or percentage) of a hedged item in a fair value hedge, see section 7.3.60. For guidance on specifically identifying a forecasted transaction in a cash flow hedge, see section 9.3.30.



Question 13.3.70

Can the shortcut method be applied when hedging a portfolio of interest-bearing assets or liabilities or group of forecasted transactions?

Interpretive response: Yes. An entity may designate a portfolio of similar interest-bearing assets or liabilities (or proportions thereof) as the hedged item or a group of forecasted transactions as the hedged transaction in a shortcut method hedge as long as: [815-20-25-105(e), 25-106(f), 25-116]

- the notional amount of the interest rate swap and the aggregate notional amount of the designated portfolio or group of forecasted transactions match (see section 13.3.30); and
- each individual item in the portfolio or group meets all applicable shortcut criteria.

As a practical matter, these criteria result in the need for the characteristics of the individual items in the portfolio or group to be the same except for their notional amounts. Therefore, opportunities for hedging a portfolio of items or group of transactions using the shortcut method are limited.

For guidance on designating a portfolio of similar assets or liabilities in a fair value hedge, see section 7.3.40. For guidance on designating a group of similar forecasted transactions, see section 9.3.60.

13.3.30 Criterion 1: Swap's notional amount matches the hedged item's principal amount



Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-104 All of the following conditions apply to both fair value hedges and cash flow hedges:

- a. The notional amount of the interest rate swap matches the principal amount of the interest-bearing asset or liability being hedged.

25-105 All of the following incremental conditions apply to fair value hedges only: ...

- d. For fair value hedges of a proportion of the principal amount of the interest-bearing asset or liability, the notional amount of the interest rate swap designated as the hedging instrument (see (a) in paragraph 815-20-25-104) matches the portion of the asset or liability being hedged.
- e. For fair value hedges of portfolios (or proportions thereof) of similar interest-bearing assets or liabilities, both of the following criteria are met:
 - 1. The notional amount of the interest rate swap designated as the hedging instrument matches the aggregate notional amount of the hedged item (whether it is all or a proportion of the total portfolio).
 - 2. The remaining criteria for the shortcut method are met with respect to the interest rate swap and the individual assets or liabilities in the portfolio.

25-106 All of the following incremental conditions apply to cash flow hedges only: ...

- e. For cash flow hedges of the interest payments on only a portion of the principal amount of the interest-bearing asset or liability, the notional amount of the interest rate swap designated as the hedging instrument (see paragraph 815-20-25-104(a)) matches the principal amount of the portion of the asset or liability on which the hedged interest payments are based.
- f. For a cash flow hedge in which the hedged forecasted transaction is a group of individual transactions (as permitted by paragraph 815-20-25-15(a)), if both of the following criteria are met:
 - 1. The notional amount of the interest rate swap designated as the hedging instrument (see paragraph 815-20-25-104(a)) matches the notional amount of the aggregate group of hedged transactions.
 - 2. The remaining criteria for the shortcut method are met with respect to the interest rate swap and the individual transactions that make up the group. For example, the interest rate repricing dates for the variable-rate assets or liabilities whose interest payments are included in the group of forecasted transactions shall match (that is, be exactly the same as) the reset dates for the interest rate swap.

When the hedged item or transaction is an entire financial asset or financial liability, the shortcut method's first criterion requires the notional amount of the interest rate swap to match the principal amount of the hedged item or transaction. [815-20-25-104(a)]



This criterion is met for portions and portfolios or groups of hedged items or transactions as follows.

	Fair value hedge	Cash flow hedge
If hedged item or transaction is a portion (i.e. percentage) of the principal amount ...	The interest rate swap notional amount must match the principal amount of the portion (i.e. a percentage) of the interest-bearing asset or liability. [815-20-25-105(d)]	The interest rate swap notional amount must match the principal amount of the portion of the asset or liability on which hedged interest payments are based. [815-20-25-106(e)]
If hedged item or transaction is a portfolio or group of similar interest-bearing assets or liabilities (or portion thereof) ...	The interest rate swap notional amount must match the aggregate principal amount of the hedged portfolio. [815-20-25-105(e)]	The interest rate swap notional amount must match the principal amount of the aggregate group of hedged transactions. [815-20-25-106(f)]



Question 13.3.80

Can the shortcut method be applied to a hedging relationship if the hedging instrument is a part of a derivative instrument?

Interpretive response: Yes, an entity may designate a proportion of an interest rate swap as the hedging instrument in a shortcut method hedge if the swap's notional amount and the hedged item's principal amount match. For example, an entity could hedge \$50 million notional of a \$100 million notional. [815-20-25-104(a)]

13.3.40 Criterion 2: Swap's fair value at hedge inception is zero



Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-104 All of the following conditions apply to both fair value hedges and cash flow hedges: ...

- b. If the hedging instrument is solely an interest rate swap, the fair value of that interest rate swap at the inception of the hedging relationship must be zero, with one exception. The fair value of the swap may be other than zero at the inception of the hedging relationship only if the swap was entered into at the relationship's inception, the transaction price of the swap was zero in the entity's principal market (or most advantageous market), and the difference between transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction. The guidance in the preceding sentence is applicable only to transactions considered at market (that is, transaction price is zero exclusive of commissions and other transaction costs, as discussed in paragraph 820-10-35-9B). If the hedging instrument is solely an interest rate swap that at the inception of the hedging relationship has a positive or negative fair value, but does not meet the one exception specified in this paragraph, the shortcut method shall not be used even if all the other conditions are met.
- c. If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in (e), the premium for the mirror-image call or put option shall be paid or received in the same manner as the premium on the call or put option embedded in the hedged item based on the following:
 1. If the implicit premium for the call or put option embedded in the hedged item is being paid principally over the life of the hedged item (through an adjustment of the interest rate), the fair value of the hedging instrument at the inception of the hedging relationship shall be zero (except as discussed previously in (b) regarding differing prices due to the existence of a bid-ask spread).
 2. If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium), the fair value of the hedging instrument at the inception of the hedging relationship shall be equal to the fair value of the mirror-image call or put option.

The shortcut method's second criterion requires the following.

If the hedged instrument is:

Solely an interest rate swap

The fair value of that interest rate swap at hedge inception must be zero, with the exception of bid-ask spreads. [815-20-25-104(b)]

If the hedged instrument is:	
A compound derivative composed of an interest rate swap with an embedded mirror-image call option	The entity must pay or receive the premium for the mirror-image call or put option and the premium for the call or put option embedded in the hedged item or transaction in the same manner. [815-20-25-104(c)]

Because of the requirement that the fair value of the interest rate swap be zero at hedge inception, it is highly unlikely that a hedging relationship could qualify for the shortcut method unless an entity designates the hedging relationship at the swap's trade date. Immediately thereafter, the swap will very likely have a fair value of other than zero because of the movement in both market interest rates and the passage of time.



Question 13.3.90

Are there exceptions to the requirement that an interest rate swap's fair value be zero at hedge inception?

Interpretive response: The shortcut method generally requires that the fair value of the interest rate swap be zero at hedge inception. However, the swap's fair value may be other than zero if: [815-20-25-104(b)]

- the entity enters into the swap at hedge inception;
- the swap's transaction price is zero (excluding commissions and other transaction costs described in Subtopic 820-10) in the entity's principal or most advantageous market as applicable; and
- the difference between the swap's transaction price and its fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction.

In addition, a compound derivative comprising an interest rate swap and a call or put option that mirrors the call or put option embedded in the hedged item or transaction may have a non-zero fair value.



Question 13.3.100

How does an entity determine whether the interest rate swap has a zero fair value if it includes a premium for an embedded call or put option?

Background: An entity may hedge an interest-bearing asset or liability that has an embedded call or put option for interest rate risk with an interest rate swap containing a mirror-image call or put option. Typically, parties to both the asset or liability and the swap will pay or receive a premium for the options. [815-20-25-102]

Interpretive response: The shortcut method requires an entity to pay or receive the premium for the mirror-image option contained in the interest rate

swap in the same manner as it receives or pays the premium on the call or put option embedded in the hedged item or transaction. [815-20-25-104(c)]

Therefore, an entity determines whether the implicit premium for the call or put option embedded in the hedged item or transaction was paid at inception (through an original issue discount or premium) or is being paid over the life of hedged item or transaction (through an interest rate adjustment). An entity makes this determination by comparing the hedged item or transaction with the embedded option to an instrument without such an embedded option, but equivalent to the hedged item or transaction in all other respects. [815-20-25-104(c)]

If the premium for a call or put option embedded in the hedged item or transaction is paid over the life of the hedged item or transaction, the fair value of the hedging instrument at hedge inception must be zero. However, if such a premium is paid at inception of the hedged item or transaction, the fair value of the hedging instrument at hedge inception must equal the fair value of the mirror-image call or put option. [815-20-25-104(c)]

Premium for call or put option embedded in the hedged item or transaction is paid:	To apply the shortcut method, the fair value of the hedging instrument at hedge inception must equal:
Over the life of the hedged item or transaction	Zero [815-20-25-104(c)]
At inception of the hedged item or transaction	The fair value of the mirror-image call or put option [815-20-25-104(c)]

When applying the shortcut method, an entity does not perform the written option effectiveness test if the options embedded in the hedging instrument and hedged item have terms that mirror one another. This is because an entity assumes that the written option effectiveness test would be met if a hedging relationship also meets the requirements for application of the shortcut method.



Example 13.3.20

Day 1 fair value of a compound interest rate swap

ABC Corp. issues a callable debt instrument with a fixed rate of 5.5% and designates the following in a shortcut method fair value hedge.

Hedged item	Callable debt with a fixed rate of 5.5%.
Hedging instrument	An interest rate swap, whereby ABC receives 5.5% and pays three-month LIBOR, that contains a written embedded call option that mirrors the call option in the debt.

If the swap did not contain the mirror option, ABC would not be able to apply the shortcut method.

Does ABC pay for the debt's premium and receive the swap's premium in the same manner?

ABC determines that the interest rate it is paying over the life of the debt instrument includes a premium of 50 bps for its purchased call option. That is, if the bond that ABC issued had been non-callable, its interest rate would have been 5%. ABC also determines that an interest rate swap with terms that match the debt and has a fair value of zero at inception would have a fixed leg that pays 5%.

Because the swap that ABC designated as the hedging instrument has a fixed-rate leg of 5.5%, it has a fair value of other than zero. However, this value is offset by the value of the written option's premium embedded in the swap. Therefore, the net fair value of the compound derivative is zero at inception of the hedging relationship. In this situation, ABC is receiving a premium of 50 bps for the swap's mirror-image written call option over the swap's life as part of the swap's fixed interest rate. Therefore, this hedging relationship meets the second criterion for the shortcut method because ABC pays for the premium on the debt and receives the premium on the swap in the same manner.

What if the debt had a fixed rate of 5%?

If ABC had instead issued debt with a fixed rate of 5% (i.e. a discount to yield 5.5%), it would pay a premium for the embedded call option at inception through an original issue discount.

However, assume the terms of the interest rate swap are the same as described above (i.e. ABC receives 5.5% and pays three-month LIBOR). In that case, ABC receives a premium of 50 bps for the swap's mirror-image written call option over the swap's life as part of the swap's fixed interest rate. In this situation, ABC does not pay for the premium on the debt and receive the premium on the swap in the same manner. Therefore, ABC cannot apply the shortcut method.

**Question 13.3.110**

Can an interest rate swap that has an embedded financing arrangement have a fair value of zero?

Interpretive response: Yes, in some cases. For example, a zero coupon swap discussed in Question 13.3.250 has an embedded financing arrangement, but it may be structured to have a zero fair value at inception. In other cases, an interest rate swap that has an embedded financing arrangement may not have a zero fair value at hedge inception because its fair value reflects the financing component. In any case, an interest rate swap with an embedded financing arrangement would not qualify for the shortcut method. This is because the swap would fail the criterion requiring it to have a consistent formula for computing net settlements each period. The swap would also fail the criterion requiring its terms to be typical for a swap and to not invalidate the assumption of perfect effectiveness. [815-20-25-14(b), 25-104(d), 25-104(g)]

**Example 13.3.30****Day 1 fair value of an interest rate swap with an embedded financing arrangement**

Bank accepts certificates of deposits acquired through Broker (i.e. brokered CDs). It designates a brokered CD as the hedged item in a shortcut method fair value hedge.

Broker charges a commission for providing the CDs to Bank. However, Bank does not pay the commission to Broker directly. Instead, Bank enters into an interest rate swap arrangement with Counterparty and designates the swap as the hedging instrument. Counterparty pays Broker the commission on behalf of Bank. Under the swap arrangement, Bank then reimburses Counterparty over time through its payments to Counterparty under the swap. That is, Bank pays Counterparty a rate that is 0.2% more than it would have if Counterparty had not financed the broker commissions.

The interest rate swap has an embedded financing arrangement. Its initial fair value is equal to Broker's commission that Counterparty has financed. Because the fair value of the swap is not zero at hedge inception (due to the embedded financing arrangement), the swap does not qualify for the shortcut method.

When evaluating whether such a transaction qualifies for the shortcut method, an entity considers all unstated rights and privileges that may have been considered in negotiating the terms of the swap.

Continued use of shortcut method following a business combination**Excerpt from ASC 815-20****>> Example 24: No Continuation of the Shortcut Method Following a Purchase Business Combination**

55-199 This Example addresses whether the shortcut method in paragraph 815-20-25-102 can be applied in the circumstances illustrated. This Example has the following assumptions:

- a. Entity A acquires Entity B in a business combination. A business combination is accounted for as the acquisition of one entity by another entity. The acquiring entity, Entity A, records the assets acquired and liabilities assumed at fair value.
- b. Subparagraph superseded by Accounting Standards Update No. 2017-12.
- c. At the date of the business combination, Entity A and Entity B both have certain hedging relationships that have met the requirements as discussed beginning in paragraph 815-20-25-102 and that are being accounted for by the respective entities under the shortcut method of accounting.

- d. At the date of the business combination, the fair value of the hedging swaps in Entity B's hedging relationships is other than zero.

55-200 Unless the applicable hedging relationships meet the requirements in paragraph 815-20-25-102 at the date of the business combination (which would be highly unlikely because the swap's fair value would rarely be zero at that date) and the combined entity chooses to designate the swaps and the hedged items as hedging relationships to be accounted for under the shortcut method, the acquiror cannot continue to use the shortcut method of accounting for the hedging relationships of the acquiree that were being accounted for by the acquiree under the shortcut method of accounting at the date of the business combination.

55-201 Entity A is acquiring the individual assets and liabilities of Entity B at the date of the business combination and accordingly any preexisting hedging relationships of old Entity B must be designated anew by the combined entity at the date of the business combination in accordance with the relevant requirements of this Subtopic.

55-202 In part, this Example entails a determination of whether the business combination results in a new inception date for the combined entity for hedging relationships entered into by the acquiree before the consummation of the business combination that remain ongoing at the date of the business combination. The concept of acquisition accounting follows the accounting for acquisitions of individual assets and liabilities. That is, the combined entity should account for the assets and liabilities acquired in the business combination consistent with how it would be required to account for those assets and liabilities if they were acquired individually in separate transactions. The acquisition method is based on the premise that in an acquisition, the acquired entity (Entity B) ceases to exist and only the acquiring entity (Entity A) survives. Thus, the postacquisition hedging relationship designated by Entity A is a new relationship that has a new inception date.

55-203 Even in the unlikely circumstance that the new hedging relationship qualifies for the shortcut method, there would be no continuation of the shortcut method of accounting that had been applied by the acquired entity.

The acquiree in a business combination may have existing hedging relationships to which it has applied the shortcut method. Any post-combination designation of the existing hedging relationship by the acquirer would be considered a new hedging relationship. [\[815-20-55-202\]](#)

After a business combination, the acquirer may not use the shortcut method for a hedge that acquiree accounted for using the shortcut method before the business combination unless: [\[815-20-55-200\]](#)

- the applicable hedging relationship meets the shortcut criteria at the date of the business combination. This would be highly unlikely because the interest rate swap's fair value rarely would be zero at that date; and
- the combined entity chooses to designate the swap and the hedged item or transaction as a hedging relationship to be accounted for under the shortcut method.

13.3.50 Criterion 3: Swap has a consistent formula for computing net settlements each period



Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-104 All of the following conditions apply to both fair value hedges and cash flow hedges:

- d. The formula for computing net settlements under the interest rate swap is the same for each net settlement. That is, both of the following conditions are met:
 1. The fixed rate is the same throughout the term.
 2. The variable rate is based on the same index and includes the same constant adjustment or no adjustment. The existence of a **stub period** and **stub rate** is not a violation of the criterion in (d) that would preclude application of the shortcut method if the stub rate is the variable rate that corresponds to the length of the stub period.

The shortcut method's third criterion requires that the formula for computing the net settlements of the interest rate swap to be the same for each net settlement. This means that throughout its term, the swap's: [\[815-20-25-104\(d\)\]](#)

- fixed rate does not change; and
- variable rate is based on the same index and includes no or a constant fixed spread.



Question 13.3.120

Can the shortcut method be applied if the hedging instrument is a forward-starting interest rate swap?

Interpretive response: No, an entity cannot apply the shortcut method to a hedging relationship that involves a forward-starting interest rate swap. [\[815-20-55-71, 25-102\]](#)

The FASB staff has noted that a forward-starting interest rate swap is not considered to have a consistent formula for computing net settlements. This is because settlements occur only after the effective date and not between the trade date and effective date.



Question 13.3.130

Can the shortcut method be applied to a hedge if the swap contains an initial stub period?

Background: The variable leg of an interest rate swap often resets every three or six months. However, entities frequently enter into interest rate swaps on

dates other than a swap reset date. An interest rate swap that resets quarterly may have a first payment period that is shorter than a full quarter, referred to as a 'stub period.' That stub period is the period that begins on the date that coupon payments begin to accrue and ends on the first payment date. The floating rate set for that shorter period is the 'stub rate'.

Interpretive response: Yes, an interest rate swap containing an initial stub period does not violate the shortcut method requirement that the swap have a consistent formula for calculating net settlements if the stub rate corresponds to the length of the stub period. A stub period is simply a market convention necessary to determine the prices of interest rate swaps that are traded on dates that do not coincide with swap reset dates. [815-20-25-104(d)(2)]



Question 13.3.140

Can the shortcut method be applied to a hedge if the first cash flow on the swap includes debt issuance fees?

Interpretive response: No. If the first cash flow on the interest rate swap includes debt issuance fees, the swap is not eligible for the shortcut method. To qualify for the shortcut method, the interest rate swap must have a consistent formula for computing net settlements each period. Therefore, if the first cash flow on the swap includes debt issuance fees, it is not eligible because the formula for each net settlement is not the same. This transaction would also not meet the second criterion for the shortcut method because the interest rate swap would not have a zero fair value at inception (see section 13.3.40). [815-20-25-104(b), 25-104(d)]

13.3.60 Criterion 4: Hedged item is not prepayable, with limited exceptions



Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-104 All of the following conditions apply to both fair value hedges and cash flow hedges:

- e. The interest-bearing asset or liability is not prepayable, that is, able to be settled by either party before its scheduled maturity or the assumed maturity date if the hedged item is measured in accordance with paragraph 815-25-35-13B, with the following qualifications:
 1. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option (put option) if the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image call option (put option).

2. The call option embedded in the interest rate swap is considered a mirror image of the call option embedded in the hedged item if all of the following conditions are met:
 - i. The terms of the two call options match exactly, including all of the following:
 01. Maturities
 02. Strike price (that is, the actual amount for which the debt instrument could be called) and there is no termination payment equal to the deferred debt issuance costs that remain unamortized on the date the debt is called
 03. Related notional amounts
 04. Timing and frequency of payments
 05. Dates on which the instruments may be called.
 - ii. The entity is the writer of one call option and the holder (purchaser) of the other call option.

25-108 Any discount or premium in the hedged debt's carrying amount (including any related deferred issuance costs) is irrelevant to and has no direct impact on the determination of whether an interest rate swap contains a mirror-image call option under paragraph 815-20-25-104(e). Typically, the call price is greater than the par or **face amount** of the debt instrument. The carrying amount of the debt is economically unrelated to the amount the issuer would be required to pay to exercise the call embedded in the debt.

>>>> Application of Prepayable Criterion

25-112 An interest-bearing asset or liability shall be considered prepayable under the provisions of paragraph 815-20-25-104(e) if one party to the contract has the right to cause the payment of principal before the scheduled payment dates unless either of the following conditions is met:

- a. The debtor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always greater than the then fair value of the contract absent that right.
- b. The creditor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always less than the then fair value of the contract absent that right.

25-113 However, none of the following shall be considered a prepayment provision:

- a. Any term, clause, or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent upon the occurrence of a specific event related to the debtor's credit deterioration or other change in the debtor's credit risk, such as any of the following:
 1. The debtor's failure to make timely payment, thus making it delinquent
 2. The debtor's failure to meet specific covenant ratios
 3. The debtor's disposition of specific significant assets (such as a factory)
 4. A declaration of cross-default
 5. A restructuring by the debtor.
- b. Any term, clause, or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent upon the occurrence of a specific event that meets all of the following conditions:
 1. It is not probable at the time of debt issuance.

2. It is unrelated to changes in benchmark interest rates, contractually specified interest rates, or any other market variable.
 3. It is related either to the debtor's or creditor's death or to regulatory actions, legislative actions, or other similar events that are beyond the control of the debtor or creditor.
- c. Contingent acceleration clauses that permit the debtor to accelerate the maturity of an outstanding note only upon the occurrence of a specified event that meets all of the following conditions:
1. It is not probable at the time of debt issuance.
 2. It is unrelated to changes in benchmark interest rates, contractually specified interest rates, or any other market variable.
 3. It is related to regulatory actions, legislative actions, or other similar events that are beyond the control of the debtor or creditor.

25-114 Furthermore, a right to cause a contract to be prepaid at its then fair value would not cause the interest-bearing asset or liability to be considered prepayable because that right would have a fair value of zero at all times and essentially would provide only liquidity to the holder.

25-115 Application of this guidance to specific debt instruments is illustrated in paragraph 815-20-55-75.

The shortcut method's fourth criterion requires that the **hedged item or transaction** not be prepayable, except in limited situations described in Question 13.3.150. [815-20-25-104(e)]



Question 13.3.150

What financial instruments does an entity consider prepayable?

Interpretive response:

Prepayment amount always equals instrument's fair value

An entity generally considers an interest-bearing asset or liability prepayable when one party can prepay or require the other party to prepay the principal amount before its scheduled payment date; or in the case of a partial-term hedge, the assumed maturity date of the hedged item.

However, it does not consider an interest-bearing asset or liability to be prepayable for purposes of applying the shortcut method if: [815-20-25-104(e), 25-112, 25-113]

The debtor has the right to:

Cause settlement of the entire instrument before its stated maturity at an amount that is always **greater** than the current fair value of the contract without that right.

Or

The creditor has the right to:

Cause settlement of the entire instrument before its stated maturity at an amount that is always **less** than the current fair value of the contract without that right.

An entity does not consider a hedged item or transaction prepayable if the right to prepay always results in a prepayment amount equal to the instrument's current fair value. This is because that right would have a fair value of zero at all times and essentially would provide only liquidity to the creditor. [815-20-25-114]

An entity should not assume that a variable-rate instrument always has a fair value equal to its par value when the interest rate resets to the applicable interest rate index. Other conditions (e.g. changes in credit risk) may affect the fair value of the variable-rate debt instrument. For example, variable-rate debt callable for par is not callable for fair value because its par value and fair value may differ due to changes in variables other than interest rates. [815-20-25-104(e)]

Prepayment feature cannot be exercised during hedge term

An entity does not consider a hedged item or transaction to be prepayable during the hedge term if the item has a prepayment feature (e.g. a call or put option) that cannot be exercised during the hedge term. This occurs in a partial-term hedge – i.e. a hedge in which an entity designates only a part of the instrument's term.

Other instruments not considered prepayable

Other debt instruments may not be considered prepayable for purposes of applying the shortcut method depending on whether certain conditions are met. These include certain debt instruments that become prepayable: [815-20-25-113]

- on the occurrence of an event related to the debtor's credit deterioration (see Question 13.3.160);
- on the occurrence of an event related to the debtor's or creditor's death, or to regulatory or legislative actions that are beyond the control of the debtor or creditor (see Question 13.3.170); and
- due to a contingent acceleration clause that permits the debtor to accelerate the maturity of an outstanding note only on the occurrence of one or more events that are beyond the control of the debtor or creditor (see Question 13.3.170).



Question 13.3.160

Is a debt instrument that becomes prepayable on the debtor's credit deterioration considered prepayable when applying the shortcut method?

Interpretive response: No. A debt instrument that gives the debtor (creditor) the right to prepay (require the other party to prepay) the debt instrument on the occurrence of a specific event related to the debtor's credit deterioration or other change in the debtor's credit risk is not considered prepayable for the purpose of applying the shortcut method. [815-20-25-113(a)]

The following are examples of such provisions:

- the debtor's failure to make timely payment, thereby making it delinquent;
- the debtor's failure to meet specific covenant ratios;
- the debtor's disposal of specific significant assets;

- cross-default; and
- a restructuring by the debtor.



Question 13.3.170

Is a debt instrument that becomes prepayable on the occurrence of an event beyond the control of the debtor or creditor considered prepayable when applying the shortcut method?

Interpretive response: It depends. A debt instrument is not considered prepayable if it gives the debtor or creditor the right to prepay or require the other party to prepay the debt instrument on the occurrence of an event that: [\[815-20-25-113\(b\)\]](#)

- is not probable at the time of debt issuance;
- is unrelated to changes in benchmark interest rates, contractually specified rates, or any other market variable; and
- is related either to the debtor's or creditor's death, or to regulatory or legislative actions, or other similar events that are beyond the control of the debtor or creditor.

In addition, an outstanding note is not considered prepayable if it permits the debtor to accelerate its maturity only on the occurrence of an event that: [\[815-20-25-113\(c\)\]](#)

- is not probable at the time of debt issuance;
- is unrelated to changes in benchmark interest rates, contractually specified rates, or any other market variable; and
- is related to regulatory or legislative actions, or other similar events that are beyond the control of the debtor or creditor.

See Illustrative debt instrument 7 in paragraph 815-20-55-75 (reproduced in the FASB example that follows) for an example of a debt instrument that meets the above criteria.

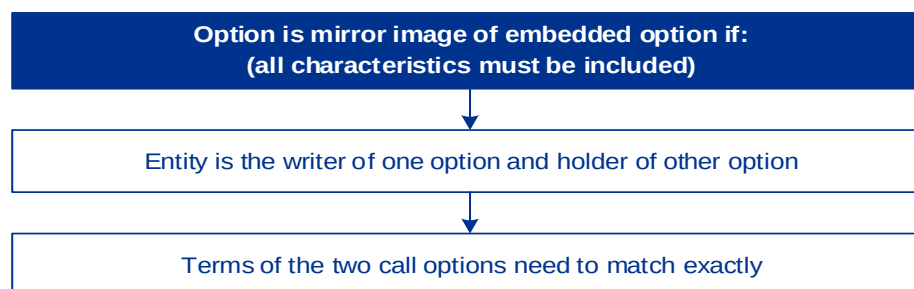


Question 13.3.180

Are there exceptions to the requirement that a hedged item or transaction not be prepayable?

Interpretive response: Yes. As an exception, a hedged item or transaction that is prepayable may qualify for the shortcut method if the hedging instrument is a compound derivative comprising an interest rate swap and an option that is the mirror image of the option embedded in the hedged item or transaction. [\[815-20-25-104\(e\)\(1\)\]](#)

The following diagram illustrates when an option is considered a mirror image of the option embedded in the hedged item or transaction. [\[815-20-25-104\(e\)\(2\)\]](#)



Each of these terms of the two call options need to match exactly:

- maturities;
- strike prices;
- notional amounts;
- notification/election dates (the option notification date partially defines the term of the option, which is a key factor in determining its fair value);
- how premiums are paid;
- style of option;
- timing and frequency of payments; and
- call dates.



Question 13.3.190

How does a debt instrument's carrying amount affect whether the swap used to hedge the debt contains a mirror-image call option?

Background: Before entering into a hedge, a debt instrument's carrying amount may differ from its redemption amount at maturity. This difference may be due to an issuance premium or discount or deferred debt issuance costs. In addition, if the debt instrument is callable, the carrying amount often differs from the call option's strike price.

Interpretive response: The carrying amount of the debt is economically unrelated to the amount the issuer would be required to pay to exercise the call embedded in the debt. Any discount or premium in the hedged debt's carrying amount (including any related deferred issuance costs) is therefore irrelevant to determining whether an interest rate swap contains a mirror-image call option.

Typically, the call price is greater than the par amount of the debt instrument. The carrying amount of the debt is economically unrelated to the amount the issuer would be required to pay to exercise the call embedded in the debt. Therefore, for example, an interest rate swap is not permitted to contain a termination payment equal to the debt issuance costs that remain unamortized on the date the option is exercised if the shortcut method is to be applied.

[815-20-25-108]

FASB Example: Applying the prepayable criterion under the shortcut method



Excerpt from ASC 815-20

>>> Application of the Prepayable Criterion under the Shortcut Method

55-74 This implementation guidance discusses the application of the **prepayable** criterion in paragraph 815-20-25-104(e) and related guidance beginning in paragraph 815-20-25-112.

55-75 A debt instrument may contain various terms and provisions that permit either the debtor or the creditor to cause prepayment of the debt (that is, cause the payment of principal before the scheduled payment dates), including the terms in the following illustrative instruments:

- a. Illustrative debt instrument 1. Some fixed-rate debt instruments include a typical call option that permits the debt instrument to be called for prepayment by the debtor at a fixed amount, for example, at par or at a specified premium over par. In some instruments, the prepayment amount varies based on when the call option is exercised. Fixed-rate debt instruments that provide the borrower with the option to prepay at a fixed amount are considered prepayable under paragraph 815-20-25-104(e), because those contracts permit settlement at an amount that is potentially below the contract's fair value (absent the effect of the call provision) as of the date of settlement. Such clauses can be exercised based on an economic advantage related to changes in the designated benchmark interest rate.
- b. Illustrative debt instrument 2. Some debt instruments include contingent acceleration clauses that permit the lender to accelerate the maturity of an outstanding note only if a specified event related to the debtor's credit deterioration or other change in the debtor's credit risk occurs (for example, the debtor's failure to make timely payment, thus making it delinquent; its failure to meet specific covenant ratios; its disposition of specific significant assets, such as a factory; a declaration of cross-default; or a restructuring by the debtor). A common example is a clause in a mortgage note secured by certain property that permits the lender to accelerate the maturity of the note if the borrower sells the property. Debt instruments that include contingent acceleration clauses that permit the lender to accelerate the maturity of an outstanding note only upon the occurrence of a specified event related to the debtor's credit deterioration or other changes in the debtor's credit risk are not considered prepayable under paragraph 815-20-25-104(e).
- c. Illustrative debt instrument 3. Some fixed-rate debt instruments include a call option that permits the debtor to repurchase the debt instrument from the creditor at an amount equal to its then fair value. Fixed-rate debt instruments that provide the debtor with the option to repurchase from the creditor the debt at an amount equal to the then fair value of the contract are not considered prepayable under paragraph 815-20-25-104(e), because that right would have a fair value of zero at all times. Such clauses, which provide the debtor with the discretionary opportunity to settle its obligation before maturity, are not exercised based on an economic advantage

related to changes in the designated benchmark interest rate because the repurchases are done at fair value.

- d. Illustrative debt instrument 4. Some fixed-rate debt instruments, typically issued in private markets, include a **make-whole provision**. A make-whole provision differs from a typical call option, which enables the issuer to benefit by prepaying the debt if market interest rates decline. In a declining interest rate market, the settlement amount of a typical call option is less than what the fair value of the debt would have been absent the call option. In contrast, a make-whole provision involves settlement at a variable amount typically determined by discounting the debt's remaining contractual cash flows at a specified small spread over the current Treasury rate. That calculation results in a settlement amount significantly above the debt's current fair value based on the issuer's current spread over the current Treasury rate. The make-whole provision contains a premium settlement amount to penalize the debtor for prepaying the debt and to compensate the investor (that is, to approximately make the investor whole) for its being forced to recognize a taxable gain on the settlement of the debt investment. In some debt instruments, the prepayment option under a make-whole provision will not be exercisable during an initial lock-out period. (For example, Private Entity A borrows from Insurance Entity B under a 10-year loan with fixed periodic coupon payments. The spread over the Treasury rate for Entity A at issuance of the debt is 275 basis points. The loan agreement contains a make-whole provision that if Entity A prepays the debt, it will pay Insurance Entity B an amount equal to all the future contractual cash flows discounted at the current Treasury rate plus 50 basis points.) Fixed-rate debt instruments that include a make-whole provision (as previously described) are not considered prepayable under paragraph 815-20-25-104(e), because it involves settlement of the entire contract by the debtor before its stated maturity at an amount greater than (rather than an amount less than) the then fair value of the contract.
- e. Illustrative debt instrument 5. Some variable-rate debt instruments include a call option that permits the debtor to repurchase the debt instrument from the creditor at each interest reset date at an amount equal to par. Although illustrative debt instrument 5, a variable-rate debt instrument, does have a fair value exposure between the date of a change in the contractually specified interest rate and the reset date, a swap would not be an appropriate hedging instrument to hedge that fair value exposure. Thus, a fair value hedge of illustrative debt instrument 5 could not qualify for the shortcut method discussed in paragraph 815-20-25-102, which requires the hedging instrument to be an interest rate swap. In cash flow hedges, if the reset provisions always result in the instrument's par amount being equal to its fair value at a reset date, then an option for the debtor to prepay the variable-rate debt instrument at par at that reset date would not be considered prepayable under paragraph 815-20-25-104(e). However, if the reset provisions can result in the instrument's par amount not being equal to its fair value at those reset dates, then an option for the debtor to prepay the variable-rate debt instrument at par at a reset date would be considered prepayable under that paragraph. (Because the reset provisions typically do not adjust the variable interest rate for changes in credit sector spreads and changes in the debtor's creditworthiness, the variable-rate debt instrument's par amount could seldom be expected to be

equal to its fair value at each reset date.) Furthermore, to qualify for cash flow hedge accounting, the hedging relationship must meet the applicable conditions in this Subtopic and the entity designating the hedge (that is, the debtor or creditor) must conclude it is probable that future interest payments will be made during the term of the interest rate swap. If the creditor's counterparty (that is, the debtor) on a recognized variable-rate asset related to the hedged forecasted interest payments can cause that asset to be prepaid, then that creditor would likely be unable to conclude that all the forecasted interest payments on its recognized interest-bearing asset are probable and, thus, the cash flow hedging relationship would not qualify for the shortcut method. (Even though the creditor believes it could immediately obtain a replacement variable-rate asset if prepayment occurs and thus could conclude that the forecasted variable interest inflows are probable, the only hedged forecasted interest inflows that are eligible for application of the shortcut method are those related to a recognized interest-bearing asset at the inception of the hedge.) However, paragraph 815-20-25-104(e) indicates that its criterion that prohibits a prepayment option in the interest-bearing asset or liability does not apply to a hedging relationship if the hedging interest rate swap contains an embedded mirror-image option. In that latter case, if both the prepayment option and the mirror-image option in the swap were exercised, there would be no future hedged interest cash flows related to the recognized interest-bearing asset or liability and no future cash flows under the swap and, thus, the existence of the prepayment option would not preclude the use of the shortcut method.

- f. Illustrative debt instrument 6. Some fixed-rate debt instruments include both a call option as described in illustrative debt instrument 1 and a contingent acceleration clause as described in illustrative debt instrument 2. The same conclusions reached relative to illustrative debt instrument 1 also apply to illustrative debt instrument 6.
- g. Illustrative debt instrument 7. Some debt instruments contain an investor protection clause (which is standard in substantially all debt issued in Europe) that provides that, in the event of a change in tax law that would subject the investor to additional incremental taxation by tax jurisdictions other than those entitled to tax the investor at the time of debt issuance, the coupon interest rate of the debt increases so that the investor's yield, net of the incremental taxation effect, is equal to the investor's yield before the tax law change. The debt issuance also contains an issuer protection clause (which is standard in substantially all debt issued in Europe) that provides that, in the event of a tax law change that triggers an increase in the coupon interest rate, the issuer has the right to call the debt obligation at par. There would be no market for the debt were it not for the prepayment and interest rate adjustment clauses that protect the issuer and investors. Illustrative debt instrument 7 is not considered prepayable under paragraph 815-20-25-104(e) because it meets the exclusion criteria under paragraph 815-20-25-113(c).

55-76 An entity is not precluded from applying the shortcut method to a fair value hedging relationship of interest rate risk involving illustrative debt instruments 1 and 6 that are prepayable due to an embedded purchased call option if the hedging interest rate swap contains an embedded mirror-image written call option.

55-77 In addition, an entity is not precluded from applying the shortcut method to a fair value hedging relationship of interest rate risk involving illustrative debt instruments 2, 3, 4, and 7 that are not considered prepayable if the hedging interest rate swap does not contain an embedded purchased or written call option related to changes in the designated benchmark interest rate.

55-78 However, an entity would likely be precluded from applying the shortcut method to a cash flow hedging relationship of interest rate risk involving illustrative debt instrument 5 because the entity would likely be unable to conclude that all the forecasted interest payments on the recognized interest-bearing asset or liability are probable.

>>> Determining Whether a Mirror-Image Call Provision Exists in Application of the Shortcut Method

55-79 This implementation guidance addresses the application of paragraph 815-20-25-104(e). It is common to quote the call prices (strike prices) on debt as a percentage of par value. In contrast, the strike prices of options embedded in interest rate swaps are generally quoted as a rate or current yield (the current fixed-rate coupon on a noncallable-nonputtable swap having zero fair value at inception). One means of determining whether these strike prices are the same would be to:

- a. Impute the yield to maturity at a price equal to the call price for a noncallable-nonputtable debt instrument that is otherwise identical to the hedged debt instrument.
- b. Compare that yield to the call or put yield embedded in the swap.

Financial instruments that are considered prepayable for purposes of the shortcut method may differ from the financial instruments that are considered prepayable for purpose of the last-of-layer method and for the purposes of applying paragraph 815-20-25-6B. For a discussion of what is considered prepayable for the purpose of applying the last-of-layer method and paragraph 815-20-25-6B, see Question 7.4.30.

13.3.70 Criterion 5: All other terms are typical and do not invalidate assumption of perfect effectiveness



Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-104 All of the following conditions apply to both fair value hedges and cash flow hedges: ...

- g. Any other terms in the interest-bearing financial instruments or interest rate swaps meet both of the following conditions:
 1. The terms are typical of those instruments.
 2. The terms do not invalidate the assumption of perfect effectiveness.

25-107 The shortcut method may be applied to a hedging relationship that involves the use of an interest rate swap-in-arrears provided all of the applicable conditions are met.

25-109 The fixed interest rate on a hedged item need not exactly match the fixed interest rate on an interest rate swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on an interest rate swap designated as a cash flow hedge. An interest rate swap's fair value comes from its net settlements. The fixed and variable interest rates on an interest rate swap can be changed without affecting the net settlement if both are changed by the same amount. That is, an interest rate swap with a payment based on LIBOR and a receipt based on a fixed rate of 5 percent has the same net settlements and fair value as an interest rate swap with a payment based on LIBOR plus 1 percent and a receipt based on a fixed rate of 6 percent.

The shortcut method's fifth criterion requires that all of the 'other' terms of the **hedging instrument** (i.e. terms other than those discussed in Criteria 1 – 4) be typical of interest-bearing financial instruments or interest rate swaps. Moreover, none of these 'other' terms can invalidate the assumption of perfect effectiveness. The FASB included this criterion to ensure that all terms of the hedging relationship are considered in evaluating the appropriateness of the shortcut method. [\[815-20-25-104\(g\)\]](#)

This criterion suggests that a highly structured interest rate swap would not meet this criterion. However, whether a feature is typical is a matter of judgment on a case-by-case basis.

In general, to not invalidate the assumption of effectiveness, the terms of the hedged item or transaction and hedging instrument must match. This includes notional amounts, dates, day count conventions, calendar adjustments for business days for payments and fixing variable rates, interest calculation periods, interest rate fixing and payment conventions (in advance versus in arrears).



Question 13.3.200

Does the shortcut method require the fixed rate on the swap to match the fixed rate on the hedged item or transaction?

Interpretive response: No, the shortcut method does not require the fixed rate on the interest rate swap to match the fixed rate on the hedged item. The difference between the swap's fixed rate and the hedged item's fixed rate relates to the difference between the credit risk of the swap and the hedged item. [\[815-20-25-109\]](#)

Because of the complication caused by the interaction of interest rate risk and credit risk that are not easily separable, comparable creditworthiness is not considered a necessary condition to assume no ineffectiveness in a hedge of interest rate risk. [\[815-20-25-111\]](#)



Question 13.3.210

Can the shortcut method be applied to a hedge of a convertible debt instrument?

Interpretive response: No, a convertible debt instrument cannot be designated as the hedged item or transaction in a shortcut method hedge. The FASB staff has noted that the interaction between equity prices and interest rates on convertible debt adds a level of complexity not envisioned by the FASB in the shortcut method.



Question 13.3.220

Can the shortcut method be applied to a hedge of a debt instrument issued by a trust preferred structure?

Background: Banks sometimes issue securities known as trust preferred securities through a trust structure. The bank establishes the trust that it funds with debt. The bank then sells ownership interests in the trust (trust preferred securities) to investors. These trust preferred securities are considered preferred stock and pay dividends on a set schedule. However, because the trust holds the bank's debt, the payments the investors receive qualify as interest income for IRS purposes.

Interpretive response: No. We believe debt instruments with complex features, such as interest deferral features in debt instruments issued by financial institutions under trust preferred structures, cannot be designated as a hedged item or transaction in a shortcut method hedge. These interest deferral features allow the entity to defer the payment of interest at its option for a period of time if the entity is not in default. The deferred amounts themselves bear interest.

This feature would prohibit an entity from assuming perfect effectiveness, unless the interest rate swap had a mirror feature. Even if the swap did have a mirror feature, the hedging relationship would not meet the third criterion of the shortcut method because the swap would not have a consistent formula for computing net settlement (see section 13.3.50).



Question 13.3.230

Can the shortcut method be applied if the hedging instrument is a swap with a variable leg that reprices in arrears?

Background: In a plain vanilla interest rate swap, the swap's variable interest rate is determined (i.e. reset) at the beginning of each period and payment generally occurs at the end of the period. In contrast, in an interest rate swap-in-

arrears, the swap's variable interest rate reprices in arrears. This means the swap's variable rate is determined at the end of the period and is applied retrospectively to calculate the swap settlement.

Interpretive response: Yes. Topic 815 specifically permits the shortcut method for hedging relationships that involve interest rate swaps-in-arrears as long as other shortcut criteria are met. [815-20-25-107]



Question 13.3.240

Can the shortcut method be applied to a hedge of a fixed-rate debt instrument with an interest rate that increases if the issuer's credit rating deteriorates?

Interpretive response: No, an entity may not apply the shortcut method when the hedged item is a fixed-rate debt instrument with an interest rate that increases if the issuer's credit rating deteriorates.

The hedged item's cash flows include the potential increased interest cash flows due to a deterioration of the issuer's credit rating. However, a swap that would be appropriate for the shortcut method would not have cash flows with a similar potential to increase. When the hedged item's cash flows have this potential to increase, the change in fair value of the swap is not expected to fully offset the hedged item's change in fair value attributable to interest rate risk. Therefore, the hedging relationship would not meet the requirement that all terms be typical and not invalidate the assumption of perfect effectiveness.

Even if the swap has a mirror-image feature (i.e. the fixed leg of the swap increased as the interest rate on the debt increased), the shortcut method still would not apply. This is because:

- the shortcut method can be used only when the risk being hedged is interest rate risk, and in this case the hedging relationship would incorporate both interest rate and credit risk; and
- the fixed rate on the swap is not the same throughout the term as required by the third criterion— i.e. the swap must have a consistent formula for computing net settlements each period (see section 13.3.50).



Question 13.3.250

Can the shortcut method be applied to a hedge of a zero-coupon bond?

Background: A zero-coupon bond is a debt instrument that doesn't pay interest (a coupon), and as a result it sells at a deep discount. It renders its profit at maturity when the investor redeems the bond for its face value.

For economic purposes, an entity may want to hedge a zero-coupon bond with a zero-coupon swap. Typically, a zero-coupon swap has a fixed leg with one lump sum payment at maturity and a floating leg that is tied to a floating rate that resets and settles periodically. The following is an example.

Hedged item	Five-year zero-coupon bond with a face value of \$90 million that was issued for \$70 million (an imputed interest rate of 5.15% compounded annually).
Hedging instrument	A zero-coupon swap with a notional of \$70 million that receives \$20 million at maturity and pays three-month LIBOR every three months.

Interpretive response: We believe an entity may not apply the shortcut method to a hedging relationship where the hedged item is a zero-coupon bond and the hedging instrument is a zero-coupon swap. Unlike a typical interest rate swap, which has a fixed leg that pays a fixed rate periodically during the life of the swap, a zero-coupon swap does not have a fixed leg that pays periodically. It typically makes one lump payment at maturity.

This means the swap contains a financing element – i.e. the periodic payments of the floating leg during the term of the swap finance the fixed payments of the fixed leg of the swap. Therefore, we believe that a zero-coupon swap violates the fifth criterion to qualify for the shortcut method, which requires all other terms of the interest-bearing financial instrument or interest rate swap to be typical for those instruments. In addition, the swap would also violate the third criterion, which requires it to have a consistent formula for computing net settlements each period (see section 13.3.50).

13.3.80 Additional criteria for fair value hedges



Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-105 All of the following incremental conditions apply to fair value hedges only:

- a. The expiration date of the interest rate swap matches the maturity date of the interest-bearing asset or liability or the assumed maturity date if the hedged item is measured in accordance with paragraph 815-25-35-13B.
- b. There is no floor or cap on the variable interest rate of the interest rate swap.
- c. The interval between repricings of the variable interest rate in the interest rate swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).
- ...
- f. The index on which the variable leg of the interest rate swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.

In addition to the general requirements and the five specific criteria necessary to apply the shortcut method to both fair value and cash flow hedges, fair value hedges are required to meet the following additional criteria.

Additional shortcut criteria for fair value hedges

The maturity dates of the swap and hedged item(s) match. [815-20-25-105(a)]

The variable interest rate of the swap has no cap or floor. [815-20-25-105(b)]

The repricing intervals on the swap's variable rate are frequent enough to assume that the variable rate is a market rate. [815-20-25-105(c)]

The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the hedged interest rate. [815-20-25-105(f)]



Question 13.3.260

Can the shortcut method be applied to a partial-term fair value hedge?

Background: In a partial-term hedge, an entity designates only certain consecutive interest payments of a financial instrument that represent an assumed term (see section 7.3.80). An assumed term begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable. [815-25-35-13B]

Interpretive response: The shortcut method may be used in a partial-term hedge if the expiration date of the interest rate swap matches the assumed maturity date of the hedged item and all the other shortcut method criteria are met. [815-20-25-104(a)]



Question 13.3.270

Can the shortcut method be applied to a fair value hedge if the swap expires one day before or after the hedged item's maturity date or assumed maturity date?

Interpretive response: No. For an entity to apply the shortcut method, the expiration date of the interest rate swap must exactly match the maturity date of the hedged item, or the last day of the assumed term in the case of a partial-term hedge. [815-20-25-102, 25-105(a), 815-25-35-13B]



Question 13.3.280

Can the shortcut method be applied to a fair value hedge if the swap's variable leg is based on a tenor different from the hedged risk?

Interpretive response: No. To qualify for the shortcut method, the index on which the variable leg of the interest rate swap is based must exactly match the hedged risk. [815-20-25-105(f)]

To meet this criterion, we believe the tenors must match exactly. For example, the relationship would not qualify for the shortcut method if the variable leg of a swap is indexed to 90-day LIBOR and the entity designates 60-day LIBOR as the hedged risk.



Question 13.3.290

Can the shortcut method be applied to a fair value hedge if the variable interest rate of the swap has a cap or floor?

Interpretive response: No, an entity may not apply the shortcut method to a hedging relationship where the variable interest rate of the swap has a cap or floor. If an entity were to enter into an interest rate swap with a cap or floor, changes in interest rates above the cap or below the floor would not affect the fair value of the swap. This would be inconsistent with the assumption of perfect effectiveness. [815-20-25-105(b)]

13.3.90 Additional criteria for cash flow hedges



Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-106 All of the following incremental conditions apply to cash flow hedges only:

- a. All interest receipts or payments on the variable-rate asset or liability during the term of the interest rate swap are designated as hedged.
- b. No interest payments beyond the term of the interest rate swap are designated as hedged.
- c. Either of the following conditions is met:
 1. There is no floor or cap on the variable interest rate of the interest rate swap.
 2. The variable-rate asset or liability has a floor or cap and the interest rate swap has a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. For purposes of

this paragraph, comparable does not necessarily mean equal. For example, if an interest rate swap's variable rate is based on LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the interest rate swap would be comparable to a 12 percent cap on the asset.

- d. The repricing dates of the variable-rate asset or liability and the hedging instrument must occur on the same dates and be calculated the same way (that is, both shall be either prospective or retrospective). If the repricing dates of the hedged item occur on the same dates as the repricing dates of the hedging instrument but the repricing calculation for the hedged item is prospective whereas the repricing calculation for the hedging instrument is retrospective, those repricing dates do not match.
- ...
- g. The index on which the variable leg of the interest rate swap is based matches the contractually specified interest rate designated as the interest rate being hedged for that hedging relationship.

In addition to the general requirements and the five specific criteria necessary to apply the shortcut method to both fair value and cash flow hedges, cash flow hedges are required to meet the following additional criteria.

Additional shortcut criteria for cash flow hedges

All of the hedged transaction's interest payments during the swap's term are hedged, and none of its interest payments beyond the swap's term are hedged. [815-20-25-106(a), 25-106(b)]

Either the swap has no cap or floor, or if the hedged transaction has a cap or floor, the swap has a comparable cap or floor. [815-20-25-106(c)]

The repricing dates of the swap and the hedged transaction match. [815-20-25-106(d)]

The index on which the variable leg of the swap is based matches the contractually specified interest rate designated as the hedged interest rate. [815-20-25-106(g)]



Question 13.3.300

Can the shortcut method be applied to a cash flow hedge if the swap's variable leg is based on a tenor different from the hedged risk?

Interpretive response: No. To qualify for the shortcut method, the index on which the variable leg of the interest rate swap is based must exactly match the hedged risk. To meet this criterion, we believe the tenors must match exactly. For example, the relationship would not qualify for the shortcut method if the variable leg of a swap is indexed to 90-day LIBOR and the entity designates 60-day LIBOR as the hedged risk. [815-20-25-106(g)]



Question 13.3.310

Can the shortcut method be applied to a cash flow hedge if the hedged item is a variable-rate debt that contains a cap or floor?

Interpretive response: Yes, an entity may apply the shortcut method to a cash flow hedging relationship where the hedged transaction is a variable-rate debt instrument that contains a cap or floor. However, the interest rate swap that is designated as the hedging instrument must contain a comparable cap or floor, which does not necessarily mean an equal cap or floor. For example, if an interest rate swap's variable rate is based on LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the interest rate swap would be comparable to a 12 percent cap on the asset. [815-20-25-106(c)]

It is important for an entity to understand how the interest rate terms are defined in the legal documents for the hedged item and the swap – to determine what could happen if the underlying referenced interest rate were to become negative. If the hedged item or interest rate swap have terms that would prevent the rate from becoming negative, such a feature would be considered a floor.



Question 13.3.320

Can the shortcut method be applied to a cash flow hedge of interest payments arising from variable-rate debt if the debt matures after the swap expires?

Interpretive response: Yes, an entity may apply the shortcut method to cash flow hedges of the interest payments on only a portion of the term of the debt. Therefore, an entity may apply the shortcut method to a variable-rate debt instrument and an interest rate swap if the debt instrument matures after the swap expires. [815-20-25-106(a), 25-106(b)]

In this case, the entity has hedged all interest receipts or payments on the variable-rate asset or liability during the term of the swap. In addition, it has not hedged any interest payments beyond the term of the swap. [815-20-25-106(a), 25-106(b)]



Question 13.3.330

Can the shortcut method be applied to a cash flow hedge if the swap reprices in arrears, but the hedged forecasted transaction does not?

Interpretive response: No, an entity may not apply the shortcut method to an interest rate swap that reprices in arrears and a forecasted transaction that does not reprice in arrears. The term 'match' is defined narrowly and is intended to mean "be exactly the same as or correspond exactly." Therefore, if the swap

reprices in arrears, the hedged forecasted transaction also must reprice in arrears. [815-20-25-102, 25-106(d)]

13.3.100 Counterparty credit risk



Excerpt from ASC 815-20

>>> Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap (the Shortcut Method)

25-103 Implicit in the conditions for the shortcut method is the requirement that a basis exist for concluding on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair values or cash flows. In applying the shortcut method, an entity shall consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity.

25-111 Comparable credit risk at inception is not a condition for assuming perfect effectiveness even though actually achieving perfect offset would require that the same discount rate be used to determine the fair value of the swap and of the hedged item or hedged transaction. To justify using the same discount rate, the credit risk related to both parties to the swap as well as to the debtor on the hedged interest-bearing asset (in a fair value hedge) or the variable-rate asset on which the interest payments are hedged (in a cash flow hedge) would have to be the same. However, because that complication is caused by the interaction of interest rate risk and credit risk, which are not easily separable, comparable creditworthiness is not considered a necessary condition for assuming perfect effectiveness in a hedge of interest rate risk.



Question 13.3.340

Does an entity consider counterparty credit risk or its own nonperformance risk when applying the shortcut method?

Interpretive response: Yes, counterparty credit risk and nonperformance risk are considered when applying the shortcut method.

Fair value of the interest rate swap

An entity considers counterparty credit risk and its own nonperformance risk when determining the fair value of the interest rate swap. This is the case regardless of whether it applies the shortcut method. [820-10]

The counterparty credit risk of a derivative instrument that is acquired on a regulated exchange is the credit risk of the exchange. [820-10]

See also KPMG Handbook, [Fair value measurement](#), including:

- Section O, Application issues: Derivatives and hedging, including Question O70, which provides additional information about whether (and how) the requirements to include counterparty credit risk and an entity's own nonperformance risk in measuring the fair values of derivative instruments affect hedging relationships.
- Question C70, which addresses how to consider the existence of a separate arrangement (such as a master netting agreement or credit support agreement) that mitigates credit risk exposure in the event of default when measuring the fair value of a financial instrument.

Hedge inception

Comparable credit risk between the hedging instrument and the hedged item or transaction is not necessary to assume perfect effectiveness for accounting purposes. The FASB allowed this accommodation as a practical matter even though a perfect economic offset requires the interest rate swap and hedged item or transaction to have the same credit risk. Nonetheless, an ongoing expectation of high effectiveness is implicit in the shortcut method. Therefore, when applying the shortcut method, an entity considers the likelihood of the counterparty complying with the swap's payment terms. We believe this guidance should apply to the entity's own nonperformance risk as well. [815-20-25-103, 25-111]

Changes in counterparty credit risk and own nonperformance risk

When using the shortcut method, an entity monitors hedges for changes in counterparty credit risk and nonperformance risk. We believe an entity may continue the shortcut method if the likelihood that the counterparty or the entity will not default continues to be probable. However, if the likelihood that the counterparty or the entity will not default is no longer probable, the entity should discontinue hedge accounting altogether.

If the entity can identify the date on which the counterparty or the entity not defaulting became less than probable, the entity stops hedge accounting prospectively from that day forward. If the entity cannot identify that date, it does not apply hedge accounting for the entire reporting period in which the counterparty or the entity not defaulting became less than probable.

13.3.110 Discontinuing the shortcut method



Excerpt from ASC 815-20

>>>> Application of Whether the Shortcut Method Was Not or No Longer Is Appropriate

25-117A In the period in which an entity determines that use of the shortcut method was not or no longer is appropriate, the entity may use a quantitative method to assess hedge effectiveness and measure hedge results without dedesignating the hedging relationship if both of the following criteria are met:

- a. The entity documented at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(04) which quantitative method it would use to assess hedge effectiveness and measure hedge results if the shortcut method

was not or no longer is appropriate during the life of the hedging relationship.

- b. The hedging relationship was highly effective on a prospective and retrospective basis in achieving offsetting changes in fair value or cash flows attributable to the hedged risk for the periods in which the shortcut method criteria were not met.

25-117B If the criterion in paragraph 815-20-25-117A(a) is not met, the hedging relationship shall be considered invalid in the period in which the criteria for the shortcut method were not met and in all subsequent periods. If the criterion in paragraph 815-20-25-117A(a) is met, the hedging relationship shall be considered invalid in all periods in which the criterion in paragraph 815-20-25-117A(b) is not met.

25-117C If an entity cannot identify the date on which the shortcut criteria ceased to be met, the entity shall perform the quantitative assessment of effectiveness documented at hedge inception for all periods since hedge inception.

25-117D The terms of the hedged item and hedging instrument used to assess effectiveness, in accordance with paragraph 815-20-25-117A(b), shall be those existing as of the date that the shortcut criteria ceased to be met. For cash flow hedges, if the hypothetical derivative method is used as a proxy for the hedged item, the value of the hypothetical derivative shall be set to zero as of hedge inception.

The shortcut method is discontinued when:

- any of the applicable shortcut criteria are no longer met; or
- an entity determines that the shortcut method was inappropriately applied.

However, an entity may not need to dedesignate the hedging relationship if certain criteria are met.

Hedging relationship may continue	In the period in which an entity makes this determination, it may use a quantitative method to assess hedge effectiveness and measure hedge results without dedesignating the hedging relationship if it: [815-20-25-117A] — documented at hedge inception which quantitative method it would use to assess hedge effectiveness if the shortcut method becomes inappropriate; and — determines that when that quantitative method is applied the hedge was highly effective for the periods in which the shortcut method criteria were not met.
Hedging relationship must be dedesignated	If the above criteria are not met, the hedging relationship must be dedesignated. For guidance on the accounting consequences when the shortcut method is misapplied, see Question 13.3.350.

When these criteria are met, the quantitative method is used to assess hedge effectiveness in all periods for which the shortcut method was not appropriate.



Question 13.3.350

What happens if an entity does not document a quantitative method that it would use if the shortcut method was not (or no longer is) appropriate?

Interpretive response: If an entity applies the shortcut method and does not document a quantitative effectiveness assessment method in the initial hedge documentation, there is no consequence if the shortcut method remains appropriate to use in all periods.

In contrast, there are accounting consequences when the shortcut method is misapplied and the entity did not document a quantitative effectiveness assessment method. In this event, an entity treats the misapplication as an accounting error under Topic 250 in all periods in which the shortcut method was misapplied. The amount of this accounting error usually will be greater than the amount of the accounting error had a quantitative assessment method been documented. This is because when no such method is documented, the amount of the error does not consider whether the hedging relationship would have been highly effective. Instead, it assumes that hedge accounting should not have been applied in those periods.

When the shortcut method is misapplied, the entity also evaluates the severity of any control deficiencies related to the failure to identify the inappropriate use of the shortcut method.



Question 13.3.360

When the shortcut method is required to be discontinued, as of what date(s) should an entity perform the quantitative assessments?

Interpretive response: If a shortcut method hedge is required to be discontinued, an entity should perform quantitative effectiveness assessments beginning at the date the shortcut method was not (or no longer is) appropriate. However, this assumes that the entity documented at hedge inception which quantitative method it would use if the shortcut method was not or no longer is appropriate.

The date(s) from which quantitative assessments should be performed depends on when the shortcut method ceased to be appropriate. [815-20-25-117B – 25-117C, ASU 2017-12.BC191 – BC192]

The criteria for applying the shortcut method were not met at hedge inception	Quantitative assessments should be performed for all periods since hedge inception.
A term of the hedged item or hedging instrument changed after inception, causing the shortcut method criteria to no longer be met	Quantitative assessments should be performed for all periods since the date the shortcut method criteria were no longer met.

The date at which the shortcut method ceased to be appropriate cannot be identified

Quantitative assessments should be performed for all periods since hedge inception.



Question 13.3.370

What is the effect of performing quantitative assessments once the shortcut method is discontinued?

Interpretive response: If the shortcut method was applied during prior periods when it was not appropriate, the guidance for accounting errors in Topic 250 is followed. However, permitting an entity to retroactively apply a quantitative method of assessing hedge criteria in this instance reduces the likelihood that the error is material (thereby reducing the likelihood of restatement).

The determination of the error when an entity documented a quantitative assessment method at hedge inception depends on whether the relationship was highly effective in the prior period(s) affected.

- **Not highly effective.** In this situation, the amount of the error is the difference between not applying hedge accounting and the results recorded by applying the shortcut method.
- **Highly effective.** In this situation, whether there is an error (and if so, its nature) depends on the type of hedge and also on whether the hedging instrument is measured appropriately.
 - **Cash flow hedges.** If the hedging instrument is measured properly, there is no error. However, the hedging instrument may not have been measured appropriately if its characteristics (including consideration of credit risk) were not properly defined in the prior reporting periods – e.g. because a changed term was not captured in its measurement. This would result in the hedging instrument’s recorded amount and the related amount recorded in AOCI being incorrect.
 - **Fair value hedges.** Under the shortcut method, the change in fair value of the hedging instrument is used as a proxy to measure the change in the fair value of the hedged item with no effect on net income. This approach for measuring the hedged item’s fair value is not appropriate in periods when the shortcut method is not appropriate. Because the hedged item was measured incorrectly in prior reporting periods, an error will result. Additionally, the hedging instrument may not have been measured appropriately if its characteristics (including consideration of credit risk) were not properly defined in prior reporting periods. Incorrect measurements would result in the recorded amounts for the hedged item and/or the hedging instrument – along with the related gains (losses) recognized in net income – being incorrect.

In both circumstances, the entity also evaluates the severity of any control deficiencies related to the failure to identify the inappropriate use of the shortcut method.

13.4. Critical terms match method

13.4.10 Overview



Excerpt from ASC 815-20

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-84 If the critical terms of the hedging instrument and of the hedged item or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be perfectly effective if all of the following criteria are met:

- a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase. Location differences do not need to be considered if an entity designates the variability in cash flows attributable to changes in a **contractually specified component** as the hedged risk and the requirements in paragraphs 815-20-25-22A through 25-22B are met.
- b. The fair value of the forward contract at inception is zero.
- c. Either of the following criteria is met:
 1. The change in the discount or premium on the forward contract is excluded from the assessment of effectiveness pursuant to paragraphs 815-20-25-81 through 25-83.
 2. The change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

25-84A In a cash flow hedge of a group of forecasted transactions in accordance with paragraph 815-20-25-15(a)(2), an entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match in accordance with paragraph 815-20-25-84(a) if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month.

25-85 If all of the criteria in paragraphs 815-20-25-84 through 25-84A are met, an entity shall still perform and document an assessment of hedge effectiveness at the inception of the hedging relationship and, as discussed beginning in paragraph 815-20-35-9, on an ongoing basis throughout the hedge period. No quantitative effectiveness assessment is required at hedge inception if the criteria in paragraphs 815-20-25-84 through 25-84A are met (see paragraph 815-20-25-3(b)(2)(iv)(01)).

>> Assessing Effectiveness Based on Whether the Critical Terms of the Hedging Instrument and Hedged Item Match Relative Ease of Assessing Effectiveness

35-9 If, at inception, the critical terms of the hedging instrument and the hedged forecasted transaction are the same (see paragraphs 815-20-25-84 through 25-84A), the entity can conclude that changes in cash flows attributable to the risk being hedged are expected to be completely offset by the hedging derivative. Therefore, subsequent assessments can be performed by verifying and documenting whether the critical terms of the hedging instrument and the forecasted transaction have changed during the period in review.

35-10 Because the assessment of hedge effectiveness in a cash flow hedge involves assessing the likelihood of the counterparty's compliance with the contractual terms of the derivative instrument designated as the hedging instrument, the entity must also assess whether there have been adverse developments regarding the risk of counterparty default, particularly if the entity planned to obtain its cash flows by liquidating the derivative instrument at its fair value.

35-11 If there are no such changes in the critical terms or adverse developments regarding counterparty default, the entity may conclude that the hedging relationship is perfectly effective. In that case, the change in fair value of the derivative instrument can be viewed as a proxy for the present value of the change in cash flows attributable to the risk being hedged.

35-12 However, the entity must assess whether the hedging relationship is expected to continue to be highly effective using a quantitative assessment method (either a dollar-offset test or a statistical method such as regression analysis) if any of the following conditions exist:

- a. The critical terms of the hedging instrument or the hedged forecasted transaction have changed.
- b. There have been adverse developments regarding the risk of counterparty default.

The critical terms match method is elective and greatly simplifies the hedge effectiveness assessment when the hedging instrument is a forward or futures or option contract. [\[815-20-25-84 – 25-85\]](#)

If a hedging relationship meets the criteria for this method, the entity can assume that the hedging relationship is perfectly effective. Therefore, the method simplifies the hedge effectiveness assessment by eliminating the quantitative aspect of the assessment. [\[815-20-25-84 – 25-85\]](#)

One of the criteria for applying this method is that the critical terms of the hedging instrument and the hedged transaction are the same. When the critical terms are the same, the change in the cash flows of the hedging instrument (except for any amounts excluded from the assessment of effectiveness) can be viewed as a proxy for the change in the cash flows of the hedged transaction. [\[815-20-25-84\]](#)

This section discusses the application of the critical terms match method solely in the context of **cash flow hedges**. While Topic 815 permits application of the

critical terms match method for fair value hedges, we believe the FASB intended the method to apply only to hedging relationships that will be perfectly effective. This has the practical effect of precluding the use of the critical terms match method for fair value hedges in the vast majority of circumstances because fair value hedges are rarely perfectly effective. There commonly is a lack of perfect effectiveness in fair value hedges because changes in both counterparty credit risk and an entity's own nonperformance risk affect the measurement of changes in the fair value of the derivative hedging instrument. These changes commonly have no offsetting effect on changes in the measurement of the hedged item attributable to the hedged risk.

13.4.20 Criteria

The criteria for applying the critical terms match method are as follows.

Criterion 1	The hedging instrument (forward, futures or option contract) is for the purchase of the same quantity of the same commodity at the same time and location as the hedged transaction. [815-20-25-84(a)]
Criterion 2	Forward or futures contract has a fair value of zero at hedge inception. If the contract is an option it has an intrinsic value of zero at hedge inception. [815-20-25-104(b), 25-104(c)]

These criteria can be illustrated through a hedging transaction involving the forecasted sale of West Texas natural gas. If the hedging instrument is a forward contract, the criteria for the critical terms match method are met if the forward contract:

- has West Texas natural gas as its underlying;
- is for the same quantity of natural gas as the hedged transaction;
- settles at the same time and in the same location as the hedged transaction; and
- has a fair value of zero at hedge inception.

Criterion 3	For forwards or futures contracts: [815-20-25-84(c)(1)] — change in the spot-forward difference on the forward or futures contract is excluded from the assessment of effectiveness; or — the change in the cash flows of the hedged transaction is based on the commodity's forward price. For option contracts, the change in the time value of the option is excluded from the assessment of effectiveness.



Question 13.4.10

Can the critical terms match method be applied if the hedging instrument has a non-zero fair value at hedge inception?

Background: The second criterion to apply the critical terms match method is that the fair value of the hedging instrument at hedge inception is zero. [815-20-25-84(b)]

Interpretive response: It depends. We believe an entity may apply the critical terms match method to a hedging relationship that uses a hedging instrument with a non-zero fair value at hedge inception. However, this is only the case if the non-zero fair value is due solely to a bid-ask spread. All of the other criteria for the critical terms match method must be met.

FASB Example: Cash flow hedge of the forecasted sale of a commodity when the critical terms match inventory



Excerpt from ASC 815-30

>> Example 5: Cash Flow Hedge of the Forecasted Sale of a Commodity When the Critical Terms Match

55-20 This Example illustrates the application of the guidance in paragraphs 815-20-25-84 through 25-85 and this Subtopic to the accounting for a cash flow hedge of a forecasted sale of a commodity. The terms of the hedging derivative have been negotiated to match the terms of the forecasted transaction. Assume that there is no time value in the derivative instrument. Entity ABC has chosen to hedge the variability of the cash flows from the forecasted sale of the commodity instead of the changes in its fair value. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

55-21 Because there is no **contractually specified component**, Entity ABC hedges the risk of changes in its cash flows relating to changes in the sales price of a forecasted sale of 100,000 bushels of Commodity A by entering into a derivative instrument, Derivative Z. Entity ABC expects to sell the 100,000 bushels of Commodity A on the last day of Period 1. On the first day of Period 1, Entity ABC enters into Derivative Z and designates it as a cash flow hedge of the forecasted sale. Entity ABC neither pays nor receives a premium on Derivative Z (that is, its fair value is zero). Entity ABC expects that there will be perfect offset between the hedging instrument and the hedged item because all of the following conditions exist:

- a. The notional amount of Derivative Z is 100,000 bushels and the forecasted sale is for 100,000 bushels.
- b. The underlying of Derivative Z is the price of the same variety and grade of Commodity A that Entity ABC expects to sell (assuming delivery to Entity ABC's selling point).
- c. The settlement date of Derivative Z is the last day of Period 1 and the forecasted sale is expected to occur on the last day of Period 1.

The entity need not perform an initial quantitative assessment of hedge effectiveness in accordance with paragraph 815-20-25-3(b)(2)(iv)(01) because the conditions in paragraphs 815-20-25-84 through 25-85 are met.

55-22 At inception of the hedge, the expected sales price of 100,000 bushels of Commodity A is \$1,100,000. On the last day of Period 1, the fair value of Derivative Z has increased by \$25,000, and the expected sales price of 100,000 bushels of Commodity A has decreased by \$25,000. Both the sale of 100,000 bushels of Commodity A and the settlement of Derivative Z occur on the last day of Period 1. The following table illustrates the accounting, including the net effect on earnings and other comprehensive income, for the situation described.

	Debit (Credit)			
	Cash	Derivative	Other Comprehensive Income	Earnings
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	\$ 1,100,000	\$ -	\$ -	\$ (1,100,000)

55-23 At the inception of the hedge, Entity ABC anticipated that it would receive \$1,100,000 from the sale of 100,000 bushels of Commodity A. This 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, Entity ABC still received a total of \$1,100,000 in cash flows even though the sales price of Commodity A declined during the period.

13.4.30 Scope

This section addresses the types of hedging relationships that may be eligible for the critical terms match method.



Question 13.4.20

Can the critical terms match method be applied to a hedging relationship that uses an interest rate swap as the hedging instrument?

Interpretive response: No. We believe the FASB intended that each general type of hedging instrument be able to qualify for a less burdensome method of documenting and assessing effectiveness. Therefore, we believe the critical terms match method is not available for hedging relationships that use interest rate swaps as the hedging instrument. This is the case even if the interest rate swap is perfectly effective at hedging the interest rate risk.

%↑ Interest rate risk. When hedging interest rate risk with an interest rate swap, an entity should apply the shortcut method (see section 13.3) or one of the other assessment methods for interest rate risk (see section 13.8).



Question 13.4.30

Can the critical terms match method be applied if one derivative instrument hedges multiple transactions over a period of time?

Interpretive response: Yes, an entity may designate one derivative instrument as the hedging instrument for a hedge of a group of forecasted transactions. The entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match (as required by paragraph 815-20-25-84(a)) if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month.

[815-20-25-84A]

Example 23 in Subtopic 815-30 illustrates how to apply the critical terms match method to a group of forecasted transactions (reproduced below).



Excerpt from ASC 815-30

>> Example 23: Designation of a Cash Flow Hedge of a Forecasted Purchase of Inventory for Which Commodity Exposure Is Managed Centrally

55-142 This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to the designation of a **cash flow hedge** of a forecasted purchase of inventory in which the commodity exposure is managed centrally at the aggregate level. Assume the entity elects to perform subsequent assessments of hedge effectiveness on a qualitative basis and all hedge documentation requirements were satisfied at inception.

55-143 Entity Q is seeking to hedge the variability in cash flows associated with commodity price risk of its monthly plastic purchases for the next 12 months. It has two different manufacturing plant locations (Plant A and Plant B) that are purchasing five different grades of plastic from Supplier A. The plastic purchase price for each month is based on the month-end Joint Plastic

(JP) index and a fixed basis differential component. The fixed basis differential offered by the supplier is determined by:

- The grade of the plastic purchased
- The distance between the plant location and supplier location.

55-144 At January 1, 20X1, Entity Q enters into a supply agreement with Supplier A to purchase plastic over the next 12 months. The respective agreements allow Entity Q to purchase the various grades of plastic at both of its plant locations as the need arises over the following year. The following table summarizes the pricing provisions contained in the supply agreement for each grade of plastic.

	Grade 1	Grade 2	Grade 3	Grade 4	Grade 5
Plant A	JP + \$0.14	JP + \$0.11	JP + \$0.09	JP + \$0.05	JP – \$0.02
Plant B	JP + \$0.16	JP + \$0.12	JP + \$0.07	JP + \$0.06	JP – \$0.03

55-145 Entity Q's risk management objective is to hedge the variability in the purchase price of plastic attributable to changes in the JP index of the first 80,000 pounds of plastic purchased in each month regardless of grade or plant location delivered to. To accomplish this objective, Entity Q executes 12 separate forward contracts at January 1, 20X1, to purchase plastic as follows.

	Settlement Date	Notional Amount	Underlying Index
Jan forward	January 30, 20X1	80,000 (lbs)	JP
Jan forward	January 30, 20X1	80,000 (lbs)	JP
Feb forward	February 28, 20X1	80,000 (lbs)	JP
Mar forward	March 30, 20X1	80,000 (lbs)	JP
April forward	April 30, 20X1	80,000 (lbs)	JP
May forward	May 30, 20X1	80,000 (lbs)	JP
June forward	June 30, 20X1	80,000 (lbs)	JP
July forward	July 30, 20X1	80,000 (lbs)	JP
Aug forward	August 30, 20X1	80,000 (lbs)	JP
Sep forward	September 30, 20X1	80,000 (lbs)	JP
Oct forward	October 30, 20X1	80,000 (lbs)	JP
Nov forward	November 30, 20X1	80,000 (lbs)	JP
Dec forward	December 30, 20X1	80,000 (lbs)	JP

55-146 Entity Q determines that the variable JP index referenced in the supply agreement constitutes a contractually specified component and that the requirements to designate variability in the cash flows attributable to changes in a contractually specified component as the hedged risk in paragraph 815-20-25-22A are met.

55-147 Because Entity Q determined that it will purchase at least 80,000 pounds of plastic each month in the coming 12 months to fulfill its expected manufacturing requirements, it documents that the hedged item (that is, the **forecasted transaction** within each month) is probable of occurring. Entity Q designates each forward contract as a cash flow hedge of the variability in cash flows attributable to changes in the contractually specified JP index on the first 80,000 pounds of plastic purchased (regardless of grade or plant location

delivered to) for the appropriate month. The individual purchases of differing grades of plastic by Plant A and Plant B during each month share the risk exposure to the variability in the purchase price of the plastic attributable to changes in the contractually specified JP index. Therefore, the individual transactions in the hedged portfolio of plastic purchases for each month share the same risk exposure for which they are designated as being hedged in accordance with paragraph 815-20-25-15(a)(2).

55-148 In accordance with paragraph 815-20-25-3(b)(2)(iv)(01)(B), if Entity Q has determined the critical terms of the hedged item and hedging instrument match, it may elect to assess effectiveness qualitatively both at inception of the hedging relationship and on an ongoing basis on the basis of the following factors in accordance with paragraphs 815-20-25-84 through 25-85:

- a. The hedging instrument's underlying matches the index upon which plastic purchases will be determined (that is, the JP Index).
- b. The notional of the hedging instrument matches the forecasted quantity designated as the hedged item.
- c. The date on which the derivatives mature matches the timing in which the forecasted purchases are expected to be made. That is, the quantity of the hedged item, 80,000 pounds, is an aggregate amount expected to be purchased over the course of the respective month (that is, the same 31-day period) in which the derivative matures.
- d. Each hedging instrument was traded with at-market terms (that is, it has an initial fair value of zero).
- e. Assessment of effectiveness will be performed on the basis of the total change in the fair value of the hedging instrument.
- f. Although the amount of plastic being hedged each period is a cumulative amount across multiple grades of plastic, the basis differentials between grades of plastic and location are not required to be included in assessments of effectiveness because Entity Q has designated the variability in cash flows attributable to changes in the JP index (the contractually specified component) as the hedged risk within its purchases of plastics.



Question 13.4.40

Can the critical terms match method be applied to a forecasted transaction that gives rise to a receivable or payable that settles subsequently?

Background: A forecasted sale of goods expected to occur on a certain date (e.g. September 30, Year 1) will give rise to an accounts receivable that will settle later (e.g. October 31, Year 1). The company enters into a forward contract that matures on September 30, Year 1 and hedges the cash flow variability only up to the forecasted sale date.

Interpretive response: Yes, assuming all the criteria are met. The first criterion of the critical terms match method requires that the forward or futures contract settle at the same time as the hedged transaction. [815-20-25-84(a)]

In the background example, we believe this criterion is met because in effect the forecasted sale transaction creates a cash inflow from the sale of the goods and a simultaneous cash outflow for the financing of the sale on September 30,

Year 1. Therefore, a forward contract that hedges the forecasted sale transaction and expires on September 30, Year 1 has the same cash settlement date as the forecasted sale transaction.



Question 13.4.50

Can the critical terms match method be applied if the hedging instrument is a cross-currency interest rate swap?

Background: A cross-currency interest rate swap (CCIRS) is a contractual agreement between two parties to exchange fixed principal amounts of currencies as well as periodic interest cash flows. For further discussion of CCIRS, see section 6.6.20.

Interpretive response: We believe a receive-fixed, pay-fixed CCIRS designated to hedge the foreign exchange risk in a fixed-rate foreign currency denominated financial asset or liability is eligible for the critical terms match method for a number of reasons.

- We believe the FASB intended that each general type of hedging instrument be able to qualify for a less burdensome method of documenting and assessing effectiveness – e.g. the shortcut method or the critical terms match method. Because the shortcut method can only be applied to interest rate swaps, it appears reasonable that a receive-fixed, pay-fixed CCIRS is eligible for the critical terms match method.
- A CCIRS with two fixed legs has foreign exchange risk as the dominant risk exposure and is not considered a compound derivative instrument. We believe a compound derivative instrument (i.e. a derivative with more than one underlying) is not eligible for the critical terms match method.
- The fair value of a CCIRS reacts to changes in currency rates similar to a foreign currency forward contract. Therefore, economically a CCIRS is similar to a foreign currency forward contract, which is eligible for the critical terms match method.

We believe the following conditions should be met for the hedging relationship to be eligible for the critical terms match method:

- the two currencies underlying the exchange rate of the CCIRS are the entity's functional currency and the currency in which the hedged foreign currency financial asset or liability is denominated;
- the notional amount of the foreign currency leg of the CCIRS matches the designated portion of the principal amount of the hedged transaction throughout the term of the hedge;
- the interest payments on the foreign currency leg of the CCIRS match the designated portion of the hedged interest payments (both timing and amount);
- the maturity date of the CCIRS matches the final principal repayment date of the hedged transaction; and

— the fair value of the CCIRS at hedge inception is zero.

Note: The principal amounts on the CCIRS will be exchanged at inception, but the net effect of this exchange should be based on current spot rates and therefore will be zero.



Question 13.4.60

Does an entity consider counterparty nonperformance risk when evaluating whether it is probable that a forecasted transaction will occur?

Background: In order to apply cash flow hedge accounting, including the critical terms match method, the hedged transaction has to be probable of occurring.

Interpretive response: Yes, an entity considers counterparty nonperformance risk when evaluating whether it is probable that a forecasted transaction that is part of a cash flow hedge will occur even if it uses the critical terms match method. For further discussion of considering nonperformance credit risk, see section 13.2.60. [815-20-35-10]



Question 13.4.70

Can the critical terms match method be applied to an all-in-one hedge?

Background: In an all-in-one hedge, the hedged transaction and hedging instrument are essentially the same (see section 9.3.90). In this hedging relationship, a derivative is designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the forecasted transaction that will occur upon gross settlement of the derivative.

Interpretive response: Yes, an entity can apply the critical terms match method to an all in-one-hedge.

For example, Gas Co. enters into a forward contract (firm commitment) to purchase natural gas for the daily purchase of 5,000 MMBTUs at a fixed price in the month of January Year 10. The purchase contract does not qualify for the NPNS scope exception and is accounted for as a derivative. Gas Co. can document this transaction as an all-in-one hedge by designating the forecasted purchase of 5,000 MMBTUs per day in January Year 10 as the hedged transaction. The hedging instrument is the firm commitment (i.e. the same transaction). Therefore, the critical terms of the forecasted transaction and hedging instrument match.

13.4.40 Assessment

Applying the critical terms match method does not eliminate the requirement to assess hedge effectiveness. However, it does eliminate the need to measure hedge effectiveness quantitatively. [815-20-25-85]

Initial assessment

During the initial hedge effectiveness assessment, the entity determines whether the critical terms of the hedging instrument and hedged transaction match and that the other criteria for the critical terms match method are met. The entity documents its conclusion that the changes in the cash flows attributable to the risk being hedged are expected to be completely offset by changes in the cash flows of the hedging instrument. [815-20-25-85]

The extent of that assessment is based on judgment and varies depending on the complexity of the derivative and hedged transaction. However, an entity need not initially assess hedge effectiveness quantitatively. [815-20-25-85]

Subsequent assessments

An entity performs subsequent assessments by verifying and documenting that the critical terms of the hedging instrument and the hedged transaction have not changed during the assessment period. An entity also assesses whether there have been adverse developments related to counterparty credit risk or the entity's own nonperformance risk related to the derivative hedging instrument.

The entity concludes and documents that the hedging relationship has been perfectly effective if it determines that there have been no changes in: [815-20-25-85, 35-10 – 35-11]

- critical terms; and
- creditworthiness of the counterparty to the derivative and the entity's own nonperformance risk that would make the likelihood of the counterparty or the entity not defaulting no longer probable.

In contrast, an entity discontinues the critical terms match method if: [815-20-35-12]

- the critical terms of the hedging instrument or the hedged transaction no longer match; or
- the likelihood that the counterparty or the entity will not default is no longer probable.



Question 13.4.80

If the critical terms cease to match after hedge inception, is an entity required to discontinue hedge accounting?

Interpretive response: Not necessarily. If the critical terms of the hedging instrument and the hedged transaction cease to match at any point, or if there has been an adverse development regarding the risk of counterparty default, an entity is required to assess whether the hedging relationship is expected to continue to be highly effective using a quantitative assessment method. [815-20-35-12]

If the hedging relationship is expected to continue to be highly effective based on a quantitative effectiveness assessment, the hedging relationship may continue with ongoing effectiveness assessments performed quantitatively. The quantitative method may be selected when the criteria for the critical terms match method is no longer met. It does not need to be preselected upon hedge inception. See section 13.6.

If the hedging relationship is not expected to continue to be highly effective based on a quantitative effectiveness assessment, the hedging relationship is required to be discontinued (see section 6.10.50). [815-20-35-12]



Question 13.4.90

How does an entity consider counterparty credit risk or its own nonperformance risk when applying the critical terms match method to a cash flow hedge?

Interpretive response: Counterparty credit risk and the entity's own nonperformance risk are considered when applying the critical terms match method to a cash flow hedge as follows.

Fair value of the forward or futures contract or option contract

An entity considers counterparty credit risk and its own nonperformance risk when determining the fair value of the forward, futures or option contract. This is the case regardless of whether it applies the critical terms match method. [820-10]

The counterparty credit risk of an exchange-traded futures contract is generally the credit risk of the futures exchange. [820-10]

See also KPMG Handbook, [Fair value measurement](#), including:

- Section O, Application issues: Derivatives and hedging, including Question O70, which provides additional information about whether (and how) the requirements to include counterparty credit risk and an entity's own nonperformance risk in measuring the fair values of derivative instruments affect hedging relationships.
- Question C70, which addresses how to consider the existence of a separate arrangement (such as a master netting agreement or credit support agreement) that mitigates credit risk exposure in the event of default when measuring the fair value of a financial instrument.

Hedge inception

Comparable credit risk between the hedging instrument and the hedged transaction is not necessary for a cash flow hedge to assume perfect

effectiveness for accounting purposes. The FASB allowed this accommodation as a practical matter even though a perfect economic offset requires the forward, futures or option contract and hedged transaction to have the same credit risk.

Nonetheless, an ongoing expectation of high effectiveness is implicit in the critical terms match method. Therefore, when applying this method, an entity considers the likelihood of the counterparty complying with the hedging instrument's payment terms. [815-20-35-9]

We believe this guidance should also apply to the entity's own nonperformance risk.

Changes in counterparty credit risk and own nonperformance risk

When using the critical terms match method, an entity monitors hedges for changes in counterparty credit risk and nonperformance risk. We believe an entity may continue the critical terms match method if the likelihood that the counterparty or the entity will not default continues to be probable. However, if the likelihood that the counterparty or the entity will not default is no longer probable, the entity should discontinue hedge accounting altogether. [815-20-35-10 – 35-12]

If the entity can identify the date on which the counterparty or the entity not defaulting became less than probable, the entity stops hedge accounting prospectively from that day forward. If the entity cannot identify that date, it does not apply hedge accounting for the entire reporting period in which the counterparty or the entity not defaulting became less than probable.

13.5 Qualitative effectiveness assessments

13.5.10 Overview



Excerpt from ASC 815-20

>> Effectiveness Assessments on a Qualitative Basis

35-2A An entity may qualitatively assess hedge effectiveness if both of the following criteria are met:

- An entity performs an initial quantitative test of hedge effectiveness on a prospective basis (that is, it is not assuming that the hedging relationship is perfectly effective at hedge inception as described in paragraph 815-20-25-3(b)(2)(iv)(01)(A) through (H)), and the results of that quantitative test demonstrate highly effective offset.
- At hedge inception, an entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods.

See paragraphs 815-20-55-79G through 55-79N for implementation guidance on factors to consider when determining whether qualitative assessments of effectiveness can be performed after hedge inception.

35-2B An entity may elect to qualitatively assess hedge effectiveness in accordance with paragraph 815-20-35-2A on a hedge-by-hedge basis. If an entity makes this qualitative assessment election, only the quantitative method specified in an entity's initial hedge documentation must comply with paragraph 815-20-25-81.

>>> Eligibility of Hedging Relationships for Subsequent Qualitative Effectiveness Assessments

55-79G An entity should use judgment in determining whether it can reasonably support performing assessments of effectiveness after hedge inception on a qualitative basis. That judgment should include careful consideration of the following factors:

- a. Results of the quantitative assessment of effectiveness performed for the hedging relationship.
- b. Alignment of the critical terms of the hedging relationship. If one or more of the critical terms of the hedging instrument and the hedged item are not aligned, an entity should consider whether changes in market conditions may cause the changes in fair values or cash flows of the hedging instrument and hedged item or hedged forecasted transaction attributable to the hedged risk to diverge as a result of those differences in terms.
 1. In cases in which the underlyings of the hedged item and hedging instrument are different, an entity should consider the extent and consistency of the correlation exhibited between the changes in the underlyings of the hedged item and hedging instrument.
 - i. This may inform the entity about whether expected changes in market conditions could cause the changes in fair values or cash flows of the hedging instrument and the hedged item or hedged forecasted transaction attributable to the hedged risk to diverge. Particularly in the context of reverting to qualitative assessments of hedge effectiveness after being required to perform a quantitative assessment (as discussed in paragraph 815-20-35-2D), this may inform an entity about whether there is a reasonable expectation that the hedging relationship is expected to remain stable or whether that divergence is expected to continue or recur in the future.
 - ii. A specific event or circumstance may cause a temporary disruption to the market that results in an entity concluding that the facts and circumstances of the hedging relationship have changed such that it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective. In those instances, if the results of the quantitative assessment of effectiveness do not significantly diverge from the results of the initial assessment of effectiveness, that market disruption should not prevent the entity from returning to qualitative testing in subsequent periods. If the results of the quantitative assessment of effectiveness do significantly diverge from the results of the initial assessment of effectiveness, the entity should continually monitor whether the temporary market disruption has been resolved when determining whether to return to qualitative testing in subsequent periods.

Topic 815 permits an entity to perform its subsequent effectiveness assessments on a qualitative (rather than quantitative) basis if certain criteria are met.

To elect to perform quarterly effectiveness assessments qualitatively, both of the following criteria must be met: [\[815-20-35-2A\]](#)

Criterion 1	An initial quantitative test of hedge effectiveness on a prospective basis is performed and demonstrates highly effective offset.
Criterion 2	At hedge inception, the entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods.

An entity uses judgment to determine whether it can reasonably support an expectation of high effectiveness on a qualitative basis after hedge inception. Factors to consider include: [\[815-20-55-79G, ASU 2017-12.BC202\]](#)

- the results of the quantitative assessment of effectiveness performed for the hedging relationship at hedge inception; and
- how well the critical terms of the hedging relationship are aligned.

When the critical terms are not aligned, an entity considers additional factors. [\[815-20-55-79G\]](#)

Critical terms that are not aligned	Factor(s) to consider
Critical terms of the hedging instrument and the hedged item are not aligned – e.g. underlyings, notional amounts, maturities, quantities, locations, delivery dates	— Whether changes in market conditions may cause the changes in fair values or cash flows of the hedging instrument and hedged item or hedged transaction attributable to the hedged risk to diverge as a result of those differences in terms.
Underlyings of the hedged item and hedging instrument are different.	— The extent and consistency of the correlation exhibited between the changes in the underlyings of the hedged item and hedging instrument. — As part of this evaluation, the entity considers whether expected changes in market conditions are anticipated to prevent the hedging relationship from achieving highly effective offset.

Formal documentation. When an entity elects qualitative effectiveness assessments, its initial hedge documentation is required to specify a quantitative method that will be used to assess effectiveness if facts and circumstances change and the entity is required to assess effectiveness quantitatively. This method is required to be the same as that used to support the entity's initial prospective hedge effectiveness assessment. See section 6.9.30. [\[815-20-25-3\(b\)\(2\)\(iv\)\(03\)\]](#)

An entity is permitted to elect qualitative effectiveness assessments on a hedge-by-hedge basis, rather than being required to assess all similar hedges on a qualitative basis. However, if quantitative effectiveness assessments are

required due to changes in facts and circumstances, the same quantitative method is required for similar hedges (see Question 13.2.210). [815-20-35-2B]



Question 13.5.10

When the hedging relationship does not have perfect offset, how does an entity reasonably support its expectation of high effectiveness on a qualitative basis in subsequent periods?

Interpretive response: A hedging relationship may not achieve perfect offset on a quantitative basis because some of the critical terms of the hedged item and the hedging instrument are not aligned – e.g. when the underlying of the hedged item and hedging instrument are different.

In this circumstance, it may be more difficult for an entity to reasonably support an expectation of high effectiveness on a qualitative basis at hedge inception based on the factors the entity is required to consider under Topic 815. Additionally, it may be more difficult to determine when it is no longer appropriate to perform qualitative (rather than quantitative) assessments in subsequent periods; see Question 13.5.20 for factors to consider to be able to assert qualitatively that the hedge was and continues to be highly effective.

An entity should also consider the nature of its selected quantitative method for assessing effectiveness when evaluating the effect of known changes in relationships. For example, when the dollar-offset method is used, if the hedging instrument and the hedged transaction involve small dollar amounts but large percentages, small changes can result in the hedge not being perfectly effective. Conversely, an unusual change in the relationship that occurred during a period may not result in a lack of high effectiveness under regression analysis (e.g. because many data points are regressed). Such an unusual change may indicate that solely qualitative analyses are no longer appropriate. Additionally, when they occur over periods of time, small changes in each period may cumulatively cause the relationship between a hedging instrument and hedged item or transaction to cease being highly effective, regardless of the method used.

When evaluating whether the hedging relationship will be highly effective prospectively, an entity is required to consider all reasonably possible scenarios. [815-20-25-79(a)]

When some of the terms of the hedged item and the hedging instrument are different (see section 13.2.10 for examples of terms that are not aligned), we believe performing qualitative hedge effectiveness assessments includes monitoring whether the conditions in the subsequent periods are consistent with the conditions that were evaluated to support the initial determination that a qualitative assessment approach was appropriate. We also believe all factors that affect hedge effectiveness should be considered when evaluating whether an assertion of high effectiveness in subsequent periods is reasonably supported. For example, an entity is required to measure the fair value of both the hedging instrument and the fair value of the hedged item attributable to the hedged risk in a fair value hedge for purposes of accounting for the fair value

hedge (see chapter 8); an entity should not disregard information obtained for this purpose when performing a qualitative hedge effectiveness assessment.

An entity may find it useful to include in its initial prospective assessment hypothetical scenarios that simulate changes in factors that affect hedge effectiveness to see whether the relationship still meets the highly effective threshold in each of the hypothetical scenarios. For example, if the underlyings in the hedged item and the hedging instrument are not aligned, identifying the extent of movements in those underlyings (whether in the same or opposite directions) that cause the relationship to cease being highly effective would allow the entity to compare the movements in subsequent periods to those in the hypothetical scenarios to demonstrate that those movements did not cause the relationship to cease being highly effective.

Formal documentation. We believe an entity should document its consideration of factors considered in support of its assertion that it could reasonably support its expectation of high effectiveness.

Examples

The following FASB examples (paragraphs 815-20-55-79H to 55-79N) demonstrate when an expectation of high effectiveness can be reasonably supported in subsequent periods. It is followed by Example 13.5.10, adapted in part from the FASB examples to further illustrate when this expectation can be reasonably supported.



Excerpt from ASC 815-20

>>> Eligibility of Hedging Relationships for Subsequent Qualitative Effectiveness Assessments

55-79H In the following scenarios, assume that the entity is required to perform a quantitative assessment of effectiveness at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(01). For each scenario, a discussion of whether the entity could reasonably support performing qualitative assessments of effectiveness is included in paragraphs 815-20-55-79L through 55-79N.

>>>> Scenario A

79-I The following factors are present in the hedging relationship:

- a. The results of the initial or most recent quantitative assessment of effectiveness performed indicate that the hedging relationship is close to achieving perfect offset.
- b. All critical terms of the hedging relationship match except for the underlyings of the hedged item and hedging instrument.
 1. The changes in the underlyings of the hedged item and hedging instrument have been consistently highly correlated such that expected changes in market conditions are not anticipated to prevent the hedging relationship from achieving highly effective offset.

>>>> Scenario B

55-79J The following factors are present in the hedging relationship:

- a. The results of the initial or most recent quantitative assessment of effectiveness performed indicate that the hedging relationship is close to failing the effectiveness test.
- b. All critical terms of the hedging relationship match except for the underlyings of the hedged item and the hedging instrument.
 - 1. The changes in the underlyings of the hedged item and the hedging instrument have not been consistently highly correlated such that expected changes in market conditions could prevent the hedging relationship from achieving highly effective offset.

>>>> Scenario C

55-79K The following factors are present in the hedging relationship:

- a. The results of the initial or most recent quantitative assessment of effectiveness performed indicate that the hedging relationship is neither close to achieving perfect offset nor close to failing the effectiveness test.
- b. All critical terms of the hedging relationship match except for the underlyings of the hedged item and the hedging instrument.
 - 1. The changes in the underlyings of the hedged item and the hedging instrument have not been consistently highly correlated such that expected changes in market conditions could prevent the hedging relationship from achieving highly effective offset.

55-79L In Scenario A, the entity could reasonably support performing qualitative assessments of effectiveness. The quantitative assessment of effectiveness was close to achieving perfect offset and past observations of changes in the underlyings of the hedged item and hedging instrument (that is, the only critical term that did not match) consistently exhibited high correlation. This indicates that the results of subsequent assessments of effectiveness may not significantly differ from those observed from the assessment of effectiveness performed at hedge inception.

55-79M In Scenario B, the entity could not reasonably support performing qualitative assessments of effectiveness. The lack of consistent high correlation exhibited between the changes in the underlyings of the hedged item and the hedging instrument could prevent the entity from concluding that the results of subsequent assessments of effectiveness will be similar to the results observed from the initial assessment of effectiveness. Had the changes in underlyings of the hedged item and the hedging instrument been consistently highly correlated, the entity may conclude that it is still unable to reasonably support performing subsequent assessments of effectiveness on a qualitative basis. Because the hedging relationship is close to failing its quantitative assessment, minimal changes in the relationship between the hedged item and hedging instrument could result in the hedging relationship not being highly effective.

55-79N In Scenario C, the entity could not reasonably support performing qualitative assessments of effectiveness. Although this hedging relationship is not close to failing the quantitative assessment of effectiveness as in Scenario B, the lack of consistent high correlation exhibited between the changes in the underlyings of the hedged item and the hedging instrument

prevent the entity from concluding that the results of subsequent assessments of effectiveness will be similar to the results observed from the initial or most recent quantitative assessment of effectiveness. Had the changes in value of the underlyings of the hedged item and the hedging instrument consistently been highly correlated, the entity may conclude that it could reasonably support performing subsequent assessments of effectiveness on a qualitative basis.



Example 13.5.10

Whether an expectation of high effectiveness can be reasonably supported in subsequent periods

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

ABC Corp. performs a quantitative assessment of effectiveness at hedge inception for five hedging relationships (Hedges A – E). In each hedging relationship, all critical terms match except the underlyings of the hedged item and hedging instrument.

The following table summarizes each relationship and discusses whether an expectation of high effectiveness in subsequent periods can be reasonably supported.

	Results of initial quantitative effectiveness assessment	Extent and consistency of correlation between changes in underlyings	Do initial testing results and evaluation of correlation indicate the potential for an expectation of high effectiveness?
Hedge A	Close to achieving perfect offset.	Changes have been consistently highly correlated.	Yes. The high degree of offset achieved and the high correlation between changes in the underlyings indicate that the results of subsequent quarterly hedge effectiveness assessments may not significantly differ from those observed at hedge inception. [815-20-55-79I, 55-79L]
Hedge B	Close to failing effectiveness test.	Changes have <i>not</i> been consistently highly correlated.	No. The lack of consistent high correlation between changes in the underlyings precludes a conclusion that subsequent quarterly hedge effectiveness assessments will be similar to the results observed at hedge inception. [815-20-55-79J, 55-79M]
Hedge C	Close to failing effectiveness test.	Changes have been consistently highly correlated.	Maybe not. Although the changes in underlyings are consistently highly correlated, the relationship is close to failing, so minimal changes in the relationship between the hedged item and hedging instrument could result

	Results of initial quantitative effectiveness assessment	Extent and consistency of correlation between changes in underlyings	Do initial testing results and evaluation of correlation indicate the potential for an expectation of high effectiveness?
			in the hedging relationship not being highly effective. [815-20-55-79J, 55-79M]
Hedge D	Neither close to achieving perfect offset nor close to failing effectiveness test.	Changes have <i>not</i> been consistently highly correlated.	No. The lack of consistent high correlation between changes in the underlyings precludes a conclusion that subsequent quarterly hedge effectiveness assessments will be similar to the results observed at hedge inception. [815-20-55-79K, 55-79N]
Hedge E	Neither close to achieving perfect offset nor close to failing effectiveness test.	Changes have been consistently highly correlated.	Yes. The high degree of offset achieved and the high correlation between changes in the underlyings indicate that the results of subsequent quarterly hedge effectiveness assessments may not significantly differ from those observed at hedge inception. [815-20-55-79K, 55-79N]

13.5.20 Changes in facts and circumstances



Excerpt from ASC 815-20

>> Effectiveness Assessments on a Qualitative Basis

35-2C When an entity performs qualitative assessments of hedge effectiveness, it shall verify and document whenever financial statements or earnings are reported and at least every three months that the facts and circumstances related to the hedging relationship have not changed such that it can assert qualitatively that the hedging relationship was and continues to be highly effective. While not all-inclusive, the following is a list of indicators that may, individually or in the aggregate, allow an entity to continue to assert qualitatively that the hedging relationship is highly effective:

- An assessment of the factors that enabled the entity to reasonably support an expectation of high effectiveness on a qualitative basis has not changed such that the entity can continue to assert qualitatively that the hedging relationship was and continues to be highly effective. This shall include an assessment of the guidance in paragraph 815-20-25-100 when applicable.
- There have been no adverse developments regarding the risk of counterparty default.

35-2D If an entity elects to assess hedge effectiveness on a qualitative basis and then facts and circumstances change such that the entity no longer can assert qualitatively that the hedging relationship was and continues to be highly effective in achieving offsetting changes in fair values or cash flows, the entity shall assess effectiveness of that hedging relationship on a quantitative basis in subsequent periods. In addition, an entity may perform a quantitative assessment of hedge effectiveness in any reporting period to validate whether qualitative assessments of hedge effectiveness remain appropriate. In both cases, the entity shall apply the quantitative method that it identified in its initial hedge documentation in accordance with paragraph 815-20-25-3(b)(2)(iv)(03).

35-2E When an entity determines that facts and circumstances have changed and it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective, the entity shall begin performing subsequent quantitative assessments of hedge effectiveness as of the period that the facts and circumstances changed. If there is no identifiable event that led to the change in the facts and circumstances of the hedging relationship, the entity may begin performing quantitative assessments of effectiveness in the current period.

35-2F After performing a quantitative assessment of hedge effectiveness for one or more reporting periods as discussed in paragraphs 815-20-35-2D through 35-2E, an entity may revert to qualitative assessments of hedge effectiveness if it can reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods. See paragraphs 815-20-55-79G through 55-79N for implementation guidance on factors to consider when determining whether qualitative assessments of effectiveness can be performed after hedge inception.

When an entity elects to perform quarterly hedge effectiveness assessments on a qualitative basis, it may perform subsequent quarterly assessments on a qualitative basis as long as it qualifies to do so (see section 13.2.20). Therefore, during each quarterly assessment, an entity determines whether it qualifies to perform the assessment on a qualitative basis under the current facts and circumstances. [815-20-35-2C]

If facts and circumstances change, an entity may no longer be able to assert qualitatively that the hedging relationship was and continues to be highly effective. In that situation, the entity is required to assess effectiveness using the quantitative method identified in the hedge documentation at inception (see section 6.9.30). [815-20-35-2D]



Question 13.5.20

Under what circumstances is a subsequent quantitative assessment required if an entity initially elects to perform qualitative assessments?

Interpretive response: Determining whether the facts and circumstances have changed such that an entity is required to perform a quarterly hedge

effectiveness assessment on a quantitative (rather than qualitative) basis requires judgment. In making this determination, an entity should consider whether: [815-20-35-2C, ASU 2017-12.BC203]

- the factors assessed at inception of the hedging relationship that enabled the entity to reasonably support an expectation of high effectiveness on a qualitative basis have changed; and
- there have been any adverse developments in the risk of counterparty default.



Question 13.5.30

If required, for what periods are subsequent quantitative assessments performed?

Interpretive response: Quantitative assessments (if required) are performed beginning as of the period in which facts and circumstances changed such that the entity can no longer support qualitatively that the relationship is highly effective.

- If there is an identifiable event that led to the change, the quantitative assessments are performed beginning in the period that includes that event.
- If there is no identifiable event that led to the change, the quantitative assessments may begin in the current period.

Quantitative assessments are performed for each period thereafter unless it is appropriate to revert to qualitative effectiveness assessments in a future period (see Question 13.5.50). [815-20-35-2F]

See also Question 13.5.10 regarding how to support an expectation of high effectiveness when a relationship does not have perfect offset and Question 13.5.40 regarding the consequence of failing to timely identify that such an expectation is not supported.



Question 13.5.40

What is the consequence of failing to identify that an entity could not reasonably support performing qualitative assessments in a prior period?

Interpretive response: If an entity fails to identify that it was not appropriate to apply the qualitative method in a prior period(s), the quantitative assessment approach documented at hedge inception is used to determine whether the relationship was highly effective in that period(s).

The guidance in Topic 250 (accounting changes and errors) on accounting errors is also applied, and the determination of the error depends on whether the relationship was highly effective in the prior period(s) affected.

- **Not highly effective.** If the relationship was *not* highly effective in prior reporting periods, the amount of the error is the difference between not

applying hedge accounting and the results recorded in the prior reporting period. [ASU 2017-12.BC215]

- **Highly effective.** If the relationship was highly effective and the hedged item (for a fair value hedge) and hedging instrument are measured properly, there is no error. However, an error will result if either of these is measured incorrectly. The nature of any error differs between cash flow and fair value hedges.

Fair value hedge	Cash flow hedge
The hedged item and/or the hedging instrument may not have been measured appropriately if their characteristics (including consideration of credit risk) were not properly defined in the prior reporting periods. This would result in the recorded amounts for the hedged item and/or the hedging instrument – along with the related gains (losses) recognized in net income – being incorrect.	The hedging instrument may not have been measured appropriately if its characteristics (including consideration of credit risk) were not properly defined in the prior reporting periods. This would result in the hedging instrument's recorded amount and the related amount recorded in AOCI being incorrect.

In both circumstances, the entity also evaluates the severity of any control deficiencies related to the failure to identify the inappropriate use of the qualitative approach.

See KPMG [ICFR reference guide](#) for insights on assessing internal controls over financial reporting, including evaluating deficiencies.



Question 13.5.50

May an entity performing quantitative effectiveness assessments revert to qualitative effectiveness assessments?

Interpretive response: Yes. An entity that initially elects to perform qualitative effectiveness assessments may be required (or may elect) to perform a quantitative effectiveness assessment in a subsequent period(s). In this case, it may revert to performing qualitative effectiveness assessments once it can reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods. In making this determination, the entity considers the same factors that it considered when making the initial election to perform qualitative assessments (see section 13.5.10). [815-20-35-2E – 35-2F]

The FASB considered whether returning to qualitative effectiveness assessments should be prohibited. However, it decided that not all circumstances requiring an entity to perform quantitative assessments mean that facts and circumstances have changed to such a degree that performing qualitative assessments is no longer reliable. Rather, some changes in facts and circumstances may be the result of a “temporary market disruption or an anomalous or infrequent event that is not expected to recur.” As a result, the FASB concluded that an entity may revert to performing qualitative

effectiveness assessments if it can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods. [815-20-35-2F, ASU 2017-12.BC204–BC206]

FASB Examples

The following FASB examples (815-20-55-79P to 55-79V) demonstrate when it may or may not be appropriate to revert to qualitative assessments after performing quantitative assessments.



Excerpt from ASC 815-20

>>> Change in Facts and Circumstances in Qualitative Effectiveness Assessments

>>>> Scenario A

55-79P Entity B expects to purchase 10,000 metric tons of cottonseed meal throughout April 20X3 based on the spot price of the cottonseed meal index on the respective date of each purchase. Entity B wants to hedge the variability in cash flows attributable to changes in the cottonseed meal index on the price that it will pay for the cottonseed meal. It enters into a forward contract on August 24, 20X1, with a notional of 10,000 metric tons, a maturity of April 1, 20X3, and an underlying of the soybean meal index because no market exists for derivatives indexed to the cottonseed meal index. Concurrent with the execution of the forward, Entity B designates the forward as the hedging instrument in a hedging relationship in which the hedged item is documented as the forecasted purchases of the first 10,000 metric tons of cottonseed meal expected to be purchased during April 20X3 and the hedged risk is documented as the variability in cash flows attributable to changes in the contractually specified cottonseed meal index in the not-yet-existing contract. On August 24, 20X1, Entity B determines that all requirements for cash flow hedge accounting are met and that the requirements of paragraph 815-20-25-22A will be met in the contract once executed in accordance with paragraph 815-20-25-22B. Entity B also will assess whether the criteria in 815-20-25-22A are met in the contract when it is executed.

55-79Q Because the hedged risk and forward contract are based on different indexes, the hedging relationship does not qualify for one of the exemptions in paragraph 815-20-25-3(b)(2)(iv)(01). Entity B performs an initial quantitative hedge effectiveness assessment and determines that the hedging instrument is highly effective at achieving offsetting cash flows associated with the hedged item attributable to the hedged risk. In Entity B's hedge documentation, it elects to perform subsequent assessments of hedge effectiveness on a qualitative basis. It makes this election based on the following factors:

- a. The results of the quantitative effectiveness assessment performed at hedge inception indicate that the hedging relationship is close to achieving perfect offset.
- b. Changes in the value of the cottonseed meal index have been consistently highly correlated with changes in value of the soybean meal index such

that expected changes in market conditions are not anticipated to prevent the hedging relationship from achieving highly effective offset.

- c. Although the underlyings of the hedging instrument and hedged item do not match, the notional amount of the derivative and the expected quantity to be purchased do match. Based on the quantitative effectiveness assessment, Entity B also determined that the difference in timing between the maturity date of the derivative and the dates on which the group of forecasted purchases is expected to occur is insignificant.

55-79R During the fourth quarter of 20X1, a storm damages the soybean harvest, which leads to a shortage in soybean meal supply and a sharp increase in the price of soybean meal based on the soybean meal index. The cottonseed meal index has not experienced a similar increase because cotton harvests were unaffected by the storm that damaged the soybean harvest. Because the increase in the soybean meal index is not reflected in the cottonseed meal index, Entity B concludes that a change in facts and circumstance has occurred that prevents a qualitative assertion in subsequent periods that the hedging relationship continues to be highly effective at achieving offsetting cash flows. Thus, on the next subsequent effectiveness assessment date (December 31, 20X1), the company begins performing quantitative assessments of hedge effectiveness based on the method used to perform the initial prospective assessment of effectiveness. In the effectiveness assessment performed on December 31, 20X1, Entity B determines that the hedging relationship remains highly effective but that it is not close to achieving perfect offset.

55-79S Entity B returns to assessing effectiveness qualitatively as of June 30, 20X2, because the evaluation of the following criteria leads to the conclusion that high effectiveness can be asserted prospectively on a qualitative basis:

- a. Entity B determines that the event that caused the soybean meal index and cottonseed meal index to experience a lack of correlation was temporary, that it was an isolated weather event, and the effect of the weather event has passed.
- b. The changes in value of the soybean meal index and cottonseed meal index reverted to levels of correlation that were consistent with those before the storm.
- c. The results of the June 30, 20X2 quantitative assessment of effectiveness are in line with the results of the quantitative assessment of effectiveness performed at hedge inception.
- d. No further disruptions in supply are expected.

>>>> Scenario B

55-79T On August 17, 20X1, Entity C issues at par a \$100 million 5-year fixed-rate noncallable debt instrument with an annual 8 percent interest coupon. On that date, Entity C enters into a 5-year interest rate swap with Financial Institution D and designates it as the hedging instrument in a fair value hedge of the LIBOR interest rate risk of the \$100 million liability. Under the terms of the interest rate swap, Entity C will receive fixed interest at 6 percent and pay variable interest at LIBOR based on a notional amount of \$100 million. The variable leg of the interest rate swap resets at the end of each quarter for the interest payment that is due at the end of the following quarter.

55-79U Entity C performs the initial quantitative and first subsequent hedge effectiveness assessments on September 30 (the entity's first quarterly testing date after hedge inception) and determines that the hedging relationship is highly effective at achieving offsetting changes in fair value attributable to interest rate risk. Entity C also elects at hedge inception to subsequently assess hedge effectiveness on a qualitative basis and documents how it would carry out that qualitative assessment. In its quarterly effectiveness assessment on December 31, the entity asserts that facts and circumstances related to the hedging relationship have not changed and the hedging relationship was and continues to be highly effective.

55-79V However, in the first quarter of 20X2, Financial Institution D's risk of default significantly increases, which affects the valuation of the interest rate swap with Entity C. Entity C notes that it no longer can qualitatively assert that the hedging relationship was and continues to be highly effective at achieving offsetting changes in fair value attributable to changes in benchmark interest rates. Thus, on the next subsequent effectiveness assessment date (March 31, 20X2), Entity C begins performing quantitative assessments of effectiveness using the method documented at hedge inception. In subsequent periods, Entity C does not return to qualitative effectiveness assessments because it cannot reasonably support an expectation of high effectiveness on a qualitative basis for the following reasons:

- a. The significant risk of default of Financial Institution D has not reversed and is not expected to be temporary.
- b. The results of quantitative effectiveness tests performed indicate that the hedging relationship is close to no longer being highly effective.

13.6 Quantitative methods of assessing effectiveness

13.6.10 Overview



Excerpt from ASC 815-20

>> Hedge Effectiveness—After Designation

35-2 If a fair value hedge or cash flow hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test on either a quantitative basis (using either a dollar-offset test or a statistical method such as regression analysis) or a qualitative basis. See paragraphs 815-20-35-2A through 35-2F for additional guidance on qualitative assessments of effectiveness. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting. At least quarterly, the hedging entity shall determine whether the hedging relationship has been highly effective in having achieved offsetting changes in fair value or cash flows through the date of the periodic assessment.

35-4 Electing to use a regression or other statistical analysis approach instead of a dollar-offset approach to perform retrospective evaluations of assessing hedge effectiveness may affect whether an entity can apply hedge accounting for the current assessment period.

>>> Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges

55-68 As discussed in paragraph 815-20-25-80, if an entity assesses hedge effectiveness on a quantitative basis and elects at the inception of a hedging relationship to utilize a regression analysis approach for prospective considerations of assessing effectiveness and the dollar-offset method to perform retrospective evaluations of assessing effectiveness, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Thus, in its retrospective evaluation, an entity might conclude that, under a dollar-offset approach, a designated hedging relationship does not qualify for hedge accounting for the period just ended, but that the hedging relationship may continue because, under a regression analysis approach, there is an expectation that the relationship will be highly effective in achieving offsetting changes in fair value or cash flows in future periods. In its retrospective evaluation, if that entity concludes that, under a dollar-offset approach, the hedging relationship has not been highly effective in having achieved offsetting changes in fair value or cash flows, hedge accounting may not be applied in the current period. Whenever a hedging relationship fails to qualify for hedge accounting in a certain assessment period, the overall change in fair value of the derivative instrument for that current period is recognized in earnings (not reported in other comprehensive income for a cash flow hedge) and the change in fair value of the hedged item would not be recognized in earnings for that period (for a fair value hedge).

This section discusses the quantitative approach to assessing hedge effectiveness by explaining the common methods used when that approach is applied. Previous sections of this chapter discuss the other methods of effectiveness testing, including:

- the qualitative approach (section 13.5);
- shortcut method (section 13.3); and
- critical terms match method (section 13.4).

Topic 815 does not prescribe which quantitative method should be used to perform effectiveness assessments. Instead, Topic 815 provides an entity with flexibility in determining the method to use for assessing hedge effectiveness, provided the method is reasonable and is defined and documented at the inception of the hedging relationship. In addition, the chosen quantitative method needs to be consistent with the hedging strategy (see section 13.2.30).

Unlike the approaches listed above, there are no pre-conditions for electing a quantitative approach, aside from the documentation requirements. Rather, it is the fall-back approach when a hedging relationship does not qualify for any other approach. But even when other approaches are allowable, an entity can still elect to use the quantitative approach, and may even prefer to.

The two common quantitative methods are dollar-offset and statistical analysis, with the most common statistical analysis being a regression analysis. Either of

these methods can be used in both the prospective and retrospective hedge effectiveness assessments. Alternatively, an entity may use one method for the prospective assessment and the other method for the retrospective assessment (see Question 13.2.40).

Each of the dollar-offset and statistical analysis methods has advantages and disadvantages. Moreover, each method may yield different results when applied to the same hedging relationship. Therefore, because the results of effectiveness assessments determine whether the entity can continue to apply hedge accounting, the selection of the right method to assess effectiveness at the inception of the hedging relationship should be carefully considered. [815-20-35-4]

The following diagram summarizes some main advantages and disadvantages of selecting dollar-offset versus statistical analysis (e.g. regression).

	Advantages	Disadvantages
Dollar-offset (section 13.6.20)	Mathematically simple and easy to interpret results	- Only considers data for the most recent assessment period - Limited elapsed time period may increase the likelihood that an unusual event or short-term volatility could result in a hedge not being highly effective over a short period - Impact of 'law of small numbers' less likely to demonstrate hedge is highly effective (see Question 13.6.40)
Statistical analysis (e.g. regression) (section 13.6.30)	- Historical data can be used to develop an assessment of effectiveness - Using a longer timeframe reduces the effect of short-term volatility or unusual events	Difficult to apply and interpret the results

An entity chooses and documents a method at the inception of a hedging relationship. It cannot switch from one method to another without dedesignating the hedging relationship (see section 13.6.40).

The following guidance discussed in previous sections also applies for the quantitative assessments of hedge effectiveness:

- An entity is permitted to exclude some components of a hedging instrument from its effectiveness assessments (see section 13.2.70).
- An entity is required to use the same assessment method for similar hedging relationships, including whether any components are excluded (see section 13.2.80).
- An entity should consider the effect of counterparty credit risk (entity's own nonperformance risk) on hedging relationships (see section 13.2.60).

- An entity generally is required to discontinue a hedging relationship if the results of retrospective testing indicate the relationship was not highly effective (see section 6.10.50). However, if a hedging relationship was not highly effective retrospectively, but is expected to be highly effective prospectively, hedge accounting is not necessarily required to be discontinued (see Question 6.10.90).

Formal documentation. Because Topic 815 provides for alternative methods and those methods have various application possibilities, an entity is required to document at the inception of a hedging relationship its decision about how it will assess effectiveness both on a retrospective and prospective basis. See section 6.9 for further discussion of the formal hedge documentation requirements.



Question 13.6.10

Why might an entity elect to use a quantitative method, even if the hedging relationship is eligible for a different method?

Interpretive response: Quantitative methods tend to be more complex to apply in practice than other methods. However, an entity may choose to apply a quantitative method – even if the hedging relationship is eligible for another method – due to limitations of, or cost considerations related to, the other effectiveness methods. For example:

- Using a quantitative method may mitigate the risk of being required to discontinue hedge accounting and/or of misapplying other methods such as the shortcut method or qualitative method.
- If an entity has a large number of hedging relationships, it may have systems and processes in place that are capable of performing timely quantitative tests for all hedges. In these situations, it may be more efficient for an entity to apply quantitative methods to all of its hedging relationships than the other available methods (e.g. the qualitative method described in section 13.5).
- Practical implications of applying a qualitative approach, where the assessment of effectiveness may not be easily determined qualitatively, requires a level of judgment, and quarterly documentation of those judgments, as well as additional processes and controls and monitoring efforts.



Question 13.6.20

Can an entity choose different effectiveness assessment methods each period based on the expected outcome?

Interpretive response: No. An entity is required to document its planned method of assessing hedge effectiveness at the inception of the hedging

relationship as part of its formal documentation (see requirements in section 6.9). The documentation should be specific as to which method will be used for retrospective and prospective effectiveness testing. Moreover, this documented method must be used throughout the hedging relationship.

Additionally, an entity is not permitted to document that it will use a variety of different techniques for the prospective assessment (or the retrospective assessment), depending on the circumstances at the time of the testing.

For example, an entity may believe that the effectiveness of the hedging relationship will significantly change if there are unexpected movements in the fair value or cash flows of the hedged item or transaction or the hedging instrument. However, it cannot devise and document a variety of effectiveness tests whereby one method would be used in certain cases while another method would be used in other cases.



Question 13.6.30

Which technique for assessing hedge effectiveness is more prevalent?

Interpretive response: It is our understanding that more entities choose to use regression analysis in their retrospective and prospective hedge effectiveness assessments.

While it is more difficult to apply and understand the results (see Questions 13.6.80 and 13.6.90), regression analysis is generally regarded as advantageous because it allows an entity to use historical data for periods before the inception of the hedge for both the initial and subsequent effectiveness assessments. In contrast, in applying the dollar-offset method for the ongoing retrospective effectiveness assessment, only data from the hedge period is considered.

For example, an entity is retrospectively assessing hedge effectiveness at the end of the first reporting period after inception of a hedging relationship (i.e. one quarter after inception) and the changes in the fair value or cash flows of the hedging instrument during the period did not effectively offset the changes in the fair value or cash flows of the hedged item or transaction.

- **Dollar-offset.** If the entity initially chose to use the dollar-offset method in its retrospective assessment, it would be required to conclude that the designated hedging relationship would not qualify for hedge accounting for the period just ended.
- **Statistical analysis (regression).** If the entity initially chose to use a statistical analysis based on a trailing 12-month period, which at the end of the first quarter after hedge inception includes three months of the hedge period and nine months before the hedge period, it may be able to conclude that the designated hedging relationship qualifies for hedge accounting for the period just ended. This is because the results of the nine months preceding the hedge period may negate the unfavorable hedge results of the most recent three months.

The hedge effectiveness testing results in this example – where one method (statistical analysis) supports hedge accounting while another method (dollar-offset) does not – is neither uncommon nor incorrect. Instead, it serves to highlight the importance of the selection of a method.

13.6.20 Dollar-offset method



Excerpt from ASC 815-20

>> Quantitative Hedge Effectiveness Assessments after Hedge Designation

35-5 In periodically (that is, at least quarterly) assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows) under a dollar-offset approach, an entity shall use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges):

- a. Period-by-period approach. The period-by-period approach involves comparing the changes in the hedging instrument's fair values (or cash flows) that have occurred during the period being assessed to the changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged that have occurred during the same period. If an entity elects to base its comparison of changes in fair value (or cash flows) on a period-by-period approach, the period cannot exceed three months. Fair value (or cash flow) patterns of the hedging instrument or the hedged item (or hedged transaction) in periods before the period being assessed are not relevant.
- b. Cumulative approach. The cumulative approach involves comparing the cumulative changes (to date from inception of the hedge) in the hedging instrument's fair values (or cash flows) to the cumulative changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged.

35-6 If an entity elects at inception of a hedging relationship to base its comparison of changes in fair value (or cash flows) on a cumulative approach, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Electing to utilize a period-by-period approach instead of a cumulative approach (or vice versa) to perform retrospective evaluations of assessing hedge effectiveness under the dollar-offset method may affect whether an entity can apply hedge accounting for the current assessment period.

The dollar-offset method compares the dollar amount of the change in fair value or cash flows of the hedging instrument with the dollar amount of the change in fair value or cash flows of the hedged item or transaction for the risk being hedged over the assessment period.

There are two approaches that may be used when applying the dollar-offset method: the period-by-period approach and the cumulative approach. Either

approach can be elected to calculate the hedge effectiveness, which an entity documents as part of its formal hedge documentation. An entity is not permitted to switch from one approach to the other without dedesignating (and redesignating) the hedging relationship (see section 13.6.40). [815-20-35-5]

Period-by-period	Cumulative
The period-by-period approach involves comparing the changes in the hedging instrument's fair values or cash flows <i>during the period being assessed</i> with the changes in the hedged item's or transaction's fair value or cash flows attributable to the hedged risk <i>during the same period</i>. The period for this assessment can be as short as an entity chooses (and documents), but cannot exceed three months. [815-20-35-5(a)]	The cumulative approach involves comparing the cumulative changes in the hedging instrument's fair value or cash flows to the cumulative changes in the hedged item's or transaction's fair value or cash flows attributable to the hedged risk <i>since inception of the hedging relationship</i>. [815-20-35-5(b)]



Question 13.6.40

What implications arise under the dollar-offset method when changes in fair values during the period are small?

Interpretive response: The dollar-offset method may be less likely to demonstrate that the hedging relationship is highly effective when the change in the fair value or cash flows of the hedging instrument and the hedged item or transaction involve small dollar amounts but large percentages.

For example, if the fair value of a hedging instrument with a notional of \$1 million changed by \$1,000 while the hedged item's fair value changed by \$1,500, the dollar-offset method would indicate that the hedge was only 66% effective ($\$1,000 \div \$1,500$), which is out of the highly effective range of 80% – 125% (see section 13.2.40). However, this change may be insignificant when compared to the \$1 million principal balance of the loan and \$1 million notional of the hedging instrument.

This is referred to as the 'small dollar problem' or the 'law of small numbers'.



Question 13.6.50

Which approach is more commonly applied when using the dollar-offset method: cumulative or period-by-period?

Interpretive response: It is our understanding most entities that choose the dollar-offset method for the retrospective assessment of effectiveness testing elect the cumulative approach instead of the period-by-period approach.

This is because the cumulative approach provides more periods of data, which may minimize the impact of short-term volatility or unusual events.

13.6.30 Regression analysis



Excerpt from ASC 815-20

>> Quantitative Hedge Effectiveness Assessments after Hedge Designation

35-2G Quantitative assessments can be based on regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information.

35-3 If an entity elects at the inception of a hedging relationship to use the same regression analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness, then during the term of that hedging relationship both of the following conditions shall be met:

- a. Those regression analysis calculations shall generally incorporate the same number of data points.
- b. That entity must periodically update its regression analysis (or other statistical analysis).

>>> Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges

55-69 As discussed in paragraph 815-20-35-3(b), if an entity assesses hedge effectiveness on a quantitative basis and elects at the inception of a hedging relationship to utilize a regression analysis (or other statistical analysis) approach for either prospective considerations or retrospective evaluations of assessing effectiveness, then that entity shall periodically update its regression analysis (or other statistical analysis). As long as an entity reruns its regression analysis and determines that the hedging relationship is still expected to be highly effective, then it can continue to apply hedge accounting without interruption.

55-70 The application of a regression or other statistical analysis approach to assessing effectiveness is complex. Those methodologies require appropriate interpretation and understanding of the statistical inferences.

Regression analysis is a statistical approach to measuring the effect that a change in one variable (the independent variable) can have on another variable (the dependent variable). In the case of hedging, a regression analysis could determine the relationship between the hedged item or transaction and a hedged instrument and whether it is expected to be – and actually has been – highly effective.

While regression analysis and other statistical analysis methods can be used for assessing effectiveness on a retrospective and/or prospective basis, applying those methods to assess effectiveness is complex. Appropriate interpretation

and an understanding of the statistical inferences of statistical methods are critical in applying those methods. [815-20-55-70]

To determine if a highly effective relationship exists, multiple data points need to be evaluated. Topic 815 does not specify the number of data points (i.e. data that represents the relationship of the independent and dependent variables over time) that must be incorporated into a regression analysis.

As time progresses in the hedging relationship, the data points in the regression analysis should be updated to include the current data. The entity should generally incorporate the same number of data points in each analysis, as the current data replaces the old data. This may help to further prove, or disprove, the effectiveness of the hedging relationship. [815-20-35-3, 55-69]

A detailed discussion of regression analysis and other statistical methods for assessing hedge effectiveness is beyond the scope of this publication.



Question 13.6.60

What should be compared (regressed) in a regression analysis?

Interpretive response: Generally regression analysis is applied to the changes in two variables over time.

When using statistical analysis, such as regression analysis, the objective of the assessment is to conclude that the hedging relationship has been or is expected to be highly effective or both – i.e. that the change in the fair value or cash flows of the derivative hedging instrument will be (and/or has been) highly effective at offsetting changes in the fair value or cash flows of the hedged item or transaction attributable to the hedged risk.

As a result, a regression analysis generally evaluates the relationship between *changes in* the fair values or cash flows of the derivative and the hedged item or transaction instead of the fair values or cash flows themselves.



Question 13.6.70

Must an entity perform the actual regression calculation if it is mathematically certain a cash flow hedge will be perfectly effective?

Interpretive guidance: No. In some circumstances, the variables to be compared through regression may be known at inception to always be identical.

For example, if an entity is using the hypothetical derivative method in a cash flow hedge and the terms of the actual hedging derivative exactly match those of the perfectly effective hypothetical derivative (see section 13.7.30), the entity knows with certainty that the changes in fair value or cash flows of the hypothetical derivative will be identical to the changes in fair value or cash flows of the actual hedging derivative. As a result, the entity knows with

mathematical certainty that the relationship will be 100% effective without performing the actual quantitative calculation.

In those circumstances, we believe an entity is not required to perform the actual calculation. This is because when the corresponding values to be compared are identical, the results of the calculation are known with mathematical certainty without performing the full calculation. Instead, we believe an entity may satisfy the requirement to initially assess effectiveness by documenting this fact.



Question 13.6.80

What outputs of regression analysis should be evaluated?

Interpretive guidance: The SEC staff has indicated that an entity must consider all relevant outputs from a regression analysis used to determine whether the hedging relationship has been and is expected to be highly effective. [\[2003 AICPA Conf\]](#)

While that assessment will be determined based on the facts and circumstances of the specific relationship, the SEC staff stated that at least the following regression outputs should be considered.

- R^2 statistic (coefficient of determination): the portion of variability in a dependent variable that can be explained by variability in the independent variable.
- Slope coefficient: the straight line that represents the 'best fit' of the individual data points.
- F-statistic or t-statistic: statistics that aid in determining whether the relationship between the variables is statistically valid.

Depending on the specifics of the hedging strategy, other regression outputs may also need to be considered.



Question 13.6.90

Should an entity consider using specialists when it uses statistical analysis to assess effectiveness?

Interpretive guidance: Yes. Applying statistical analysis (including regression) is complex and an appropriate interpretation and understanding of the statistical inferences of statistical methods are critical in applying those methods. As a result, we believe an entity should ensure that it involves personnel with the requisite knowledge to apply the methods properly.



Question 13.6.100

Do quantitative effectiveness assessments require judgment?

Interpretive response: Yes. While they are quantitative in nature, judgment is still involved in assessing effectiveness using quantitative methods. In evaluating the overall effectiveness test of the given hedging relationship, the overall understanding of the method selected and the inputs into the quantitative methods are important considerations.

The following are examples of inputs to a quantitative assessment that frequently require the judgment.

Type of hedging relationship	Inputs to quantitative assessment	Example judgment
Fair value	— Fair value of the hedged item — Fair value of the hedging instrument	— Estimating fair value of the hedged item, unless the hedged risk is total changes in fair value and a quoted price for an identical item traded in an active market is available (i.e. Level 1 inputs). — Estimating the fair value of the derivative hedging instrument, unless there are no excluded components and a quoted price for an identical item traded in an active market is available (i.e. Level 1 inputs).
Cash flow	— Cash flows of the hedged forecasted transaction — Cash flows of the derivative hedging instrument	— Estimating the amount and timing of the cash flows of the hedged forecasted transaction, which may involve a probability-weighted assessment. — Estimating the cash flows of the derivative hedging instrument, unless there are no excluded components and a quoted price for an identical item traded in an active market is available (i.e. Level 1 inputs).
Fair value and cash flow	— Selection of quantitative technique — Number of data points used in a regression analysis — Historical period used — Determination of data to include in the assessment (daily points, monthly, etc).	— Determination of data to include in the assessment (daily points, monthly, etc). — Determining the number of data points to be used in a regression analysis. — Determining the historical period to be used in effectiveness assessments (see Question 13.2.80).

See also KPMG Handbook, [Fair value measurement](#), including Section O, Application issues: Derivatives and hedging.

13.6.40 Changing quantitative methods for assessing effectiveness



Excerpt from ASC 815-20

>> Hedge Effectiveness Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

25-80 All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship. An entity shall use the quantitative effectiveness assessment method defined at hedge inception consistently for the periods that the entity either elects or is required to assess hedge effectiveness on a quantitative basis.

>>>> Change in Hedge Effectiveness Method When Hedge Effectiveness Is Assessed on a Quantitative Basis

35-19 If the entity identifies an improved method of assessing hedge effectiveness in accordance with the guidance in paragraph 815-20-25-80 and wants to apply that method prospectively, it shall do both of the following:

- a. Discontinue the existing hedging relationship
- b. Designate the relationship anew using the improved method.

35-20 The new method of assessing hedge effectiveness shall be applied prospectively and shall also be applied to similar hedges unless the use of a different method for similar hedges is justified. A change in the method of assessing hedge effectiveness by an entity shall not be considered a change in accounting principle as defined in Topic 250.

>>> Changes in Quantitative Assessment Methods

55-55 If an entity elects to or is required to assess hedge effectiveness on a quantitative basis after the initial quantitative assessment of hedge effectiveness, examples of changes in the types of methods an entity may use in assessing hedge effectiveness (see paragraph 815-20-35-20) could include the following:

- a. A change from the dollar-offset method to the use of regression analysis or vice versa
- b. A change between any one of the three methods discussed beginning in paragraph 815-30-35-10 (for example, a change from the change in variable cash flows method to either the hypothetical derivative method or the change in fair value method)
- c. A change from excluding certain components of a derivative instrument gain or loss to including such components or vice versa (for example, a change from assessing effectiveness based on changes in intrinsic value to the entire change in an option's fair value)

- d. A change from assessing hedge effectiveness on a period-by-period basis to a cumulative basis or vice versa.

55-56 This Subtopic permits a hedging relationship to be dedesignated (that is, discontinued) at any time. (See paragraphs 815-25-40-1(c) and 815-30-40-1(c).) If an entity wishes to change any of the critical terms of the hedging relationship (including the method designated for use in assessing hedge effectiveness), as documented at inception, the mechanism provided in this Subtopic to accomplish that change is the dedesignation of the original hedging relationship and the designation of a new hedging relationship that incorporates the desired changes. However, as discussed in paragraph 815-30-35-37A, a change to the hedged risk in a cash flow hedge of a forecasted transaction does not result in an automatic dedesignation of the hedging relationship if the hedging instrument continues to be highly effective at achieving offsetting cash flows associated with the hedged item attributable to the revised hedged risk. The dedesignation of an original hedging relationship and the designation of a new hedging relationship represents the application of this Subtopic and is not a change in accounting principle under Topic 250, even though the new hedging relationship may differ from the original hedging relationship only with respect to the method designated for use in assessing the hedge effectiveness of that hedging relationship. Although paragraph 815-20-35-19 refers to discontinuing an existing hedging relationship and then designating and documenting a new hedging relationship using an improved method for assessing effectiveness, that reference was not meant to imply that the perceived improved method had to be justified as a preferable method of applying an accounting principle under Topic 250.

55-56A For the purposes of applying the guidance in paragraph 815-20-55-56, a change in the counterparty to a derivative instrument that has been designated as the hedging instrument in an existing hedging relationship would not, in and of itself, be considered a change in a critical term of the hedging relationship.

As discussed in section 6.9, an entity generally is required to define and document the quantitative method it will use for assessing hedge effectiveness at the time it designates a hedging relationship. That method must be applied consistently throughout the period of the hedge. [815-20-25-3(b)(2), 25-80]

If an entity wishes to change the documented hedge effectiveness method – i.e. because it has identified an improved method for assessing effectiveness – it generally must discontinue the existing hedging relationship and designate a new hedging relationship using the improved method. The new relationship must meet all hedging criteria, including the formal documentation requirements. [815-20-35-19]

The effect of discontinuing a hedging relationship is discussed in sections 8.5 (fair value hedges) and 10.5 (cash flow hedges).

The following are examples of changes in hedge effectiveness methods, and whether dedesignation and redesignation of the hedging relationship is required. [815-20-35-19, 55-55 – 55-56A]

Changes in hedge effectiveness methods – dedesignation and redesignation required	Changes in hedge effectiveness methods – dedesignation and redesignation <i>not</i> required
— Change from the dollar-offset method to regression analysis or vice versa (see sections 13.6.20 and 13.6.30). — Change from period-by-period basis to cumulative basis or vice versa (see section 13.6.20). — Change between any of the following methods (see section 13.7) — change-in-variable-cash-flows method — hypothetical derivative method — change-in-fair-value method. — Change from excluding to including certain components of a derivative instrument's gain or loss or vice versa (see section 13.2.70).	— An entity documents that it will use the qualitative method for subsequent effectiveness assessments and later is required (or elects) to perform quantitative effectiveness assessments using the method documented at hedge inception (see section 13.5.20). — Shortcut method is determined to not be or no longer be appropriate and the entity had documented at hedge inception the quantitative method that would be used in such circumstances (see section 13.3.110). — Critical terms cease to match when an entity applies the critical terms match method (see Question 13.4.80).

Discontinuing a hedging relationship and designating a new hedging relationship with a different effectiveness assessment method is not a change in an accounting principle under Topic 250. As a result, no preferability letter is necessary and the auditor's report need not refer to this change. Nevertheless, an entity that changes methods needs to: [\[815-20-35-20, 55-56\]](#)

- document its justification for the change, including why the new method is an improvement;
- apply the new method to all similar hedges, unless facts and circumstances support a different method (see section 13.2.80); and
- prepare documentation for the new hedging relationship (see section 6.9).

13.6.50 Illustrative examples of quantitative methods to assess effectiveness

The following examples illustrate the quantitative hedge effectiveness testing methods:

- Dollar-offset method for retrospective test (fair value hedge) (Example 13.6.10).
- Assessing effectiveness of a cash flow hedge of a forecasted purchase of inventory with a forward contract (contractually specified component) (Subtopic 815-30's Example 22).
- Hedging forecasted purchases of fuel using regression analysis and the dollar-offset method (Example 13.6.20).



Example 13.6.10

Dollar-offset method for retrospective test (fair value hedge)

At inception of the hedge, on March 31, Year 1, a hedging relationship was expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is expected to be in place.

Formal documentation

ABC Corp. documented that its retrospective assessment of hedge effectiveness will be assessed based on changes in the fair value of the derivative hedging instrument and changes in the fair value of the hedged item attributable to the hedged risk on a **cumulative basis**.

Quarterly effectiveness testing – March 31, Year 2

The following is ABC's documentation supporting its retrospective assessment of hedge effectiveness using the cumulative dollar-offset method at March 31, Year 2.

Three months ended	Derivative hedging instrument gain (loss)	Hedged item gain (loss)	Period change ratio	Cumulative change ratio
March 31, Year 1	\$100	\$ (90)	111%	111%
June 30, Year 1	25	(21)	119%	113%
September 30, Year 1	(20)	24	83%	121%
December 31, Year 1	(5)	4	125%	120%
March 31, Year 2	25	(19)	132%	123%
Net gain (loss) to date	\$125	\$(102)		

To be highly effective, the extent of offset between the hedging instrument and the hedged item or forecasted transaction should be 80%–125% (see section 13.2.40).

ABC concludes that it cannot apply hedge accounting for the three months ended March 31, Year 2 if it selects the period-by-period dollar-offset method for its retrospective assessment of hedge effectiveness. This is because the extent of offset under the period-to-period assessment was 132% – i.e. not within a range of 80%–125%.

However, ABC is able to apply hedge accounting for the three months ended March 31, Year 2 because its chosen method of retrospectively assessing effectiveness is based on cumulative changes. As the table demonstrates, on a cumulative basis, this relationship has been highly effective.



Excerpt from Subtopic 815-30

>> Example 22: Assessing Effectiveness of a Cash Flow Hedge of a Forecasted Purchase of Inventory with a Forward Contract (Contractually Specified Component)

55-134 This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic for assessing effectiveness for a cash flow hedge of a forecasted purchase of inventory with a forward contract for which the hedged risk is variability in cash flows attributable to changes in a **contractually specified component**. Assume the entity elects to perform subsequent assessments of hedge effectiveness on a quantitative basis using a cumulative-dollar-offset approach and all hedge documentation requirements were satisfied at inception.

55-135 Entity J manufactures keys for door locks on buildings and cars. The keys are cut from sheets of metal called key plates. Entity J primarily purchases its key plates from Supplier 1 as needed. Supplier 1 and Entity J have an outstanding agreement specifying that the per-unit cost of each key plate will be determined by Supplier 1 on the first business day of each month on the basis of the following pricing formula:

- a. Spot price of COMEX Zinc per pound $\times$ 0.2 pounds, plus
- b. Spot price of COMEX Copper per pound $\times$ 0.1 pounds, plus
- c. The current cost of refining copper and zinc into key plates, plus
- d. The current cost of transporting the key plates to Entity J.

55-136 In January 20X1, Entity J expects to purchase 100,000 key plates in July 20X1, which requires 10,000 pounds of copper for the manufacturing process. Entity J decides that it wishes to hedge only the change in value of the price of COMEX Copper used to create the key plates being purchased in July 20X1.

55-137 On January 15, 20X1, Entity J enters into a forward contract maturing on July 1, 20X1 (that is, the date on which the price of copper used to manufacture the key plates is fixed) to purchase 10,000 pounds of COMEX Copper at \$2.10 per pound. Any settlement amount on the forward contract will be based on the difference between the contract price of \$2.10 per pound and the spot price of COMEX Copper on the maturity date (July 1, 20X1), multiplied by the notional amount of 10,000 pounds.

55-138 Entity J designates a cash flow hedge in which the hedging instrument is the forward contract, the hedged item is the forecasted purchase of key plates in July 20X1, and the hedged risk is the variability in the purchase price of the key plates attributable to changes in the COMEX Copper price index, which is a contractually specified component within the frame agreement. Entity J documents in its hedge documentation that the requirements to designate variability in cash flows attributable to changes in a contractually specified component as the hedged risk in paragraph 815-20-25-22A are met.

55-139 Entity J bases its assessment of hedge effectiveness on cumulative changes in the fair value of the hedging instrument and the hedged item attributable to changes in the hedged risk.

55-140 In assessing hedge effectiveness on an ongoing basis, Entity J must consider the extent of offset between the change in expected cash flows on the hedging instrument (the copper forward contract) and the hedged item attributable to changes in the hedged risk (change in expected cash flows associated with forecasted purchases of key plates attributable to changes in the COMEX Copper price index). The table below illustrates the cumulative changes in the hedging instrument and hedged item attributable to changes in the hedged risk as of the first subsequent quarterly effectiveness assessment date.

	Estimate of Change in Cash Flows	
	Hedging Instrument	Hedged Item Due to Fluctuation in Hedged Risk
Forward price of copper (dollars per pound)		
At hedge inception (Jan 15, 20X1)	\$ 2.10	\$ 2.10
At first subsequent assessment date (March 31, 20X1)	\$ 2.25	\$ 2.25
Change in forward price of copper	\$ 0.15	\$ 0.15
Cumulative change in copper (per pound) x 10,000 pounds of copper	\$ 1,500.00	\$ 1,500.00

55-141 Entity J could assess effectiveness as of March 31, 20X1, by comparing the \$1,500 change in the hedging instrument with the \$1,500 change in the hedged item attributable to changes in the hedged risk because the hedging instrument's maturity date and the date on which the price of copper will be fixed match (that is, July 1, 20X1).



Example 13.6.20

Hedging forecasted purchases of fuel using regression analysis and the dollar-offset method

This is the continuation of Examples 6.9.50 and 9.3.30 involving forecasted purchases of fuel when hedging price risk.

- Formal documentation of hedging relationship – except for hedge effectiveness components, which are presented in this example (see Example 6.9.50).
- Similarity assessment for forecasted transactions (see Example 9.3.30).

Freight Co. purchases both jet fuel and diesel fuel at various locations across the US and internationally.

For ease of reference, details of the hedging relationships identified by Freight are summarized below.

Nature of the risk being hedged	Exposure to variability in the overall cash outflows (i.e. price risk) for the purchase of fuel due to changes in spot prices at various locations.
Groups of similar forecasted transactions	The hedged forecasted transaction is defined as the first purchases of gallons of fuel over the 30-day period beginning on the first day of the month in which the derivative contract matures/settles that: — in aggregate represent the number of gallons (or equivalent barrels) equal to the notional amount of the hedging instrument; and — are not currently being hedged by another derivative instrument or were not previously identified in a relationship originally designated earlier in priority that has been terminated for which amounts remain in AOCI. Only individual forecasted purchases that are considered to be <i>similar</i> with respect to the risk being hedged are included within the same hedged group of forecasted transactions. Hedged transactions within each of the following groups are considered similar, based first by type of fuel and then more specifically by location: — Group 1: Jet fuel; NY Harbor, US Gulf Coast, LA — Group 2: Jet fuel; Singapore, Rotterdam — Group 3: Diesel fuel; NY Harbor, US Gulf Coast — Group 4: Diesel fuel; LA
Hedging instrument	Futures or purchased options indexed to either: — the NYMEX Heating Oil or NY Harbor No. 2 index (generally used for relationships involving forecasted purchases of jet fuel); or — the NYMEX West Texas Intermediate Crude Oil index (generally used for relationships involving forecasted purchases of diesel fuel).

The hedge period for individual relationships is typically three months.

Documentation of hedge effectiveness methods

The following illustrates how the methods chosen to assess effectiveness are documented at the inception of the hedging relationships.

Hedge effectiveness at inception

Prospectively	Freight will assess prospective effectiveness using a regression analysis to demonstrate high correlation between: — the cumulative changes in fair value of the hedging instrument; and — the cumulative changes in fair value of a PEH derivative (a proxy for the change in the present value of the expected future cash flows of the hedged forecasted purchases of fuel). Because the prospective assessment is intended to justify an expectation that the relationship will be highly effective over future periods in achieving offsetting changes in cash flows, the

	regression analysis will demonstrate high correlation over a series of 32 three-month periods. The hedged forecasted transaction specified for each hedging relationship is a group of individual forecasted purchases of fuel of the same type but from differing locations. Therefore, Freight will perform separate regression analyses (using 32 sets of data points for each analysis) to demonstrate that the hedging instrument is expected to be highly effective at hedging overall price risk for purchases at each of the individual locations identified within each group of hedged forecasted transactions. For example, for an individual hedging relationship associated with Group 1 above, three regression analyses would be prepared to demonstrate that the derivative would be highly effective at hedging forecasted purchases whose price varies upon (1) the NY Harbor index, (2) the US Gulf Coast index and (3) the LA index. This analysis demonstrates that the hedging relationship would be highly effective regardless of the ultimate composition of the hedged group of forecasted transactions (e.g. if 100% of the forecasted purchases were from any one of the identified locations).

Each set of data points to be used in the regression analysis will be determined as discussed below. The regression will encompass 32 such data points, each based on the cumulative change in fair value over a three-month period for the series of three-month periods beginning at the inception of the hedge and going back a total of 32 three-month periods.

Cumulative change in fair value of hedging instrument	The cumulative change in the fair value of the derivative over a three-month period. If historical prices for the hedging instrument do not exist, the fair values will be measured with inputs based on: — the current spot price of the commodity underlying the derivative; — the derivative's maturity/settlement date; and — the applicable forward price curve for that particular date to ensure that the valuations reflect the historical price curves actually in place during each of the 32 three-month periods. Freight believes that using changes in prices for the previous 32 three-month periods is reasonable for purposes of identifying possible changes in prices over the next three months.
Cumulative change in fair value of PEH 1 and PEH 2	The cumulative change in the fair value of the PEH derivative over a three-month period. — Futures contracts. For relationships involving futures contracts, PEH 1 is a futures contract (with a zero fair value at inception of the hedging relationship) to purchase the type of fuel being hedged (e.g. jet fuel or diesel fuel) at the location within that group of forecasted transactions for which the regression is being prepared. — Purchased options. For relationships involving purchased option contracts, PEH 2 is a European option contract to purchase the type of fuel being hedged at the location within that group of forecasted transactions for which the regression is being prepared; Freight is assessing

	effectiveness for option relationships based on total changes in the option's cash flows. The strike price on the option is equal to the specified threshold over which the increase in the overall market price of fuel (either jet fuel or diesel fuel) is designated as the risk being hedged.
Settlement date of PEH 1 and PEH 2	The settlement date of PEH 1 and PEH 2 is determined at the inception of the hedge based on an analysis of the purchases made in the prior three-month period for each particular group of hedged forecasted transactions. For example, in March Freight designates an individual relationship for the purchase of the first one million gallons of jet fuel associated with Group 1 in June. There were no other hedging relationships related to Group 1 previously designated for forecasted purchases in June. Freight accumulates the purchase data from the three-month period spanning December – February to determine how many days it took to purchase one million gallons of Group 1's fuel; this is from the beginning of December because the hedged forecasted transaction is defined as the first purchases. Freight then computes a weighted-average number of days into the three-month period and uses that weighted average to determine the settlement date of PEH 1 and PEH 2. For example, if the first two purchases during the three-month period were 500,000 gallons each, one purchase occurring on December 1, and the second purchase occurring on January 31, the PEH derivatives would have a settlement date of January 1. However, if there was already a hedging relationship in place for the first two million gallons of jet fuel purchased, the settlement date for the PEHs for the next one million gallons purchased would be based on the weighted-average number of days that it took during the three-month period spanning December – February to purchase gallons 2,000,001–3,000,000. The activity for the previous three-month period is used because Freight believes that recent historical information regarding the individual groups is an appropriate basis on which to develop the best estimate of future settlements.
Fair value of PEH 1 and PEH 2	The fair value of each of PEH 1 and PEH 2 is measured with inputs based on the current spot price of the type of fuel and applicable location (e.g. NYMEX New York Harbor Jet Kerosene, NYMEX US Gulf Coast Low-Sulfur No. 2 Diesel Fuel) for which the regression is being prepared and the applicable forward price curve for that particular date to ensure that the valuation reflects the historical price curves actually in place during each three-month period. Freight believes that using changes in prices for the previous 32 three-month periods is reasonable for purposes of identifying possible changes in prices over the next three months.

Hedge effectiveness during the hedging relationship

Freight will update the regression analyses discussed above on a monthly basis, continuously using the most current 32 data points.

Retrospectively	The retrospective assessment is intended to determine whether the relationship has been highly effective cumulatively to date. Freight will assess retrospective effectiveness on a dollar-offset

	basis. To support hedge accounting for all relationships within each group for the previous period, the cumulative change in the fair value of the actual derivatives will need to offset at least 80%, and up to 125%, of the cumulative change in the fair value of the associated PEH derivatives.
Prospectively	Freight will determine whether it expects the hedging relationships to continue to be highly effective based on the updated regression analyses.

13.7 Cash flow hedges – Methods for measuring cash flows

13.7.10 Overview

Topic 815 does not prescribe a method for measuring the changes in the derivative hedging instrument's cash flows or the changes in the hedged transaction's cash flows attributable to the hedged risk. However, it describes several methods for measuring cash flows in cash flow hedges, some of which are only available for certain hedging strategies and/or when certain conditions are met.

Terminal value method (section 13.7.20)	This method may be used for certain cash flow hedging relationships when the hedging instrument is an option.
— Change-in-variable-cash-flows method — Hypothetical derivative method — Change-in-fair-value method (section 13.7.30)	These methods are applicable to cash flow hedges of variability in interest receipts or payments when the hedging instrument is an interest rate swap.

These methods may be used to measure the expected cash flows to be used when performing quantitative tests (see section 13.6). Some of these methods result in a hedge that is perfectly effective, depending on whether the critical terms of the hedging instrument and hedged transaction match.

In many cases, Topic 815 does not prescribe methods that must be used for assessing effectiveness for cash flow hedges. For example, Topic 815 does not prescribe specific guidance in the following situations:

- the hedging relationship includes a basis difference, to the extent that those bases do not move in tandem; this might occur, for example, when a pound sterling-based hedging instrument is used to hedge a euro-based forecasted transaction; and
- the critical terms do not match – e.g. when there is a difference between the notional amounts, maturities, quantity, location or delivery dates of the derivative hedging instrument and the hedged transaction.

In these situations, an entity is required to determine the changes in the forecasted transaction's cash flows attributable to the hedged risk and compare these changes to the changes in cash flows of the derivative hedging instrument. As a result, methods have developed in practice for situations when Topic 815 does not prescribe how cash flows should be measured, including the following.

Hypothetical derivative method (section 13.7.30)	This method is described in Topic 815 as being relevant to certain hedges involving interest payments when the hedging instrument is an interest rate swap. Additionally, FASB examples (e.g. Subtopic 815-30's Example 1, which is reproduced in section 13.7.30) demonstrate using this method for other types of hedging relationships. In practice, the PEH derivative instrument is used as a proxy for the change in expected cash flows of the hedged transaction attributable to the hedged risk for all types of cash flow hedging relationships.
Project future cash flows using forward price curves or using recent sales or purchase orders (section 13.7.50)	This method is used when hedging a forecasted sale or purchase of certain nonfinancial assets and a market is not available to help make estimates of their cash flows.



Question 13.7.10

What should an entity consider when assessing hedge effectiveness for a group of similar forecasted transactions?

Background: As discussed in section 9.3.60, a group of forecasted transactions (rather than an individual transaction) may be designated as the hedged transaction in a cash flow hedge, provided the transactions share the same risk exposure and certain conditions are met.

Interpretive response: Although each item in a group of transactions may share the same risk exposure, we believe an entity that identifies a group of transactions as the hedged transaction in a cash flow hedging relationship should consider additional factors when assessing whether the hedge is highly effective. Therefore, a group of transactions could pass the similarity test but the hedging relationship may not be highly effective.

The circumstances outlined below could result in a hedging relationship that is not highly effective.

Timing of cash flows	Regardless of the risk being hedged, the timing of the individual cash flows of each transaction within a group of transactions will often not be the same as the timing of the cash flow(s) of a single derivative used as the hedging instrument.
Basis differences	Basis differences occur when the underlying price/index, contractually specified component or contractually specified interest rate of the hedged transaction is different from the price, index or interest rate of the hedging instrument.

	For example, a hedged transaction varies based on 30-day LIBOR and the hedging instrument varies based on 90-day LIBOR. For discussion of similarity assessments related to contractually specified interest rates, see Question 9.3.80.
Margin variability	 When hedging price risk , margin variability may occur when each individual forecasted transaction in a group is based on the same underlying price, index or rate, but the spread above that price, index or rate may be different due to various factors. This would not be a factor when hedging exposure to changes in a contractually specified component or contractually specified interest rate.

If the hedging relationship for a group of similar transactions is not highly effective, an entity may have the following alternatives:

- **Changing the groupings of hedged transactions.** Depending on the circumstances, an entity may need to consider whether multiple hedging relationships would be more appropriate. This could be different hedging relationships for each individual transaction or more disaggregated groups of similar forecasted transactions.
- **Use a combination of hedging instruments.** Alternatively, an entity could use a dynamic hedging strategy that uses a combination of derivatives as hedging instruments. As discussed in section 13.2.50, a dynamic hedging strategy involves an entity committing itself to an ongoing repositioning strategy for its hedging relationship and to an assessment period that is shorter than the term of the hedging instrument.

13.7.20 Terminal value method for certain cash flow hedges using an option as the hedging instrument



Excerpt from ASC 815-20

>>>> Assessing Hedge Effectiveness Based on an Option's Terminal Value

25-126 The guidance in paragraph 815-20-25-129 addresses a cash flow hedge that meets all of the following conditions:

- The hedging instrument is a purchased option or a combination of only options that comprise either a net purchased option or a zero-cost collar.
- The exposure being hedged is the variability in expected future cash flows attributed to a particular rate or price beyond (or within) a specified level (or levels).
- The assessment of effectiveness is documented as being based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in fair value, not just changes in intrinsic value).

25-127 This guidance has no effect on the accounting for fair value hedging relationships. In addition, in determining the accounting for seemingly similar

cash flow hedging relationships, it would be inappropriate to analogize to this guidance.

25-128 For a hedging relationship that meets all of the conditions in paragraph 815-20-25-126, an entity may focus on the hedging instrument's terminal value (that is, its expected future pay-off amount at its maturity date) in determining whether the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. An entity's focus on the hedging instrument's terminal value is not an impediment to the entity's subsequently deciding to dedesignate that cash flow hedge before the occurrence of the hedged transaction. If the hedging instrument is a purchased cap consisting of a series of purchased caplets that are each hedging an individual hedged transaction in a series of hedged transactions (such as caplets hedging a series of hedged interest payments at different monthly or quarterly dates), the entity may focus on the terminal value of each caplet (that is, the expected future pay-off amount at the maturity date of each caplet) in determining whether each of those hedging relationships is expected to be highly effective in achieving offsetting cash flows. The guidance in this paragraph applies to a purchased option regardless of whether at the inception of the cash flow hedging relationship it is at the money, in the money, or out of the money.

25-129 A hedging relationship that meets all of the conditions in paragraph 815-20-25-126 may be considered to be perfectly effective if all of the following conditions are met:

- a. The critical terms of the hedging instrument (such as its notional amount, underlying, maturity date, and so forth) completely match the related terms of the hedged forecasted transaction (such as the notional amount, the variable that determines the variability in cash flows, the expected date of the hedged transaction, and so forth)
- b. The strike price (or prices) of the hedging option (or combination of options) matches the specified level (or levels) beyond (or within) which the entity's exposure is being hedged.
- c. The hedging instrument's inflows (outflows) at its maturity date completely offset the change in the hedged transaction's cash flows for the risk being hedged.
- d. The hedging instrument can be exercised only on a single date—its contractual maturity date.

The condition in (d) is consistent with the entity's focus on the hedging instrument's terminal value. If the holder of the option chooses to pay for the ability to exercise the option at dates before the maturity date (for example, by acquiring an American-style option), the hedging relationship would not be perfectly effective.

25-129A In a hedge of a group of forecasted transactions in accordance with paragraph 815-20-25-15(a)(2), an entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match in accordance with paragraph 815-20-25-129(a) if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month.



Excerpt from ASC 815-30

>> Hedging Relationship in Which Hedge Effectiveness Is Based on an Option's Terminal Value

35-33 If an entity concludes under paragraphs 815-20-25-129 through 25-129A that the hedging relationship may not be considered to be perfectly effective, the entity shall assess hedge effectiveness by comparing the following amounts:

- a. The change in fair value of the actual hedging instrument
- b. The change in fair value of a perfectly effective hypothetical hedging instrument. That hypothetical hedging instrument shall have terms that meet the four conditions listed in paragraphs 815-20-25-129 through 25-129A.

35-34 The change in fair value of the hypothetical hedging instrument can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction(s).

When an option is used as the derivative hedging instrument in a cash flow hedging relationship, the total change in the option's cash flows may not perfectly offset the change in the forecasted transaction's cash flows when the option premium (or time value) is included in that calculation.

In these situations, an entity may elect to use the terminal value method. This method includes the time value component of the option in the assessment of effectiveness. However, it focuses on the hedging instrument's terminal value (i.e. the expected pay-off at its maturity date) in determining whether the hedging relationship is expected to be highly effective at achieving offsetting cash flows that are attributable to the hedged risk during the term of the hedge.

As a result, the terminal value method will result in higher effectiveness than an approach that compares the total changes in the option's cash flows with the changes in the expected cash flows of the forecasted transaction.

The following table summarizes the terminal value method.

Conditions for applying this method: [815-20-25-126]	— Hedging instrument. The hedging instrument is a purchased option or a combination of only options that comprise either a net purchased option or a zero-cost collar (see sections 6.7.50 and 6.7.60). — Hedged risk. The hedged risk is variability in expected future cash flows attributable to a particular rate or price beyond (or within) a specified level (or levels). — Hedge effectiveness. The effectiveness assessment is based on total changes in the option's cash flows – i.e. it includes the hedging instrument's entire change in fair value, not just changes in intrinsic value.
Conditions that will result in	— The critical terms of the hedging instrument completely match the related terms of the hedged transaction (notional amount, underlying, maturity and strike price). This includes that it is

perfect effectiveness¹: [815-20-25-129 – 25-129A]	probable that the counterparty to the derivative and the entity will not default. — The strike prices of the hedging option (or combination of options) matches the specified level (or levels) beyond (or within) which the entity's exposure is being hedged. — The hedging instrument's inflows (outflows) at its maturity date completely offset the outflows (inflows) from any increase or decrease in the hedged transaction's cash flows, from the date of hedge designation, for the risk being hedged. — The hedging instrument can be exercised only on a single date, its contractual maturity date. — See also Question 13.2.50 regarding whether subsequent assessments are performed on a qualitative or quantitative basis.
What is compared in assessing effectiveness: [815-30-35-33 – 35-34]	This method involves comparing: — the option's changes in the expected pay-off at its maturity; and — the changes in the expected cash flows of the forecasted transaction. However, if the conditions that will result in perfect effectiveness (above) are <i>not</i> met, an entity must perform initial and subsequent hedge effectiveness assessments by comparing the change in fair values of: — the actual hedging instrument; and — the perfectly effective hypothetical derivative (see section 13.7.30).
Note: 1. In determining whether these conditions are met, the entity may treat the timing of the hedged transactions and the hedging instrument as matching, if the hedged transactions occur and the hedging instrument matures within the same 31-day period (or fiscal month). [815-20-25-129A]	

The terminal value method is available only for **cash flow hedges** (not fair value hedges) and cannot be used in cash flow hedges that do not meet the eligibility requirements included in the above table. [815-20-25-127]

As an alternative to the terminal value method, an entity may exclude changes in time value from its assessment of effectiveness (see section 13.2.70) to improve the extent of offset when an option premium (or time value) is paid. When time value is an excluded component, changes in time value are recognized using either an amortization approach or a mark-to-market approach. Either of these methods will result in the initial time value being recognized in earnings over the term of the hedging relationship. See also Example 10.3.30, which illustrates and compares the earnings effect of time value under each method. [815-20-25-83A – 25-83B]



Question 13.7.20

May the terminal value method be used by the buyer when the hedging instrument is a swaption?

Interpretive response: It depends on the hedged transaction.

The terminal value method focuses on the expected pay-off of the option at its maturity date, not the potential cash flows on the interest rate swap. As a result, the terminal value method would require an entity to focus on the increase in cash flows to be received (in the form of cash or the fair value of the swap) on expiration of the option portion of the interest rate swaption; this is instead of the increase or decrease in cash flows to be exchanged during the term of the interest rate swap. As a result, using a swaption as the hedging instrument when the terminal value method is used to assess effectiveness may be effective when the hedged transaction is proceeds from issuing a fixed-rate debt instrument but may not be effective when hedging variability in individual interest payments from a forecasted variable-rate debt issuance (see Example 13.7.10).

An interest rate swaption is an option to enter into a specified interest rate swap at maturity of the option. In exchange for an option premium, the buyer has the right (but not the obligation) to enter into a specified swap agreement; or, in some cases, to receive cash proceeds for the fair value of that swap agreement at the expiration of the option. In essence, if the buyer of the swaption is in a gain position at the option's maturity, it will exercise the option; however, if the buyer is in a loss position at the option's maturity, it will not exercise the option.

We believe an interest rate swaption represents a purchased option from the perspective of the buyer. As a result, the terminal value method may be used by the buyer when the hedging instrument is an interest rate swaption in a cash flow hedging relationship as long as the other eligibility requirements are met. Additionally, the hedging relationship may be considered perfectly effective if certain conditions are met.

Examples

The following are examples that demonstrate the terminal value method.

- Terminal value method is not appropriate (Example 13.7.10).
- Purchased option used in a cash flow hedge (Subtopic 815-20's Example 27).
- Terminal value method for hedge of forecasted foreign currency denominated sale with a purchased option (Example 13.7.20).



Example 13.7.10

Terminal value method is not appropriate

ABC Corp. expects to issue \$100 million of 10-year variable-rate debt in six months. ABC will be exposed to variability in cash flows in the future

quarterly interest payments on the debt due to changes in the expected contractually specified interest rate.

ABC enters into a swaption to hedge the variability in the 40 future quarterly interest payments attributable to changes in the benchmark interest rate above 6% over the next 10 years related to its 10-year \$100 million debt that begins in six months.

The swaption provides ABC the right (but not the obligation) to enter into a 10-year, receive-three-month LIBOR, pay-fixed 6% interest rate swap with a notional amount of \$100 million and payment and receipt dates that coincide with the payment dates on the debt instrument. When three-month LIBOR is above 6%, ABC will exercise its option. When three-month LIBOR is below 6%, ABC will allow its option to expire.

The conditions to apply the terminal value method are not met for the following reasons.

- The hedging instrument for the first time period of the proposed hedging relationship is a purchased option; however for the second time period it is an interest rate swap.
- The exposure being hedged for the first time period of the proposed hedging relationship is variability in interest payments above 6%; however, in the second time period, it is increases or decreases in three-month LIBOR from 6%.



Excerpt from ASC 815-20

>> Example 27: Purchased Option Used in a Cash Flow Hedge

55-208 This Example illustrates the application of paragraph 815-20-25-126.

55-209 An entity forecasts that 1 year later it will purchase 1,000 ounces of gold at then current market prices for use in its operations. The entity wishes to protect itself against increases in the cost of gold above the current market price of \$275 per ounce. The entity purchases a 1-year cash-settled at-the-money gold option on 1,000 ounces of gold, paying a premium of \$10,000. If the price of gold is above \$275 at the maturity (settlement) date, the counterparty will pay the entity 1,000 times the difference. If the price of gold is \$275 or below at the maturity date, the contract expires worthless. The option cannot be exercised before its contractual maturity date. The entity designates the purchased option contract as a hedge of the variability in the purchase price (cash outflow) of the 1,000 ounces of gold for prices above \$275 per ounce.

55-210 In assessing the effectiveness of the cash flow hedge, the entity would determine that because the change in the expected future pay-off amount of the purchased option completely offsets the change in the expected future cash flows on the purchase of 1,000 ounces of gold above \$275 per ounce, the

hedging relationship is expected to be highly effective under paragraph 815-20-25-75(b).

55-211 The entity would conclude there is perfect effectiveness because all of the following conditions exist:

- a. All the critical terms of the hedging derivative completely match the hedged forecasted transaction.
- b. The strike price of the hedging instrument matches the specified level (\$275) beyond which the entity's exposure is being hedged.
- c. The hedging derivative's inflows at expiration completely offset the hedged transaction's outflows for any increase in the price of gold above \$275 per ounce.
- d. The hedging option cannot be exercised before its contractual maturity date.



Example 13.7.20

Terminal value method for a hedge of a forecasted foreign currency denominated sale with a purchased option

ABC Corp.'s functional currency is the US dollar.

On January 1, Year 1, ABC forecasts a sale on credit for 10,000,000 euros (€). The sale is expected to occur on December 31, Year 1.

ABC purchases a European style put option for \$442,000 for €10,000,000 notional amount with an exercise rate of €1 = \$0.90.

ABC designates a cash flow hedge of the functional currency equivalent cash flows due to a depreciation of the euro below \$0.90 from the date the sale is forecasted to be probable through the expected sale date.

The following additional facts are relevant.

- ABC expects this hedging relationship to be perfectly effective in hedging against a depreciation of the euro below \$0.90. This is because the critical terms of the forecasted transaction match the critical terms of the put option (notional amount, underlying, maturity and strike price of the specified exposure level being hedged).
 - ABC will assess effectiveness based on the terminal value method.
 - The put option is expected to generate cash flows at maturity that offset the change in cash flows of the hedged sale for the risk being hedged.
 - Based on these factors and the option's single exercise date at maturity, ABC will not record any portion of the option's cost or change in fair value in earnings until the forecasted sale affects earnings.
- The €/ \$ spot rate and fair value of the put option are as follows.

Spot rate €/ \$	Fair value of put option ¹	Change in fair value of put option gain (loss)

January 1, Year 1	0.90	\$442,000	N/A
March 31, Year 1	0.88	491,000	\$49,000
June 30, Year 1	0.92	211,000	(280,000)
September 30, Year 1	0.89	261,000	50,000
December 31, Year 1	0.84	600,000	339,000
Note:			
1. The fair value of the put option is based on an option pricing model.			

- The put option settles on December 31, Year 1 with ABC receiving \$600,000.
 - Also on December 31, Year 1, the forecasted sale occurs.
- For simplicity, this example makes the following assumptions.
- It ignores the effect of commissions and other transaction costs, initial margins and income taxes.
 - The hedging relationship is perfectly effective.

Journal entry – January 1, Year 1

ABC records the following journal entries at January 1, Year 1.

	Debit	Credit
Put option	442,000	
Cash		442,000
<i>To record purchase of put option at fair value.</i>		

There would also be a memorandum entry made on January 1, Year 1 documenting the existence of this hedging relationship.

Journal entries – March 31, Year 1

ABC records the following journal entry.

	Debit	Credit
Put option	49,000	
OCI – Gains (losses) on cash flow hedging derivatives		49,000
<i>To record change in fair value of derivative for which hedge accounting is applied.</i>		

Journal entries – June 30, Year 1

ABC records the following journal entry.

	Debit	Credit
OCI – Gains (losses) on cash flow hedging derivatives	280,000	
Put option		280,000

	Debit	Credit
<i>To record change in fair value of derivative for which hedge accounting is applied.</i>		

Journal entries – September 30, Year 1

ABC records the following journal entry.

	Debit	Credit
Put option	50,000	
OCI – Gains (losses) on cash flow hedging derivatives		50,000
<i>To record change in fair value of derivative for which hedge accounting is applied.</i>		

Journal entries – December 31, Year 1

ABC records the following journal entries.

	Debit	Credit
Accounts receivable	8,400,000	
Sales revenue		8,400,000
<i>To record sale on credit.¹</i>		
Put option	339,000	
OCI – Gains (losses) on cash flow hedging derivatives		339,000
<i>To record change in fair value of derivative for which hedge accounting is applied.</i>		
Cash	600,000	
Put option		600,000
<i>To record cash received from settlement of put option.</i>		
AOCI – Gains (losses) on cash flow hedging derivatives	158,000	
Sales revenue		158,000
<i>To reclassify net derivative gain from AOCI into earnings because hedged transaction (sale) affected earnings.²</i>		
Notes:		
1. €10,000,000 sale price x €/€ spot rate of 0.84.		
2. \$600,000 settlement - purchase price \$442,000.		

Financial statement excerpts

At the end of each period, ABC's financial statements reflect the following related to this hedging relationship.

Account	3 months ended Mar 31	6 months ended Jun 30	9 months ended Sep 30	Year ended Dec 31
Balance sheet – assets				
Put option	\$491,000	\$211,000	\$261,000	-
Balance sheet – equity				
AOCI – Gains (losses) on cash flow hedging derivatives	\$49,000	\$(231,000)	\$(181,000)	-
Income statement				
Sales revenue	-	-	-	\$8,558,000

At December 31, Year 1, ABC records a sale of \$8,400,000 along with a gain on the put option of \$158,000 for a total of \$8,558,000 for the hedged €10,000,000 sale.

The difference between the functional currency equivalent value of \$9,000,000 at the forecast date ($\text{€}10,000,000 \times \$0.90$ spot rate at the forecast date) and the net recorded amount of \$8,558,000 is the cost of the put option (\$442,000). Absent this hedge, ABC would have recorded only the sale of \$8,400,000 and would have had an economic loss of \$600,000 due to unhedged changes in the foreign exchange rate from the forecasted date.

The put option was effective at hedging functional currency equivalent cash flows for a depreciation of the euro below \$0.90. As a result of the hedge, ABC's net effect on earnings attributable to changes in the foreign currency exchange rate during the forecasted period was the cost of the put option (\$442,000) rather than the full effect of depreciation in the euro during the forecasted period (\$600,000).

Options with periodic (multiple) settlements

Certain purchased option contracts comprise a series of contracts, each with a potential cash flow, that are used to hedge a series of forecasted transactions. For example, a purchased cap comprises a series of purchased caplets that may be used to hedge a series of hedged transactions (such as caplets that hedge a series of interest payments at different quarterly dates). When that type of option is designated as the hedging instrument in a cash flow hedge, the entity may focus on the terminal value of each caplet (i.e. the expected future pay-off amount at the maturity date of each caplet) in determining whether each of those hedging relationships is expected to be highly effective in achieving offsetting cash flows. [815-20-25-128]

As with other cash flow hedging relationships, the net derivative gain or loss that is reported in AOCI is reclassified into earnings when the hedged transaction affects earnings when the terminal value method is used. When the caplet method is used, because the amount in AOCI is a net amount that comprises both derivative gains and derivative losses, the original allocated fair value amount for an individual caplet that is reclassified out of AOCI into earnings may be greater than the net amount in AOCI.

As discussed in section 10.3.20, Topic 815 provides guidance for accounting for an initial non-zero fair value when a single derivative is used to hedge the variability in multiple cash flows or periodic settlements (e.g. purchased caps). In those situations, amounts in AOCI that are related to the initial fair value are required to be reclassified to earnings on a systematic and rational basis over the periods during which the hedged transactions affect earnings. One acceptable method for reclassification is the caplet method (see Question 10.3.50). [815-30-35-41A – 35-41B]



Example 13.7.30

Using the caplet method to reclassify amounts from AOCI into earnings

ABC Corp. documents a single interest rate cap as the hedging instrument in a hedge of the interest rate risk on variable-rate debt with quarterly interest payments over the next two years. ABC will use the terminal value method for assessing effectiveness and the conditions that will result in perfect effectiveness are met.

ABC allocates the fair value of the cap at the inception of the hedging relationship to the respective caplets within the single cap on a fair value basis at the inception of the hedging relationship. ABC reclassifies that original allocated fair value amount out of AOCI into earnings when each of the respective hedged transactions (the eight interest payments) affects earnings.

Because the amount in AOCI is a net amount that comprises both derivative gains and derivative losses, the original allocated fair value amount for an individual caplet that is reclassified out of AOCI into earnings may be greater than the net amount in AOCI.

See also Scenario 3 of Example 10.3.30.

13.7.30 Hypothetical derivative method

As mentioned in section 13.7.10, the hypothetical derivative method is used in practice for all types of cash flow hedges.

The following table summarizes the hypothetical derivative method.

Conditions that will result in perfect effectiveness: [815-20-25-3(b)(2)(iv)(01)(F)]	— The critical terms of the hedging instrument match the related terms of the hedged transaction (that is, the terms of the actual hedging instrument and the perfectly effective hypothetical derivative are the same). — The fair value of a PEH derivative (when the hedging instrument is a swap or a forward contract) is zero at hedge inception. — See also Question 13.2.50 regarding whether subsequent assessments are performed on a qualitative or quantitative basis.
What is compared in assessing effectiveness: [815-30-35-25]	— The change in fair value of the actual hedging instrument. — The change in fair value for a hypothetical derivative that would result in perfect offset (the PEH derivative).

The PEH derivative instrument is one whose terms identically match the terms of the forecasted transaction. Therefore, the hypothetical derivative would be expected to perfectly offset the hedged cash flows. The change in the fair value of the PEH derivative can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction when assessing effectiveness.

The fair values of both the PEH interest rate swap and the actual interest rate swap should use discount rates based on the relevant interest rate swap curves, as appropriate. As discussed in Question 13.2.300, under the hypothetical derivative method, an entity is permitted to use the same credit risk adjustment that is used to determine the fair value of the derivative when calculating the change in the cash flows of the hedged transaction, as long it is probable that the counterparty to the derivative or the entity will not default. As a result, credit risk (or the entity's own nonperformance risk) and changes therein do not affect hedge effectiveness. [815-30-35-29]

If the original terms of the forecasted transaction change during the hedge period, but the original transaction is still probable as described in the original hedge documentation, the terms of the PEH derivative are changed to perfectly offset the new terms of the transaction – i.e. the PEH derivative would be reset to the new terms of the transaction with a start date equal to the original date of the hedging relationship, and a fair value of zero if the hedging instrument is a swap or forward contract.

This method is relatively operational because entities are likely to be able to value cash flows that are identical to the variable-rate asset or liability being hedged without difficulty.

See also section 13.7.40 for discussion of applying the PEH derivative method when an interest rate swap is used in a cash flow hedge of variability in interest receipts or payments.



Question 13.7.30

Can the hypothetical derivative method result in perfect effectiveness when the hedging instrument is not an interest rate swap and the hedged risk is not variability in interest receipts or payments?

Interpretive response: Yes. Topic 815 only specifies that the hypothetical derivative method may result in perfect effectiveness when an interest rate swap is used in a cash flow hedge of variability in interest receipts or payments. However, we believe the same result will occur for all types of cash flow hedging relationships that use the hypothetical derivative method.

That is, when the critical terms of the actual hedging instrument match those of the perfectly effective hypothetical derivative, the hedging relationship will be perfectly effective.

In these situations, we believe the entity is not required to perform the actual calculation. This is because when the variables to be compared are identical, the results of the calculation are known with mathematical certainty without performing the full calculation (see Question 13.6.80).



Question 13.7.40

How is the PEH derivative defined when a cross-currency interest rate swap is used to hedge intercompany fixed-rate debt in a cash flow hedge?

Interpretive response: There are unique considerations when applying the hypothetical derivative method for assessing effectiveness when a fixed-for-fixed cross-currency interest rate swap is used to hedge intercompany fixed-rate debt. This is because – under Topic 830 (foreign currency matters) – the intercompany interest is eliminated in consolidation while the effect of foreign currency exposure of the intercompany principal is not.

In a cash flow hedge of the foreign currency risk associated with foreign currency denominated (FCD) debt issued by a third party where the hedging instrument is a fixed-for-fixed cross-currency interest rate swap, the PEH derivative has a zero fair value at inception of the hedging relationship and the terms would match the terms of the hedged transactions.

However, judgment is required in defining the hypothetical derivative when the FCD debt is intercompany.

We believe there are two acceptable approaches that an entity may consider when determining the terms of the PEH derivative.

Approach 1: Define the hedged risk as solely the foreign currency risk associated with the principal amount of the intercompany debt

Under this approach, the PEH derivative would be defined as a forward contract that exactly matches the principal amount of the intercompany debt. In this situation, the foreign currency risk inherent in that principal amount is a risk that

affects consolidated earnings during the life of the hedging relationship under Topic 830, even though the debt and the interest payments on that debt are eliminated in consolidation.

This approach does *not* include the foreign currency risk related to the interest payments on the intercompany debt because they are eliminated in consolidation. Accordingly, under Topic 830, foreign currency risk affects consolidated earnings only when interest payments are accrued but unpaid.

Under this approach, the relationship may not be highly effective due to the changes in fair value of the net coupon payments included in the hedging instrument (i.e. the fixed-for-fixed cross-currency interest rate swap) that would not be included in the hypothetical derivative.

Approach 2: Define the hedged risk as the foreign currency risk associated with both (a) the principal amount of the intercompany debt and (b) the forecasted interest payments on the intercompany debt

Under this approach, the PEH derivative is defined as a fixed-for-fixed cross-currency interest rate swap that exactly matches the principal amount of the intercompany debt and the forecasted interest payments of the intercompany debt. In this situation, the foreign currency risk inherent in the principal amount is a risk that under Topic 830 affects consolidated earnings during the life of the hedging relationship and the foreign currency risk inherent in the forecasted interest payments will eventually affect earnings as each interest payment is accrued.

While the foreign currency risk related to each interest payment does not affect earnings until it is accrued, we believe this approach is acceptable by analogy to paragraph 815-20-25-38(d) (reproduced in section 11.6.20). That paragraph permits an entity to hedge the foreign currency risk related to the forecasted sale to a foreign subsidiary or the forecasted royalty from a foreign subsidiary. With the forecasted sale to or royalty from a foreign subsidiary, foreign currency risk does not affect consolidated earnings until either the sale is recorded as a payable/receivable or the royalty is earned and recorded as a payable/receivable.

When an entity uses this approach, we believe amounts should be reclassified from AOCI into earnings in a pattern that is identical to the one that would be used if the debt were issued to a third party (and interest payments were not eliminated in consolidation). Reclassifying in this manner is necessary so that the AOCI balance at the end of the hedged period for the hedging relationship is zero.

However, these reclassifications will introduce volatility in consolidated earnings because the interest payments will only affect consolidated earnings for the risk being hedged (foreign currency risk) from the time they are accrued until the time they are paid.

FASB Example: Effectiveness of cash flow hedge of a forecasted purchase of inventory with a forward contract



Excerpt from Subtopic 815-30

>> Example 1: Effectiveness of Cash Flow Hedge of a Forecasted Purchase of Inventory with a Forward Contract

55-1A This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to assessing effectiveness for a cash flow hedge of a forecasted purchase of inventory with a forward contract in which the forward contract index differs from the index of the underlying hedged transaction. Assume that the entity elected to perform subsequent quarterly hedge effectiveness assessments on a quantitative basis and that all hedge documentation requirements were satisfied at inception.

55-2 Entity G forecasts the purchase of 500,000 pounds of Brazilian coffee for U.S. dollars in 6 months. The agreement outlining purchase terms between Entity G and its supplier contains a **contractually specified component** referencing a Brazilian coffee index denominated in U.S. dollars. Entity G designates the variability in cash flows related to its forecasted purchase of Brazilian coffee attributable to changes in the contractually specified component (Brazilian coffee index) as the hedged risk. Rather than acquire a **derivative instrument** based on Brazilian coffee, Entity G enters into a 6-month forward contract to purchase 500,000 pounds of Colombian coffee for U.S. dollars and designates the forward contract as a hedging instrument in a cash flow hedge of the variability in cash flows attributable to changes in the contractually specified Brazilian coffee index component of its forecasted purchase of Brazilian coffee.

55-3 Entity G bases its assessment of hedge effectiveness on changes in forward prices, with the resulting gain or loss discounted to reflect the time value of money. Both at inception and on an ongoing basis, Entity G could assess the effectiveness of the hedge by comparing changes in the expected cash flows from the Colombian coffee forward contract with the expected net change in cash outflows attributable to changes in the contractually specified component for purchasing the Brazilian coffee for different market prices. (A simpler method that should produce the same results would consider the expected future correlation of the prices of Brazilian and Colombian coffee, based on the correlation of those prices over past six-month periods.)

55-4 In assessing hedge effectiveness on an ongoing basis, Entity G also must consider the extent of offset between the change in expected cash flows on its Colombian coffee forward contract and the expected net change in expected cash flows for the forecasted purchase of Brazilian coffee attributable to changes in the contractually specified component. Both changes would be measured on a cumulative basis for actual changes in the forward price of the respective coffees during the hedge period.

55-5 See Topic 820 (including paragraph 820-10-55-13) for a discussion of expected cash flow.

55-6 Because the only difference between the forward contract and forecasted purchase relates to the type of coffee (Colombian versus Brazilian), Entity G could consider the changes in the cash flows on a forward contract for Brazilian coffee to be a measure of perfectly offsetting changes in cash flows for its forecasted purchase of Brazilian coffee. For example, for given changes in the U.S. dollar prices of six-month and three-month Brazilian and Colombian contracts, Entity G could compute the effect of a change in the price of coffee on the expected cash flows of its forward contract on Colombian coffee and of a forward contract for Brazilian coffee as follows.

	Estimate of Change in Cash Flows	
	<i>Hedging Instrument: Forward Contract on Colombian Coffee</i>	<i>Estimate of Forecasted Transaction: Forward Contract on Brazilian Coffee</i>
Forward price of Colombian and Brazilian coffee:		
At hedge inception—6-month price	\$ 2.54	\$ 2.43
3 months later—3-month price	2.63	2.53
Cumulative change in price—gain	\$ 0.09	\$ 0.10
x 500,000 pounds of coffee	x 500,000	x 500,000
Estimate of change in cash flows	\$ 45,000	\$ 50,000

55-7 See Topic 820 (including paragraph 820-10-55-13) for a discussion of expected cash flows.

55-8 Using the amounts in paragraph 815-30-55-6, Entity G could evaluate effectiveness 3 months into the hedge on its first subsequent quarterly effectiveness assessment testing date by comparing the \$45,000 change on its Colombian coffee contract with what would have been a perfectly offsetting change in cash flow for its forecasted purchase—the \$50,000 change on an otherwise identical forward contract for Brazilian coffee. Entity G concludes that the hedging relationship would be highly effective, and it would record the \$45,000 change in the fair value of the forward contract on Colombian coffee in other comprehensive income.

13.7.40 Methods applicable when an interest rate swap is used in a cash flow hedge of variability in interest receipts or payments



Excerpt from ASC 815-30

>> Assessing Hedge Effectiveness in Certain Cash Flow Hedges Involving Interest Rate Risk When Effectiveness Is Assessed on a Quantitative Basis

35-10 This guidance addresses the following three methods of assessing effectiveness of certain cash flow hedges when hedge effectiveness is assessed on a quantitative basis in accordance with paragraphs 815-20-25-3(b)(2)(iv)(01) and 815-20-35-2 through 35-2F:

- a. Change-in-variable-cash-flows method
- b. Hypothetical-derivative method
- c. Change-in-fair-value method

35-11 Those three methods relate to assessing the effectiveness of a cash flow hedge that involves any of the following:

- a. A receive-variable, pay-fixed interest rate swap designated as a hedge of the variable interest payments on an existing floating-rate liability
- b. A receive-fixed, pay-variable interest rate swap designated as a hedge of the variable interest receipts on an existing variable-rate asset
- c. Cash flow hedges of the variability of future interest payments on interest-bearing assets to be acquired or interest-bearing liabilities to be incurred (such as the rollover of an entity's short-term debt as described in Example 9 [see paragraph 815-30-55-52]).

35-12 The hedging relationships covered by this guidance encompass either of the following:

- a. Hedges of interest rate risk (pursuant to paragraph 815-20-25-15(j)(2)) that do not qualify for the shortcut method
- b. Hedges of the risk of overall changes in the hedged cash flows related to the asset or liability (pursuant to paragraph 815-20-25-15(j)(1)).

35-13 If, at the inception of the hedge, the fair value of the interest rate swap designated as the hedging instrument is zero or is somewhat near zero, any of the three methods in paragraph 815-30-35-10 may be applied to assess hedge effectiveness.

35-14 In contrast, if, at the inception of the hedge, the fair value of the interest rate swap is not somewhat near zero, the change-in-variable-cash-flows method shall not be applied to assess hedge effectiveness because that method does not require entities to consider the interest element of the change in fair value of a hedging instrument that incorporates a financing element; instead, either the hypothetical-derivative method or the change-in-fair-value method shall be applied. Those latter two methods require entities to consider the interest element of the change in fair value of a hedging instrument that incorporates a financing element that is not somewhat near zero, such as if the interest rate swap has been structured to be significantly in the money at the inception of the hedging relationship.

35-15 Under all three methods, an entity shall consider the risk of default by counterparties that are obligors with respect to the hedging instrument (the interest rate swap) or hedged transaction, pursuant to the guidance in paragraphs 815-20-25-122 and 815-20-25-16(a), respectively. An underlying assumption in this guidance is that the likelihood of the obligor not defaulting is assessed as being probable.

35-15A When assessing hedge effectiveness using any of the three methods specified in paragraph 815-30-35-10, in addition to the guidance specific to each method, an entity also shall apply the general guidance in paragraph 815-

20-25-79 on prospective considerations and retrospective evaluations of hedge effectiveness.

When a cash flow hedging relationship that involves an interest rate swap and variability in interest receipts or payments is not eligible for (or the entity does not elect) the shortcut method (see section 13.3), an entity is required to perform periodic assessments of effectiveness.

Topic 815 describes three methods that may be elected for certain of those hedging relationships, which are summarized in the following table. Alternatively, an entity may choose to use methods that have developed in practice, such as projecting cash flows based on forward price curves (see section 13.7.50). [815-30-35-10 – 35-14, 815-20-25-15(j)(1) – 25-15(j)(2)]

Hedged risks	Hedged transactions	Methods for assessing effectiveness
% Interest rate risk (see sections 6.3.20 and 9.4) - Contractually specified interest rate on existing variable-rate financial instruments or on forecasted issuances or purchases of variable-rate financial instruments - Benchmark interest rate on forecasted issuances or purchases of fixed-rate debt instruments Price risk – i.e. overall changes in the hedged cash flows (see section 6.3.70)	- An interest rate swap is used in a hedge of variable interest payments on an existing variable-rate asset or liability - A hedge of the variability of future interest payments on interest-bearing assets to be acquired or interest-bearing liabilities to be incurred such as the rollover of an entity's short-term debt as described in Subtopic 815-30's Example 9 (reproduced in section 10.5.10) - These hedged transactions are referred to collectively in this section as 'variability in interest receipts or payments'	Methods described in Topic 815: - If the initial fair value is zero (or somewhat near zero): - Change-in-variable-cash-flows method - Hypothetical derivative method - Change-in-fair-value method - If the initial fair value is <i>not</i> zero (or somewhat near zero): - Hypothetical derivative method - Change-in-fair-value method

Change-in-variable-cash-flows method



Excerpt from ASC 815-30

>>> Change-in-Variable-Cash-Flows Method

35-16 An entity shall assess hedge effectiveness under the change-in-variable-cash-flows method by comparing the following items:

- a. The variable leg of the interest rate swap
- b. The hedged variable-rate cash flows on the asset or liability.

35-17 As noted in paragraph 815-30-35-14, the change-in-variable-cash-flows method shall not be used in certain circumstances.

35-18 The change-in-variable-cash-flows method is consistent with the cash flow hedge objective of effectively offsetting the changes in the hedged cash flows attributable to the hedged risk. The method is based on the premise that only the floating-rate component of the interest rate swap provides the cash flow hedge, and any change in the interest rate swap's fair value attributable to the fixed-rate leg is not relevant to the variability of the hedged interest payments (receipts) on the floating-rate liability (asset).

35-19 An entity shall assess hedge effectiveness under this method by comparing the following amounts:

- a. The present value of the cumulative change in the expected future cash flows on the variable leg of the interest rate swap
- b. The present value of the cumulative change in the expected future interest cash flows on the variable-rate asset or liability.

35-20 Because the focus of a cash flow hedge is on whether the hedging relationship achieves offsetting changes in cash flows, if the variability of the hedged cash flows of the variable-rate asset or liability is based solely on changes in a variable-rate index, the present value of the cumulative changes in expected future cash flows on both the variable-rate leg of the interest rate swap and the variable-rate asset or liability shall be calculated using the discount rates applicable to determining the fair value of the interest rate swap.

35-22 The change-in-variable-cash-flows method will result in a perfectly effective hedge if all of the following conditions are met:

- a. The variable-rate leg of the interest rate swap and the hedged variable cash flows of the asset or liability are based on the same interest rate index (for example, three-month London Interbank Offered Rate (LIBOR) swap rate).
- b. The interest rate reset dates applicable to the variable-rate leg of the interest rate swap and to the hedged variable cash flows of the asset or liability are the same.
- c. The hedging relationship does not contain any other basis differences (for example, if the variable leg of the interest rate swap contains a cap and the variable-rate asset or liability does not).
- d. The likelihood of the obligor not defaulting is assessed as being probable.

35-23 However, a hedge would not be perfectly effective if any basis differences existed. For example, this would be expected to result from either of the following conditions, among others:

- a. A difference in the indexes used to determine cash flows on the variable leg of the interest rate swap (for example, the three-month U.S. Treasury rate) and the hedged variable cash flows of the asset or liability (for example, three-month LIBOR)

- b. A mismatch between the interest rate reset dates applicable to the variable leg of the interest rate swap and the hedged variable cash flows of the hedged asset or liability.

35-24 Example 15 (see paragraph 815-30-55-91) illustrates the application of the change-in-variable-cash-flows method.

The objective of a cash flow hedge is to offset the changes in the hedged cash flows related to the hedged risk. The change-in-variable-cash-flows method is most consistent with that objective. [\[815-30-35-18\]](#)

The following table summarizes the change-in-variable-cash-flows method.

Conditions for applying this method: [815-30-35-14, 35-17]	— This method may not be used if the fair value of the swap is not zero or somewhat near zero at inception of the hedge since this method does not require an entity to consider the interest element of the change in fair value of a hedging instrument that incorporates a financing element.
Conditions that will result in perfect effectiveness: [815-30-35-22]	— The variable-rate leg of the swap and the hedged variable cash flows of the asset or liability are based on the same interest rate index. — The interest rate reset dates that apply to the variable-rate leg of the swap and to the hedged variable cash flows of the asset or liability are the same. — The payment dates on the swap and hedged variable cash flows are the same. — The hedging relationship does not contain any other basis differences. — The likelihood of the obligor not defaulting is assessed as being probable. — See also Question 13.2.50 regarding whether subsequent assessments are performed on a qualitative or quantitative basis.
What is compared in assessing effectiveness: [815-30-35-16, 35-19]	— The present value¹ of the cumulative change in the expected future cash flows on the variable leg of the swap. — The present value¹ of the cumulative change in the expected future interest cash flows on the floating-rate asset or liability.
Note: 1. When determining the present values, the discount rates should be the rates that would be used to determine the fair value of the swap. [815-30-35-20]	

The theory behind this methodology is that the cash flow hedge is accomplished primarily through the variable leg of the interest rate swap. Therefore, the hedge's effectiveness should not be affected by the change in fair value that is attributable to the fixed leg portion of the swap. Said differently, only the floating-rate component of the swap provides the cash flow hedge and any change in the swap's fair value that is attributable to the fixed-rate leg is not relevant to the variability of the hedged interest payments (receipts) on the floating-rate liability (asset). [\[815-30-35-18\]](#)

Perfect effectiveness will not result if any of the conditions specified in the table are not met. The following are examples.

- Any basis differences exist. For example, difference in the indices used to determine cash flows on the variable leg of the swap (e.g. the three-month Treasury rate) and the hedged variable cash flows of the asset or liability (e.g. three-month LIBOR).
- There is a mismatch between the interest rate reset dates that apply to the variable leg of the swap and the hedged variable cash flows of the hedged asset or liability.

FASB Example: Change-in-variable-cash-flows method for assessing hedge effectiveness



Excerpt from ASC 815-30

>>>> Example 15: Change-in-Variable-Cash-Flows Method for Assessing Hedge Effectiveness

55-91 This Example demonstrates the application of the change-in-variable-cash-flows method discussed in paragraph 815-30-35-16 to assess hedge effectiveness.

55-92 An entity designates a receive-variable, pay-fixed interest rate swap with a zero fair value as a hedge of variable interest rate payments on a debt instrument. The variable leg of the interest rate swap is based on the three-month U.S. Treasury rate, and the variable cash flows of the debt are based on three-month LIBOR. Assume that the overall change in fair value of the interest rate swap from inception of the hedge is \$16,300, the present value of the cumulative change in the cash flow on the variable leg of the interest rate swap is a gain (increased cash inflow) of \$16,596, and the present value of the cumulative change in the expected future interest cash flows on the variable-rate liability due to changes in the cash flows expected for the remainder of the hedge term is a loss (increased cash outflow) of \$16,396. (The cumulative changes in expected future cash flows on both the variable leg of the interest rate swap and the variable-rate debt are discounted using the rates applicable to determining the fair value of the derivative instrument.)

55-93A The entity assesses effectiveness by comparing the present value of the cumulative change in the cash flow on the variable leg of the interest rate swap of \$16,596 with the present value of the cumulative change in the expected future interest cash flows on the variable-rate liability of \$16,396 and concludes that the hedging relationship is highly effective. As a result, the balance in accumulated other comprehensive income would reflect the cumulative change in the fair value of the swap since hedge inception (\$16,300).

Hypothetical derivative method



Excerpt from ASC 815-30

>>> Hypothetical-Derivative Method

35-25 An entity shall assess hedge effectiveness under the hypothetical-derivative method by comparing the following amounts:

- a. The change in fair value of the actual interest rate swap designated as the hedging instrument
- b. The change in fair value of a hypothetical interest rate swap having terms that identically match the critical terms of the floating-rate asset or liability, including all of the following:
 1. The same **notional amount**
 2. The same repricing dates
 3. The same index (that is, the index on which the hypothetical interest rate swap's variable rate is based matches the index on which the asset or liability's variable rate is based)
 4. Mirror image caps and floors
 5. A zero fair value at the inception of the hedging relationship.

35-26 Essentially, the hypothetical derivative would need to satisfy all of the applicable conditions in paragraphs 815-20-25-104 and 815-20-25-106 necessary to qualify for use of the shortcut method except the criterion in paragraph 815-20-25-104(e). Thus, the hypothetical interest rate swap would be expected to perfectly offset the hedged cash flows. Because the requirements of paragraph 815-20-25-104(e) were developed with an emphasis on fair value hedging relationships, they do not fit the more general principle that the hypothetical derivative in a cash flow hedging relationship should be expected to perfectly offset the hedged cash flows.

35-27 The change in the fair value of the perfect hypothetical interest rate swap can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction.

35-29 The determination of the fair value of both the perfect hypothetical interest rate swap and the actual interest rate swap shall use discount rates based on the relevant interest rate swap curves.

Section 13.7.30 describes the hypothetical derivative method.

To use the hypothetical derivative method in cash flow hedges of variability in interest receipts or payments, the terms of a PEH interest rate swap need to match the critical terms of the variable-rate asset or liability. Specifically, the following terms of the PEH swap need to identically match those of the hedged transaction: [\[815-30-35-25\]](#)

- same notional amount;
- same repricing dates;
- the index on which the hypothetical swap's variable rate is based matching the index on which the asset or liability's variable rate is based;
- mirror image caps and floors; and

— a zero fair value at the inception of the hedging relationship.

Essentially, the PEH derivative needs to satisfy all of the applicable conditions for the shortcut method (see section 13.3), except that the PEH is not required to include a mirror-image call or put option, as explained in Subtopic 815-20's Example 7 (reproduced below). If these terms match, the PEH swap is expected to perfectly offset the hedged cash flows. As a result, the change in the fair value of the PEH swap can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction. [815-30-35-26 – 35-27]

As discussed in Question 13.2.300, under the hypothetical derivative method, an entity is permitted to use the same credit risk adjustment that is used to determine the fair value of the derivative when calculating the change in the cash flows of the hedged transaction, as long as it is probable that the counterparty to the derivative or the entity will not default. As a result, credit risk (or the entity's own nonperformance risk) and changes therein do not affect hedge effectiveness. [815-30-35-29]

If the actual hedging instrument meets the above conditions (i.e. if all of the critical terms match), the hedging relationship will result in perfect effectiveness. [815-20-25-3(b)(2)(iv)(01)(F)]



Question 13.7.50

How is the PEH derivative defined when a deal contingent swap is used to hedge a forecasted debt issuance contingent on a business combination?

Background: As discussed in Question 6.5.60, we believe it could be acceptable to hedge the forecasted issuance of debt that is contingent on consummation of a business combination if the forecasted transaction does not directly affect the purchase price or the purchase accounting associated with the acquisition. An entity may wish to use a deal contingent forward-starting interest rate swap as the hedging instrument in such a relationship.

Interpretive response: When an entity hedges a forecasted debt issuance that is contingent on a business combination, we believe the PEH derivative is a forward-starting interest rate swap whose critical terms match those of the forecasted debt issuance and does *not* include a deal contingency.

Whether the entity will consummate a business combination is considered when determining whether the forecasted debt issuance is probable, which is a necessary condition for applying cash flow hedge accounting. Because the terms of the debt, once issued, will not be contingent on the business combination occurring, the PEH derivative should also not include a contingency related to consummation of the business combination.

If the actual derivative hedging instrument includes a deal contingency, the hedging relationship will not be perfectly effective because the deal contingency will be considered when measuring the expected cash flows of the actual derivative – but not when measuring the expected cash flows of the PEH derivative.

Examples

Following are examples that demonstrate the hypothetical derivative method when an interest rate swap is used to hedge variability in interest cash flows.

- PEH swap in a hedge of variable-rate debt that contains a floor (Example 13.7.40).
- Determination of the appropriate hypothetical derivative for variable-rate debt that is prepayable at par at each interest reset date (Subtopic 815-20's Example 7).



Example 13.7.40

PEH swap in a hedge of variable-rate debt that contains a floor

ABC Corp. issues variable-rate debt that pays interest at the Prime rate (a contractually specified interest rate) plus a fixed credit spread. The debt agreement provides that the Prime rate can never be negative – i.e. it has a floor of zero. The floor was included in the debt agreement so that the lender receives a minimum amount of interest (i.e. the initial credit spread) and never has to make an interest payment to ABC.

ABC enters into an interest rate swap to hedge its exposure to variability in interest cash flows caused by changes in the benchmark interest rate. However, the variable leg of the interest rate swap does not have a matching floor of zero. ABC documents the interest rate swap as a hedge of its exposure to changes in the variable benchmark rate above the floor of zero.

Because the interest rate swap has no matching floor, ABC is precluded from using the shortcut method, and the hedging relationship will not have perfect offset. ABC documents that it will use the hypothetical derivative method to assess effectiveness.

The PEH swap incorporates terms that identically match the critical terms of the debt instrument and have an initial fair value of zero. The PEH swap will have the following differences from the actual hedging instrument.

- The PEH swap will incorporate a floor.
- As a result of the floor, the PEH swap will also likely have a different fixed leg than the actual swap so that the PEH swap will have an initial fair value of zero.

These differences from the actual swap are required to be considered when assessing whether the hedging relationship is highly effective.

It is not necessary for the Prime rate to actually decline below zero for this relationship to lack perfect offset. The mere potential for negative interest rates results in a lack of perfect offset because the probability of a negative benchmark rate is considered as part of determining the fair value of the PEH swap that contains the floor.

See also Example 10.2.20 for an example of accounting for a cash flow hedge of variable-rate debt when the hedging instrument (i.e. an interest rate swap)

has a cap and a floor but the hedged transaction (i.e. variable-rate debt) does not.



Excerpt from ASC 815-20

>> Example 7: Determination of the Appropriate Hypothetical Derivative for Variable-Rate Debt That Is Prepayable at Par at Each Interest Reset Date

55-106 This Example illustrates the application of paragraph 815-20-25-20.

55-107 Entity A issues variable-rate debt that is prepayable at par on each interest rate reset date. The credit sector spread on the debt issuance is not reset on the interest rate reset dates. Specifically, the debt bears interest at a rate of LIBOR plus 100 basis points, with LIBOR reset every quarter. Entity A also enters into a receive-variable, pay-fixed interest rate swap that is designated as a hedge of the variability in the debt interest payments due to changes in the contractually specified interest rate (LIBOR). During the term of the hedging relationship (that is, the specific term of the interest rate swap), Entity A expects to issue new variable-rate debt (in the event the original debt is repaid before maturity) to maintain an aggregate debt principal balance equal to or greater than the notional amount of the interest rate swap, and expects the new debt (if any) to share the key characteristics of the original debt issuance (specifically, quarterly repricing to the LIBOR index and no minimum, maximum, or periodic constraints of the debt interest rate). The hedging relationship meets all of the criteria for shortcut method accounting beginning in paragraph 815-20-25-102 except for the criterion in paragraph 815-20-25-104(e); the debt is prepayable and the interest rate swap does not contain a mirror-image call option to match the call option embedded in the debt instrument, as required by that paragraph.

55-108 Entity A wishes to apply the hypothetical derivative method (as described beginning in paragraph 815-30-35-25) for its initial and subsequent quantitative assessments of hedge effectiveness. Because the actual interest rate swap used in Entity A's hedging relationship already meets all of the criteria in paragraph 815-20-25-102 except the criterion in paragraph 815-20-25-104(e), this guidance would seem to suggest that the hypothetical interest rate swap would need to be the same as the actual interest rate swap except that a mirror-image call option would need to be added to meet the criterion in that paragraph and the guidance beginning in paragraph 815-30-35-10. However, Entity A observes that because the hedged transactions are the variable interest payments (on debt with a principal amount equal to the notional amount of the swap) due to changes in the contractually specified interest rate (LIBOR), and because the transaction had to be probable of occurring under paragraph 815-20-25-15(b) for it to qualify for hedge accounting, the actual swap would be expected to perfectly offset the hedged cash flows.

55-109 In this fact pattern, the hypothetical interest rate swap under the guidance beginning paragraph 815-30-35-10 would be the same as the actual

interest rate swap described in this Example. Because Entity A has concluded that if the original debt issuance is repaid before maturity, it is probable that a sufficient principal amount of variable-rate debt with key characteristics that match those of the original debt issuance (specifically quarterly repricing to the LIBOR index and no minimum, maximum, or periodic constraints of the debt interest rate) will be issued and remain outstanding during the term of the hedging relationship (providing exposure to LIBOR-interest-rate-based variable cash payments), the prepayment provisions of the debt instrument should not be considered in determining the appropriate hypothetical derivative under that guidance. The prepayment of the original variable-rate debt eliminates the contractual obligation to make those interest payments; however, this Subtopic permits replacing the hedged interest payments that are no longer contractually obligated to be paid without triggering the dedesignation of the original cash flow hedging relationship. Replacing the original debt issuance with a new variable-rate debt issuance is permissible in a cash flow hedge of interest rate risk and does not automatically result in the discontinuation of the original cash flow hedging relationship.

55-110 Although the entity can terminate the debt at any interest rate reset date for reasons that may be totally unrelated to changes in the contractually specified interest rate (which is the hedged risk), it expects to be at risk for variability in cash flows due to changes in the contractually specified interest rate in an amount based on debt principal equal to or greater than the notional amount of the swap during the specific term of the interest rate swap. Therefore, the prepayment feature of the debt is not relevant for purposes of determining the appropriate hypothetical swap under the guidance beginning in paragraph 815-30-35-10 as long as the relevant conditions to qualify for cash flow hedge accounting have been met with respect to the hedged transaction.

Change-in-fair-value method



Excerpt from ASC 815-30

>>> Change-in-Fair-Value Method

35-31 An entity shall assess hedge effectiveness under the change-in-fair-value method by comparing the following amounts:

- a. The present value of the cumulative change in expected variable future interest cash flows that are designated as the hedged transactions
- b. The cumulative change in the fair value of the interest rate swap designated as the hedging instrument.

35-32 The discount rates applicable to determining the fair value of the interest rate swap designated as the hedging instrument shall also be applied to the computation of present values of the cumulative changes in the hedged cash flows.

The following table summarizes the change-in-fair-value method.

What is compared in assessing effectiveness: [815-30-35-31]	— The present value¹ of the cumulative change in expected future cash flows related to the asset or liability being hedged - and — The cumulative change in the fair value of the swap designated as the hedging instrument
Note: 1. The discount rates for measuring the fair value of the swap are also applied to the computation of present values of the cumulative changes in the hedged cash flows, as long as it is probable that the counterparty to the swap or the entity will not default. [815-30-35-32]	

Even though the same discount rates are applied to the swap and the present value of the cumulative change in expected cash flows of the hedged transaction, this method appears to be the least desirable of the three methodologies described in Topic 815 for cash flow hedges of variability in interest receipts or payments because of the effect of fair valuing the fixed leg of the interest rate swap.

13.7.50 Project future cash flows using forward price curves or using recent sales or purchase orders

An entity may have the information available to use forward price curves to determine changes in the expected future cash flows of the hedged transaction. In these situations, that information can be used to estimate changes in expected future cash flows by performing the following steps.

- At the end of each reporting period, use the appropriate current forward price curve to determine the expected future cash flows for the remaining term to maturity.
- If the effectiveness technique requires a discounted value, discount those expected future cash flows. Because Topic 815 does not specify the rate to be used, an entity documents the discount rate it will use in its initial hedge documentation. See also section 13.2.110 regarding consideration of the time value of money for cash flow hedges.
- The difference between the amount calculated above (either discounted or undiscounted, as appropriate) for the current reporting period and the amount calculated at inception of the hedging relationship can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction.

When hedging a forecasted sale or purchase of certain nonfinancial assets, an entity may be required to estimate future sales or purchase prices because a market is not available to help make these estimates. An approach that would remove some of the inherent limitations in the entity's estimate involves basing the estimates on recent sales orders or purchase orders with similar terms to the terms of the hedged forecasted sale or purchase.



Example 13.7.50

Projecting future cash flows using recent purchase orders

On January 1, Year 1, ABC Co. enters into a hedgeable forecasted transaction to sell 10,000 widgets at the then-current market price one year into the future. To lock in the sales price of the widgets, ABC enters into a forward contract to sell 10,000 units for \$95,000, which represents the current selling price of widgets with terms that match the forecasted transaction (\$100,000) less a discount that represents the time value of money (\$5,000). This implies a current price for each widget on January 1, Year 1, of \$10 ($\$100,000 \div 10,000$).

On March 31, Year 1, ABC enters into purchase orders for widgets to be delivered in nine months for a similar number of units at a sales price of \$9.90 per unit. ABC could base its estimate of the cumulative change in cash flows of the forecasted sale of 10,000 units using \$1,000 ($10,000 \text{ units} \times \text{the difference between the original implied price of } \$10 \text{ less the current price of } \$9.90$).

13.8 Examples of effectiveness assessment methods relevant to various hedging instruments

Type of hedging relationship / Reference	Hedged item or transaction	Hedged risk	Method for assessing effectiveness	Comments
Interest rate swaps (section 6.6.20)				
Fair value (section 13.3)	Recognized interest-bearing asset or liability	Interest rate risk: Benchmark interest rate	Shortcut method (if certain criteria are met)	Assumes perfect effectiveness
Cash flow (section 13.3)	Variability in interest receipts or payments on recognized interest-bearing asset or liability	Interest rate risk: Contractually specified interest rate	Shortcut method (if certain criteria are met)	Assumes perfect effectiveness
Cash flow (section 13.7.40)	Variability in interest receipts or payments	Interest rate risk or Overall changes in the hedged cash flows (i.e. price risk)	Change-in-variable-cash-flows method	If the initial fair value is not zero (or somewhat near zero), this method may not be used. If certain conditions are met, this method will result in perfect effectiveness

Type of hedging relationship / Reference	Hedged item or transaction	Hedged risk	Method for assessing effectiveness	Comments
Cash flow (section 13.7.40)	Variability in interest receipts or payments	Interest rate risk or Overall changes in the hedged cash flows (i.e. price risk)	Hypothetical derivative method	If certain conditions are met, this method will result in perfect effectiveness
Cash flow (section 13.7.40)	Variability in interest receipts or payments	Interest rate risk or Overall changes in the hedged cash flows (i.e. price risk)	Change-in-fair-value method	
Fair value (sections 13.5 or 13.6)	Recognized interest-bearing asset or liability (or a firm commitment)	Interest rate risk: Benchmark interest rate	Other quantitative or qualitative method (if shortcut method is not appropriate or not selected)	Effectiveness may be assessed based on all contractual cash flows or on the benchmark interest rate component of contractual cash flows
Cash flow (sections 13.5 or 13.6; 13.2.110)	Variability in interest receipts or payments	Interest rate risk or Overall changes in the hedged cash flows (i.e. price risk)	Quantitative method	
Other swaps (e.g. commodity, equity and foreign currency) (section 6.6.20)				
Cash flow – cross-currency interest rate swap (section 13.4)	Fixed rate foreign currency denominated financial asset or liability	Foreign currency risk	Critical terms match	Assumes perfect effectiveness
Net investment hedge – eligible cross-currency interest rate swap (section 12.4)	Net investment in a foreign operation	Foreign currency risk	Spot method, forward method, or qualitative method	If certain conditions are met, the spot or forward methods will result in perfect effectiveness
Fair value or cash flow (sections 13.5 or 13.6)	Any eligible hedged item or transaction	Any eligible risk	Other quantitative or qualitative method	

Type of hedging relationship / Reference	Hedged item or transaction	Hedged risk	Method for assessing effectiveness	Comments
Forwards /futures contracts (section 6.6.20)				
Cash flow (section 13.4)	Any eligible forecasted transaction	Any eligible risk	Critical terms match	Assumes perfect effectiveness
Net investment hedge (section 12.4)	Net investment in a foreign operation	Foreign currency risk	Spot method, forward method, or qualitative method	If certain conditions are met, the spot or forward methods will result in perfect effectiveness
Fair value or cash flow (sections 13.5 or 13.6; 13.2.110)	Any eligible hedged item or transaction	Any eligible risk	Other quantitative or qualitative method	
Options, combinations of options, or combination of an option contract with a non-option derivative (<i>for written options</i> , section 6.7.50; <i>for combinations of options</i> , section 6.7.60)				
Cash flow (section 13.7.20)	Any eligible hedged transaction	Any eligible risk	Terminal value method	If certain conditions are met, this method will result in perfect effectiveness
Cash flow (section 13.4)	Any eligible hedged transaction	Any eligible risk	Critical terms match	Assumes perfect effectiveness
Fair value or cash flow (sections 13.5 or 13.6; 13.2.90; 13.2.110)	Any eligible hedged item or transaction	Any eligible risk	Other quantitative or qualitative method	
Net investment hedge (section 12.4)	Net investment in a foreign operation	Foreign currency risk	Spot method, forward method, or qualitative method	If certain conditions are met, the spot or forward methods will result in perfect effectiveness

13.9 Comparison of methods for assessing effectiveness

Shortcut method (section 13.3)	Critical terms match method (section 13.4)	Simplified hedge accounting approach (section 16.2)	Subsequent qualitative assessment approach (sections 12.4 and 13.5)	Quantitative methods (sections 12.4 and 13.6)
Types of hedging relationships				
Fair value or cash flow	Cash flow ¹	Cash flow	Fair value, cash flow or net investment hedges	Fair value, cash flow or net investment hedges
Initial effectiveness assessment				
Quantitative testing not required.	Quantitative testing not required.	Quantitative testing not required.	Quantitative testing required.	Quantitative testing required.
Nature of subsequent effectiveness assessments				
If the shortcut method requirements are met, the entity evaluates whether the credit risk of the counterparty to the derivative or its own nonperformance risk has changed such that it is no longer probable that the counterparty or it will not default. If neither party's credit risk has changed in this manner, no further assessment is required.	Assessment of whether: - the critical terms match - there has been an adverse development regarding counterparty credit risk or the entity's own non-performance risk for the hedging instrument (see section 13.2.60) - there has been an adverse development regarding credit risk of the counterparty to the hedged transaction (see section 13.2.60)	If the simplified hedge accounting requirements are met, the entity evaluates whether the credit risk of the counterparty to the derivative or its own non-performance risk has changed such that it is no longer probable that the counterparty or it will not default. If neither party's credit risk has changed in this manner, no further assessment is required.	Qualitative assessments that consider whether facts and circumstances have changed such that the entity cannot assert qualitatively that the hedging relationship was and continues to be highly effective. This is an assessment requiring the entity to apply more judgment than the critical terms match method.	Quantitative.
Timing of selection of quantitative method to be used if the respective approach is no longer appropriate				
Made at hedge designation, if elected.	Made at the time the critical terms change that cause this method to no	Not applicable. If this approach is no longer appropriate, the hedging	Required to be made at hedge designation.	Not applicable.

Shortcut method (section 13.3)	Critical terms match method (section 13.4)	Simplified hedge accounting approach (section 16.2)	Subsequent qualitative assessment approach (sections 12.4 and 13.5)	Quantitative methods (sections 12.4 and 13.6)
	longer be appropriate.	relationship is discontinued.		
Ability to revert to the approach after having to test quantitatively				
Not available.	Not available.	Not available.	Available.	Not applicable.
Ability to deem settlement dates of hedged transactions and the hedging instrument as being the same				
No.	Yes. Settlement dates of a group of hedged transactions and the hedging instrument may be deemed the same if they occur within the same 31-day period (or fiscal month).	Yes. The repricing and settlement dates for the interest rate swap and the borrowing are deemed the same if they differ by no more than a few days.	No.	Terminal value method (see section 13.7.20): Settlement dates of a group of hedged transactions and the hedging instrument may be deemed the same if they occur within the same 31-day period (or fiscal month). Other methods: No.
Note: 1. We believe the critical terms match method is precluded for fair value hedging relationships in the vast majority of circumstances (see section 13.4.20).				

14. Presentation**

Detailed contents

This is a new chapter added in this edition **

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14.5 Cash flows

14.1 How the standard works

Topic 815's specific presentation guidance is relatively limited and is driven by the Topic's recognition and measurement principles. The following table summarizes the presentation guidance and KPMG interpretations.

Topic	Summary
Balance sheet	
Balance sheet offsetting (section 14.2.20)	Derivative instruments may be offset as a policy election when: — each of the two parties owes the other determinable amounts; — the reporting party has the right to set off the amount owed with the amount owed by the other party; and — the right to setoff is enforceable by law.
Classification as current or noncurrent (section 14.2.30)	Determining the current or noncurrent classification of a derivative contract may often be complex. Entities should develop an accounting policy, apply that policy consistently, and disclose their policy accordingly.
Income statement	
Changes in fair value of derivative instrument (section 14.3.10)	— Nonhedging derivatives: Topic 815 does not provide specific presentation guidance. — Fair value or cash flow derivative hedging instruments: When they are recognized in the income statement, changes in fair value – including amounts related to excluded components – are recognized in the same line item as the earnings effect of the hedged item or transaction. However, Topic 815 does not provide specific guidance for amounts reclassified from AOCI to earnings related to missed forecasts of cash flow hedging relationships. For guidance on when changes in fair value of derivative hedging instruments are recognized in the income statement, see chapter 8 for fair value hedging relationships and chapter 10 for cash flow hedging relationships. — Net investment derivative hedging instruments: Changes in fair value that are included in the effectiveness assessment are included in the same line item as the earnings effect of the hedged net investment. Topic 815 does not provide specific presentation guidance related to amounts excluded from the effectiveness assessment.
Gross vs net presentation of gains or losses (section 14.3.20)	— Derivative is held for trading purposes or will be settled net: Net presentation is appropriate. — Derivative is not held for trading purposes and will be settled gross: Judgment is applied based on relevant facts and circumstances.

Topic	Summary
OCI and AOCI	
Required presentation (or disclosure) of changes in AOCI (section 14.4.10)	An entity is required to present certain changes in AOCI on the face of the financial statements (or disclose them in the notes).
Cash flow statement	
Classification of cash receipts and payments (section 14.5)	— Cash receipts and payments from/for a derivative are generally classified as operating, financing or investing based on the instrument's nature. — Additional guidance applies to derivatives with 'other-than-insignificant' financing elements.

14.2 Balance sheet

14.2.10 Overview

Topic 815 requires all derivative instruments to be recognized on the balance sheet and to be measured initially and subsequently at fair value. A derivative contract's rights and obligations dictate whether it is recognized as an asset or as a liability. [815-10-25-1, 35-1]



Question 14.2.10

What are the balance sheet presentation requirements for derivative instruments?

Interpretive response: Topic 815 does not provide presentation guidance for derivatives. However, an entity should consider other relevant presentation guidance including the following.

- Financial instruments with different measurement attributes (e.g. fair value versus amortized cost) must be separately presented on the balance sheet. Therefore, derivative instruments should not be aggregated with other financial instruments that are not measured at fair value. [825-10-45-1A]
- Derivative assets and derivative liabilities can be presented as a net asset or net liability on the balance sheet provided the requirements in section 14.2.20 for offsetting are met. However, because offsetting is an accounting policy election, an entity may choose not to offset.
- Topic 210 (balance sheet) does not specify balance sheet categories. In practice, items with similar economic characteristics are generally aggregated. We believe an entity can aggregate all derivative instruments. Alternatively, an entity can disaggregate them (e.g. by instrument type or risk category).



Question 14.2.20

Can a derivative instrument be aggregated with an item that it hedges?

Interpretive response: Generally, no. A derivative hedging instrument represents an asset or liability that is separate from the item it is hedging. A derivative asset may be hedging a hedged item that is an asset or a liability; similarly a derivative liability may be hedging a hedged item that is an asset or a liability. As a result, we believe it is generally inappropriate to aggregate derivative instruments with the items they hedge on the balance sheet.

Further, Topic 825 specifies that aggregation is not appropriate when the measurement attribute of a derivative hedging instrument is different from the hedged item that is a financial instrument (e.g. fair value versus amortized cost) and Subtopic 210-20 prohibits offsetting of assets and liabilities unless certain criteria are met (see section 14.2.20). [\[825-10-45-1A\]](#)

14.2.20 Balance sheet offsetting



Excerpt from ASC 815-10

> Balance Sheet—Netting

45-1 Subtopic 210-20 establishes the criteria for offsetting amounts in the balance sheet.

45-2 None of the provisions in this Subtopic support netting a hedging derivative's asset (or liability) position against the hedged liability (or asset) position in the balance sheet.

45-3 The following guidance addresses offsetting certain amounts related to derivative instruments. For purposes of this guidance, derivative instruments include those that meet the definition of a **derivative instrument** but are not included in the scope of this Subtopic.

45-5 In accordance with paragraph 210-20-45-1, but without regard to the condition in paragraph 210-20-45-1(c), a reporting entity may offset fair value amounts recognized for derivative instruments and **fair value** amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from derivative instrument(s) recognized at fair value executed with the same counterparty under a master netting arrangement. Solely as it relates to the right to reclaim cash collateral or the obligation to return cash collateral, fair value amounts include amounts that approximate fair value. The preceding sentence shall not be analogized to for any other asset or liability. The fair value recognized for some contracts may include an accrual component for the periodic unconditional receivables and payables that result from the contract; the accrual component included therein may also be offset for contracts executed with the same counterparty under a master netting arrangement. A master netting arrangement exists if the reporting entity has multiple contracts, whether for the same type of derivative

instrument or for different types of derivative instruments, with a single counterparty that are subject to a contractual agreement that provides for the net settlement of all contracts through a single payment in a single currency in the event of default on or termination of any one contract.

45-6 A reporting entity shall make an accounting policy decision to offset fair value amounts pursuant to the preceding paragraph. The reporting entity's choice to offset or not must be applied consistently. A reporting entity shall not offset fair value amounts recognized for derivative instruments without offsetting fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral. A reporting entity that makes an accounting policy decision to offset fair value amounts recognized for derivative instruments pursuant to the preceding paragraph but determines that the amount recognized for the right to reclaim cash collateral or the obligation to return cash collateral is not a fair value amount shall continue to offset the derivative instruments.

45-7 A reporting entity that has made an accounting policy decision to offset fair value amounts is not permitted to offset amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral against net derivative instrument positions if those amounts either:

- a. Were not fair value amounts
- b. Arose from instruments in a master netting arrangement that are not eligible to be offset.

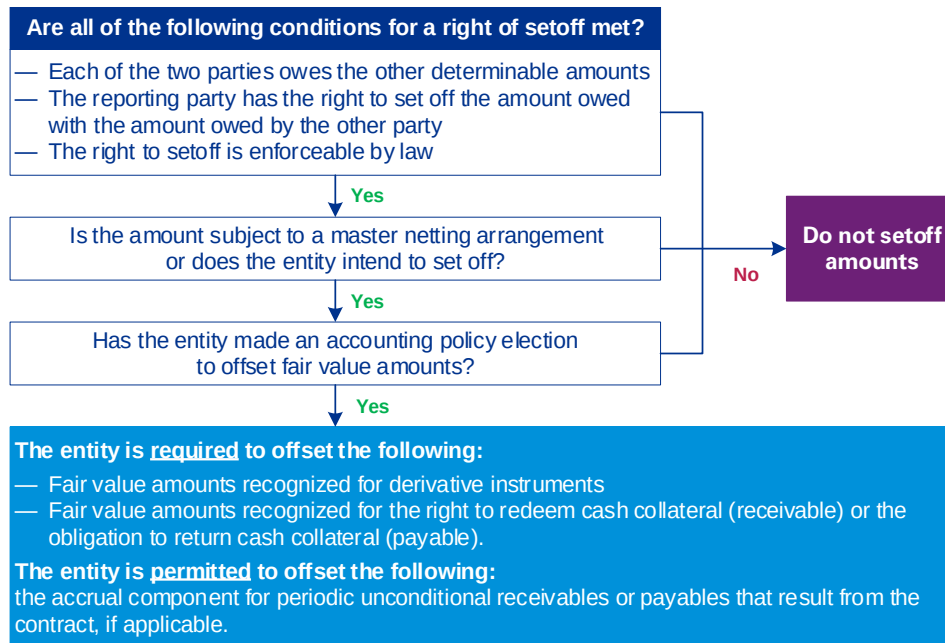
Derivative instruments, including those designated as hedging instruments, represent rights or obligations that meet the definition of assets or liabilities. Generally, an entity is permitted to present assets and liabilities net on the balance sheet provided a right of setoff exists.

A right of setoff exists when all of the following conditions are met: [\[210-20-45-1\]](#)

- each of the two parties owes the other determinable amounts;
- the reporting party has the right to set off the amount owed with the amount owed by the other party;
- the reporting party intends to set off; and
- the right to setoff is enforceable by law.

However, an entity is permitted to offset fair value amounts arising from derivative instruments without regard to whether it intends to set off those amounts when they are subject to a master netting agreement. Effectively, this condition to have a master netting agreement replaces the condition that the reporting party intends to set off. [\[815-10-45-5\]](#)

The following decision tree summarizes whether amounts related to derivative instruments should be offset on the balance sheet. [\[815-10-45-4 – 45-6\]](#)



Question 14.2.30 What is a master netting arrangement?

Interpretive response: A master netting arrangement is a contractual agreement that provides for the net settlement of multiple contracts with a single counterparty should any one of the contracts be terminated or experience a default. [815-10-45-5]

The contractual agreement must require a single payment in a single currency should its net settlement provision be triggered. The contracts subject to the master netting arrangement can be for the same or different types of derivative instruments.



Question 14.2.40 Which amounts related to cash collateral are not eligible to be offset?

Interpretive response: An entity is not permitted to offset amounts related to cash collateral against amounts recognized for derivative instruments if the amounts related to cash collateral: [815-10-45-5, 45-7]

- are not measured at fair value (or at amounts that approximate fair value); or
- arose from instruments in a master netting agreement that are not eligible to be offset.

If an entity has elected to offset fair value amounts related to derivative instruments, but amounts recognized related to cash collateral do not equal or

approximate fair value, the entity continues to offset the fair value of the derivative instruments and any amounts related to cash collateral that is measured at fair value. [815-10-45-6]



Question 14.2.50

Do the balance sheet offsetting criteria apply to variation margin payments of derivatives that are legal settlements?

Background: Central clearing organizations typically require clearing members and their end-user customers to post cash collateral (i.e. variation margin) based on the daily changes in the amount calculated in accordance with the rules of the clearing organization for derivative contracts.

The rules of some central clearing organizations treat certain variation margin payments as the legal settlement (settled-to-market or STM) of the outstanding derivative contract exposure instead of the posting of collateral (collateralized-to-market or CTM) in certain circumstances.

Interpretive response: No. When variation margin payments are legal settlements of the outstanding derivative contract exposure, they are not accounted for as a separate unit of account from the derivative contract. This means that an entity does not recognize a separate receivable or payable for the variation margin paid or received. Instead, those values are incorporated into the fair value of the derivative.

See also Question O45 of KPMG Handbook, [Fair value measurement](#), about whether variation margin values provided by a central clearing organization represent fair value under Topic 820.

14.2.30 Classification of derivative instruments as current or noncurrent

Typically, assets and liabilities are classified as either current or noncurrent based on whether they can or will be settled within one year. [210-10-45-1 – 45-9]

Determining the correct classification of a derivative instrument can be complex for a number of reasons, including the following.

- The value of a derivative is typically measured on a net basis and represents all expected cash flows throughout its remaining life – as opposed to the actual amount expected to be paid or received.
- The contract may represent a net asset in one period and a net liability in another depending on market movements.
- When a derivative has multiple settlements, expected future cash flows can be in a receive or pay position; however, the offsetting cash flows are netted together to determine the total fair value of the derivative contract.

Topic 815 does not provide specific guidance for resolving such classification issues.



Question 14.2.60

What are the best practices for classifying a derivative on a classified balance sheet?

Interpretive response: Because Topic 815 does not provide specific guidance for classifying derivative instruments on a classified balance sheet, we believe an entity should develop an accounting policy for classifying derivative instruments, consistently apply its policy and disclose it.

Best practices for classification are summarized as follows.

Situation	Classification
Derivative that matures within one year, as a whole	Current
Derivative in a liability position that the counterparty can terminate at any time	Current (similar to demand obligations)
Neither of the above situations applies	Classified based on the expected timing of cash flows. — Current portion: Fair value of cash flows expected to occur within one year. — Noncurrent portion: Fair value of cash flows expected to occur beyond one year. In applying this best practice, an entity may consider analogizing to the guidance for determining the disclosure of the amount of AOCI that will be reclassified into earnings in the next year.



Question 14.2.70

Can a derivative instrument that would otherwise be classified as current be classified as noncurrent when it is designated as a hedge of a noncurrent item?

Interpretive response: It depends on whether the derivative instrument is an asset or a liability.

- **Asset.** We believe a derivative asset can be classified as noncurrent if it is designated as a hedge of the acquisition of a noncurrent asset or the liquidation of debt that is classified as noncurrent, even if the derivative asset would otherwise be classified as current. This is based on analogy to the guidance in Topic 210 that permits cash designated for acquiring or constructing noncurrent assets or segregated for liquidating long-term debts to be excluded from current assets, even if those funds are not actually set aside in special accounts. [\[210-10-45-4\]](#)

- **Liability.** When a derivative liability would otherwise be classified as current, we believe noncurrent classification is not appropriate, even if that derivative is designated as a hedge of a noncurrent item. We do not believe it is appropriate to analogize to the guidance in paragraph 210-10-45-4 when a derivative is in a liability position.

14.2.40 Presentation of hybrid financial instruments



Excerpt from ASC 815-15

General

45-1 In each statement of financial position presented, an entity shall report hybrid financial instruments measured at **fair value** under the election and under the practicability exception in paragraph 815-15-30-1 in a manner that separates those reported fair values from the carrying amounts of assets and liabilities subsequently measured using another measurement attribute on the face of the statement of financial position. To accomplish that separate reporting, an entity may do either of the following:

- Display separate line items for the fair value and non-fair-value carrying amounts
- Present the aggregate of the fair value and non-fair-value amounts and parenthetically disclose the amount of fair value included in the aggregate amount.

45-2 If an entity has designated a **financial liability** under the fair value election in accordance with paragraphs 815-15-25-4 through 25-6, the entity shall apply the guidance in paragraph 825-10-45-5 on the presentation of changes in the liability's fair value that result from change in instrument-specific credit risk.

A hybrid instrument is a contract that embodies both an embedded derivative and a host contract. [\[815-15-20 Glossary\]](#)

If a hybrid instrument is measured in its entirety at fair value, the amounts measured at fair value are presented either parenthetically or as a separate line item on the balance sheet. As further discussed in section 5.5.10, a hybrid instrument is measured in its entirety at fair value when its embedded derivative meets the criteria for bifurcation and: [\[815-15-25-4, 25-52 – 25-53, 30-1, 35-2, 45-1\]](#)

- the entity irrevocably elects to initially and subsequently measure the hybrid instrument in its entirety at fair value; or
- the entity cannot reliably identify and measure the embedded derivative; in this case, the entity measures the hybrid instrument in its entirety at fair value.

If the hybrid instrument is a financial liability that is measured in its entirety at fair value due to an entity's irrevocable election, the portion of the total change in the fair value that results from a change in the instrument-specific credit risk

is presented in OCI. All other changes in fair value are recorded in earnings. [815-15-25-4, 30-1(a), 35-1, 45-2]

See section 5.5 for embedded derivative accounting guidance.



Question 14.2.80

How is a hybrid instrument presented if it is not measured in its entirety at fair value?

Interpretive response: Topic 815 does not specifically address how to present a bifurcated embedded derivative instrument on the balance sheet. We believe either of the following approaches is acceptable as an accounting policy election.

- Present the embedded derivative instrument together with the host contract – i.e. following the legal form of the instrument. In this situation, the carrying amount of the hybrid instrument will reflect the aggregate carrying amount of the host contract and the fair value of the embedded derivative instrument. In our experience, most entities follow this approach.
- Present the embedded derivative instrument separately from the host contract.

Regardless of the presentation alternative chosen, an entity should consistently apply its policy and disclose it.

14.2.50 Presentation of basis adjustments (fair value hedges)

The **fair value hedge** accounting model requires the carrying amount of the hedged item (e.g. asset, liability or firm commitment) to be adjusted for the change in its fair value attributable to the risk being hedged. This adjustment is referred to as a basis adjustment. See chapter 8 for fair value hedge accounting guidance. [815-25-35-8 – 35-9A]



Question 14.2.90

How is a basis adjustment presented on the balance sheet?

Interpretive response: We believe a basis adjustment is an integral part of the hedged item rather than a separate asset or liability, and should be presented as follows.

- **Hedged item is recognized asset or liability.** The basis adjustment should be presented as part of the hedged item's carrying amount.
- **Hedged firm commitments.** The basis adjustment should be presented in a manner consistent with the balance sheet presentation of the underlying transaction. For example, if the hedged item is a firm commitment to purchase fixed assets in six months, the carrying amount of the firm commitment should be aggregated with other fixed assets, even if the firm

commitment is a negative amount (i.e. decreases the total amount of fixed assets).

14.3 Income statement presentation

14.3.10 Overview



Excerpt from ASC 815-10

> Income Statement Classification

45-8 Except for the guidance in the following paragraph and paragraph 815-10-45-10, this Subtopic does not provide guidance about the classification in the income statement of a derivative instrument's gains or losses, including the adjustment to fair value for a contract that newly meets the definition of a derivative instrument.



Excerpt from ASC 815-20

> Income Statement Classification

45-1A For qualifying fair value and cash flow hedges, an entity shall present both of the following in earnings in the same income statement line item that is used to present the earnings effect of the hedged item:

- a. The change in the fair value of the hedging instrument that is included in the assessment of hedge effectiveness
- b. Amounts excluded from the assessment of hedge effectiveness in accordance with paragraphs 815-20-25-83A through 25-83B.

See paragraphs 815-20-55-79W through 55-79AD for related implementation guidance.

45-1B For cash flow hedges in which the hedged forecasted transaction is probable of not occurring in accordance with paragraph 815-30-40-5, this Subtopic provides no guidance on the required income statement classification of amounts reclassified from accumulated other comprehensive income to earnings.

45-1C For qualifying net investment hedges, an entity shall present in the same income statement line item that is used to present the earnings effect of the hedged net investment those amounts reclassified from accumulated other comprehensive income to earnings. This Subtopic provides no guidance on the required income statement classification of amounts excluded from the assessment of effectiveness in net investment hedges.

45-1D While the Derivatives and Hedging Topic does not specify whether certain income statement line items are either permitted or appropriate, the

other hedging-related Subtopics in this Topic do contain specific disclosure requirements for those items. See Section 815-10-50 and Subtopics 815-25, 815-30, and 815-35.

>>> Income Statement Presentation of Hedging Instruments

55-79W Paragraph 815-20-45-1A requires an entity to present the change in the fair value of the hedging instrument included in the assessment of hedge effectiveness and the amount excluded from the assessment of hedge effectiveness in the same income statement line item that is used to present the earnings effect of the hedged item. The following scenarios include implementation guidance on the meaning of the phrase *the same income statement line item that is used to present the earnings effect of the hedged item*.

>>>> Scenario A

55-79X Entity A designates a fair value hedge of interest rate risk in which the hedged item is a portfolio of fixed-rate loans. The derivative designated as the hedging instrument is a receive-floating-rate, pay-fixed-rate interest rate swap. In this scenario, Entity A's objective is to convert the interest cash flows on the portfolio of fixed-rate loans to floating-rate.

55-79Y The interest rate swap is a highly effective hedge of the interest rate risk of the portfolio of fixed-rate loans. Therefore, the change in the fair value of the interest rate swap should be presented in the same income statement line item used to present the earnings effect of the hedged item. Before applying hedge accounting, the earnings effect of the hedged item (that is, the interest accruals) is presented in an interest income line item. Therefore, Entity A should present all changes in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same interest income line item in the income statement.

Gains and losses may be recognized in the income statement due to the requirement to recognize and measure all derivative instruments on the balance sheet at fair value. Presentation of derivative gains or losses in the income statement depends on whether the derivative is a **hedging instrument**. Further, for a hedging instrument, the presentation depends on the type of hedging relationship and on whether the entity has elected to exclude certain components of the instrument from the assessment of **hedge effectiveness** (the 'excluded component'; see section 13.2.70). [815-10-35-2]

The following table summarizes the income statement presentation for changes in a derivative instrument's fair value. [815-20-45-1A –45-1D]

Component	Presentation in income statement
Nonhedging derivative instruments	
Changes in fair value of a nonhedging derivative instrument	Topic 815 does not provide specific presentation guidance, except for the following: — Gains and losses of derivative instruments held for trading purposes are presented net in the income statement; see guidance on gross versus net presentation in section 14.3.20. — Changes in fair value of options granted to employees are presented as compensation expense prior to vesting, but are not required to be so presented after vesting; see section 2.13.30 regarding a scope exception from derivative accounting for contracts issued by an entity that are in the scope of Topic 718 (stock compensation). See Questions 14.3.10 and 14.3.20 for additional guidance on this component.
Fair value hedge (see section 8.2 for guidance about earnings recognition)	
Both of the following: — Changes in fair value that are included in the assessment of hedge effectiveness — Changes in fair value that are excluded from the assessment of hedge effectiveness	Same line as the earnings effect of hedged item
Cash flow hedge (see section 10.2 for guidance about earnings recognition)	
Both of the following, when recognized in the income statement, except when amounts are reclassified to earnings from AOCI in connection with a missed forecast: — Changes in fair value that are included in the assessment of hedge effectiveness — Changes in fair value that are excluded from the assessment of hedge effectiveness For guidance on when these amounts are recognized in the income statement, see chapter 10.	Same line item as the earnings effect of hedged transaction
Amounts reclassified to earnings from AOCI due to a missed forecast	Topic 815 does not provide specific presentation guidance. See Question 14.3.30 for guidance on this component.

Component	Presentation in income statement
Net investment hedge (see section 12.2 for timing of earnings recognition guidance)	
Changes in fair value that are included in the assessment of hedge effectiveness	Same line item that is used to present the earnings effect of the hedged net investment (i.e. generally reported as part of the gain or loss on sale or liquidation of the hedged net investment; see section 12.5.20) [830-30-40-1, 815-35-35-1]
Amounts excluded from the assessment of effectiveness	Topic 815 does not provide specific presentation guidance for these amounts. See Question 14.3.40 for guidance on this component.



Question 14.3.10

Should changes in the fair value of a nonhedging derivative instrument be presented in operating income?

Interpretive response: We believe the gains and losses arising from these changes (whether realized or unrealized) should be included in operating income to the extent that nonhedging derivative activities are part of the normal operations of the entity – e.g. as part of trading activities. However, we believe they may be presented in nonoperating income (loss) if the nonhedging derivative activities are ancillary to an entity's operations.

Further, an entity's classification policy cannot conflict with other GAAP that addresses income statement line item classification. For example, separate, freestanding contracts that serve to mitigate credit losses (e.g. purchased credit default swaps or certain types of insurance) should not be considered for the purposes of estimating expected credit losses. We believe the gains and losses on these credit derivatives should not be included in credit loss expense. [326-20-30-12, 35-1]

An entity should consistently apply its policy and disclose it.



Question 14.3.20

Can realized gains or losses on a nonhedging derivative instrument be presented separately from unrealized gains or losses in the income statement?

Interpretive response: No. Although Topic 815 does not prescribe specific presentation guidance for gains or losses on nonhedging derivative instruments, the SEC staff has stated that it is not appropriate to present gains and losses on nonhedging derivative instruments in different line items in the income statement before and after settlement – i.e. presenting realized and unrealized amounts in different line items. [AICPA SEC Reg Comm 09/2003]

This prohibited practice is referred to as 'synthetic hedge accounting' because such split accounting results in an accounting treatment that mimics hedge accounting for arrangements that do not qualify for hedge accounting.

We believe this guidance should be followed by all entities.

For example, ABC Corp. enters into an interest rate swap to economically hedge its exposure to the variability in future cash flows related to its variable-rate debt. ABC does not designate the swap as a hedging instrument for accounting purposes. When a derivative instrument is not designated in a hedge accounting relationship, the requirement to recognize changes in its fair value usually results in earnings volatility.

ABC would like to classify gains and losses on the swap as follows.

- Unrealized gains and losses: Classify as other income and expense.
- Realized gains and losses: Upon periodic settlement of the swap, reclassify the realized portion of the gain or loss to interest expense.

The result of this accounting treatment would be to report interest expense as if ABC's debt were effectively hedged, while excluding from interest expense the earnings volatility caused by the swap being a nonhedging instrument. We do not believe this would be appropriate.

Instead, we believe both realized and unrealized gains and losses on nonhedging derivative instruments should be presented in one line item in the income statement – in this example, operating revenues or interest expense.

We believe the selection of the line item is an accounting policy election that should be consistently applied and disclosed – and it should not conflict with other GAAP that addresses income statement classification (see Question 14.3.10).



Question 14.3.30

Where are amounts related to a missed forecast or derecognized firm commitment presented in the income statement?

Background: In certain situations, amounts are required to be immediately recognized in the income statement when a hedging relationship is discontinued.

- **Cash flow hedge.** When an entity has a missed forecast, amounts in AOCI are immediately reclassified into earnings, unless the forecasted transaction will occur within an additional two-month period or extenuating circumstances apply (see section 10.5.20).
- **Fair value hedge.** When a hedged firm commitment is modified such that it no longer meets the definition of a firm commitment, the asset or liability previously recognized is recognized in earnings immediately (see Question 6.10.50).

Interpretive response: Topic 815 does not provide specific presentation guidance in these situations. We believe amounts immediately recognized in the income statement in these situations generally should be presented as part

of operating income because they arise in the normal course of an entity's operations.

Because Topic 815 does not provide specific presentation guidance, an entity may exercise judgment in determining the income statement classification. We believe an entity should apply a consistent policy for presenting these amounts in the income statement, and disclose it. For example, an entity could choose a policy that presents these amounts in the income statement line item where the missed forecasted transaction or firm commitment would have been recorded.



Question 14.3.40

Where is the effect of the excluded components presented in earnings for net investment hedges?

Interpretive response: For net investment hedges, Topic 815 does not specify a required presentation in earnings for excluded components. [815-20-45-1C]

For **fair value** and **cash flow** hedges, Topic 815 requires that excluded components be presented in the same income statement line item in which the earnings effect of the hedged item is presented.

However, the FASB decided not to provide similar guidance for **net investment hedges**. This is because amounts in CTA related to a hedged net investment are not reclassified into earnings until the hedged net investment is sold, exchanged or liquidated (see [section 12.5.20](#)). In contrast, the initial value of the excluded component is recognized in earnings over the life of the hedging instrument (using either an amortization or mark-to-market approach). As a result, requiring the excluded components to be presented together with the earnings effect of the hedged item could result in presentation in an income statement line item such as 'gain or loss on sale of subsidiary' even when that subsidiary has not or will not be sold. [ASU 2017-12.BC131]

Regardless of whether the entity chooses the amortization or mark-to-market approach, we believe it should develop a policy for presenting excluded components in the income statement, apply that policy consistently for all applicable net investment hedges, and disclose it.

For example, many entities present the excluded component for net investment hedges in interest expense.

14.3.20 Gross vs net presentation of gains or losses on derivative instruments



Excerpt from ASC 815-10

>> Derivative Instruments Held for Trading Purposes

45-9 Gains and losses (realized and unrealized) on all derivative instruments within the scope of this Subtopic shall be shown net when recognized in the income statement, whether or not settled physically, if the derivative instruments are held for **trading purposes**. On an ongoing basis, reclassifications into and out of trading shall be rare.

>> Other Presentation Matters

>>> Income Statement Presentation of Realized Gains And Losses

55-62 Determining whether realized gains and losses on physically settled derivative instruments not held for **trading purposes** should be reported in the income statement on a gross or net basis is a matter of judgment that depends on the relevant facts and circumstances. Consideration of the facts and circumstances should be made in the context of the various activities of the entity rather than based solely on the terms of the individual contracts. In evaluating the facts and circumstances for purposes of determining whether an arrangement should be reported on a gross or net basis, all of the following may be considered:

- The economic substance of the transaction
- The guidance set forth in Topic 845 relative to nonmonetary exchanges
- The principal versus agent considerations provided in paragraphs 606-10-55-36 through 55-40.



Question 14.3.50

Are gains or losses on derivative instruments presented gross or net in the income statement?

Interpretive response: Unrealized gains and losses are always presented net. In contrast, we believe how realized gains and losses are presented depends on the considerations summarized in the following table.

Intent of issuer (or holder)	Settlement method	Gross vs net presentation in the income statement
Held for trading purposes	Either physically settled or not physically settled	Net presentation [815-10-45-9, 55-62]
Not held for trading purposes	Not physically settled	Net presentation

Intent of issuer (or holder)	Settlement method	Gross vs net presentation in the income statement
Not held for trading purposes	Physically settled	Depends on relevant facts and circumstances. Consideration should be given to: [815-10-45-9, 55-62] — the entity's various activities; — the economic substance of the transaction; — guidance in Topic 845 (nonmonetary transactions); and — principal versus agent considerations in Topic 606.



Question 14.3.60

When is a derivative instrument held for trading purposes?

Background: The presentation of gains and losses on a derivative instrument as gross or net in the income statement depends in part on whether the derivative instrument is held for trading purposes.

Interpretive response: This determination is based on the intent of its issuer (or holder). Trading activities are typically characterized as activities involving the frequent buying and selling of instruments with the objective of generating profits in the near term. [815-10-20 Glossary]



Question 14.3.70

Does designating a derivative instrument that is held for trading purposes as a hedging instrument affect the presentation of gains and losses?

Interpretive response: No. A derivative that is held for trading purposes is not precluded from being designated as a hedging instrument, provided all of the applicable hedge criteria are met. The use of a derivative instrument as a hedging instrument does not affect whether its gains and losses should be reported on a gross or net basis in the income statement.



Example 14.3.10

Presentation of realized gains and losses on derivatives

This example is based on examples in EITF 03-11, Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133

and Not 'Held for Trading' Purposes as Defined in Issue No. 02-3. Those examples were not codified.

On January 1, Year 1, ABC Corp. enters into a forward contract to purchase one barrel of crude oil at \$30 for delivery on July 1, Year 1. ABC Corp. does not pay or receive any consideration for entering into the forward contract.

The forward contract is a derivative that will be physically (gross) settled, and ABC does not designate it as a normal purchase – i.e. it does not elect the NPNS scope exception (see section 2.4). Further, ABC does not designate it as the hedging instrument in a hedging relationship.

The following are the spot and market forward prices for the July 1, Year 1 delivery of one barrel of crude.

	Spot price	Forward price	Fair value asset (liability) ¹	Change in fair value
Jan 1, Year 1	\$ 30	\$ 30	\$ -	N/A
Mar 31, Year 1	\$ 27	\$ 25	\$(5)	\$ (5)
June 30, Year 1	\$ 35	\$ 35	\$ 5	\$ 10
July 1, Year 1	\$ 35	N/A	\$ 5	\$ -
Note:				
1. Measured using the change in forward rates. For simplicity, this example ignores the effect of discounting on fair value measurement.				

On July 1, Year 1, ABC purchases the barrel of crude oil by physically settling the contract. On July 31, Year 1, ABC sells the barrel of crude oil for \$37.

For simplicity, this example ignores commissions and other transaction costs.

Scenario 1: ABC holds the forward contract for trading purposes – Net presentation in the income statement is required

Journal entries – January 1, Year 1

A memorandum entry is made on January 1, Year 1 documenting the existence of this forward contract. ABC's financial records are otherwise not affected as of this date because the forward contract is at market rates.

Journal entries – March 31, Year 1

ABC records the following journal entry.

	Debit	Credit
Trading revenue, net	5	
Derivative liability		5
<i>To record change in fair value of forward contract.</i>		

Journal entries – June 30, Year 1

ABC records the following journal entry.

	Debit	Credit
Derivative liability ¹	5	
Derivative asset ¹	5	
Trading revenue, net		10
<i>To record change in fair value of forward contract.</i>		
Note:		
1. The derivative instrument represents a liability as of March 31, Year 1 and an asset as of June 30, Year 1.		

At June 30, Year 1, ABC's financial statements reflect the following.

Account	6 months ended June 30
Balance sheet	
Derivative asset	\$ 5
Income statement	
Trading revenue – net	\$ 5

Journal entries – July 1, Year 1

ABC records the following journal entry.

	Debit	Credit
Inventory	35	
Cash		30
Derivative asset		5
<i>To record settlement of forward contract.</i>		

Journal entries – July 31, Year 1

ABC records the following journal entry.

	Debit	Credit
Accounts receivable	37	
Inventory		35
Trading revenue, net		2
<i>To record sale of one barrel of crude from inventory.</i>		

At July 31, Year 1, ABC's financial statements reflect the following.

Account	7 months ended July 31
Balance sheet	
Accounts receivable	\$ 37
Income statement	
Trading revenue – net	\$ 7

Scenario 2: ABC does *not* hold the forward contract for trading purposes and determines that gross presentation in the income statement is appropriate

In this scenario, the entries recorded as of January 1, March 31, June 30 and July 1 are the same as Scenario 1 (although the account descriptions may differ). However, the journal entry as of July 31 is different.

Journal entries – July 31, Year 1

ABC records the following journal entry.

	Debit	Credit
Cost of goods sold	35	
Inventory		35
Accounts receivable	37	
Sales		37
<i>To record sale of one barrel of crude from inventory.</i>		

At July 31, Year 1, ABC's financial statements reflect the following.

Account	7 months ended July 31
Balance sheet	
Accounts receivable	\$ 37
Income statement	
Trading revenue – net	\$ 5
Sales	\$ 37
Cost of goods sold	\$ (35)

14.4 Changes in OCI and AOCI

14.4.10 Overview



Excerpt from ASC 815-20

>> Other Comprehensive Income

45-3 An entity shall display as a separate classification within other comprehensive income the net gain or loss on **derivative instruments** designated and qualifying as fair value or cash flow hedging instruments that are reported in comprehensive income pursuant to paragraphs 815-20-25-65, 815-20-25-83A, and 815-30-35-3.



Excerpt from ASC 220-10

45-10A Items of other comprehensive income include the following: ...

- d. Gains and losses on derivative instruments that are designated as, and qualify as, cash flow hedges (see paragraph 815-20-35-1(c))
- dd. For derivatives that are designated in qualifying hedging relationships, the difference between changes in fair value of the excluded components and the initial value of the excluded components recognized in earnings under a systematic and rational method in accordance with paragraphs 815-20-25-83A and 815-35-35-5A...



Excerpt from ASC 815-30

50-2 As part of the disclosures of accumulated other comprehensive income, pursuant to paragraphs 220-10-45-14 through 45-14A, an entity shall separately disclose all of the following:

- a. The beginning and ending accumulated derivative instrument gain or loss
- b. The related net change associated with current period hedging transactions
- c. The net amount of any reclassification into earnings
- d. The difference between the change in fair value of an excluded component and the initial value of that excluded component recognized in earnings under a systematic and rational method in accordance with paragraph 815-20-25-83A.

Subtopic 220-10 (comprehensive income) requires an entity to report items that meet the definition of comprehensive income in either a single continuous statement of comprehensive income or in two separate but consecutive financial statements (a statement of net income and a statement of OCI).

Regardless of an entity's selected reporting format, Topic 815 requires an entity to display as a separate classification within OCI the net gain or loss on derivative instruments that is reported in OCI (see Question 14.4.10). [220-10-45-1, 45-1C, 45-10A, 815-20-45-3]

At the end of an accounting period, the total of OCI for the period is transferred to a component of equity that is presented separately from retained earnings and APIC on the balance sheet; this is referred to as AOCI. Among other things, Subtopic 220-10 requires an entity to present the changes in the accumulated balances for each component of AOCI either on the face of the financial statements or in the notes to the financial statements. In making that presentation (or disclosure), Subtopic 815-10 requires an entity to separately present the following: [220-10-45-14A; 815-30-50-2]

- beginning and ending accumulated derivative gain or loss;
- the related net change associated with current period hedging transactions;
- the net amount of any reclassification into earnings; and
- the difference between the change in fair value of an excluded component and the initial value of that excluded component recognized in earnings under a systematic and rational method.



Question 14.4.10

Which items resulting from hedging relationships are included in OCI?

Interpretive response: The following items resulting from hedging relationships are included in OCI: [220-10-45-10A, 815-20-25-83A, 45-3, 815-35-35-5A]

- gains and losses on derivative instruments that are designated and qualify as **cash flow hedges**; and
- for derivatives that are designated in qualifying **cash flow hedges**, **fair value hedges** or **net investment hedges**, the difference between changes in fair value of the excluded components and the initial value of the excluded components recognized in earnings under the amortization approach.



Question 14.4.20

Must the changes in fair values of hedging instruments be presented in OCI by the type of hedged risks?

Interpretive response: No. Gains and losses arising from hedging activities may be attributable to different types of risks – e.g. foreign currency risk, interest rate risk, risk of changes in creditworthiness. However, an entity is not required to categorize and present separately in OCI the net gain or loss on derivative hedging instruments by the different types of hedged risks.

14.5 Cash flows



Excerpt from ASC 815-10

> Cash Flow Statement Classification

>> Derivative Instrument with a Financing Element

45-11 An instrument accounted for as a derivative instrument under this Subtopic that, at its inception, includes off-market terms, or requires an up-front cash payment, or both often contains a financing element. Identifying a financing element within a derivative instrument is a matter of judgment that depends on facts and circumstances.

45-12 If an other-than-insignificant financing element is present at inception—other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract)—then the borrower shall report all cash inflows and outflows associated with that derivative instrument in a manner consistent with financing activities as described in paragraphs 230-10-45-14 through 45-15.

45-13 An at-the-money plain-vanilla interest rate swap that involves no payments between the parties at inception would not be considered as having a financing element present at inception even though, due to the implicit forward rates derived from the yield curve, the parties to the contract have an expectation that the comparison of the fixed and variable legs will result in payments being made by one party in the earlier periods and being made by the counterparty in the later periods of the swap's term.

45-14 If a derivative instrument is an at-the-money or out-of-the-money option contract or contains an at-the-money or out-of-the-money option contract, a payment made at inception to the writer of the option for the option's time value by the counterparty shall not be viewed as evidence that the derivative instrument contains a financing element.

45-15 In contrast, if the contractual terms of a derivative instrument have been structured to ensure that net payments will be made by one party in the earlier periods and subsequently returned by the counterparty in the later periods of the derivative instrument's term, that derivative instrument shall be viewed as containing a financing element even if the derivative instrument has a fair value of zero at inception.

> Statement of Cash Flows

60-1 For circumstances in which cash receipts and payments include more than one class of cash flows, see paragraphs 230-10-45-22 through 45-23.



Excerpt from ASC 815-20

> Statement of Cash Flows

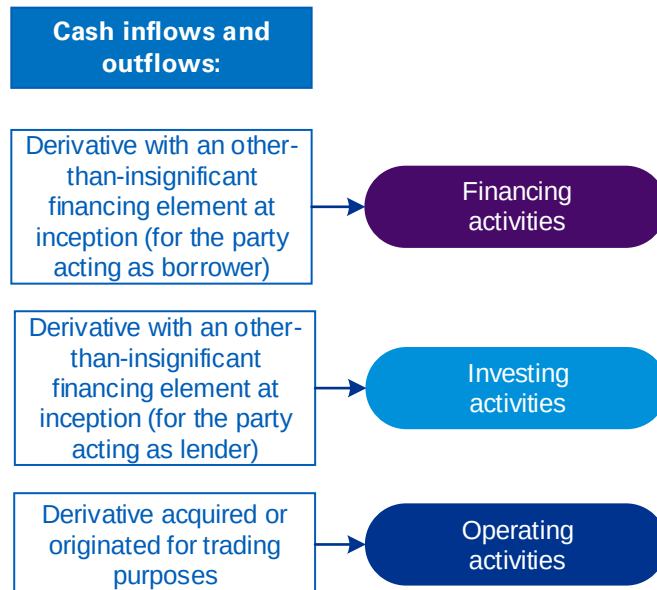
45-2 For guidance on the classification of cash receipts and payments related to hedging activities, see paragraph 230-10-45-27.

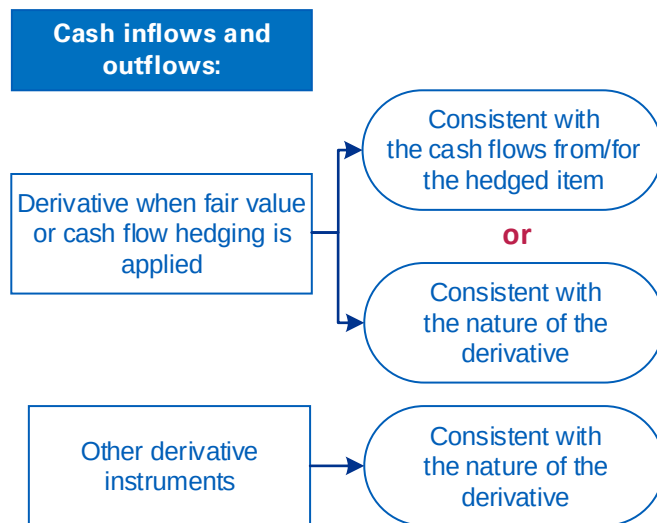
Derivative instruments involve a variety of cash flows at inception and throughout the life of the instrument, such as:

- cash payments for purchases of derivative instruments;
- cash receipts for sales of derivative instruments;
- cash receipts and payments of cash collateral;
- cash settlements for periodic payments for a swap;
- cash payments to exercise the strike price of an option; and
- cash payments or receipts at the maturity or extinguishment of derivative instruments.

Generally, cash receipts and payments from/for a derivative are classified as operating, financing or investing based on the instrument's nature. However, there are some exceptions, with the most difficult to apply being for derivatives with 'other-than-insignificant' financing elements – i.e. providing financing to one of the contracting parties. Such instruments have their own classification principles, irrespective of whether they are used as hedging instruments.

The following chart summarizes some of the classification issues encountered, which are explained in more detail in chapter 13 of KPMG Handbook, [Statement of cash flows](#).





16. Private companies and entities that do not report earnings

Detailed contents

New item added in this chapter: **

Item significantly updated in this chapter: #

16.1 How the standard works

16.2 Simplified hedge accounting approach

- 16.2.10 Overview
- 16.2.20 Simplified hedge accounting criteria
- 16.2.30 Subsequent measurement
- 16.2.40 Discontinuation of simplified hedge accounting
- 16.2.50 Timing and extent of documentation

Questions

- 16.2.10 What types of entities can apply the simplified hedge accounting approach?
- 16.2.20 Do all interest rate swaps qualify for simplified hedge accounting?
- 16.2.30 Does simplified hedge accounting have to be applied to all eligible swaps?
- 16.2.40 Why might a private company choose not to use simplified hedge accounting?
- 16.2.50 What are the ongoing requirements when applying simplified hedge accounting?
- 16.2.60 Can the hedged risk be a nonbenchmark interest rate risk?
- 16.2.70 What qualifies as a plain vanilla swap to be eligible for simplified hedge accounting?
- 16.2.80 Can an entity hedge borrowings with embedded interest rate caps or floors under simplified hedge accounting?
- 16.2.90 How should an entity evaluate the difference between the repricing and settlement dates of the debt and the interest rate swap?
- 16.2.100 How is the settlement value of an interest rate swap different from fair value?

16. Private companies and entities that do not report earnings

- 16.2.110 Can an entity voluntarily change from simplified hedge accounting to general hedge accounting?

16.3 Additional hedging relief when simplified hedge accounting is not applied

- 16.3.10 Overview
- 16.3.20 Documentation requirements #
- 16.3.30 Subsequent quarterly hedge effectiveness assessments

Questions

- 16.3.10 Which private companies and NFPs may take advantage of the timing relief?
- 16.3.20 Are there downsides to delaying the quarterly hedge effectiveness assessments?
- 16.3.30 Why are certain entities without quarterly reporting requirements required to perform quarterly hedge effectiveness assessments?

Examples

- 16.3.10 Timing of preparing initial hedge documentation
- 16.3.20 Timing of performing quarterly hedge effectiveness assessments

16.4 Entities that do not report earnings **

- 16.4.10 Overview **
- 16.4.20 Split-interest agreements **

Questions

- 16.4.10 Can an NFP healthcare organization in the scope of Topic 954 apply cash flow hedge accounting, and an amortization approach for excluded components when applying fair value hedge accounting? **
- 16.4.20 Does an NFP healthcare organization present the gain or loss on nonhedging derivatives within the performance indicator? **
- 16.4.30 Does an NFP recognize a derivative or bifurcate an embedded derivative related to a split-interest agreement? **

16.1 How the standard works#

Relief provisions for private companies and NFPs

Many private companies historically have found the hedging requirements under the general hedge accounting guidance to be onerous. To provide relief to these companies, the FASB developed a simplified hedge accounting approach for private companies' qualifying **cash flow hedging** relationships, as well as relief in the timing of **documentation** and **hedge effectiveness** requirements for private companies not adopting the simplified hedge accounting approach and certain NFPs.

		Private companies	NFP entities
Simplified hedge accounting:	Available for certain interest rate swaps in cash flow hedges	✓	✗
Relaxed time requirements for documentation:	Available if simplified hedge accounting not elected	✓	✓

Entities that do not report earnings

Topic 815 applies to all entities, including those that do not report earnings as a separate caption. For these entities:

- amounts that would normally be reported in earnings are instead reported in the change in net assets; and
- hedge accounting may be used, except that these entities cannot use cash flow hedge accounting.

16.2 Simplified hedge accounting approach



Excerpt from ASC 815-20

> Hedge Accounting Provisions Applicable to Certain Private Companies

>> Assuming Perfect Hedge Effectiveness in a Cash Flow Hedge of a Variable-Rate Borrowing with a Receive-Variable, Pay-Fixed Interest Rate Swap Recorded under the Simplified Hedge Accounting Approach

25-133 Paragraphs 815-10-35-1A through 35-1C, 815-10-50-3, 815-20-25-3A, 815-20-25-119, 815-20-25-134 through 25-138, 815-20-55-79A through 55-79B, 825-10-50-3, and 825-10-50-8 provide guidance for an entity electing the simplified hedge accounting approach. See paragraph 815-10-65-6 for transition guidance on applying the simplified hedge accounting approach.

25-134 The conditions for the simplified hedge accounting approach determine which cash flow hedging relationships qualify for a simplified version of hedge accounting. If all of the conditions in paragraphs 815-20-25-135 and 815-20-25-

137 are met, an entity may assume perfect effectiveness in a cash flow hedging relationship involving a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap.

25-135 Provided all of the conditions in paragraph 815-20-25-137 are met, the simplified hedge accounting approach may be applied by a **private company** except for a financial institution as described in paragraph 942-320-50-1. An entity may elect the simplified hedge accounting approach for any receive-variable, pay-fixed interest rate swap, provided that all of the conditions for applying the simplified hedge accounting approach specified in paragraph 815-20-25-137 are met. Implementation guidance on the conditions set forth in paragraph 815-20-25-137 is provided in paragraphs 815-20-55-79A through 55-79B.

25-136 In applying the simplified hedge accounting approach, the documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed by the date on which the first annual **financial statements are available to be issued** after hedge inception rather than concurrently at hedge inception.

25-137 An eligible entity under paragraph 815-20-25-135 must meet all of the following conditions to apply the simplified hedge accounting approach to a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap:

- a. Both the variable rate on the swap and the borrowing are based on the same index and reset period (for example, both the swap and borrowing are based on one-month London Interbank Offered Rate [LIBOR] or both the swap and borrowing are based on three-month LIBOR).
- b. The terms of the swap are typical (in other words, the swap is what is generally considered to be a “plain-vanilla” swap), and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap.
- c. The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days.
- d. The swap’s fair value at inception (that is, at the time the derivative was executed to hedge the interest rate risk of the borrowing) is at or near zero.
- e. The notional amount of the swap matches the principal amount of the borrowing being hedged. In complying with this condition, the amount of the borrowing being hedged may be less than the total principal amount of the borrowing.
- f. All interest payments occurring on the borrowing during the term of the swap (or the effective term of the swap underlying the forward starting swap) are designated as hedged whether in total or in proportion to the principal amount of the borrowing being hedged.

>>> Simplified Hedge Accounting Approach

55-79A In complying with the condition in paragraph 815-20-25-137(b), comparable does not necessarily mean equal. For example, if the swap’s variable rate is the London Interbank Offered Rate (LIBOR) and the borrowing’s variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the borrowing.

55-79B For a forward-starting swap, only the effective term of the receive-variable, pay-fixed interest rate swap (that is, from its effective date through its expiration date) shall be considered in complying with the condition in paragraph 815-20-25-137(f). The period from the swap's inception to the date the swap is effective shall not be considered in complying with the condition in paragraph 815-20-25-137(f) because the effective date of a forward-starting swap occurs after the swap's inception. For example, a forward-starting receive-variable, pay-fixed, interest rate swap with a five-year effective term and an effective date commencing one year after the swap's inception would meet the condition in paragraph 815-20-25-137(f) if designated as a hedge of a five-year, variable-rate borrowing forecasted to be entered into one year after the swap's inception.

20 Glossary

Private Company – An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.

16.2.10 Overview

Topic 815 provides a simplified hedge accounting approach to account for interest rate swaps that are used to hedge the variability in cash flows of variable-rate borrowings. If the criteria to apply the simplified hedge accounting approach are met (see section 16.2.20), a private company:

Hedge effectiveness

- may assume perfect hedge effectiveness for the qualifying **cash flow hedging** relationships; [815-20-25-134]
- is exempt from quarterly hedge effectiveness testing because perfect effectiveness is assumed; [815-20-25-134]

Hedge documentation

- has additional time to prepare the required hedge documentation (see section 16.2.50); and [815-20-25-136]

Hedging instrument

- is allowed to measure the interest rate swap designated in the cash flow hedging relationship at settlement value instead of fair value (see section 16.2.30). [815-10-35-1A]



Question 16.2.10

What types of entities can apply the simplified hedge accounting approach?

Interpretive response: The simplified hedge accounting approach can be used by a private company other than a financial institution. A private company is any entity that is not a public business entity, an NFP or an employee benefit plan. A financial institution is a bank, savings and loan association, savings bank, credit union, finance company or insurance entity. [815-20-25-135, 815-20 Glossary, 942-320-50-1]

Financial institutions were excluded from the simplified hedge accounting approach because they generally have greater exposure to financial instruments and typically have quarterly reporting requirements. [ASU 2017-12.BC184]



Question 16.2.20

Do all interest rate swaps qualify for simplified hedge accounting?

Interpretive response: No. Only the following types of swaps qualify for simplified hedge accounting:

- a receive-variable, pay-fixed interest rate swap that is designated in a cash flow hedge of a variable-rate borrowing; and
- a forward-starting receive-variable, pay-fixed interest rate swap.

To qualify for simplified hedge accounting, these interest rate swaps need to meet the criteria specified in paragraph 815-20-25-137 (see section 16.2.20). [815-20-25-134, 25-138]



Question 16.2.30

Does simplified hedge accounting have to be applied to all eligible swaps?

Interpretive response: No. An eligible private company can elect to apply simplified hedge accounting on a swap-by-swap basis, provided that all of the criteria for applying simplified hedge accounting are met for each individual swap. [ASU 2014-03.BC20]

If a private company does not elect simplified hedge accounting, it may avail itself of the documentation relief applicable to private companies (see section 16.3) or follow the general hedge accounting guidance (see chapter 6).



Question 16.2.40

Why might a private company choose not to use simplified hedge accounting?

Interpretive response: There are two common reasons why a private company may decide not to apply simplified hedge accounting.

Entity may not qualify throughout the hedging relationship's life

Before it adopts simplified hedge accounting, a private company may want to consider if it will be eligible to apply the simplified approach throughout the life of the hedging relationship. There may be costs due to the time and effort associated with discontinuing simplified hedge accounting and redesignating a new hedging relationship to apply the general hedge accounting guidance.

For example, a private company that becomes a public business entity will no longer be eligible for simplified hedge accounting for existing hedges or discontinued hedges that are included in the financial statements. In these circumstances, the entity will be required to retrospectively adjust its financial statements to remove the effects of the private company accounting guidance, including the accounting effects under simplified hedge accounting (see section 16.2.40). The entity will not be allowed to adopt the general hedge accounting guidance from inception of the hedge, because the contemporaneous documentation requirement and the additional qualifying criteria will not have been met (see section 6.9).

Entity's financial statements are incorporated into the financial statements of an SEC registrant

A private company's financial statements that are incorporated into a public parent entity's financial statements (as filed with the SEC) cannot incorporate simplified hedge accounting. This means that the private company could adopt simplified hedge accounting for its stand-alone reporting, but not for consolidation by the public parent entity. If the entity wanted to apply hedge accounting at the consolidated level, it would have to comply with the general hedge accounting guidance.



Question 16.2.50

What are the ongoing requirements when applying simplified hedge accounting?

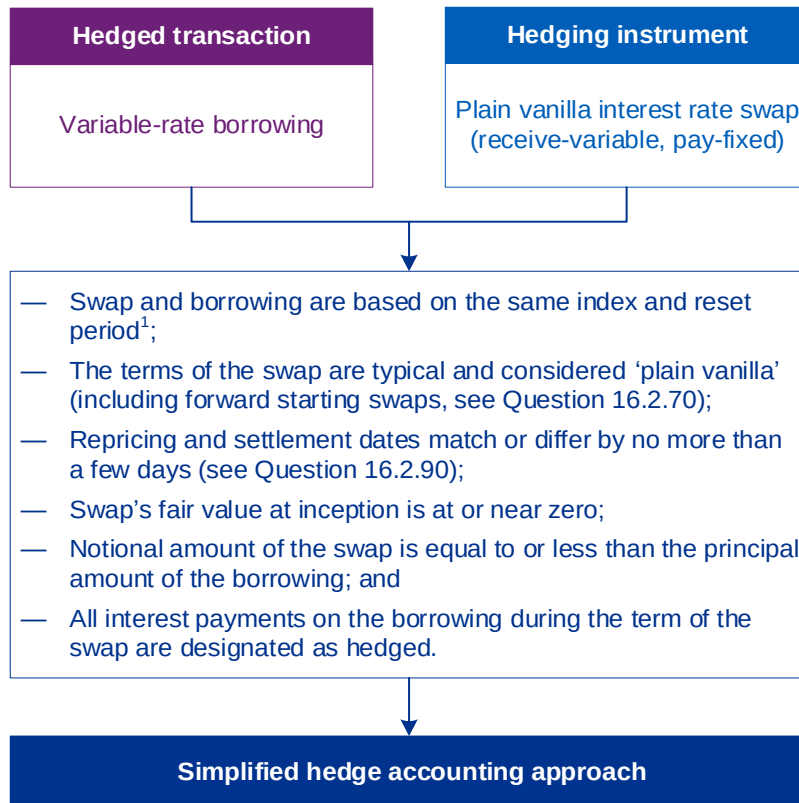
Interpretive response: A private company that adopts simplified hedge accounting is exempt from quarterly hedge effectiveness testing. However, a private company should periodically verify that the criteria to apply simplified hedge accounting are still met.

If the interest rate swap is a forward-starting swap, the company should periodically reassess if the interest payments are still probable. If any of the conditions to apply simplified hedge accounting subsequently cease to be met, or the relationship otherwise ceases to qualify for hedge accounting, the simplified approach is discontinued (see section 16.2.40).

16.2.20 Simplified hedge accounting criteria

The following criteria must be met before an entity applies simplified hedge accounting. [815-20-25-137]

16. Private companies and entities that do not report earnings



Note:

1. This would include borrowings where the borrower has an option to select the interest rate index (you pick 'em debt) as long as the interest rate of the swap and borrowing are based on the same index at the inception of the swap and thereafter.



Question 16.2.60

Can the hedged risk be a nonbenchmark interest rate risk?

Interpretive response: Yes. Although interest rate swaps are commonly based on benchmark interest rates, simplified hedge accounting is not limited to hedges of benchmark interest rates. Therefore, simplified hedge accounting may be applied to borrowings that are not based on a benchmark interest rate (e.g. prime rate) as long as all the criteria are met. In other words, both the variable rate on the swap and the borrowing must be based on the same index and reset period, but that index does not have to be a benchmark interest rate.

[815-20-25-137]



Question 16.2.70

What qualifies as a plain vanilla swap to be eligible for simplified hedge accounting?

Interpretive response: The term ‘plain vanilla’ swap is not defined under US GAAP; therefore, judgment is required to determine what types of swaps are plain vanilla.

The FASB deliberated whether swaps other than plain vanilla swaps should be allowed to be designated under simplified hedge accounting. It decided to limit simplified hedge accounting to a narrow set of circumstances such that the approach addresses the prevalent practice issue of a private company entering into a plain vanilla receive-variable, pay-fixed interest rate swap for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing.

As such, the FASB observed that using of other than plain vanilla swaps may reflect more sophisticated structured financing arrangements that would not provide the sufficiently narrow set of circumstances to apply simplified hedge accounting. [\[ASU 2014-03.BC9\]](#)

The FASB acknowledged that forward-starting interest rate swaps may qualify if the occurrence of the hedged forecasted interest payments to be swapped is probable and the required criteria to apply simplified hedge accounting are met (see below, Forward-starting interest rate swaps). [\[ASU 2014-03.BC12\]](#)



Question 16.2.80

Can an entity hedge borrowings with embedded interest rate caps or floors under simplified hedge accounting?

Interpretive response: Yes. Borrowings with embedded interest rate caps or floors may qualify for simplified hedge accounting if there is a comparable feature in the swap. Topic 815 indicates that comparable does not necessarily mean equal. For example, if the swap’s variable rate is the LIBOR and the borrowing’s variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap is comparable to a 12 percent cap on the borrowing. [\[815-20-55-79A, ASU 2014-03.BC11\]](#)



Question 16.2.90

How should an entity evaluate the difference between the repricing and settlement dates of the debt and the interest rate swap?

Interpretive response: Paragraph 815-20-25-137 indicates that the repricing and settlement date of the swap and borrowing may differ by a few days but does not provide additional guidance. The FASB observed that a ‘few days’ is not intended to provide a blanket or extended period. Instead, it is provided only

as a means to address administrative or other practicability concerns. [ASU 2014-03.BC15]

Forward-starting interest rate swaps



Excerpt from ASC 815-20

> Hedge Accounting Provisions Applicable to Certain Private Companies

>> Assuming Perfect Hedge Effectiveness in a Cash Flow Hedge of a Variable-Rate Borrowing with a Receive-Variable, Pay-Fixed Interest Rate Swap Recorded under the Simplified Hedge Accounting Approach

25-138 A cash flow hedge established through the use of a forward starting receive-variable, pay-fixed interest rate swap may be permitted in applying the simplified hedge accounting approach only if the occurrence of forecasted interest payments to be swapped is probable. When forecasted interest payments are no longer probable of occurring, a cash flow hedging relationship will no longer qualify for the simplified hedge accounting approach and the General Subsections of this Topic shall apply at the date of change and on a prospective basis.

20 Glossary

Forecasted Transaction – A transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

A forward-starting receive-variable, pay-fixed interest rate swap is an interest rate swap with settlements that will begin at a later date. They can be used to hedge interest payments associated with obligations that are expected to arise in the future. For example, if an entity intends to obtain a construction loan in two years, it could enter into a forward-starting interest rate swap with settlements that begin at the time the construction loan is expected to be entered into.

Because the hedge is of future interest payments on a borrowing that is expected to be issued at a future date, the entity has to demonstrate that the future interest payments are probable. Probability is assessed at the same threshold level as required for nonprivate companies as explained in section 9.3.40. If the interest payments are no longer probable, the entity has to discontinue the cash flow hedging relationship. [815-20-25-138]

Forecasted transactions

To verify that the probability assessment has not changed and the conditions to apply the simplified approach are still met, the entity periodically reassesses if the interest payments are still probable.

For further information on forecasted transactions, the eligibility criteria of applying hedge accounting to forecasted transactions and the probability assessment of forecasted transactions, see section 9.3.

16.2.30 Subsequent measurement



Excerpt from ASC 815-10

35-1A As a practical expedient, a receive-variable, pay-fixed interest rate swap for which the simplified hedge accounting approach (see paragraphs 815-20-25-131AB through 25-131E for scope) is applied may be measured subsequently at settlement value instead of fair value.

35-1B The primary difference between settlement value and fair value is that **nonperformance risk** is not considered in determining settlement value. One approach for estimating the receive-variable, pay-fixed interest rate swap's settlement value is to perform a present value calculation of the swap's remaining estimated cash flows using a valuation technique that is not adjusted for nonperformance risk.

50-3 If the simplified hedge accounting approach (see paragraphs 815-20-25-133 through 25-138) is applied in accounting for a qualifying receive-variable, pay-fixed interest rate swap, the settlement value of that swap may be used in place of **fair value** when disclosing the information required by this Section or in providing other fair value disclosures, such as those required under Topic 820 on fair value. For the purposes of complying with these disclosure requirements, amounts disclosed at settlement value will be subject to all of the same disclosure requirements as amounts disclosed at fair value. Any amounts disclosed at settlement value shall be clearly stated as such and disclosed separately from amounts disclosed at fair value.

When applying the simplified hedge accounting approach, a private company may elect to measure the interest rate swap at settlement value instead of at fair value. However, any amounts disclosed at settlement value need to be clearly stated as settlement values in the disclosures. The disclosure requirements relating to fair value in Topic 815 and Topic 820 (fair value measurement), apply regardless of whether the swap is measured at fair value or settlement value. [815-10-35-1A, 50-3]



Question 16.2.100

How is the settlement value of an interest rate swap different from fair value?

Interpretive response: The primary difference between settlement value and fair value is that nonperformance risk is not considered in measuring settlement value. [815-10-35-1B]

A private company may elect to record the settlement value of the swap on the financial statements and in the required disclosures instead of recording the fair value of the swap. If a company elects to use the settlement value, it should be clearly stated.

Although a private company may choose to measure an interest rate swap at settlement value under simplified hedge accounting, the FASB noted that the guidance in Topic 815 requiring the consideration of counterparty credit risk still applies. To initially and subsequently qualify for simplified hedge accounting, a private company is required to satisfy the requirements of Topic 815 regarding the consideration of counterparty credit risk and the possibility of default by the counterparty to a hedging derivative. [\[ASU 2014-03.BC17, BC25\]](#)

If the likelihood that the counterparty to a hedging derivative will not default ceases to be probable, a private company will be unable to conclude that the cash flow hedging relationship is highly effective in offsetting cash flows. For further discussion on assessing counterparty credit risk when qualifying for cash flow hedge accounting, see section 13.2.60. [\[815-20-25-122, 35-14 – 35-15\]](#)

16.2.40 Discontinuation of simplified hedge accounting



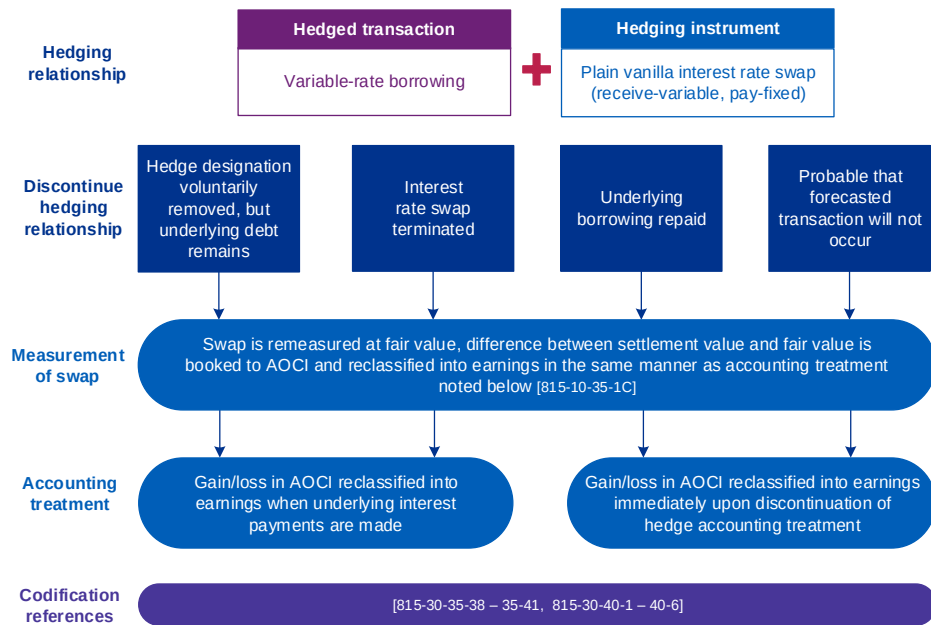
Excerpt from ASC 815-10

35-1C If any of the conditions in paragraph 815-20-25-131D for applying the simplified hedge accounting approach subsequently cease to be met or the relationship otherwise ceases to qualify for hedge accounting, the General Subsections of this Topic shall apply at the date of change and on a prospective basis. For example, if the related variable-rate borrowing is prepaid without terminating the receive-variable, pay-fixed interest rate swap, the gain or loss on the swap in accumulated other comprehensive income shall be reclassified to earnings in accordance with paragraphs 815-30-40-1 through 40-6 with the swap measured at fair value on the date of change and subsequent changes in fair value reported in earnings in accordance with paragraph 815-10-35-2. Similarly, if the receive-variable, pay-fixed interest rate swap is terminated early without the related variable-rate borrowing being prepaid, the gain or loss on the swap in accumulated other comprehensive income shall be reclassified to earnings in accordance with paragraphs 815-30-40-1 through 40-6.

If the criteria to qualify for simplified hedge accounting cease to be met, a private company may no longer apply the approach. For example, a simplified hedge accounting relationship involving a forecasted borrowing should be discontinued if the forecasted borrowing is no longer probable. [\[815-10-35-1C\]](#)

The subsequent accounting for the gains or losses on the interest rate swap depends on the reason for discontinuing the hedging relationship. For example, if it is probable that the forecasted borrowing will not occur, the gain or loss on the interest rate swap previously recognized in AOCI is reclassified into earnings immediately. [\[815-30-40-5\]](#)

The following diagram depicts scenarios in which simplified hedge accounting is discontinued and the related accounting effect.



For a discussion of the subsequent accounting for discontinued hedges when the hedged transactions are still probable, see section 10.5.

Redesignation. A private company that no longer meets the conditions to apply the simplified hedge accounting approach may choose to redesignate the interest rate swap in a new hedging relationship under the general hedge accounting guidance if the hedge qualifying criteria are met (see section 6.10.70).



Question 16.2.110

Can an entity voluntarily change from simplified hedge accounting to general hedge accounting?

Interpretive response: Yes, but the entity will have to dedesignate the hedging relationship and redesignate the hedging relationship taking into account the general hedge accounting requirements (see section 6.10.70). However, the swap may no longer have a zero fair value, which will impact the effectiveness assessment of the hedging relationship under the general hedge accounting guidance (see Question 6.10.120).

When an entity discontinues the simplified hedge accounting approach, the interest rate swap is measured at fair value on the date of the discontinuance and the difference between the fair value and settlement value is recognized in AOCI. [815-10-35-1C]

In addition, as discussed above, the entity has to consider the timing of reclassification of amounts recognized in AOCI related to the dedesignated hedging relationship.

16.2.50 Timing and extent of documentation

While the general hedge designation requirements in paragraph 815-20-25-3 apply to simplified hedge accounting (see chapter 6), the simplified approach extends the length of time a private company has to document its hedging relationship.

Element of hedge documentation	Timing
Simplified hedge accounting approach	
All hedge designation documentation [815-20-25-3]	By the date on which the first annual financial statements are available to be issued after hedge inception [815-20-25-136]

The hedge documentation, including assessment of the qualifying criteria for simplified hedge accounting, should be completed with information applicable at inception of the hedge.

16.3 Additional hedging relief when simplified hedge accounting is not applied



Excerpt from ASC 815-20

>> Timing of Hedge Documentation for Certain Private Companies If Simplified Hedge Accounting Approach Is Not Applied

>>> Concurrent Hedge Documentation

25-139 Concurrent with hedge inception, a **private company** that is not a financial institution as described in paragraph 942-320-50-1 shall document the following:

- The hedging relationship in accordance with paragraph 815-20-25-3(b)(1)
- The hedging instrument in accordance with paragraph 815-20-25-3(b)(2)(i)
- The hedged item in accordance with paragraph 815-20-25-3(b)(2)(ii), including (if applicable) firm commitments or the analysis supporting a last-of-layer designation in paragraph 815-20-25-3(c), or forecasted transactions in paragraph 815-20-25-3(d)
- The nature of the risk being hedged in accordance with paragraph 815-20-25-3(b)(2)(iii).

25-140 A private company that is not a financial institution is not required to perform or document the following items concurrent with hedge inception but

rather is required to perform or document them within the time periods discussed in paragraph 815-20-25-142:

- a. The method of assessing hedge effectiveness at inception and on an ongoing basis in accordance with paragraph 815-20-25-3(b)(2)(iv) and (vi)
- b. Initial hedge effectiveness assessments in accordance with paragraph 815-20-25-3(b)(2)(iv)(01) through (04).

25-141 Example 1A beginning in paragraph 815-20-55-80A illustrates hedge documentation when the critical terms of the hedging instrument and hedged forecasted transaction match. Although that Example illustrates the documentation of the method of assessing hedge effectiveness, private companies that are not financial institutions may complete hedge documentation requirements in accordance with paragraphs 815-20-25-139 through 25-140.

>>> Hedge Effectiveness Assessments

25-142 For a private company that is not a financial institution, the performance and documentation of the items listed in paragraph 815-20-25-140, as well as required subsequent quarterly hedge effectiveness assessments, may be completed before the date on which the next interim (if applicable) or annual financial statements are available to be issued. Even though the completion of the initial and ongoing assessments of effectiveness may be deferred to the date on which **financial statements are available to be issued** the assessments shall be completed using information applicable as of hedge inception and each subsequent quarterly assessment date when completing this documentation on a deferred basis. Therefore, the assessment should be performed to determine whether the hedge was highly effective at achieving offsetting changes in fair values or cash flows at inception and in each subsequent quarterly assessment period up to the reporting date.

> Hedge Accounting Provisions Applicable to Certain Not-for-Profit Entities

25-143 Not-for-profit entities (except for not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market) may apply the guidance on the timing of hedge documentation and hedge effectiveness assessments in paragraphs 815-20-25-139 through 25-142. Specifically, those entities shall document the items listed in paragraph 815-20-25-139 concurrent with hedge inception, but they may perform and document the items listed in paragraph 815-20-25-140 and perform the required subsequent quarterly hedge effectiveness assessments in accordance with paragraph 815-20-25-142 within the time periods discussed in paragraph 815-20-25-142.

16.3.10 Overview

If a private company does not elect simplified hedge accounting for its cash flow hedging relationships of interest rate risk, it may still take advantage of the following relief for such hedging relationships, as well as other hedging relationships:

Hedge documentation	— relaxed timing of documentation requirements (see section 16.3.20); and
Hedge effectiveness	— relaxed timing of initial and subsequent quarterly hedge effectiveness assessments (see section 16.3.30).

These relaxed requirements are also available to certain NFPs.

Although the FASB granted additional time to prepare or perform certain hedge documentation and effectiveness assessments, they decided to continue requiring these entities to document certain elements of the hedging relationship at inception.

This is because the FASB concluded that sound risk management practices support such information being considered and documented concurrently with derivative execution, and also to prevent retroactive designation (or dedesignation) of hedging relationships to achieve desired outcomes. [ASU 2017-12.BC179, BC186]



Question 16.3.10

Which private companies and NFPs may take advantage of the timing relief?

Interpretive response: The following types of private companies and NFPs may take advantage of the relaxed timing requirements discussed in sections 16.3.20 and 16.3.30:

- private companies that are not financial institutions, as that term is described in paragraph 942-320-50-1. A private company is an entity other than a public business entity, an NFP or an employee benefit plan in the scope of Topics 960 through 965 on plan accounting. [815-20-25-139 – 25-140, 815-20 Glossary]
- NFPs other than those that have issued (or are a conduit bond obligor for) securities that are traded, listed or quoted on an exchange or an over-the-counter market. [815-20-25-143]

For a discussion of the timing of documentation for a private company that elects simplified hedge accounting, see section 16.2.50.

16.3.20 Documentation requirements#

The documentation requirements for a private company not electing to apply simplified hedge accounting are the same as for an entity applying the general hedge accounting guidance. However, the timing of the preparation of documentation is relaxed. This relaxed timing is also available to certain NFPs (see Question 16.3.10).

The following table summarizes the required timing of the elements of initial hedge documentation, including initial hedge effectiveness assessment.

16. Private companies and entities that do not report earnings

Element of hedge documentation	Timing	
	Certain private companies and certain NFPs (not applying simplified hedge accounting)	Entities applying general hedge accounting guidance (section 6.9)
Risk management objective and strategy. — The hedging relationship — The hedging instrument — The hedged item or transaction or the analysis supporting a last-of-layer designation — The nature of the risk being hedged — Documentation applicable to fair value hedges only — Documentation applicable to cash flow hedges only [815-20-25-3(b)(1) – 25-3(b)(2)(iii), 25-3(c) – 25-3(d)]	Concurrent with hedge designation. [815-20-25-139, 25-143]	Concurrent with hedge designation. [815-20-25-3]
Hedge effectiveness method. The method that will be used subsequently to retrospectively and prospectively assess hedge effectiveness. [815-20-25-3(b)(2)(iv)] — If subsequent hedge effectiveness assessments will be assessed qualitatively, how it will be carried out and which quantitative method will be used if required. The same quantitative method is required to be used for the initial and subsequent prospective hedge effectiveness assessments. [815-20-25-3(b)(2)(iv)(03)] — If the shortcut method is applied and, if the entity so elects, the quantitative method that will be used if it is later determined that the shortcut method was	By the date on which the next interim (if applicable) or annual financial statements are available to be issued. [815-20-25-140, 25-142, 25-143]	Concurrent with hedge designation. [815-20-25-3]

16. Private companies and entities that do not report earnings

Element of hedge documentation	Timing	
	Certain private companies and certain NFPs (not applying simplified hedge accounting)	Entities applying general hedge accounting guidance (section 6.9)
not or is no longer appropriate. [815-20-25-3(b)(2)(iv)(04)]		
Initial hedge effectiveness. Initial prospective assessment of hedge effectiveness (if quantitative testing is required). [815-20-25-3(b)(2)(iv)]	By the date on which the next interim (if applicable) or annual financial statements are available to be issued after hedge inception. [815-20-25-140, 25-142, 25-143]	Earlier of the following: [815-20-25-3(b)(2)(iv)] — first quarterly hedge effectiveness assessment date; — date the financial statements that include the hedged transaction are available to be issued; — date any hedge accounting criterion is no longer met; — date the hedging instrument expires or is sold, terminated or exercised; — date the hedging relationship is dedesignated; or — for a cash flow hedge of a forecasted transaction (under paragraph 815-20-25-13(b)), the date the forecasted transaction occurs. See also section 6.9.40 .



Example 16.3.10

Timing of preparing initial hedge documentation

The following scenario illustrates the required timing for preparing initial hedge documentation for a private company hedging relationship that is not eligible for simplified hedge accounting. The example does not demonstrate the timing of performing quarterly hedge effectiveness assessments, which is discussed in section 16.3.30.

Fact pattern

PrivateCo is a private company that is not a financial institution, so it is not required to document certain additional elements of the hedging relationship until after hedge inception. PrivateCo does not prepare interim financial statements.

Hedging relationship begins earlier in the quarterly period

PrivateCo enters into a cash flow hedging relationship on March 15, Year 1, in which the hedged item is a forecasted transaction expected to occur in one year.



A	On this date, the initial hedge documentation is required to include the following: the hedging relationship, hedging instrument, hedged transaction and nature of risk being hedged, as well as other documentation specifically applicable to a cash flow or fair value hedge, as applicable.
B	By this date, the following are required to be performed/documentated: — the method that will be used subsequently to retrospectively and prospectively assess hedge effectiveness; and — the initial prospective quantitative effectiveness assessment.

16.3.30 Subsequent quarterly hedge effectiveness assessments

An entity applying hedge accounting is generally required to perform a prospective assessment at hedge inception to demonstrate that the hedging relationship is expected to be highly effective. [815-20-25-79(a)]

Additionally, subsequent to inception, the entity is generally required to perform both prospective and retrospective assessments of **hedge effectiveness**. These are referred to as 'quarterly hedge effectiveness assessments'. [815-20-25-79]

Certain private companies and NFPs (see Question 16.3.10) may be eligible for the relief in the timing requirements relating to the ongoing hedge

effectiveness assessments. The following table summarizes the required timing of the elements of the ongoing hedge effectiveness assessment.

Hedge accounting for private companies and NFPs	Entities applying general hedge accounting guidance
Additional relief when simplified hedge accounting is not applied	
Quarterly hedge effectiveness assessments need not be performed until the next interim or annual financial statements are available to be issued.	Hedge effectiveness testing performed on a quarterly basis (see section 13.2.20).

Although the timing of hedge effectiveness and quarterly effectiveness testing is relaxed, the testing should be performed with information available at each quarterly assessment date. [\[815-20-25-142\]](#)



Question 16.3.20

Are there downsides to delaying the quarterly hedge effectiveness assessments?

Interpretive response: Yes. Although the relaxed timing for hedge effectiveness assessments may initially seem advantageous, an entity may run into problems if the hedge effectiveness testing is not performed timely. For example, if the hedge is not highly effective throughout the entire year, the entity will not be able to maintain the hedge accounting treatment and will have to dedesignate the hedging relationship from the last time period when it was highly effective.



Question 16.3.30

Why are certain entities *without* quarterly reporting requirements required to perform quarterly hedge effectiveness assessments?

Interpretive response: The FASB noted that Topic 815's original intent was for hedge effectiveness to be continuously monitored on an ongoing basis. However, to make the model operable, the guidance required formal effectiveness assessments every three months. [\[ASU 2017-12.BC184\]](#)

One reason the FASB decided to provide certain private companies (and certain NFPs) with additional time to perform effectiveness assessments is because many do not have quarterly reporting requirements.

However, the FASB decided not to reduce the minimum quarterly frequency of effectiveness assessments. This is because if an entity only assesses effectiveness once before its annual financial statements are available to be issued and that assessment reveals the hedge to not be highly effective, it may be more difficult to determine when the hedge ceased to be highly effective

than if effectiveness assessments were performed on a quarterly basis. [815-20-25-142 – 25-143, ASU 2017-12.BC184]



Example 16.3.20

Timing of performing quarterly hedge effectiveness assessments

The following scenarios illustrate the required timing for preparing quarterly hedge effectiveness assessments by certain private companies (and certain NFPs) for a hedging relationship that is not eligible for simplified hedge accounting.

PrivateCo is a private company that is not a financial institution. The same fact pattern as in Example 16.3.10 applies here.

The following additional assumptions are relevant to the given scenario.

- PrivateCo is required to perform an initial prospective effectiveness assessment quantitatively and ongoing hedge effectiveness assessments.
- PrivateCo performs prospective and retrospective quarterly hedge effectiveness assessments as of every three months on the last day of the quarter, with the first date being March 31, Year 1.
- PrivateCo is permitted to perform its assessments at later times, but is required to use information as of the quarterly hedge effectiveness assessment dates. (Scenario 1 only)

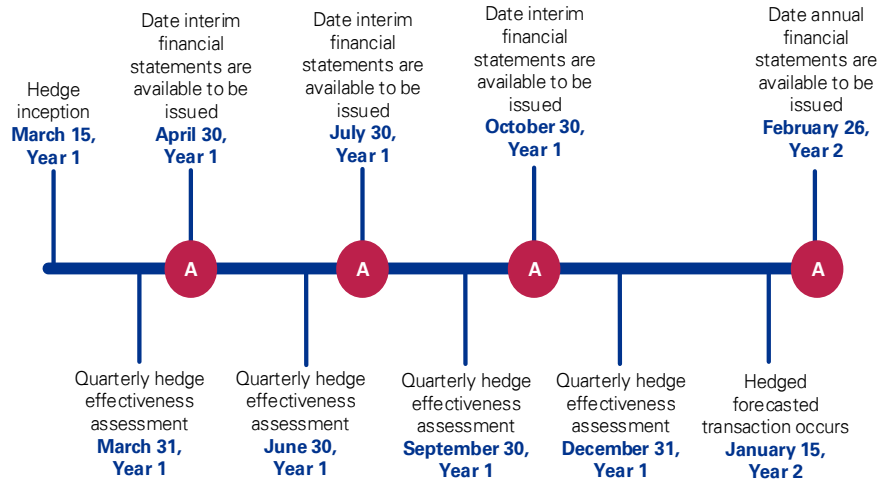
In both scenarios, assume the next quarterly effectiveness assessment date is March 31, Year 1.

Scenario 1: PrivateCo does not prepare interim financial statements



A

By the date PrivateCo's annual financial statements are available to be issued, it is required to perform quarterly effectiveness assessments using information applicable as of each quarter-end date.

Scenario 2: PrivateCo prepares interim financial statements

A

By the date PrivateCo's quarterly and annual financial statements are available to be issued, it is required to perform quarterly effectiveness assessments using information applicable as of the related quarter-end date.

16.4 Entities that do not report earnings**

16.4.10 Overview



Excerpt from ASC 815-10

> Entities

15-1 This Subtopic applies to all entities. Some entities, such as not-for-profit entities (NFPs) and defined benefit pension plans, do not report earnings as a separate caption in a statement of financial performance. The application of this Subtopic to those entities is set forth in paragraphs 815-10-35-3, 815-20-15-1, 815-25-35-19 and 815-30-15-3.

General

35-3 An entity that does not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit entity [NFP] or a defined benefit pension plan) shall recognize the gain or loss on a nonhedging derivative instrument as a change in net assets in the period of change.

**Excerpt from ASC 815-20****> Entities**

15-1 The guidance in this Subtopic applies to all entities, with the following exceptions:

- a. Entities that do not report earnings separately are not permitted to use cash flow hedge accounting as described in this Subtopic or Subtopic 815-30 on cash flow hedges.
- b. Entities that do not report earnings separately are not permitted to elect the amortization approach for amounts excluded from the assessment of effectiveness under fair value hedge accounting in accordance with paragraphs 815-20-25-83A and 815-25-35-1(a).

**Excerpt from ASC 815-25****> Entities That Do Not Report Earnings**

35-19 An entity that does not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit entity [NFP] or a defined benefit pension plan) shall recognize the gain or loss on a hedging instrument as a change in net assets in the period of change unless the hedging instrument is designated as a hedge of the foreign currency exposure of a net investment in a foreign operation. In that circumstance, the provisions of paragraphs 815-20-25-66 and 815-35-35-1 through 35-2 shall be applied. Entities that do not report earnings shall recognize the changes in the carrying amount of the hedged item pursuant to paragraphs 815-25-35-1 and 815-25-35-4 in a fair value hedge as a change in net assets in the period of change.

**Excerpt from ASC 815-30****> Entities**

15-2 The guidance in this Subtopic does not apply to the following entities:

- a. Entities that do not report earnings. Those entities are not permitted to use **cash flow hedge** accounting because they do not report earnings separately.

15-3 Consistent with the provisions of Topic 958, this Subtopic does not prescribe how a not-for-profit entity (NFP) should determine the components of an operating measure, if one is presented. For guidance on the application of this Subtopic by not-for-profit health care entities, see Subtopic 954-815.

Topic 815 applies to all entities that apply US GAAP as promulgated by the FASB. This includes entities that do not report earnings as a separate caption on the balance sheet, such as certain NFPs and defined benefit pension plans. [815-10-15-1]

For these entities, amounts that would normally be reported in earnings are reported in the change in net assets – i.e. changes in the fair value of: [815-10-35-3, 815-25-35-19]

- a nonhedging derivative instrument;
- a hedging derivative instrument – other than those instruments designated as a hedge of the foreign currency exposure of a net investment in a foreign operation; and
- a hedged item in a fair value hedge that is attributable to the hedged risk.

The foreign currency transaction gain or loss on a hedging derivative or nonderivative instrument that is the hedging instrument in a net investment hedging relationship is reported in the same manner as a translation adjustment. [815-25-35-19]

Hedge accounting is generally available to these entities, except that they cannot apply **cash flow hedge accounting** and they cannot elect an amortization approach for excluded components when applying fair value hedge accounting.

The effect of both of these prohibitions is to report certain amounts in OCI, rather than earnings. For cash flow hedging, changes in the fair value of a derivative hedging instrument are reported in OCI; and when an amortization approach is used for an excluded component in a fair value hedge, the difference between the change in fair value of the excluded component and the amount recognized in income is included in OCI.

Because these entities do not differentiate between earnings and OCI on their balance sheet, they cannot apply cash flow hedge accounting or apply an amortization approach for excluded components when applying fair value hedge accounting. [815-20-15-1, 815-30-15-2]



Question 16.4.10**

Can an NFP healthcare organization in the scope of Topic 954 apply cash flow hedge accounting, and an amortization approach for excluded components when applying fair value hedge accounting?

Background: Many healthcare organizations are organized as NFPs and Topic 958 (NFPs) does not require NFPs to report earnings. However, Topic 954 (healthcare organizations) requires nongovernmental healthcare organizations – including those organized as NFPs – to report a defined measure of earnings (performance indicator) as a separate caption in the statement of operations. [958-220-05-1, 954-220-45-5]

Interpretive response: Yes. Subtopic 954-815 clarifies that NFP healthcare organizations in its scope should apply Topic 815 in the same manner as for-profit entities. This includes being permitted to apply cash flow hedge

accounting, and to apply an amortization approach for excluded components when applying fair value hedge accounting. The performance indicator is considered analogous to income from continuing operations of a for-profit enterprise. [954-815 Glossary, 954-815-45-1 – 45-2]

NFP healthcare organizations are also required to provide the disclosures required by Topic 815, including disclosures related to reclassifications into earnings of gains and losses that are reported in AOCI.

Although such organizations are not otherwise required to report changes in the components of comprehensive income, they do need to separately disclose the following in a manner similar to that described in paragraph 815-30-50-2: [954-815-50-1]

- the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator;
- the related net change associated with current period hedging transactions; and
- the net amount of any reclassifications into the performance indicator.

NFPs outside the scope of Topic 954 cannot apply cash flow hedge accounting.



Question 16.4.20**

Does an NFP healthcare organization present the gain or loss on nonhedging derivatives within the performance indicator?

Interpretive response: Yes. Because an entity that reports earnings would report the gains or losses on nonhedging derivative instruments in earnings, we believe an NFP healthcare organization should report the change in fair value of its nonhedging derivative instruments within the performance indicator.

The performance indicator is considered analogous to income from continuing operations of a for-profit enterprise. The performance indicator is expected to report changes in assets from operations, while items not related to operations are reported separately from the performance indicator. Further, Subtopic 954-220 provides a list of items that should be excluded from the performance indicator, which are similar to items treated as part of OCI for entities that report earnings. [954-220-45-8, 954-815 Glossary]

16.4.20 Split-interest agreements**



Excerpt from ASC 958-30

>>> Split-Interest Agreements with Embedded Derivatives

25-7 The following two aspects of a split-interest agreement's payment terms affect the accounting treatment for an NFP's liability for the payment or payments to the donor or the donor's beneficiary:

- a. Whether the payments are a fixed or variable cash amount
- b. Whether the agreement is period-certain or life-contingent.

25-8 An NFP's liability for its obligation to the donor or the donor's beneficiary under an irrevocable split-interest agreement shall be analyzed to determine whether it qualifies for the exception in paragraphs 815-10-15-52 through 15-57, in which case that liability would not be subject to the requirements of Topic 815. For example, if the obligation is solely life-contingent (that is, contingent upon the survival of an identified individual, in which case the payments are made only if the individual is alive when the payments are due), that obligation would qualify for the exception in paragraphs 815-10-15-52 through 15-57.

25-9 If an NFP's liability for its obligation under the split-interest agreement does not qualify for the exception in paragraphs 815-10-15-52 through 15-57 because the agreement is not solely life-contingent, the NFP shall determine whether that liability meets the definition of a derivative instrument in its entirety under paragraph 815-10-15-83 or whether it contains an embedded derivative that could warrant separate accounting under paragraph 815-15-25-1 unless a fair value election is made pursuant to Section 815-15-25.

25-10 The NFP's liability for its obligation under a split-interest agreement would typically not meet the definition of a derivative instrument in its entirety because it would not meet the criterion in paragraph 815-10-15-83(b) that requires the contract to have no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. In contrast, the initial net investment for the liability recognized for typical split-interest agreements is its **fair value**.

25-11 If an NFP's liability for its obligation under the split-interest agreement does not in its entirety meet the definition of a derivative instrument in paragraph 815-10-15-83, that liability shall be analyzed to determine whether it contains provisions that constitute an embedded derivative that warrants separate accounting under paragraph 815-15-25-1.

25-12 Generally, the liability representing an obligation under a split-interest agreement contains an embedded derivative if the payments are variable and the agreement is period-certain (rather than life-contingent). The embedded derivative shall be bifurcated and accounted for as a derivative instrument pursuant to the requirements of paragraph 815-15-25-1 unless a fair value election is made pursuant to Section 815-15-25 or the Fair Value Option Subsections of Subtopic 825-10.

25-13 Example 2, Cases A through H (see paragraphs 958-30-55-6 through 55-29) illustrate the applicability of paragraphs 958-30-25-7 through 25-12 to various split-interest agreements that are invested in shares of common stock.

25-14 Other split-interest agreements may involve the gift of corporate or U.S. government debt securities, or other securities that are not equity. In determining whether or not those split-interest agreements contain an embedded derivative, the same analysis outlined in paragraph 815-15-25-1 shall be applied. The notion of clearly and closely related, as defined in paragraph 815-15-25-1(a), shall involve an assessment of the economic characteristics and risks associated with the nonequity securities in relation to the economic

characteristics and risks of the NFP's debt host contract. Generally, because of the differences in credit risk, the change in the fair value of corporate bonds (based on that corporation's credit and interest rate risk) will not be clearly and closely related to the change in the economic characteristics and risks of the NFP's debt host contract. Thus, an embedded derivative requiring bifurcation and separate accounting for the embedded derivative would exist unless a fair value election is made pursuant to Section 815-15-25 or the Fair Value Option Subsections of Subtopic 825-10.

In a split-interest agreement, a donor enters into a trust or other arrangement under which an NFP receives benefits that are shared with other beneficiaries.

A typical split-interest agreement comprises two components, either of which may be held by the NFP.

- **Lead interest.** This represents the rights to the benefits of the transferred assets during the term of the agreement, which starts on the date the agreement is signed and ends either after a specified number of years (period-certain) or upon the occurrence of an event, commonly death of the donor or lead beneficiary (life-contingent).
- **Remainder interest.** This represents the right to receive all or a portion of the assets remaining at the end of the agreement's term.

Typically, the contributed assets are under the NFP's control. However, the NFP has an obligation to make specified cash payments to the designated beneficiary or convey the remaining assets to the donor or its beneficiaries.



Question 16.4.30**

Does an NFP recognize a derivative or bifurcate an embedded derivative related to a split-interest agreement?

Interpretive response: Yes, if the agreement meets the definition of a derivative (or embedded derivative) and no scope exception applies. An NFP is subject to Topic 815, including its requirements to recognize freestanding derivatives (see chapter 3) and to bifurcate embedded derivatives, unless there is an applicable scope exception (see chapter 2).

The following table summarizes considerations for these arrangements when the NFP has the remainder interest. See FASB Example 2 (reproduced below), which illustrates these considerations and also illustrates considerations when the NFP has the lead interest.

Type of arrangement	Topic 815 Considerations
Life-contingent Note: In our experience the majority of split-interest arrangements are life-contingent.	Solely life-contingent arrangements qualify for the scope exception applicable to certain insurance contracts (see section 2.5). [958-30-25-8, 958-815-55-1]

Type of arrangement	Topic 815 Considerations
Period-certain	These arrangements typically do not meet the initial net investment characteristic and, as a result, typically do not meet the definition of a derivative in their entirety. This is because the initial net investment for the liability recognized for a typical split-interest agreement is its fair value (the present value of the estimated future payments). [958-30-25-10] Whether a period-certain arrangement includes an embedded derivative requiring bifurcation often depends on whether it provides: [958-815-55-1] — Fixed payments. These arrangements typically do not have an embedded derivative requiring bifurcation because they do not have an underlying. [958-30-55-8] — Variable payments. These arrangements typically include an embedded derivative requiring bifurcation. [958-30-25-12, 25-14]



Excerpt from ASC 958-30

> > Example 2: Determining Whether a Split-Interest Agreement Has an Embedded Derivative

55-6 The following Cases provide an understanding of the applicability of paragraphs 958-30-25-7 through 25-14 to various split-interest agreements:

- Remainder interest—period-certain, fixed payments (Case A)
- Remainder interest—period-certain, variable payments (Case B)
- Remainder interest—life-contingent, variable or fixed payments (Case C)
- Remainder interest—period-certain-plus-life-contingent, fixed payments (Case D)
- Remainder interest—period-certain-plus-life-contingent, variable payments (Case E)
- Lead trust—period-certain, fixed or variable payments (Case F)
- Lead trust—life-contingent, fixed or variable payments (Case G)
- Lead trust—period-certain-plus-life-contingent, variable or fixed payments (Case H).

>>> Case A: Remainder Interest—Period-Certain, Fixed Payments

55-7 Shares of common stock are contributed to the control of an NFP which is required to pay the donor or the donor's beneficiary an annual fixed cash payment for 20 years, after which time the remaining shares revert to the NFP.

55-8 During the term of the agreement (20 years), the NFP has a liability that does not require bifurcation of an embedded derivative. Because the periodic cash payment is a fixed dollar amount, the liability has no underlying and, thus, does not meet the criterion in paragraph 815-10-15-83(a) of the definition of a

derivative instrument. Because there is no underlying, there is also no embedded derivative that warrants separate accounting under paragraph 815-15-25-1.

>>> Case B: Remainder Interest—Period-Certain, Variable Payments

55-9 Shares of common stock are contributed to the control of NFP, which is required to make 20 annual cash payments to the donor or the donor's beneficiary that are equal to a specified percentage of the fair value of the assets as of the beginning of each annual period (that is, a **charitable remainder unitrust**). After the 20 payments have been made, the remaining shares will revert to the NFP.

55-10 During the term of the agreement (20 years), the NFP has a liability that must be bifurcated because it contains an embedded derivative that warrants separate accounting unless a fair value election is made pursuant to Section 815-15-25 or Fair Value Option Subsections 825-10. Under paragraph 815-15-25-1, the liability represents a hybrid instrument that is composed of a debt host contract and an embedded equity-based derivative that is not clearly and closely related to the debt host contract and that would meet the definition of a derivative instrument if it were freestanding. That is, it meets all of the following criteria of paragraph 815-10-15-83:

- a. It has an underlying (price of shares).
- b. It has a notional amount (number of shares in the trust at the beginning of each annual period).
- c. It satisfies the no-or-smaller initial net investment characteristic in paragraph 815-10-15-83(b).
- d. It would meet the net settlement characteristic in paragraph 815-10-15-83(c) (because each annual payment is adjusted for the effect of the embedded equity-based derivative).

55-11 The debt host contract represents the liability for the series of 20 annual payments that would be required based on the assumption that the fair value of the common stock does not change over the 20-year period. The embedded equity-based derivative relates to the increase or decrease in each of the 20 annual payments due to changes in the fair value of the common stock.

>>> Case C: Remainder Interest—Life-Contingent, Variable or Fixed Payments

55-12 Shares of common stock are contributed to the control of an NFP, which is required to make annual cash payments to the donor or the donor's beneficiary that are either a fixed dollar amount or a specified percentage of the fair value of the assets at the beginning of each annual period until the death of the donor or the donor's beneficiary, upon which time the remaining shares will revert to the NFP.

55-13 During the term of the agreement, the NFP has a liability that is not bifurcated because it is solely life-contingent and thus qualifies for the exception in paragraphs 815-10-15-52 through 15-57.

>>> Case D: Remainder Interest—Period-Certain-Plus-Life-Contingent, Fixed Payments

55-14 Shares of common stock are contributed to the control of an NFP, which is required to pay the donor or the donor's beneficiary an annual fixed cash

payment for the longer of the beneficiary's remaining life or a specified period. The remaining shares then revert to the NFP.

55-15 During the term of the agreement, the NFP has a liability that, for purposes of applying Topic 815, must be analyzed as consisting of the following two separate liabilities:

- a. A liability relating to the period-certain cash payments
- b. A liability relating to the possible additional cash payments that are contingent upon the beneficiary living beyond the end of the period-certain payments.

55-16 The NFP's liability does not require the bifurcation of any embedded derivative because:

- a. The portion of the liability related to the fixed period-certain payments has no underlying.
- b. The portion of the liability related to the possible life-contingent payments qualifies for the exception in paragraphs 815-10-15-52 through 15-57.

>>> Case E: Remainder Trust—Period-Certain-Plus-Life-Contingent, Variable Payments

55-17 Shares of common stock are contributed to the control of an NFP, which is required to pay the donor or the donor's beneficiary an annual cash payment equal to a specified percentage of the fair value of the assets at the beginning of each annual period for the greater of the beneficiary's remaining life or a specified period. The remaining assets revert to the NFP.

55-18 During the term of the agreement, the NFP has a liability that, for purposes of applying Topic 815, must be analyzed as consisting of the following two separate liabilities:

- a. A liability relating to the period-certain cash payments
- b. A liability relating to the possible additional cash payments that are contingent upon the beneficiary living beyond the end of the period-certain payments.

55-19 Paragraph 815-15-25-1 requires that the equity-based derivative instrument embedded in the portion of the liability related to the period-certain variable cash payments be bifurcated from a debt host contract (consistent with the analysis in Case B).

55-20 The equity-based derivative instrument embedded in the portion of the liability related to the possible life-contingent cash payments that can occur after the end of the specified period is not subject to Topic 815 because it qualifies for the exception in paragraphs 815-10-15-52 through 15-57.

>>> Case F: Lead Trust—Period-Certain, Fixed or Variable Payments

55-21 An NFP receives cash from a donor, which is invested by the NFP in common equity securities. The donor designates the NFP as lead beneficiary. The NFP receives an annual cash payment of either a fixed amount or a specified percentage of the fair value of the investment amount at the beginning of each annual period for a specified period of time. After that time, the remaining assets revert to the donor or the donor's beneficiary.

55-22 During the term of the agreement, the NFP has a liability that must be bifurcated. Under paragraph 815-15-25-1, the liability represents a hybrid instrument that is composed of a debt host contract and an embedded equity-based derivative that is not clearly and closely related to the debt host contract and that would meet the definition of a derivative instrument if it were freestanding. That is, it meets all of the following criteria of paragraph 815-10-15-83:

- a. It has an underlying (price of shares).
- b. It has a notional amount (number of shares at the beginning of each annual period).
- c. It satisfies the no-or-smaller initial net investment characteristic in paragraph 815-10-15-83(b).
- c. It would meet the net settlement characteristic in paragraph 815-10-15-83(c).

55-23 Regardless of whether the **lead interest** payments are fixed or variable, the value of the liability representing the remainder interest—the assets remaining at the end of the agreement that will be paid to the donor or the donor's beneficiary—is affected by changes in the equity value, thus requiring the embedded equity-based derivative to be bifurcated from the host contract unless a fair value election is made pursuant to Section 815-15-25 or the Fair Value Option Subsections of Subtopic 825-10.

>>> Case G: Lead Trust—Life-Contingent, Fixed or Variable Payments

55-24 An NFP receives cash from a donor, which is invested by the NFP in common equity securities. The donor designates the NFP as lead beneficiary. The NFP receives an annual cash payment of either a fixed dollar amount or a specified percentage of the fair value of the investment amount at the beginning of each annual period until the death of the donor or the donor's beneficiary, at which time the remaining assets revert to the donor or the donor's beneficiary.

55-25 During the term of the agreement, the NFP has a liability that is not subject to Topic 815 because the remainder interest liability relates to a single payment whose amount and timing is life-contingent and thus qualifies for the exception in paragraphs 815-10-15-52 through 15-57.

>>> Case H: Lead Trust—Period-Certain-Plus-Life-Contingent, Variable or Fixed Payments

55-26 An NFP receives cash from a donor, which is invested by the NFP in common equity securities. The donor designates the NFP as lead beneficiary. The NFP receives an annual cash payment for either a specified percentage of the fair value of the assets at the beginning of each annual period or a fixed dollar amount. That cash payment is made for the greater of the beneficiary's (or the donor's) remaining life or a specified period. After that time, the remaining assets revert to the donor or the donor's beneficiary.

55-27 During the term of the agreement, the NFP has a liability that is not subject to Topic 815 because, unlike the liability in Case E the period-certain aspect of the liability cannot be separated from the life-contingent aspect of the liability (because there is only one payment whose timing and value are affected by mortality risk). Thus, the remainder interest liability relates to a

16. Private companies and entities that do not report earnings

single payment whose amount and timing is life-contingent and thus qualifies for the exception in paragraphs 815-10-15-52 through 15-57.

55-28 If payment occurs only when the beneficiary (or donor) is alive, such as in an agreement in which the period is for the lesser of the beneficiary's (donor's) remaining life or a specified period, then every payment is life-contingent and qualifies for the exception in paragraphs 815-10-15-52 through 15-57.

55-29 If during the terms of a greater-of-period-certain-or-life-contingent agreement, the beneficiary dies before the end of the period-certain terms in the agreement, that change in circumstance eliminates the life-contingent aspect of the contract. Thus, the agreement is now only a period-certain agreement and mirrors the agreement outlined in Case F requiring bifurcation of the embedded derivative.

17. Effective dates and transition

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New item added in this edition: **

Item significantly updated in this edition: #

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- 17.4.30 When transitioning to measure a hedged item based on the benchmark rate component of the coupon, can an entity rebalance an existing hedging relationship?
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- 17.4.70 Will transferring securities from HTM to AFS affect an entity's pre-transition intent to hold the securities to maturity?
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- 17.4.90 What financial instruments are eligible to be transferred from HTM to AFS?
- 17.4.100 What is the transition guidance for an existing hedging relationship with a non-zero fair value derivative designated at hedge inception?
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- 17.4.120 What transition approach is required to change from a long-haul to the critical terms match method for an existing hedging relationship?
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Examples

- 17.4.10 Dedesignating a portion of the hedged item
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17.5 Effective dates and transition provisions of ASU 2018-16 **

17.6 Effective dates and transition provisions of ASU 2019-04 **

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Questions

17.6.10 If an entity elects to adopt ASU 2019-04 prospectively, are changes to the amortization of the fair value hedge basis adjustment a change in estimate or accounting principle? **

17.6.20 If an entity elects to adopt ASU 2019-04 retrospectively, can it retrospectively designate new hedging relationships? **

17.1 How the standard works#

The other chapters of this Handbook assume that an entity has adopted the following ASUs:

- ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities
- ASU 2018-16, Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes
- ASU 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments.

This chapter discusses the effective dates and transition guidance for applying ASU 2017-12, ASU 2018-16 and ASU 2019-04.

ASU 2017-12 Effective dates

	Public business entities	All other entities
Effective date: [815-20-65-3(a) – 65-3(b)]	Annual and interim periods in fiscal years beginning after December 15, 2018.	— Annual periods in fiscal years beginning after December 15, 2020. — Interim periods in fiscal years beginning after December 15, 2021.
Early adoption: [815-20-65-3(c)]	Permitted in any annual or interim period.	

ASU 2018-16 Effective dates

	Public business entities	All other entities
Effective date – entities that have not adopted ASU 2017-12: [815-20-65-4(a)]	Concurrent with adoption of ASU 2017-12. See section 17.2.	Concurrent with adoption of ASU 2017-12. See section 17.2.
Effective date – entities that have adopted ASU 2017-12: [815-20-65-4(b)]	Annual and interim periods in fiscal years beginning after December 15, 2018.	Annual and interim periods in fiscal years beginning after December 15, 2019.
Early adoption: [815-20-65-4(a)(1), 65-4(b)(3)]	Required if an entity early adopts ASU 2017-12. Permitted in any interim period if an entity has already adopted ASU 2017-12.	

ASU 2019-04 Effective dates

	All entities
Effective date – entities that have not adopted ASU 2017-12: [815-20-65-5(b)]	Concurrent with adoption of ASU 2017-12. See section 17.2.
Effective date – entities that have adopted ASU 2017-12: [815-20-65-5(a)]	As of the beginning of the first annual reporting period beginning after the date of issuance of ASU 2019-04.
Early adoption: [815-20-65-5(a)]	Permitted on any date on or after the issuance of ASU 2019-04.

17.2 Effective dates for ASU 2017-12#

Effective date: [815-20-65-3(a) – 65-3(b)]	Public business entities: Annual and interim periods in fiscal years beginning after December 15, 2018.	All other entities: — Annual periods in fiscal years beginning after December 15, 2020. — Interim periods in fiscal years beginning after December 15, 2021.
Early adoption: [815-20-65-3(c)]	Permitted in any annual or interim period.	
Date of adoption and initial application date: [815-20-65-3(c) – 65-3(d)]	— The date of adoption is the date an entity elects to first apply the guidance in ASU 2017-12. This is the date used to determine existing hedging relationships. — The initial application date means the beginning of the fiscal year of adoption. This is the date at which an entity records any transition adjustments.	



Excerpt from ASC 815-20

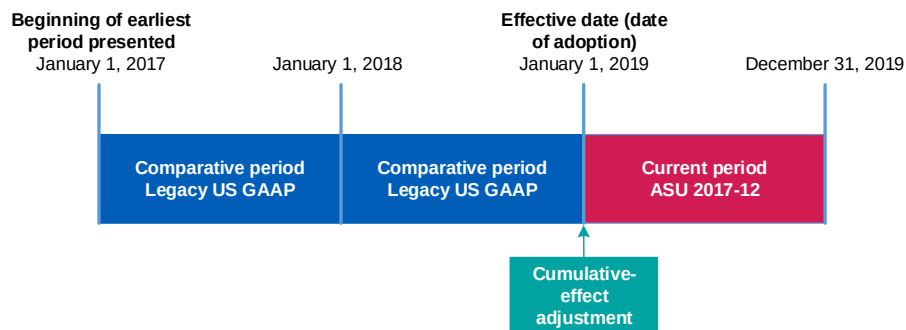
> Transition Related to Accounting Standards Updates No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities, No. 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments, and No. 2019-10, Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates

65-3 The following represents the transition and effective date information related to Accounting Standards Updates No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*:

- For **public business entities**, the pending content that links to this paragraph shall be effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.
- For all other entities, the pending content that links to this paragraph shall be effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.
- Early adoption, including adoption in an interim period, of the pending content that links to this paragraph is permitted. If an entity early adopts the pending content that links to this paragraph in an interim period, any adjustments shall be reflected as of the beginning of the fiscal year that includes that interim period (that is, the initial application date).

17.2.10 Overview

If a calendar-year public business entity adopts ASU 2017-12 in accordance with the mandatory effective date, then these are the relevant dates.



17.2.20 Early adoption considerations

If an entity early adopts ASU 2017-12 in an interim period, any cumulative-effect adjustment for existing hedges is reflected as of the beginning of the fiscal year that includes the interim period (i.e. the initial application date). [\[815-20-65-3\(c\)\]](#)



Question 17.2.10

Is an entity required to adopt ASU 2017-12 at a certain point in time within an interim period?

Interpretive response: The ASU does not specify whether an entity is required to adopt the amendments at a certain point in time within an interim period – i.e. at the beginning or the end of a quarter, or on a date in between.

We believe an entity can elect to adopt the totality of these amendments on any single date within an interim period before the mandatory effective date. In other words, there cannot be different dates of adoption within an interim period for different provisions of the ASU.



Question 17.2.20#

If an entity early adopts ASU 2017-12 in an interim period, what are the relevant considerations?

Background: For purposes of this Question, assume that a calendar year-end entity early adopts ASU 2017-12 on July 1, 2020.

Interpretive response: ASU 2017-12 provides transition guidance that differs from the general retrospective transition requirements of paragraphs 250-10-45-5 to 45-8. However, it does not provide specific guidance on how adoption in an interim period affects the results of the preceding interim periods in the fiscal year of adoption – e.g. January 1, 2020 to June 30, 2020 in the background example.

The general retrospective transition requirements in paragraphs 250-10-45-5 to 45-8 apply only when there are *no* transition requirements specific to a particular Codification update. Therefore, we believe there are two acceptable approaches for reporting changes to the preceding interim periods in the fiscal year of adoption.

- **Approach 1.** Record the prior-period impact related to the adoption of ASU 2017-12 in the interim period of adoption – e.g. the financial results for the three months ended September 30, 2020; or
- **Approach 2.** Retrospectively apply ASU 2017-12 to preceding interim periods, with the effect of any changes to those previous periods recorded in the year-to-date results before adoption.

These approaches should only be applied to hedging relationships existing at the date of adoption of July 1, 2020. An entity that early adopts ASU 2017-12 in an interim period should disclose which of these transition approaches was applied.

We believe an entity that early adopts in an interim period is not required to amend previously issued interim financial statements. An entity does include disclosures required by paragraph 815-20-65-3(k) for the change in accounting principle in the interim period of adoption, and in the annual financial statement period (see section 17.3.40).

However, we believe there are additional reporting considerations for an entity that elects to retrospectively apply ASU 2017-12 to the preceding interim periods (Approach 2), including the following.

- The quarterly results of operations, if applicable, presented in the annual financial statements in the year of adoption need to reflect the retrospectively adjusted interim amounts.
- In the year after adoption, comparative information and disclosures in the interim financial statements need to reflect the retrospectively adjusted interim amounts.



Example 17.2.10#

Adopting ASU 2017-12 by retrospectively adjusting previous interim periods

ABC Corp., a calendar year-end entity, early adopts the guidance on July 1, 2020 – i.e. in its Q3 reporting period.

Interim reporting considerations in the year of adoption

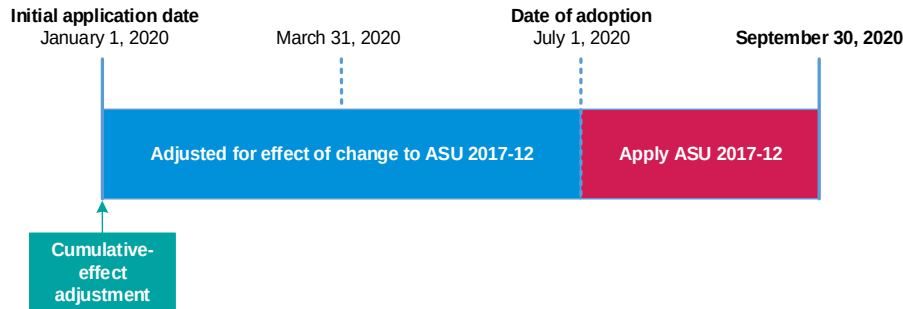
ABC records a cumulative-effect adjustment as of January 1, 2020 (the initial application date) in accordance with the transition requirements in ASU 2017-12. It also retrospectively adjusts the interim period results between the initial application date and the date of adoption to reflect the period-specific effects of applying ASU 2017-12.

ABC elects to modify the recognition model for the excluded component from a mark-to-market approach to an amortization approach. ABC elects the transition provision that allows it to modify an existing hedging relationship without dedesignating and redesignating the hedging relationship. Instead, ABC does not dedesignate its existing hedging relationships at the date of adoption (July 1, 2020), and it recognizes the cumulative-effect adjustment as of January 1, 2020. For guidance on elective transition guidance for excluded components, see section 17.4.50.

In the period between the initial application date and the date of adoption (January 1, 2020 to June 30, 2020) ABC previously recognized the excluded component using a mark-to-market approach. ABC calculates the effect of the change to an amortization approach during this period, and adjusts amounts previously recorded.

The adjusted amounts reflect what would have been recognized had the amortization approach been adopted on January 1, 2020. The effect of any changes from retrospectively adjusting the results of the previous interim periods are reflected in the interim financial statements for Q3 2020, within the financial results for the nine months ended September 30, 2020.

The graphic summarizes the interim reporting considerations for Q3 2020.



Interim reporting considerations in the year after adoption

In the first and second quarters of 2021, ABC updates the comparative amounts for the quarterly periods ended March 31, 2020 and June 30, 2020 to reflect the retrospectively adjusted interim amounts.

Because the results of operations for periods presented have been adjusted retroactively subsequent to the initial reporting of such period, we believe ABC should disclose the effect of the change.

Therefore, the first and second quarters of 2021 should include information to explain the effect of any changes made to the quarterly periods ended March 31, 2021 and June 30, 2021, from amounts previously reported for the first and second quarters of 2020.

17.3 Required transition provisions for ASU 2017-12

Transition:

[815-20-65-3(d) – 65-3(k)]

Required transition provisions (section 17.3)

- Modified retrospective basis applied to existing hedging relationships as of the date of adoption, generally achieved through a cumulative-effect adjustment to AOCI with a corresponding adjustment to opening retained earnings as of the initial application date.
- Changes to income statement presentation and financial statement disclosures are applied prospectively.

Elective transition principles (section 17.4)

Specific transition elections and guidance are provided for:

- fair value hedges of interest rate risk and risk component hedging;
- one-time ability to transfer certain securities from the HTM to the AFS category; the securities must be eligible for the last-of-layer method;
- certain cash flow hedges;
- recognition and presentation of excluded components;
- assessing hedge effectiveness; and
- one-time ability to modify existing hedge documentation.



Comparison to legacy US GAAP Summary of changes for ASU 2017-12

The following table summarizes the key changes from legacy US GAAP related to specific transition provisions discussed in this chapter.

Income statement presentation and eliminating ineffectiveness (section 17.3.20)	While not changing the requirement to determine whether a hedge is 'highly effective', the ASU eliminates the requirement to separately measure and disclose hedge ineffectiveness. The ASU also updates income statement presentation for the following. — The entire change in fair value of the hedging instrument is included in the same income statement line item as the earnings effect of the hedged item or transaction. — For fair value and cash flow hedges, amounts related to excluded components are recognized in earnings in the same income statement line item as the earnings effect of the hedged item or transaction.
Fair value hedges of interest rate risk (sections 17.4.20 and 17.4.30)	The ASU provides opportunities for entities to apply fair value hedge accounting to hedging strategies that are either not allowed or impractical under legacy US GAAP. This includes: — benchmark interest rate component (section 7.3.70) — interest rate risk hedges of prepayable financial instruments (section 7.4.10) — last-of-layer method (section 7.3.100) — partial-term hedges (section 7.3.80). Further, the SIFMA Municipal Swap Rate and SOFR OIS were added as eligible benchmark interest rates (see section 6.3.30).
Cash flow hedges (section 17.4.40)	The ASU provides new alternatives for applying hedge accounting to additional hedging strategies. The ASU amends legacy US GAAP to permit an entity to apply hedge accounting for: — contractually specified interest rate (section 6.3.40) — contractually specified component price risk for nonfinancial transactions (section 9.4.10).
Recognition and presentation of excluded components (section 17.4.50)	The ASU introduces the option to recognize permissible excluded components using a systematic and rational method (amortization approach) as an alternative to recognizing all fair value changes in the excluded components in current earnings (mark-to-market approach). The ASU also allows an entity to exclude the portion of the change in fair value of a currency swap attributable to a cross-currency basis spread for fair value and cash flow hedges.
Assessing hedge effectiveness (section 17.4.60)	The ASU makes targeted improvements to the hedge effectiveness assessment process. These improvements include the following. — Qualitative effectiveness assessments. Subsequent quarterly effectiveness assessments (after an initial quantitative assessment) may be performed on a qualitative (rather than quantitative) basis if an entity can

reasonably support an expectation that the hedge is highly effective at inception and in subsequent periods.

- **Shortcut method.** An entity that inappropriately applied the 'shortcut method' may continue to apply hedge accounting if certain conditions are met.
- **Critical terms match.** The 'critical terms match' method may be applied to groups of forecasted transactions in which the individual transactions occur, and the hedging derivative matures, within the same 31-day period or fiscal month.

17.3.10 Modified retrospective transition approach



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging*, and Topic 825, *Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815)*, and Leases (Topic 842): Effective Dates

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging*, and Topic 825, *Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815)*, and Leases (Topic 842): *Effective Dates*: ...

- d. For **cash flow hedges** and net investment hedges existing (that is, the hedging instrument has not expired, been sold, terminated, or exercised or the entity has not removed the designation of the hedging relationship) as of the date of adoption, an entity shall apply the pending content that links to this paragraph related to the elimination of the separate measurement of ineffectiveness by means of a cumulative-effect adjustment to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the initial application date.

An entity adopts ASU 2017-12 by applying a modified retrospective approach to existing hedging relationships. Under this method, an entity records the cumulative effect of applying certain amendments in ASU 2017-12 to the opening balance of retained earnings as of the initial application date.

This modified retrospective approach includes eliminating the separate measurement of ineffectiveness (see section 17.3.20), and other amendments available for adoption with elected transition provisions (see section 17.4).

Existing hedging relationships

The modified retrospective transition method applies only to existing hedging relationships as of the date of adoption.

The following table illustrates whether a cumulative-effect adjustment needs to be recorded based on whether the hedging relationship existed on the initial application date, the date of adoption or both.

Hedging relationship existed at the:		Cumulative-effect adjustment recorded as of the initial application date?
Initial application date	Date of adoption	
Yes	Yes	Yes
No	Yes	No ¹
Yes	No	No ²
Notes: 1. For hedging relationships existing on the date of adoption, but not on the initial application date, any impact on adoption should be recorded in the year-to-date results. The impact is not reflected in the cumulative-effect adjustment on the initial application date because the hedging relationship did not exist then. 2. For hedging relationships that did not exist at the date of adoption, there is no cumulative-effect adjustment. Further, there is no retrospective adjustment to preceding interim periods in the year of adoption.		

17.3.20 Income statement presentation and eliminating ineffectiveness



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, Topic 815, *Derivatives and Hedging*, and Topic 825, *Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815)*, and Leases (Topic 842): Effective Dates

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, Topic 815, *Derivatives and Hedging*, and Topic 825, *Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic*

326), *Derivatives and Hedging (Topic 815)*, and *Leases (Topic 842)*: *Effective Dates*: ...

- j. On a prospective basis only for existing hedging relationships on the date of adoption (in all interim periods and fiscal years ending after the date of adoption), an entity shall:
1. Present the entire change in the fair value of the hedging instrument in the same income statement line item as the earnings effect of the hedged item when the hedged item affects earnings (with the exception of amounts excluded from the assessment of hedge effectiveness in a net investment hedge) in accordance with paragraphs 815-20-45-1A and 815-20-45-1C.

ASU 2017-12 replaces existing guidance with specific income statement requirements for the earnings effect of hedging instruments, and eliminates the requirement under legacy US GAAP to separately measure and disclose hedge ineffectiveness (see excluded components in section 17.4.50). The following table summarizes the transition requirements related to these amendments.

	Legacy US GAAP	ASU 2017-12	Required transition
Cash flow hedges (section 10.2.10)	— Effective portion is recognized in AOCI and reclassified into earnings when the hedged transaction affects earnings. Ineffective portion is recognized in earnings. [815-20-35-1(c), 815-30-35-2 – 35-3] — Ineffective portion is separately measured and disclosed. [815-10-50-4C(d), 815-30-35-2 – 35-3]	— Entire change in fair value of components included in the effectiveness assessment is recognized in AOCI and reclassified into earnings when the hedged transaction affects earnings. [815-20-35-1(c), 815-30-35-3] — Ineffective portion is not separately measured or disclosed.	Reverse any ineffectiveness previously recorded in earnings on cash flow hedging relationships existing on the date of adoption in the cumulative-effect adjustment on the initial application date. [815-20-65-3(d)]
	Ineffective portion and excluded portion can be presented in an income statement line item different from the effective portion. [815-20-45-1]	Entire change in fair value (including any excluded portion) is presented in the same income statement line item as the earnings effect of the hedged transaction. [815-20-45-1A]	Presentation guidance is applied prospectively. [815-20-65-3(j)]

	Legacy US GAAP	ASU 2017-12	Required transition
Fair value hedges (section 8.2.10)	- Entire change in fair value is recognized in earnings. [815-25-35-1 – 35-3] - Ineffective portion is separately measured and disclosed. [815-10-50-4C, 815-25-50-1(a)]	- Entire change in fair value of components included in the effectiveness assessment is recognized in earnings. [815-20-35-1(b), 815-25-35-1] - Ineffective portion is not separately measured or disclosed.	For fair value hedging relationships existing on the date of adoption, the entire change in the fair value of the hedging instrument (including the ineffective portion) has been previously recorded in earnings. Therefore, no cumulative-effect adjustment is necessary on the initial application date.
	Ineffective portion or excluded portion can be presented in an income statement line item different from the effective portion. [815-20-45-1]	Entire change in fair value (including any excluded portion) is presented in the same income statement line item used to present the earnings effect of the hedged item. [815-20-45-1A]	Presentation guidance is applied prospectively. [815-20-65-3(j)]
Net investment hedges (section 12.5)	- Effective portion is recognized in CTA in AOCI and reclassified into earnings when the foreign operation is sold or substantially liquidated. [815-20-35-1(d), 815-35-35-1] - Ineffective portion is recognized in earnings. [815-35-35-4, 35-13]	Entire change in fair value of components included in the effectiveness assessment is recognized in CTA in AOCI and reclassified into earnings when the foreign operation is sold or substantially liquidated. [815-20-35-1(d), 815-35-35-1]	Reverse any ineffectiveness previously recorded on net investment hedging relationships existing on the date of adoption in the cumulative-effect adjustment on the initial application date. [815-20-65-3(d)]
	Ineffective portion is separately measured and disclosed. [815-10-50-4C, 815-35-35-4, 35-13]	Ineffective portion is not separately measured or disclosed.	Presentation guidance is applied prospectively. [815-20-65-3(j)]

17.3.30 New disclosure requirements for ASU 2017-12



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*: ...

- j. On a prospective basis only for existing hedging relationships on the date of adoption (in all interim periods and fiscal years ending after the date of adoption), an entity shall: ...
 - 2. Disclose the items in the pending content that links to this paragraph in Subtopic 815-10.

The disclosure guidance amended by ASU 2017-12 is to be applied prospectively for hedging relationships existing on the date of adoption. [815-20-65-3(j)]

17.3.40 Disclosures for accounting changes under Topic 250



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*: ...

326), *Derivatives and Hedging (Topic 815)*, and *Leases (Topic 842): Effective Dates: ...*

- j. An entity shall provide the following disclosures within Topic 250 on accounting changes and error corrections:
 1. The nature of and reason for the change in accounting principle
 2. The cumulative effect of the change on the opening balance of each affected component of equity or net assets in the statement of financial position as of the date of adoption
 3. The disclosures in (1) through (2) above in each interim and annual financial statement period in the fiscal year of adoption.

In the interim and annual period of adoption, an entity provides the disclosures required by Topic 250 (accounting changes and error corrections), which include: [\[815-20-65-3\]](#)

- the nature of and reason for the change in accounting principle; and
- the cumulative-effect adjustment for each affected component of equity or net assets on the date of adoption.

17.4 Elective transition provisions for ASU 2017-12

17.4.10 Overview



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, Topic 815, *Derivatives and Hedging*, and Topic 825, *Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815)*, and *Leases (Topic 842): Effective Dates*

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, Topic 815, *Derivatives and Hedging*, and Topic 825, *Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815)*, and *Leases (Topic 842): Effective Dates: ...*

- f. For private companies that are not financial institutions as described in paragraph 942-320-50-1 and **not-for-profit entities** (except for not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market), the elections in (e) above shall be determined before the next interim (if applicable) or annual **financial statements are available to be issued**.

- g. For all other entities, the elections in (e) above shall be determined before the first quarterly effectiveness assessment date after the date of adoption.

The transition provisions offer several elections that can provide relief when applying the ASU 2017-12 amendments to existing hedging relationships. An entity may apply each election on a stand-alone basis. [\[ASU 2017-12.BC246, BC259\]](#)

The following types of entities have until the first quarterly effectiveness assessment date after the date of adoption to make these elections:

- public business entities;
- private companies that are financial institutions; and
- certain not-for-profit entities (that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or over-the-counter market).

All other entities have until their next interim (if applicable) or annual financial statements are available to be issued to make any of these elections. [\[815-20-65-3\(f\) – 65-3\(g\)\]](#)

If an entity does not elect a transition provision within the allotted timeframe, any hedging relationship existing at the date of adoption will not qualify for transition relief. Instead, an entity will have to dedesignate and redesignate existing hedging relationships to change the critical terms (see section 6.10).

The amendments to ASU 2017-12's transition provisions as a result of ASU 2019-04 are incorporated into sections 17.4.20, 17.4.30 and 17.4.60.

17.4.20 Transition elections for fair value hedges of interest rate risk



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*: ...

- e. An entity may elect any of the following items upon adoption of the pending content that links to this paragraph:
1. For a **fair value hedge of interest rate risk** existing as of the date of adoption, an entity may modify the measurement methodology for a hedged item in accordance with either paragraph 815-20-25-6B or paragraph 815-25-35-13 without dedesignation of the hedging relationship. The cumulative basis adjustment carried forward shall be adjusted to an amount that reflects what the cumulative basis adjustment would have been at the initial application date had the modified measurement methodology been used in all past periods in which the hedging relationship was outstanding. When making this election, the benchmark rate component of the contractual coupon cash flows shall be determined as of the hedging relationship's original inception date. The cumulative effect of applying this election shall be recognized as an adjustment to the basis adjustment of the hedged item recognized on the balance sheet with a corresponding adjustment to the opening balance of retained earnings as of the initial application date.
 2. For the fair value hedges of interest rate risk for which an entity modifies the measurement methodology for the hedged item based on the benchmark rate component of the contractual coupon cash flows in accordance with (1) above, an entity may elect to rebalance the hedging relationship through any of the following approaches, including any combination of these approaches:
 - i. Increasing the dedesignated notional amount of the hedging instrument
 - ii. Decreasing the dedesignated notional amount of the hedging instrument
 - iii. Increasing the designated proportion of the hedged item
 - iv. Decreasing the designated proportion of the hedged item

An entity may not add a new hedging instrument or hedged item to an existing hedging relationship. If an entity applies the guidance in (iii) or (iv) above, the cumulative effect of changing the designated proportion of the hedged item shall be recognized as an adjustment to the basis adjustment of the hedged item recognized on the balance sheet with a corresponding adjustment to the opening balance of retained earnings as of the initial application date.

...
 - h. For fair value hedges existing as of the date of adoption in which the hedged item is a tax-exempt **financial instrument**, the hedged risk may be modified to interest rate risk related to the **Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate**. The modification shall be considered a dedesignation and immediate redesignation of the hedging relationship. In this situation, the cumulative basis adjustment of the hedged item from the dedesignated hedging relationship shall be amortized to earnings on a level-yield basis over a period of time based on the applicable requirements in other Topics.

The following table summarizes the transition elections available for certain fair value hedges of interest rate risk existing as of the date of adoption, as well as a comparison of the changes from legacy US GAAP.

	Legacy US GAAP	ASU 2017-12	Required transition
Hedging portions of financial items: Benchmark interest rate component (section 7.3.70)	Measure the change in a hedged item's fair value attributable to changes in the benchmark interest rate based on the entire contractual coupon cash flows. [815-25-35-13]	Measure the change in a hedged item's fair value attributable to changes in the benchmark interest rate based on either the hedged item's: [815-25-35-13] — entire contractual coupon cash flows; or — the benchmark rate component of the contractual coupon cash flows determined at inception of the hedging relationship.	— Change in measurement methodology for the hedged item does not require a dedesignation of the existing hedging relationship. — The cumulative basis adjustment included in the amortized cost basis of the hedged item is adjusted as of initial application date based on the amount that would have been recorded as if the modified measurement methodology had been used since inception of the hedging relationship (see Question 17.4.10). — Benchmark interest rate component of the hedged item determined as of the original hedge inception date. — Dedesignate a portion of the hedged item and reclassify the basis adjustment associated with the portion of the hedged item dedesignated to the opening balance of retained

	Legacy US GAAP	ASU 2017-12	Required transition
			earnings as of the initial application date. [815-20-65-3(e)(1) – 3(e)(2)]
Interest rate risk hedges of prepayable financial instruments (section 7.4.10)	Consider the effect of all factors (e.g. credit risk, liquidity, interest rates) on the decision to prepay a financial instrument. [815-20-25-6]	Option to consider only the effect of changes in the benchmark interest rate on the decision to prepay a financial instrument. [815-20-25-6B]	— Change in measurement methodology for the hedged item does not require a dedesignation of the existing hedging relationship. — The cumulative basis adjustment included in the amortized cost basis of the hedged item is adjusted as of the initial application date based on the amount that would have been recorded as if the modified measurement methodology had been used since inception of hedging relationship (see Question 17.4.10). [815-20-65-3(e)(1)]
Interest rate risk: Benchmark interest rate (section 6.3.30)	In the United States, the following benchmark rates are eligible to be designated in a hedge: [815-20-25-6A] — US treasury rate; — LIBOR swap rate; and — Fed funds effective rate overnight index swap rate.	SIFMA Municipal Swap Rate added as eligible benchmark interest rate. [815-20-25-6A]	To change the hedged risk to interest rate risk related to the SIFMA Municipal Swap Rate: — dedesignate and immediately redesignate the hedging relationship if it is highly effective; and — amortize the basis adjustment

	Legacy US GAAP	ASU 2017-12	Required transition
			from the dedesignated hedging relationship into earnings on a level-yield basis over a period based on applicable requirements in other Topics (e.g. Subtopic 310-20 on receivables – nonrefundable fees and other costs). [815-20-65-3(h)]



Question 17.4.10

What date is used to determine the cumulative basis adjustment when modifying the measurement methodology for a fair value hedge of interest rate risk?

Interpretive response: Paragraph 815-20-65-3(e)(1) states that the cumulative basis adjustment carried forward is “adjusted to an amount that reflects what the cumulative basis adjustment would have been at the initial application date had the modified measurement methodology been used in all past periods in which the hedging relationship was outstanding.” As such, an entity calculates the cumulative basis adjustment as of the initial application date, not the date of adoption. This approach is consistent with the modified retrospective transition approach used in other aspects of the transition guidance. [815-20-65-3(e)(1)]



Question 17.4.20

What date is used to determine the benchmark rate if the current hedging relationship was previously dedesignated and redesignated?

Interpretive response: An entity that elects to use the transition relief related to the benchmark rate component is required to determine the benchmark rate component as of the original hedge inception date. [815-20-65-3(e)(1)]

For previously dedesignated and redesignated hedging relationships existing at the date of adoption, we believe the benchmark rate component should be determined as of the most recent date of redesignation, not as of the date that

the original hedged item was designated in a hedging relationship for the first time.



Question 17.4.30

When transitioning to measure a hedged item based on the benchmark rate component of the coupon, can an entity rebalance an existing hedging relationship?

Background: Legacy US GAAP requires an entity to measure the change in fair value of the hedged item in a fair value hedge based on the cash flows from the entire contractual coupon. This requirement has caused income statement volatility when an entity hedged interest rate risk with common hedging instruments, such as interest rate swaps based on LIBOR. [815-25-35-13]

Historically, some entities limited this income statement volatility by designating a hedge ratio of other than 1:1. In other words, an entity may have designated a notional amount of the hedging instrument that was greater than or less than the principal amount of the hedged item.

Under ASU 2017-12, an entity is allowed to measure the hedged item based on the benchmark rate component of the coupon, which eliminates the need to designate hedging relationships where the hedging instrument and the hedged item have different notional/principal amounts solely to meet the highly effective threshold. For existing hedging relationships with mismatched notional/principal amounts, electing to measure the hedged item based on the benchmark rate component of the coupon may cause the hedging relationship to no longer meet the highly effective threshold. Further, an earnings mismatch would be created because of the mismatched notional/principal amounts.

Interpretive response: Yes. The transition relief allows an entity to rebalance an existing hedging relationship that has different notional/principal amounts by adjusting either the notional amount of the hedging instrument or the designated proportion of the hedged item - without dedesignating existing hedging relationships.

If an entity rebalances the relationship by increasing or decreasing the designated portion of the hedged item, the related basis adjustment is recorded directly in retained earnings and therefore will not create earnings volatility. [815-20-65-3(e)(2), ASU 2017-12.BC257]

An entity may only designate an increased proportion of a hedging instrument or an increased proportion of a hedged item if the hedging instrument or hedged item's notional/principal was not fully designated at the inception of the hedge. This means an entity may rebalance only by using the existing hedged item or the existing hedging instrument and may not add new hedged items or hedging instruments. The FASB concluded that an entity may not designate any new hedging instruments or hedged items because it would constitute a change in the critical terms of the hedging relationship and require full dedesignation. [815-20-65-3(e)(2), ASU 2017-12.BC257]

For example, an entity cannot replace the hedging instrument with a different hedging instrument, modify the terms of the hedging instrument to increase the notional amount, or increase the principal amount of the hedged item by including additional debt instruments. Further, a portion of the derivative could not have been concurrently designated as part of another hedging relationship. [815-20-65-3(e)(2)]



Example 17.4.10

Dedesignating a portion of the hedged item

ABC Corp. issues a 20-year, \$100 million debt instrument with a 7% interest coupon. On the same day it enters into a 20-year \$100 million receive 3% fixed, pay LIBOR interest rate swap that converts a portion of the fixed interest rate on the debt instrument into a LIBOR-based floating interest rate.

Subsequently, on adopting ASU 2017-12, ABC decides to modify its measurement methodology to calculate the change in fair value of the debt instrument based on the benchmark rate component of the contractual coupon cash flows.

Scenario 1: Previous hedge designation was 90% of the notional amount of the swap

ABC previously designated 90% of the notional amount of the swap (\$90 million notional) as a hedge of the \$100 million debt to meet the highly effective threshold.

On transition to ASU 2017-12, ABC records a cumulative-effect adjustment to reflect the change in the measurement method of the hedged item on the basis of the benchmark rate component of the contractual coupon cash flows.

[815-20-65-3(e)(1)]

Further, ABC has two options for rebalancing the existing hedging relationship.

Rebalancing	Updated hedging relationship	Accounting considerations at transition specifically related to the rebalancing
Dedesignate a portion of the debt¹	Principal amount: \$90 million Swap notional amount: \$90 million	The basis adjustment related to the \$10 million dedesignated portion is recorded directly in the opening balance of retained earnings. [815-20-65-3(e)(2)]
Designate the full notional amount of the existing swap	Principal amount: \$100 million Swap notional amount: \$100 million	No incremental effect on the cumulative-effect adjustment because the amount of the hedged item has not changed. The incremental \$10 million notional amount of the swap is included in the hedging relationship at adoption.
Note: 1. This assumes the remaining 10% of the notional amount of the swap (\$10 million notional) is designated in a different hedging relationship.		

Scenario 2: Previous hedge designation was 90% of principal amount of debt

ABC previously designated 90% of the principal amount of the debt (\$90 million principal) against \$100 million notional amount of the swap to meet the highly effective threshold.

On transition to ASU 2017-12, ABC records a cumulative-effect adjustment to reflect the change in the measurement method of the hedged item on the basis of the benchmark rate component of the contractual coupon cash flows.

[815-20-65-3(e)(1)]

Further, ABC has two options for rebalancing the existing hedging relationship.

Rebalancing	Updated hedging relationship	Accounting considerations at transition specifically related to the rebalancing
Dedesignate a portion of the notional amount of the swap	Principal amount: \$90 million Swap notional amount: \$90 million	No incremental effect on the cumulative-effect adjustment because the amount of the hedged item has not changed. \$10 million of the notional amount of the swap will no longer be designated as part of this hedging relationship; however, it may be designated in a different hedging relationship.
Designate the full principal amount of the existing debt	Principal amount: \$100 million Swap notional amount: \$100 million	The \$10 million principal amount of the debt is included in the hedging relationship at adoption, and a cumulative basis adjustment is recorded as of the initial application date. This is based on an assumption that the full principal amount of the debt had been designated at the inception of the hedging relationship.



Question 17.4.40

What transition approach is required to apply the partial-term hedging guidance?

Interpretive response: Under ASU 2017-12, an entity may designate only part of a financial instrument's remaining term as the hedged item (see section 7.3.80). There is no specific transition guidance for this new hedging strategy.

We believe making this change to an existing hedging relationship on adoption of ASU 2017-12 requires dedesignation and redesignation of the hedging relationship. Therefore, there would be no cumulative-effect adjustment recognized on transition.

17.4.30 Transition election to transfer securities from the HTM to the AFS portfolio



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*

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- e. An entity may elect any of the following items upon adoption of the pending content that links to this paragraph: ...
 - 7. An entity may reclassify a debt security from held-to-maturity to available-for-sale if the debt security is eligible to be hedged under the last-of-layer method in accordance with paragraph 815-20-25-12A. Any unrealized gain or loss at the date of the transfer shall be recorded in accumulated other comprehensive income in accordance with paragraph 320-10-35-10(c). That reclassification in and of itself, would not result in any of the following:
 - i. Call into question the entity's assertion at the most recent reporting date that it had the intent and ability to hold to maturity those debt securities that continue to be classified as held-to-maturity.
 - ii. Require the entity to designate the reclassified security in a hedging relationship under the last-of-layer method
 - iii. Restrict the entity from selling the reclassified security.

An entity may reclassify HTM securities that qualify to be hedged under the last-of-layer method to the AFS category. Any unrealized gain or loss at the date of the transfer is recorded in AOCl. [815-20-65-3(e)(7)]



Question 17.4.50

On what date in the period of adoption can an entity transfer securities from HTM to AFS?

Interpretive response: Transition elections must be adopted within the timeframe outlined in paragraphs 815-20-65-3(f) to 65-3(g) (see section 17.4.10). This includes the transition election available for the transfer of eligible securities from the HTM to the AFS category.

An entity may elect to transfer securities from HTM to AFS on a specific date within the period of adoption. However, we believe all the transfers should be recorded as if they occurred on the date of adoption of the ASU, with any unrealized gain or loss on that date recorded in AOCI. Unrealized gain or loss in this instance is the difference between the fair value and the amortized cost of the transferred securities.

For example, a calendar year-end public business entity adopts ASU 2017-12 on January 1, 2019 and determines all of the transition elections it will apply on March 1, 2019, which is before any quarterly effectiveness assessments. The entity should record all transfers of securities and any related unrealized gains or losses as of January 1, 2019 (the date of adoption).



Question 17.4.60

Is there any restriction on selling AFS securities after transferring them from the HTM category on adoption?

Interpretive response: No. An entity is permitted to sell the securities immediately after transferring them from the HTM to the AFS category. There is no restriction requiring an entity to hold the AFS securities for a period of time after they are transferred. [815-20-65-3(e)(7)(iii)]

The FASB determined there should be no prohibition because it would have: [ASU 2019-04.BC94]

- required separate tracking of individual reclassified securities, which could be operationally burdensome; and
- changed the nature of AFS securities because the securities would be recorded at fair value without the corresponding potential to realize any gain or loss on sale.



Question 17.4.70

Will transferring securities from HTM to AFS affect an entity's pre-transition intent to hold the securities to maturity?

Interpretive response: No. Transferring securities from the HTM to the AFS category does not, in and of itself, affect management's intent and ability to hold the securities to maturity in the period before adopting ASU 2017-12. This is because the transfer will be due to a one-time transition election available through a new accounting standard. Management's intention to sell the securities after transferring them to AFS does not alter this conclusion. [815-20-65-3-(e)(7)(i)]

For example, a calendar year-end entity elects to adopt ASU 2017-12 on January 1, 2019 and transfers eligible securities from HTM to AFS. We believe management's intent to imminently adopt ASU 2017-12 and transfer the securities to the AFS category does not affect the entity's positive intent and ability to hold the securities to maturity at December 31, 2018. On December 31, 2018, the securities would remain eligible to be classified as HTM and recorded at amortized cost, based on the entity's positive intent and ability to hold them to maturity.



Question 17.4.80

Are there any disclosure requirements for securities transferred from HTM to AFS?

Interpretive response: There are no specific transition disclosure requirements for securities transferred from the HTM to the AFS category. However, we believe the SEC staff expects clear and transparent disclosures in the financial statements to help users understand the effects of adopting ASU 2017-12. Therefore, we believe an entity should make a materiality assessment and determine what, if any, disclosures are needed in addition to those required by paragraph 815-20-65-3(k) (see section 17.3.40).

We understand that the SEC staff expects disclosures similar to those required by paragraph 320-10-50-10 for sales or transfers of HTM securities, which include:

- the net carrying amount of the sold or transferred security;
- the related realized or unrealized gain or loss; and
- the circumstances leading to the decision to sell or transfer the security.



Question 17.4.90

What financial instruments are eligible to be transferred from HTM to AFS?

Interpretive response: An entity may reclassify a debt security from the HTM to the AFS category if the debt security is eligible to be hedged under the last-of-layer method (see section 7.3.100). Only financial instruments that are considered 'prepayable' can be included in the portfolio hedged under the last-of-layer method (see Question 7.3.310). [815-20-25-12A, 65-3(e)(7)]

A financial instrument is not required to be designated in a last-of-layer hedge to be eligible for transfer from the HTM to the AFS category. Therefore, a financial instrument that is eligible for the last-of-layer method but is not designated in a hedge is eligible for transfer. [815-20-65-3(e)(7)(iii)]

17.4.40 Transition elections for cash flow hedges



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, Topic 815, *Derivatives and Hedging*, and Topic 825, *Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, Topic 815, *Derivatives and Hedging*, and Topic 825, *Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*: ...

- e. An entity may elect any of the following items upon adoption of the pending content that links to this paragraph: ...
 - 6. For cash flow hedges existing as of the date of adoption in which the hedged risk is designated as the variability in total cash flows that meet the requirements to designate as the hedged risk the variability in cash flows attributable to changes in a **contractually specified component** or a contractually specified interest rate, an entity may:
 - i. Modify the hedging relationship, without dedesignation, to specify the hedged risk is the variability in the contractually specified component or contractually specified interest rate
 - ii. Create the terms of the instrument used to estimate changes in value of the hedged risk (either under the hypothetical derivative

- method or another acceptable method in Subtopic 815-30) in the assessment of effectiveness on the basis of market data as of the inception of the hedging relationship
- iii. Consider any ineffectiveness previously recognized on the hedging relationship as part of the transition adjustment in accordance with (d) above.

The following table summarizes transition elections available for new hedging strategies related to certain types of cash flow hedges existing as of the date of adoption, as well as comparable guidance from legacy US GAAP.

	Legacy US GAAP	ASU 2017-12	Required transition
Interest rate risk: Contractually specified interest rate for cash flow hedges (section 6.3.40)	For all financial instruments, interest rate risk relates to changes in the benchmark interest rate. [815-20-25-15(j)(2)]	- For variable-rate financial instruments or forecasted issuances or purchases of variable-rate debt instruments, interest rate risk relates to changes in a contractually specified interest rate. [815-20-25-15(j)(2), 25-19A] - For forecasted issuances or purchases of fixed-rate debt, interest rate risk relates to changes in the benchmark interest rate. [815-20-25-19A]	- An entity may modify the hedging relationship to specify the hedged risk as the variability in the contractually specified interest rate, without dedesignating the hedging relationship.¹ - Terms of the instrument used to estimate changes in value of the hedged transaction attributable to the hedged risk when assessing effectiveness should be based on market data as of the date of hedge inception. - Consider any previously recognized ineffectiveness as part of the cumulative-effect adjustment recorded as of the initial application date (see section 17.3.20). [815-20-65-3(e)(6)]

	Legacy US GAAP	ASU 2017-12	Required transition
Contractually specified component price risk for nonfinancial items (section 9.4.10)	For nonfinancial items, the following risks are eligible to be hedged: [815-20-25-15(i)] — all changes in the purchase price or sales price of the asset (i.e. price risk) — foreign currency risk.	For nonfinancial items, the following risks are eligible to be hedged: [815-20-25-15(i)] — all changes in the purchase price or sales price of the asset (i.e. price risk) — changes in a contractually specified component (i.e. component price risk) — foreign currency risk.	— An entity may modify the hedging relationship to specify the hedged risk as the variability in the contractually specified component, without dedesignating the hedging relationship.¹ — Terms of the instrument used to estimate changes in value of the hedged item attributable to the hedged risk when assessing effectiveness should be based on market data as of the date of hedge inception. — Consider any previously recognized ineffectiveness as part of the cumulative-effect adjustment recorded as of the initial application date (see section 17.3.20). [815-20-65-3(e)(6)]

Note:

1. As part of the transition relief, an entity does not need to assess effectiveness for similar hedges in a similar manner. An entity may continue designating the variability in total cash flows as the hedged risk for hedging relationships existing on the date of adoption, and designate the hedged risk as the variability in the contractually specified component or contractually specified interest rate for hedging relationships executed after the date of adoption (see Question 13.2.220). [815-20-65-3(i)(2)]



Example 17.4.20

Hedged risk is changed to variability in contractually specified component

Before adopting ASU 2017-12, Bakery purchased a contract to buy flour. The contract specifies the total price to be paid as (per unit of measure) the price of wheat index ABC, plus \$1, plus transportation costs to Bakery's location. Bakery also entered into a derivative contract with an underlying based on wheat index ABC.

Hedge designation: legacy US GAAP

Bakery designated the derivative as a cash flow hedge of the variability in the anticipated purchase price of flour (wheat index + \$1 + transportation costs), with the expectation that the hedging relationship will be highly effective. Legacy US GAAP requires an entity to designate the risk of changes in cash flows related to all changes in the purchase price of the asset reflecting its actual location. [815-20-25-15(i)(2)]

Any ineffectiveness was previously recorded in earnings.

Hedge designation: at transition

Bakery elects to modify, without dedesignation, the existing hedging relationship to specify the hedged risk as the variability in the contractually specified wheat index ABC component.

Any ineffectiveness previously recognized is included as part of the cumulative-effect adjustment to AOCI and opening retained earnings as of the initial application date.

To assess effectiveness, Bakery creates the terms of the instrument used to estimate changes in value of the hedged risk (e.g. a PEH derivative) using market data for wheat index ABC at the original inception date of the hedge, and compares to actual changes in the wheat index ABC derivative instrument.



Question 17.4.100

What is the transition guidance for an existing hedging relationship with a non-zero fair value derivative designated at hedge inception?

Interpretive response: There is no transition guidance in ASU 2017-12 for existing cash flow hedging relationships where a non-zero fair value derivative was designated as the hedging instrument at hedge inception.

Under legacy US GAAP, the initial non-zero fair value of the hedging derivative may give rise to hedge ineffectiveness that is recorded in earnings throughout the life of the hedging relationship. For example, this occurs when an interest rate swap with periodic cash settlements and a non-zero fair value at hedge inception is designated in a cash flow hedge of forecasted variable interest payments.

In this situation, ASU 2017-12 requires the following. [815-30-35-41A]

- As long as the hedge is highly effective, the entire change in fair value of the hedging instrument is included in OCI and subsequently reclassified into earnings when the hedged transaction affects earnings – i.e. there is no recognition of hedge ineffectiveness in earnings.
- The amounts related to the initial fair value that are recorded in OCI during the hedging relationship are reclassified from AOCI into earnings on a systematic and rational basis over the periods during which the hedged forecasted transactions affect earnings. Section 10.3.20 provides guidance on cash flow hedge accounting when a hedging instrument with periodic settlements has a non-zero fair value at hedge inception.

On transition to ASU 2017-12, an entity is required to reverse any ineffectiveness previously recognized through a cumulative-effect adjustment recorded in AOCI and the opening balance of retained earnings as of the initial application date.

As part of calculating the cumulative-effect adjustment, we believe an entity is also required to consider the effect of the amounts related to the initial fair value that would have been reclassified from AOCI into earnings for the period from the original hedge inception date to the initial application date of ASU 2017-12.

17.4.50 Transition elections for recognition and presentation of excluded components



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, Topic 815, *Derivatives and Hedging*, and Topic 825, *Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, Topic 815, *Derivatives and Hedging*, and Topic 825, *Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*: ...

- e. An entity may elect any of the following items upon adoption of the pending content that links to this paragraph: ...
 - 3. For fair value hedges existing as of the date of adoption in which foreign exchange risk is the hedged risk or one of the hedged risks and

a currency swap is the hedging instrument, an entity may, without dedesignation, modify its hedge documentation to exclude the cross-currency basis spread component of the currency swap from the assessment of hedge effectiveness and recognize the excluded component through an amortization approach. The cumulative effect of applying this election shall be recognized as an adjustment to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the initial application date.

4. For hedges existing as of the date of adoption that exclude a portion of the hedging instrument from the assessment of effectiveness, an entity may modify the recognition model for the excluded component from a mark-to-market approach to an amortization approach without dedesignation of the hedging relationship. The cumulative effect of applying this election shall be recognized as an adjustment to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the initial application date.

The following table summarizes the transition elections related to recognizing and presenting excluded components available for hedging relationships existing on adoption, as well as a comparison of applicable changes from legacy US GAAP.

	Legacy US GAAP	ASU 2017-12	Required transition
Recognizing excluded components (section 13.2.70)	Changes in excluded components are recognized currently in earnings, together with any ineffectiveness. [815-20-25-83]	The initial value of the excluded component is recognized in earnings using either: [815-20-25-83A – 25-83B, 815-35-35-5A – 35-5B] — a systematic and rational method over the life of the hedging instrument (amortization approach); or — currently in earnings (mark-to-market approach). Under the amortization approach, any difference between the change in fair value of the excluded component and the	An entity may: — modify the recognition model for the excluded component from a mark-to-market approach to an amortization approach without dedesignating the hedging relationship;¹ and — recognize a cumulative-effect adjustment as of the initial application date. [815-20-65-3(e)(4)]

	Legacy US GAAP	ASU 2017-12	Required transition
		amounts recognized in income are included in AOCI (the CTA section of AOCI for a net investment hedge). [815-20-25-83A, 815-35-35-5A] This election is applied consistently to similar hedges. For fair value and cash flow hedges, if an entity elects to record the amounts currently in earnings, that election is disclosed. [815-10-50-4EEEE, 815-20-25-83B, 815-35-35-5B]	
Cross-currency basis spreads in currency swaps (section 13.2.70)	An entity may exclude: [815-20-25-82] - time value of options - forward points (spot-forward difference) in a forward contract.	An entity may exclude: [815-20-25-82] - time value of options - forward points (spot-forward difference) in a forward contract - cross-currency basis spreads in currency swaps (for fair value and cash flow hedges only).	Fair value hedges. For fair value hedges existing at the date of adoption, an entity: - can modify hedge documentation to exclude the cross-currency basis spread component of a cross-currency swap without dedesignating the hedging relationship; and - recognize a cumulative-effect adjustment as of the initial application date. [815-20-65-3(e)(3)]

Note:

- As part of the transition relief, an entity does not need to assess effectiveness for similar hedges in a similar manner. An entity may continue recognizing excluded components using a mark-to-market approach for hedging relationships existing on the date of adoption, and elect an amortization approach for hedging relationships executed after the date of adoption (see Question 13.2.220). [815-20-65-3(i)(3)]



Question 17.4.110

Can the transition provision for excluding cross-currency basis spreads in cross-currency swaps be applied to a cash flow or a net investment hedge?

Interpretive response: No. The FASB did not extend this transition provision to cash flow or net investment hedges.

- **Cash flow hedge.** In a cash flow hedge, cross-currency basis spread volatility does not affect earnings. All changes in fair value of the hedging instrument are deferred in OCI.
- **Net investment hedge.** For a net investment hedge, the excluded component model is different. If an entity has historically used cross-currency interest rate swaps as the hedging instrument and elected to assess effectiveness using the spot method, the hedging relationship implicitly excludes the cross-currency basis spread (along with any other component of the currency swap's fair value excluded by the spot method of assessing effectiveness) from the assessment of effectiveness. If an entity determines that it now wishes to amortize the excluded component, instead of marking the component to market, it can do so through the transition provision related to the recognition of excluded components. [IASU 2017-12.BC251](#)

17.4.60 Transition elections related to assessing hedge effectiveness



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, Topic 815, *Derivatives and Hedging*, and Topic 825, *Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*

65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, Topic 815, *Derivatives and Hedging*, and Topic 825, *Financial Instruments*, and No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*: ...

- e. An entity may elect any of the following items upon adoption of the pending content that links to this paragraph: ...

5. An entity may modify documentation without dedesignating an existing hedging relationship to specify the following:
 - i. For hedging relationships that currently use a quantitative method to assess effectiveness, that subsequent prospective and retrospective effectiveness assessments shall be performed qualitatively in accordance with paragraph 815-20-25-3(b)(2)(iv)(03)
 - ii. For hedging relationships that currently use the shortcut method to assess effectiveness, the quantitative method that would be used to perform assessments of effectiveness in accordance with paragraph 815-20-25-117A if the entity determines at a later date that use of the shortcut method was not or no longer is appropriate.
 - iii. For cash flow hedging relationships in which an entity currently uses a quantitative method to assess effectiveness, that the critical terms of the hedging instrument and the hedged item match if the criteria in paragraphs 815-20-25-84 through 25-85 or paragraphs 815-20-25-129 through 25-129A are met and that subsequent prospective and retrospective effectiveness assessments shall be performed in accordance with paragraphs 815-20-35-9 through 35-12 or in accordance with paragraphs 815-20-25-126 through 25-129A and paragraphs 815-30-35-33 through 35-34.

The following table summarizes transition elections related to targeted improvements to the hedge effectiveness assessment process for hedges existing as of the date of adoption, as well as comparable guidance from legacy US GAAP.

	Legacy US GAAP	ASU 2017-12	Required transition
Qualitative effectiveness assessments (section 13.5)	Subsequent prospective and retrospective assessments of hedge effectiveness are required to be quantitative, except for methods such as 'shortcut' or 'critical terms match'. [815-20-25-79]	Subsequent quarterly effectiveness assessments (after an initial quantitative assessment) may be performed on a qualitative (instead of quantitative) basis if an entity can reasonably support an expectation that the hedge is highly effective at inception and will continue to be in subsequent periods. [815-20-25-79, 815-20-35-2A]	An entity is permitted to amend the hedge documentation for existing hedging relationships to indicate that subsequent assessments of effectiveness will be performed qualitatively, without dedesignating the existing hedging relationships. [815-20-65-3(e)(5)(i)]
Shortcut method (section 13.3)	An entity that determines it inappropriately used the shortcut method loses hedge accounting in all previous periods in	An entity that inappropriately applied the shortcut method may continue to apply hedge accounting to	An entity is permitted to amend the hedge documentation for existing shortcut method hedging relationships without

	Legacy US GAAP	ASU 2017-12	Required transition
	which it had applied the method. [2005 AICPA Conf]	previous periods if it: [815-20-25-117A] — documented at hedge inception which quantitative method it would use to assess hedge effectiveness in the event that the shortcut method was no longer appropriate; and — when the quantitative method was identified as being applied in its hedge documentation, determines that the hedge was highly effective for the periods in which the shortcut method criteria were not met.	dedesignating the existing hedging relationships. ¹ [815-20-65-3(e)(5)(iii)]

Note:

1. As part of the transition relief, an entity does not need to assess effectiveness for similar hedges in a similar manner. An entity may document a quantitative effectiveness method for new shortcut method hedging relationships executed after the date of adoption. This is regardless of whether an entity modifies its hedge documentation to include a quantitative effectiveness method for hedges existing at the date of adoption (see Question 13.2.220). [\[815-20-65-3\(i\)\(1\), ASU 2017-12.BC261\]](#)



Question 17.4.120

What transition approach is required to change from a long-haul to the critical terms match method for an existing hedging relationship?

Background: Under ASU 2017-12, the critical terms match method may be applied to groups of forecasted transactions in which the individual transactions occur, and the hedging derivative matures, within the same 31-day period or fiscal month (see section 13.4). Under legacy US GAAP, an entity would have applied a quantitative long-haul method instead of the critical terms match method to such relationships.

Interpretive response: If an entity changes from a quantitative long-haul method to the critical terms match method for an existing hedging relationship, it may modify its documentation without dedesignating and redesignating the existing hedging relationship to specify that the critical terms of the hedging instrument and the hedged item match in accordance with paragraphs 815-20-25-84 and 25-85. [815-20-65-3(e)(5)(iii)]



Question 17.4.130

What transition approach is required to change the method used to assess effectiveness of a net investment hedge?

Background: The amendments in ASU 2017-12 allow an entity to change its method of assessing the effectiveness of its net investment hedges – from spot to forward, or vice versa (see section 12.4.40). Under legacy US GAAP, an entity was prohibited from changing its method of assessing hedge effectiveness. [815-35-35-4]

Interpretive response: The ASU does not provide transition guidance for changing the method used to assess effectiveness of a net investment hedge.

We believe making this change to an existing hedging relationship on adoption of ASU 2017-12 requires dedesignation and redesignation of the hedging relationship. This is consistent with guidance for changing the effectiveness assessment method for net investment hedges in section 12.4.40. [815-20-55-56]

17.5 Effective dates and transition provisions of ASU 2018-16* *



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2018-16, *Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes*

65-4 The following represents the transition and effective date information related to Accounting Standards Update No. 2018-16, *Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes*:

- a. An entity that has not adopted the pending content that links to paragraph 815-20-65-3 shall adopt the pending content that links to this paragraph at the same time that it adopts the pending content that links to paragraph 815-20-65-3.

1. Early adoption, including adoption in an interim period, of the pending content that links to this paragraph is required if an entity early adopts the pending content that links to paragraph 815-20-65-3.
- b. An entity that has adopted the pending content that links to paragraph 815-20-65-3 shall adopt the pending content that links to this paragraph as follows:
 1. For **public business entities**, the pending content that links to this paragraph shall be effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.
 2. For all other entities, the pending content that links to this paragraph shall be effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.
 3. Early adoption, including adoption in an interim period, of the pending content that links to this paragraph is permitted.
- c. The pending content that links to this paragraph shall be adopted prospectively for qualifying new or redesignated hedging relationships entered into on or after the date of adoption.

The FASB decided to permit designation of the SOFR OIS rate as an eligible benchmark rate only on a prospective basis for qualifying new or redesignated hedging relationships entered into on or after the date of adoption of ASU 2018-16. The FASB believed as a practical matter that the guidance would be issued contemporaneously with the emergence of contracts based on the SOFR OIS rate. [815-20-65-4(c), ASU 2018-16.BC22]

The following table summarizes the effective dates and transition guidance for ASU 2018-16. The impact of adding the SOFR OIS rate is incorporated into section 6.3.30.

	Public business entities	All other entities
Effective date – entities that have not adopted ASU 2017-12: [815-20-65-4(a)]	Concurrent with adoption of ASU 2017-12. See section 17.2.	Concurrent with adoption of ASU 2017-12. See section 17.2.
Effective date – entities that have adopted ASU 2017-12: [815-20-65-4(b)]	Annual and interim periods in fiscal years beginning after December 15, 2018.	Annual and interim periods in fiscal years beginning after December 15, 2019.
Early adoption: [815-20-65-4(a)(1), 65-4(b)(3)]	Required if an entity early adopts ASU 2017-12. Permitted in any interim period if an entity has already adopted ASU 2017-12.	
Transition requirements: [815-20-65-4(c)]	Prospective for qualifying new or redesignated hedging relationships entered into on or after the date of adoption	

17.6 Effective dates and transition provisions of ASU 2019-04**

17.6.10 Overview**



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments

65-5 The following represents the transition and effective date information related to Accounting Standards Update No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*:

- a. For an entity that has adopted the amendments in Accounting Standards Update No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, before the issuance date of Update 2019-04, the pending content that links to this paragraph shall be effective as of the beginning of the first annual reporting period beginning after the date of issuance of Update 2019-04. Early adoption is permitted on any date on or after the issuance of Update 2019-04. See (c), (d), and (e) below for additional transition guidance for entities that have adopted the amendments in Update 2017-12 before the issuance date of Update 2019-04.
- b. For an entity that has not adopted the amendments in Update 2017-12 before the issuance date of Update 2019-04, the pending content that links to this paragraph shall be effective as of the date the entity adopts the amendments in Update 2017-12 in accordance with paragraph 815-20-65-3. The pending content that links to this paragraph shall be adopted at the same time that the amendments in Update 2017-12 are adopted.

The following table summarizes the effective dates and transition guidance for applying ASU 2019-04.

	All entities
Effective date – entities that have not adopted ASU 2017-12: [815-20-65-5(b)]	Concurrent with adoption of ASU 2017-12. See section 17.2.
Effective date – entities that have adopted ASU 2017-12: [815-20-65-5(a)]	As of the beginning of the first annual reporting period beginning after the date of issuance of ASU 2019-04.

	All entities
Early adoption: [815-20-65-5(a)]	Permitted on any date on or after the issuance of ASU 2019-04.
Transition: [815-20-65-5(c), 65-5(f) – 65-5(g)]	— An entity that has adopted ASU 2017-12 before the issuance of ASU 2019-04 may elect to apply the amendments on a prospective or retrospective basis with certain exceptions. — The transition provisions require additional financial statement disclosures.

17.6.20 Transition provisions when ASU 2017-12 is already adopted**



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments

65-5 The following represents the transition and effective date information related to Accounting Standards Update No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*:

- c. For an entity that has adopted the amendments in Update 2017-12 before the issuance date of Update 2019-04, that entity shall elect to reflect all of the pending content that links to this paragraph either on a prospective basis or on a retrospective basis as of the date of adoption of the amendments in Update 2017-12 in accordance with paragraph 815-20-65-3, with the following exceptions:
 1. An entity that adopted the amendments in Update 2017-12 in an interim period and elected to modify the measurement methodology for a hedged item in accordance with either paragraph 815-20-25-6B or paragraph 815-25-35-13 without dedesignating the hedging relationship shall reflect any adjustment made in accordance with paragraph 815-20-65-3(e)(1) at the appropriate balance on the date of initial application of the amendments in Update 2017-12 if that adjustment was made as of the date of adoption of the amendments in Update 2017-12.
 2. An entity that elects fair value hedge rebalancing in accordance with paragraph 815-20-65-3(e)(2) shall reflect any adjustments for existing hedges as of the date of adoption of the amendments in Update 2017-12 on the date of initial application of the amendments in Update 2017-12 in accordance with paragraph 815-20-65-3.
 3. An entity may reclassify a debt security from held to maturity to available for sale if the debt security is eligible to be hedged under the last-of-layer guidance in accordance with paragraph 815-20-25-12A upon adoption of the pending content that links to this paragraph only

- if the entity did not reclassify one or more debt securities from held to maturity to available for sale upon adoption of the amendments in Update 2017-12. If the entity did not reclassify any debt securities from held to maturity to available for sale upon adoption of the amendments in Update 2017-12 and elects to reclassify securities in accordance with paragraph 815-20-65-3(e)(7) upon adoption of the pending content that links to this paragraph, it shall make that reclassification as of the date of adoption of the pending content that links to this paragraph in accordance with (a) above. Any unrealized gain or loss at the date of the reclassification shall be recorded in accumulated other comprehensive income in accordance with paragraph 320-10-35-10(c).
- d. For an entity that has adopted the amendments in Update 2017-12 before the issuance date of Update 2019-04 and reflects the amendments on a prospective basis in accordance with (c) above, the adjustment resulting from the amendment in paragraph 815-25-35-9A to a partial-term fair value hedge relationship's amortization shall be accounted for as a change in estimate in accordance with paragraph 250-10-45-17.
 - e. For an entity that has adopted the amendments in Update 2017-12 before the issuance date of Update 2019-04 and reflects the amendments on a retrospective basis in accordance with (c) above, new hedging relationships may be retrospectively designated between the date of adoption of the amendments in Update 2017-12 and the effective date of Update 2019-04 in accordance with (a) above for existing eligible hedging instruments and existing eligible recognized assets or liabilities or existing eligible forecasted transactions related to the amendments in paragraph 815-25-35-13B, 815-30-35-26, or 815-20-55-33G.

If an entity has adopted ASU 2017-12 before the issuance of ASU 2019-04, it may elect to apply ASU 2019-04 either prospectively or retrospectively. However, the following are three exceptions for which specific transition guidance is prescribed.

Hedging of interest rate risk (section 17.4.30)

The first exception applies when an entity adopted ASU 2017-12 in an interim period and elected to modify its calculation of the change in fair value of the hedged item in a fair value hedge of interest rate risk to consider (1) only the benchmark rate component of the contractual coupon cash flows or (2) only how changes in the benchmark interest rate affect the decision to exercise an embedded prepayment feature in the hedged item, - without dedesignating the hedging relationship.

In this case, the entity reflects any cumulative-effect adjustment as of the initial application date if it recorded the adjustment as of the date of adoption of ASU 2017-12. [815-20-65-5(c)(1)]

Hedging portions of financial items: Benchmark interest rate component (section 17.4.20)

The second exception applies when an entity elects to rebalance a fair value hedge of interest rate risk upon adoption of ASU 2019-04.

In this case, any cumulative-effect adjustments for existing hedges as of the date of adoption of ASU 2017-12 are recorded as of the initial application date of ASU 2017-12. [815-20-65-5(c)(2)]

Transfer securities from the HTM to the AFS portfolio (section 17.4.30)

Under the third exception: [815-20-65-5(c)(3)]

- an entity may reclassify HTM securities that qualify to be hedged under the last-of-layer method to the AFS category if it did not reclassify one or more debt securities from HTM to AFS when adopting ASU 2017-12;
- the reclassification is made as of the date of adoption of ASU 2019-04; and
- any unrealized gain or loss at the date of the reclassification is recorded in AOCI.



Question 17.6.10**

If an entity elects to adopt ASU 2019-04 prospectively, are changes to the amortization of the fair value hedge basis adjustment a change in estimate or accounting principle?

Background: The amendments in ASU 2019-04 clarify that for partial-term fair value hedges: [815-25-35-9A]

- an entity may begin the amortization period for fair value hedge basis adjustments before the fair value hedging relationship is discontinued; and
- if an entity elects to begin the amortization period during an outstanding partial-term hedge, the basis adjustment has to be fully amortized by the hedged item's assumed maturity date.

Interpretive response: If an entity elects to adopt these amendments to a partial-term fair value hedge on a prospective basis, the resulting amortization adjustment should be accounted for as a change in estimate in accordance with paragraph 250-10-45-17. [815-20-65-5(d)]



Question 17.6.20**

If an entity elects to adopt ASU 2019-04 retrospectively, can it retrospectively designate new hedging relationships?

Interpretive response: It depends. If an entity elects to adopt ASU 2019-04 retrospectively, new hedging relationships may be designated:

- between the date the entity adopted ASU 2017-12 and the effective date of ASU 2019-04; and
- for existing eligible hedging instruments, recognized assets or liabilities, or forecasted transactions.

The rationale for retrospectively designating new hedging relationships must be related to the amendments in ASU 2019-04. [815-20-55-33G, 20-65-5(e), 25-35-13B, 30-35-26]

17.6.30 Disclosures about adoption**



Excerpt from ASC 815-20

> Transition Related to Accounting Standards Update No. 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments

65-5 The following represents the transition and effective date information related to Accounting Standards Update No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*:

- f. An entity shall disclose the following in the period that the entity adopts the pending content that links to this paragraph:
 - 1. The nature of and reason for the change in accounting principle.
 - 2. The method of applying the change. For an entity that adopted the amendments in Update 2017-12 before the issuance of Update 2019-04, the entity shall disclose whether it adopted the eligible amendments in accordance with (c) above either on a prospective or retrospective basis.
 - 3. The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the pending content that links to this paragraph is applied. Presentation of the effect on financial statement subtotals is not required.
 - 4. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the pending content that links to this paragraph is applied.
- g. An entity that issues interim financial statements shall provide the disclosures in (f) above in each interim financial statement of the fiscal year of change and the annual financial statement of the fiscal year of change.

An entity is required to make certain disclosures in the period it adopts ASU 2019-04.

**Nature of and reason for the change
in accounting principle**

Method of applying the change

**Material effect of adoption on any
line item on the balance sheet as of
beginning of the first period for
which ASU 2019-04 is applied**

**Cumulative effect of change on
retained earnings or other
components of equity as of
beginning of first period for which
ASU 2019-04 is applied**

An entity that issues interim financial statements is required to provide these disclosures in each interim financial statement of the fiscal year of change and also in the annual financial statements of the fiscal year of change. [815-20-65-5(f) – 65-1(g)]

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