

Statutory Issue Paper No. 114

Accounting for Derivative Instruments and Hedging Activities

STATUS

Finalized October 16, 2001

Original SSAP and Current Authoritative Guidance: SSAP No. 86

Type of Issue

Common Area

SUMMARY OF ISSUE

1. *SSAP No. 31—Derivative Instruments* (SSAP No. 31) contains guidance on accounting for derivative instruments. The applicable GAAP guidance is included in *Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities* (FAS 133), FAS 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133 an amendment of FASB Statement No. 133* (FAS 137), FAS 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities—an amendment of FASB Statement No. 133* (FAS 138) and their related Emerging Issues Task Force Issues.

2. The purpose of this issue paper is to address the concepts outlined in FAS 133 and establish a comprehensive statutory accounting model for derivative instruments. This issue paper will also reassess the provisions of SSAP No. 31. The result will be a new SSAP, which will supersede SSAP No. 31. The purpose also includes development of an accounting model for derivatives that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION:

3. SSAP No. 31 is superseded in its entirety by the conclusions outlined in this issue paper.
4. This issue paper addresses the recognition of derivatives and measurement of derivatives used in:
 - a. Hedging transactions;
 - b. Income generation transactions; and
 - c. Replication transactions

Definitions (for purposes of this issue paper)

5. “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:
 - a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or
 - b. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.
6. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures

and any other agreements or instruments substantially similar thereto or any series or combination thereof.

- a. “Caps” are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder’s (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate;
- b. “Collar” means an agreement to receive payments as the buyer of an option, cap or floor and to make payments as the seller of a different option, cap or floor;
- c. “Floors” are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder (purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount;
- d. “Forwards” are agreements (other than a futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument;
- e. “Futures” are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies;
- f. “Options” are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter;
- g. “Swaps” are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash rather than by physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency and commodity swaps also are common;
- h. “Warrants” are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity.

7. “Firm commitment” is an agreement with an unrelated party, binding on both parties and expected to be legally enforceable, with the following characteristics:
- 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 agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable; and
 - For investments in subsidiary, controlled, and affiliated entities (as defined by *SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities*) and investments in limited liability companies (as defined by *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*) it must be probable that acquisition will occur within a reasonable period of time.
8. A hedging transaction is defined as a derivative transaction which is entered into and maintained to reduce:
- The risk of a change in the fair value or cash flow of assets and liabilities which the reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence; or
 - The currency exchange rate risk or the degree of exposure as to assets and liabilities which a reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence.
9. “Income generation transaction” is defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock that it already owns).
10. “Replication (Synthetic Asset) transaction” is a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.
11. “Forecasted transaction” is 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.
12. An “underlying” is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

Embedded Derivative Instruments

13. Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges

that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

Impairment

14. This issue paper adopts the impairment guidelines established by *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5) for the underlying financial assets or liabilities.

Recognition and Measurement of Derivatives Used in Hedging Transactions

15. Derivative instruments represent rights or obligations that meet the definitions of assets (*SSAP No. 4—Assets and Nonadmitted Assets*) or liabilities (SSAP No. 5) and shall be reported in financial statements. In addition, derivative instruments also meet the definition of financial instruments as defined in *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments* (SSAP No. 27). Should the cost basis of the derivative instrument be undefined (i.e., no premium is paid), the instrument shall be disclosed in accordance with paragraphs 8-10 of SSAP No. 27. Derivative instruments are admitted assets to the extent they conform to the requirements of this issue paper.

16. Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. Derivative instruments used in hedging transactions that do not meet the criteria of an effective hedge shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).

17. Entities shall not bifurcate the effectiveness of derivatives. A derivative instrument is either classified as an effective hedge or an ineffective hedge. Entities must account for the derivative using fair value accounting if it is deemed to be ineffective. Entities may redesignate a derivative in a hedging relationship even though the derivative was used in a previous hedging relationship that proved to be ineffective. An entity shall prospectively discontinue hedge accounting for an existing hedge if any one of the following occurs:

- a. Any criterion in paragraphs 20-23 is no longer met;
- b. The derivative expires or is sold, terminated, or exercised (impact recorded as realized gains or losses or, for effective hedges of firm commitments or forecasted transactions, in a manner that is consistent with the hedged transaction – see paragraph 18);
- c. The entity removes the designation of the hedge; or
- d. The derivative is deemed to be impaired in accordance with paragraph 14. A permanent decline in a counterparty's credit quality/rating is one example of impairment required by paragraph 14, for derivatives used in hedging transactions.

18. For those derivatives which qualify for hedge accounting, the change in the carrying value or cash flow of the derivative shall be recorded consistently with how the changes in the carrying value or cash flow of the hedged asset, liability, firm commitment or forecasted transaction are recorded.

Hedge Designations

19. An entity may designate a derivative instrument as hedging the exposure to:
- a. Changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk. This type of hedge can be utilized regardless of whether the hedged asset or liability is recorded in the financial statements at fair value;
 - b. Variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction; or
 - c. Foreign currency exposure. Specific examples include a fair value or cash flow hedge of a firm commitment or financial instrument.

Fair Value Hedges

20. Fair value hedges qualify for hedge accounting if all of the following criteria are met:
- a. At inception of the hedge, the formal documentation requirements of paragraph 26 are met;
 - b. Both at inception of the hedge and on an ongoing basis, the hedging relationship must be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship;
 - c. The term highly effective has the same meaning as the notion of high correlation as utilized in *FAS No. 80, Accounting for Futures Contracts* (FAS 80). As a result, highly effective describes a fair value hedging relationship where the change in the fair value of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the fair value of the hedged item attributable to the hedged risk. It shall also apply when an R-squared of .80 or higher is achieved when using a regression analysis technique. Further guidance on determining effectiveness can be found within Exhibit A and B;
 - d. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof); and
 - e. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk.

Cash Flow Hedges

21. Cash flow hedges qualify for hedge accounting if all of the following criteria are met:
- a. At inception of the hedge, the formal documentation requirements of paragraph 26 are met;
 - b. Both at inception of the hedge and on an ongoing basis, the hedging relationship shall be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship; and
 - c. The term highly effective has the same meaning as the notion of high correlation as utilized in FAS No. 80. As a result, highly effective describes a cash flow hedging relationship where the change in the cash flows of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the cash flows of the hedged item attributable to the hedged risk. It shall also apply when an R-squared of .80 or higher is achieved when using a regression analysis technique. Further guidance on determining effectiveness can be found within Exhibit A and B.

Hedging Forecasted Transactions

22. A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:
- a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.
 - b. The occurrence of the forecasted transaction is probable. An assessment of the likelihood that a forecasted transaction will take place should not be based solely on management's intent because intent is not verifiable. The transaction's probability should be supported by observable facts and the attendant circumstances. Consideration should be given to the following circumstances in assessing the likelihood that a transaction will occur:
 - i. The frequency of similar past transactions;
 - ii. The financial and operational ability of the entity to carry out the transaction;
 - iii. 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);
 - iv. The extent of loss or disruption of operations that could result if the transaction does not occur; and
 - v. 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).

The term probable requires a significantly greater likelihood of occurrence than the phrase more likely than not. In addition, both the length of time until a forecasted

transaction is projected to occur and the quantity of the forecasted transaction are considerations in determining probability. Other factors being equal, the more distant a forecasted transaction is, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be needed to support an assertion that it is probable. For example, a transaction forecasted to occur in five years may be less likely than a transaction forecasted to occur in one year. However, forecasted interest payments for the next 20 years on variable-rate debt typically would be probable if supported by an existing contract. Additionally, other factors being equal, the greater the physical quantity or future value of a forecasted transaction, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be required to support an assertion that it is probable. For example, less evidence generally would be needed to support forecasted investments of \$100,000 in a particular month than would be needed to support forecasted investments of \$950,000 in that month by an entity, even if its investments have averaged \$950,000 per month for the past 3 months.

A forecasted transaction that is expected to occur with 2 months of the original forecasted date (or time frame) may still be considered probable. If the transaction will not occur until greater than 2 months after the original forecasted date, it is no longer probable and will be accounted for as per the following paragraph.

If a forecasted transaction is determined to no longer be probable per the standards above, hedge accounting shall cease immediately and any deferred gains or losses on the derivative must be recognized in unrealized gains or losses. If an entity demonstrates a pattern of determining that hedged forecasted transactions probably will not occur, such action 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. Accordingly, hedging of forecasted transactions will no longer be permitted by that entity.

- c. If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged is (1) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient.
- d. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is (1) the risk of changes in the cash flows of the entire asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in the designated benchmark interest rate, (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates, or (4) the risk of changes in its cash flows attributable to default or changes in the obligor's creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge. Two or more of the above risks may be designated simultaneously as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must specifically be identified as part of the designation and documentation at the inception of the hedging relationship. An entity may not designate prepayment risk as the risk being hedged.

Foreign Currency Hedges

23. For foreign currency hedges, this issue paper adopts paragraphs 36-42 (except for last sentence of paragraph 38) of FAS No. 133 and paragraphs 4.b.- 4.o. of FAS No. 138 which amend FAS No. 133.

Hedge Effectiveness

24. The measurement of hedge effectiveness for a particular hedging relationship shall be consistent with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 26.

25. The gain or loss on a derivative designated as a cash flow hedge and assessed to be effective is reported consistently with the hedged item. If an entity's defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in Exhibit B), that excluded component of the gain or loss shall be recognized as an unrealized gain or loss. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option's intrinsic value, the changes in the option's time value would be recognized in unrealized gains or losses. Time value is equal to the fair value of the option less its intrinsic value.

Documentation Guidance

26. At inception of the hedge, documentation must include:

- a. A formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness;
- b. An entity's defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative's change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 63 of FAS 133;
- c. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions; and
- d. A description of the reporting entity's methodology used to verify that opening transactions do not exceed limitations promulgated by the state of domicile.

27. For all derivatives terminated, expired, or exercised during the year:

- a. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;
- b. A description, for each instrument, of the nature of the transaction, including:
 - i. The date of the transaction;

- ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;
 - iii. Number of contracts or notional amount;
 - iv. Date of maturity, expiry or settlement;
 - v. Strike price, rate or index (termination price for futures contracts);
 - vi. Counterparty, or exchange on which the transaction was traded; and
 - vii. Consideration paid or received, if any, on termination.
- c. Description of the reporting entity's methodology to verify that derivatives were effective hedges; and
 - d. Identification of any derivatives that ceased to be effective as hedges.
28. For derivatives open at quarter-end:
- a. A description of the methodology used to verify the continued effectiveness of hedges;
 - b. An identification of any derivatives which have ceased to be effective as hedges;
 - c. A description of the reporting entity's methodology to determine fair values of derivatives;
 - d. Copy of Master Agreements, if any, where indicated on Schedule DB Part E Section 1.

Recognition and Measurement of Derivatives Used in Income Generation Transactions

General

29. Income generation transactions are defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock that it already owns).

30. Because these transactions require writing derivatives, they expose the reporting entity to potential future liabilities for which the reporting entity receives a premium up front. Because of this risk, dollar limitations and additional constraints are imposed requiring that the transactions be "covered" (i.e., offsetting assets can be used to fulfill potential obligations). To this extent, the combination of the derivative and the covering asset works like a reverse hedge where an asset owned by the reporting entity in essence hedges the derivative risk.

31. As with derivatives in general, these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

32. The principal features of income generation transactions are:
- a. Premium received is initially recorded as a deferred liability;
 - b. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either fair value (e.g., common stocks) or (amortized) cost (e.g., bonds);
 - c. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it shall be subject to IMR treatment if interest rate related;
 - d. For options which are exercised, the remaining premium shall adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

Written Fixed Income Covered Call Options

33. The principal features of written fixed income covered call options are:
- a. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract if the original duration is less than one year, otherwise carry at amortized cost;
 - b. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds;
 - c. For life insurance companies, the gain or loss flows through the IMR if the covering asset or underlying interest is subject to the IMR using callable bond rules to determine the remaining life;
 - d. Reporting entities are responsible for timely recognition of any probable losses that may occur as a result of the strategy. If the exercise price is below the covering asset's book value, the asset shall be evaluated for write down or disclosure treatment in accordance with SSAP No. 5. All relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect unassigned funds (surplus) and income shall be considered.
34. Written fixed income covered call options shall be accounted for as follows:

STATUS OF OPTION	COVERING ASSET VALUED AT AMORTIZED COST	COVERING ASSET VALUED AT FAIR VALUE
Open	<p>Record premium as deferred liability.</p> <p>Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.)</p> <p>Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting.</p>	<p>Record premium as deferred liability.</p> <p>Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.</p>
Closed – Expired	<p>Premium received recognized as realized capital gain.</p> <p>Gain from expiration to flow through IMR, if applicable.</p> <p>(1)</p>	<p>Premium received recognized as realized capital gain.</p>
Closed – Exercised	<p>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</p> <p>Gain or loss from disposition to flow through IMR, if applicable.</p> <p>(1)</p>	<p>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</p>
Closed – Terminated	<p>Recognize net amount as realized capital gain/loss.</p> <p>Gain or loss from disposition to flow through IMR, if applicable.</p> <p>(1)</p>	<p>Recognize net amount as realized capital gain/loss.</p>

NOTE:

(1) If premium is attached to covering asset, the accounting treatment for the covering asset applies.

Written Covered Put Options

35. The principal features of written covered put options are:

- a. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a reporting entity wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the reporting entity might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case;
- b. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest;
- c. As with covered call writing, entities writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy.

36. Written covered put options shall be accounted for as follows:

STATUS OF OPTION	UNDERLYING INTEREST VALUED AT AMORTIZED COST	UNDERLYING INTEREST VALUED AT FAIR VALUE
Open	Record premium as deferred liability. Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.)	Record premium as deferred liability. Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain. Gain from expiration to flow through IMR, if applicable.	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust acquisition cost by premium received.	Adjust acquisition cost by premium received.
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain or loss from disposition to flow through IMR, if applicable.	Recognize net amount as realized capital gain/loss.

Written Fixed Income Caps and Floors

37. The principal features of written fixed income caps and floors are:

- a. The value of the premium received shall be amortized into income over the life of the contract. For caps and floors, where the entity is selling off possible excess interest/income, the value of the covering asset is not relevant;

- b. Gain/loss may be subject to IMR. The expected maturity would be the derivative contract's maturity.
38. Written fixed income caps and floors shall be accounted for as follows:

STATUS OF OPTION	COVERING ASSET VALUED AT AMORTIZED COST	COVERING ASSET VALUED AT FAIR VALUE
Open	<p>Record premium as deferred liability.</p> <p>Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.)</p> <p>Amortize over life of contract to produce constant yield.</p> <p>Record any interest expense as "Other Investment Income" – negative value.</p>	<p>Record premium as deferred liability.</p> <p>Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.</p>
Closed – Matured	<p>Would usually mature at zero amortized value.</p> <p>Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.</p>	Premium received recognized as realized capital gain.
Closed – Exercised	Not applicable.	Not applicable.
Closed – Terminated	<p>Recognize net amount as realized capital gain/loss.</p> <p>Gain/loss on termination to flow through IMR, if applicable.</p>	Recognize net amount as realized capital gain/loss.

Recognition and Measurement of Derivatives Used in Replication (Synthetic Asset) Transactions

39. Replication (Synthetic Asset) transaction means a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

40. Any premium paid or received shall be carried as an asset or liability on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability). Premiums paid or received on the replication (synthetic asset) derivative should be amortized into investment income or expense until the exercise, termination or maturity date of the derivative.

41. If the replication (synthetic asset) transaction would be carried at amortized cost and the cash instrument used is carried at amortized cost, then the derivative used should be carried at amortized cost. The derivative may be valued at fair value when both the replication (synthetic asset) and the cash instrument are valued at amortized cost. This is consistent with the alternative valuation methods available for hedges. If the replication (synthetic asset) transaction would be carried at fair value and/or the cash instrument used is carried at fair value, then the derivative used should be carried at fair value.

	(a)	(b)	(c)	(d)
	If the Replication (Synthetic Asset) is Valued at:	And Cash Instrument(s) Used is (are) Valued at:	The Derivative is Valued at:	Alternative Derivative Value Basis:
1.	Amortized Cost	Amortized Cost	Amortized Cost	Fair value
2.	Fair value	Fair value	Fair value	N/A
3.	Amortized Cost	Fair value	Fair value	N/A
4.	Fair value	Amortized Cost	Fair value	N/A

42. In the case of No. 3 in the chart above, the fair values for the cash instrument and derivative, when added together, shall not exceed the replication (synthetic asset) statement value. If this does occur, the excess shall reduce the fair value of the derivative.

43. If the replication (synthetic asset) transaction involves the exchange of interest related cash flows (default free assets), then the cash flows should be accrued as investment income. If the replication (synthetic asset) transaction involves the exchange of total return or change in index cash flows, then the cash flows should be segregated between interest income and fair value (equity) changes. The interest income portion should be accrued as investment income.

44. If the derivative is carried at fair value, the periodic change in the fair value should be recorded as an unrealized gain or loss adjustment to surplus until the transaction is terminated. If the replication (synthetic asset) transaction involves the exchange of total return or change in index cash flows, then the cash flows should be segregated between interest income and fair value (equity) changes. The fair value (equity) change should be recognized as a deferred asset/liability until the termination of the contract. Gains or losses on the derivative at termination or sale should be recognized as realized.

Disclosure Requirements

45. Reporting entities shall disclose the following for all derivative contracts used:

- a. General disclosures:
 - i. A description of the reporting entity's objectives for using derivatives, i.e., hedging, income generation or replication;
 - ii. A description of the context needed to understand those objectives and its strategies for achieving those objectives;
 - iii. The description for hedging objectives shall identify the category, e.g., fair value hedges, cash flow hedges, or foreign currency hedges, and for all objectives, the type of instrument(s) used;
 - iv. A description of the accounting policies for derivatives including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives used, and when recognized, where those instruments and related gains and losses are reported;

- v. The net gain or loss recognized in unrealized gains or losses during the reporting period representing the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness; and
 - vi. The net gain or loss recognized in unrealized gains or losses during the reporting period resulting from derivatives that no longer qualify for hedge accounting.
- b. Disclosures by type of instrument outstanding, e.g., call options, floors, etc.:
- i. Notional or contract amounts;
 - ii. Carrying and fair values; and
 - iii. A discussion of the market risk, credit risk, and cash requirements of the derivatives.
- c. For derivatives held for other-than-hedging purposes in addition to a and b above:
- i. Average fair value of the derivatives during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;
 - ii. Net gains or losses detailed by class, business activity or other category that is consistent with the management of those activities and where the net gains or losses are reported.
- d. The financial statements shall disclose details of covered items and/or written transactions to allow evaluation of cash flow implications for all written covered options used for income generation.
- e. For derivatives accounted for as cash flow hedges of a forecasted transaction, disclose:
- i. The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments; and
 - iii. The amount of gains and losses classified in unrealized gains/losses related to cash flow hedges that have been discontinued because it was no longer probable that the original forecasted transactions would occur by the end of the originally specified time period or within 2 months of that date.
- f. The disclosure requirements of 45 a, 45 b, and 45 e shall be included in the Annual Statement. Refer to the preamble for further discussion regarding interim disclosure requirements. The disclosure requirements of paragraphs 45.a.- 45.e. shall be included in the annual audited statutory financial reports. Paragraph 55 of the Preamble states that disclosures made within specific schedules or exhibits to the Annual Statement need not be duplicated in a separate note.

Effective Date

46. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2002.

DISCUSSION

47. The purpose of this issue paper is two-fold. First, to provide a comprehensive source on accounting for derivatives used in hedges, income generation and replication transactions. Second, to address the GAAP guidance that has been issued subsequent to the finalization of SSAP No. 31. In general, this issue paper adopts the framework established by FAS No. 133 for fair value and cash flow hedges, but not its technical guidance (discussed further in subsequent paragraphs). This issue paper adopts the provisions of FAS No. 133 and 138 related to foreign currency hedges. With the exception of guidance specific to foreign currency hedges and amendments specific to refining the hedging of interest rate risk (under FAS 138, the risk of changes in the benchmark interest rate would be the hedged risk), this issue paper rejects FAS No. 137 and 138 as well as the various related Emerging Issues Task Force interpretations (complete listing found in RELEVANT LITERATURE section of this issue paper). It should be noted that the conclusions reached in this issue paper are not intended to usurp the rules and regulations put forth by states in their respective investment laws. The contents of this issue paper are intended to provide accounting guidance on the use of derivatives as allowed by an insurer's state of domicile. It is not intended to imply that insurers may use derivatives or cash instruments that the insurer's state of domicile does not allow under the state's insurance regulatory requirements, e.g., in replication transactions.

Definitions

48. This issue paper defines a derivative instrument somewhat differently than FAS No. 133. The Statutory Accounting Principles (SAP) working group evaluated the FAS No. 133 definition and found that it was inconsistent with the manner in which derivatives are regulated in the insurance industry. While FAS 133 defines derivatives in the context of the characteristics contained in an instrument, the working group concluded that a definition based upon the legal form/contractual rights and obligations is more relevant to statutory reporting. As a result, the definition of a derivative in paragraph 5 of this issue paper is not intended to include life contracts, accident and health contracts, property and casualty contracts and deposit-type contracts as defined within SSAP No. 50—*Classifications and Definitions of Insurance or Managed Care Contracts in Force*. Some of these contracts may be considered derivatives under the FAS No. 133 definition.

Embedded Derivative Instruments

49. FAS No. 133 requires that a contract containing an embedded derivative be accounted for separately from the host contract unless the embedded instrument is clearly and closely related to economic characteristics and risks of the host contract. This issue paper rejects that requirement and stipulates that such embedded derivatives shall not be accounted for separately from the host contract. The SAP working group does not believe this provision is applicable to insurance companies as evidenced by the FASB's difficulty in providing guidance for certain life contracts that include features not associated with insured events. In addition, the SAP working group believes the insurance specific definition of a derivative used in paragraph 5 of this issue paper excludes a majority of the contracts that would include embedded derivatives.

Impairment

50. This issue paper adopts the impairment guidelines of SSAP No. 5. The application of such shall be consistent with the hedged or replicated asset. For instance, a derivative used in a hedging transaction would follow the impairment guidelines for the hedged asset, whereas a derivative used in a replication transaction would follow the impairment guidelines for the asset it is replicating. For derivatives used in hedging transactions one example of an impairment in accordance with SSAP No. 5 would be the permanent decline in the counterparty's credit rating/quality. This example is not applicable to replication transactions as a reporting entity might be try to replicate a similar scenario.

Recognition and Measurement of Derivatives Used in Hedging Transactions

51. The SAP working group believes that a prudent use of derivatives can be an important tool in a sound risk management strategy. Risk management is the practice of defining the risk level an entity desires, identifying the risk level it currently has, and using derivative or other financial instruments to adjust the actual risk level to the desired risk level. Therefore, this issue paper allows holders of derivative instruments used in hedging transactions that meet the criteria of an effective hedge to value and report the derivative in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). This would allow derivatives that effectively hedge assets valued at amortized cost to also be valued at amortized cost.

52. This treatment is a dramatic departure from the requirements of FAS No. 133 in which all derivatives are valued and reported at fair value. This is possible for GAAP accounting because of the existence of *FAS No. 115, Accounting for Certain Investments in Debt and Equity Securities* (FAS No. 115) which requires a majority of GAAP (debt and equity) investments to be recorded at fair value. Therefore, the GAAP model is consistent within its framework to value many financial instruments at fair value. FAS No. 115 has been rejected by several SSAPs as regulators have concluded that the fluctuations of fair value from period to period violates the concepts of conservatism and consistency (further discussion can be found within Issue Paper Nos. 26, 30, 32 and 43). The result of rejecting FAS No. 115 results in a mixed valuation model in which certain financial instruments are valued at cost while some others are recognized at fair value (e.g., non-impaired bonds are recorded at amortized cost, equity instruments valued at fair value, real estate valued at cost or fair value depending upon management's intent). The SAP working group does not believe it is appropriate to value all derivatives at fair value if the assets they are intended to hedge are not also recognized at fair value. Under the FAS No. 133 model, an insurer cannot utilize hedge accounting for debt securities that the entity has the positive intent and ability to hold to maturity as such securities are classified as held-to-maturity securities and reported at amortized cost. This is due to the fact that fluctuations in fair value of the derivative would not offset the fluctuations in fair value of the debt security as the debt security is recorded at amortized cost and there is no impact on surplus for changes in its fair value. By utilizing the concept of emulating valuation of the hedged assets and derivatives adopted in this issue paper consistency is achieved within the mixed valuation model. The concept of emulating valuation also supports the conservatism concept of statutory accounting in that using the amortized values and unrealized gains or losses, derivatives used in hedging should be protected from significant temporary gains from being incorporated into earnings. Further, the conservatism concept is supported in permanent losses by application of the impairment requirement.

53. This issue paper also adopts a provision to recognize the changes in fair value of a derivative that does not meet the criteria for hedge accounting to be recorded as unrealized gains or losses. SSAP No. 31 requires these changes to be recognized currently in earnings. The SAP working group believes the SSAP No. 31 treatment is inconsistent with similar guidance for equity investments in that the earnings process has not been completed.

Hedge Designations

54. This issue paper adopts the hedge designation framework established in FAS No. 133 in that entities may designate a derivative instrument as hedging the exposure to changes in fair value, variability in expected future cash flow or foreign currency exposures. This decision was made so that statutory accounting would be consistent for entities that must also conform to the documentation requirements of FAS No. 133.

55. This issue paper allows entities to hedge a portfolio of similar assets or similar liabilities but does not advocate hedging of an entire portfolio with dissimilar risks (referred to as macro hedging). If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual

liabilities must share the same risk exposure for which they are designated as being hedged. In a fair value hedge, the change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7 percent to 13 percent would be inconsistent with this provision. In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate: loan type, loan size, nature and location of collateral, interest rate type (fixed or variable) and the coupon interest rate (if fixed), scheduled maturity, prepayment history of the loans (if seasoned), and expected prepayment performance in varying interest rate scenarios.

56. To qualify for hedge accounting, this issue paper requires that fair value, cash flow and foreign currency hedges must be highly effective in achieving its offsetting objectives. The term “highly effective” is specifically defined within this issue paper unlike FAS No. 133. The SAP working group defined this term so that consistent application of effectiveness could be attained. Additionally, the issue paper rejects the FAS No. 133 concept of identifying and separately accounting for the effective and ineffective portions of a single hedge. This issue paper instructs entities not to bifurcate effectiveness; an entity either has an effective hedge (must use hedge accounting) or an ineffective hedge (must use fair value accounting). Again, deviation from FAS No. 133 was made for consistency.

57. The provisions of FAS No. 133 and 138 related to hedging foreign currency are adopted in this issue paper as they do not violate the principles that define the Statement of Concepts.

Documentation

58. This issue paper adopts documentation guidance, which is a combination of the requirements of FAS No. 133 and SSAP No. 31. None of the requirements of SSAP No. 31 were removed and the FAS No. 133 requirements were added so that entities that also complete GAAP statements would not have to maintain separate documentation.

Recognition and Measurement of Derivatives Used in Income Generation Transactions

59. This issue paper retains the requirements of SSAP No. 31 for income generation transactions. This guidance is needed for those entities who wish to write or sell derivatives in an attempt to generate additional income and therefore do not use these types of derivatives to hedge risk exposures.

Recognition and Measurement of Derivatives Used in Replication (Synthetic Asset) Transactions

60. The guidance included for replication transactions was adopted as “NAIC Preferred Accounting Treatment” by the Emerging Accounting Issues working group on June 7, 1999. Inclusion in this issue paper of the preferred accounting guidance for replications formalizes its position within the Statutory Hierarchy.

Disclosures

61. This issue paper adopts disclosure requirements that represent a combination of the provisions of FAS No. 133 and SSAP No. 31.

Drafting Notes/Comments

- The issue of disclosing derivatives embedded within financial assets will be addressed by the Invested Asset (E) Working Group
- The issue of accounting for and the reporting of insurance derivatives (used in hedging insurance exposures) will be addressed by the Insurance Securitization (E) Working Group.
- The general reference to FAS No. 133 and 138 for foreign currency hedges will be replaced with the specific language in the SSAP once the staff has an opportunity to meld the two pronouncements together.
- The reporting guidance referred to in paragraph 18 will be refined by the FAS No. 133 Subgroup after further deliberation.
- The language specific to Insurance Futures and Insurance Futures Options has not been included in this issue paper due to the lack of activity in this market.

RELEVANT STATUTORY AND GAAP GUIDANCE:**Statutory Accounting**

62. *SSAP No. 31—Derivative Instruments* provides the current statutory guidance for most derivative transactions.

63. The Emerging Accounting Issues Working Group adopted as NAIC preferred accounting treatment the conclusions reached in this issue paper for replication transactions. The following was taken from the June 7, 1999, minutes of the Working Group:

Mr. Clark reported that the working group had reached a tentative consensus on the issue of accounting for replication transactions during an interim conference call on May 12, 1999. This consensus was exposed on the NAIC website after the 1999 Spring National Meeting, and the NAIC staff received no comments on it.

Mr. Medley questioned whether the word “consideration” could be used instead of “premium” as shown on Attachment A Part (b) (see attachment 4 to the 5/12/99 conference call minutes). Maria Avila (Northwestern Mutual Life), on behalf of interested parties, indicated that the change would not modify the intent or conclusion of the proposal. Mr. Johnson made a motion to finalize the tentative consensus, as modified, and grant the proposal preferred NAIC accounting treatment. Mr. Ford seconded the motion. The working group unanimously adopted the motion.

Mr. Clark stressed that this issue falls under the old working group rules and, thus, the working group can only grant preferred NAIC accounting treatment. This issue will also be addressed by the Codification of Statutory Accounting Principles working group when SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities is reviewed under the maintenance process.

Generally Accepted Accounting Principles

64. FAS 133 provides the following guidance (the language shown in italics has been amended by FAS No. 137 and 138):

INTRODUCTION

1. This Statement addresses the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and hedging activities.

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

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

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

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

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

- a. A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to a particular risk (referred to as a fair value hedge)
- b. A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk (referred to as a cash flow hedge)
- c. A hedge of the foreign currency exposure of (1) an unrecognized firm commitment (a foreign currency fair value hedge), (2) an available-for-sale security (a foreign currency fair value hedge), (3) a forecasted transaction (a foreign currency cash flow hedge), or (4) a net investment in a foreign operation.

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

Scope and Definition

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

Derivative Instruments

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

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

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

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

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

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

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

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

- a. “Regular-way” security trades. Regular-way security trades are contracts with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9.a. and 9.b.). They provide for delivery of a security within the time generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed.
- b. Normal purchases and normal sales. Normal purchases and normal sales are contracts with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9.a. and 9.b.). They provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business.
- c. Certain insurance contracts. Generally, contracts of the type that are within the scope of *FASB Statements No. 60, Accounting and Reporting by Insurance Enterprises, No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and *No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, are not subject to the requirements of this Statement whether or not they are written by insurance enterprises. That is, a contract is not subject to the requirements of this Statement if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. The following types of contracts written by insurance enterprises or held by the insureds are not subject to the requirements of this Statement for the reasons given:
 - (1) Traditional life insurance contracts. The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.
 - (2) Traditional property and casualty contracts. The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.

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

- d. Certain financial guarantee contracts. Financial guarantee contracts are not subject to this Statement if they provide for payments to be made only to reimburse the guaranteed party for a loss incurred because the debtor fails to pay when payment is due, which is an identifiable insurable event. In contrast, financial guarantee contracts are subject to this Statement if they provide for payments to be made in response to changes in an underlying (for example, a decrease in a specified debtor’s creditworthiness).
- e. Certain contracts that are not traded on an exchange. Contracts that are not exchange-traded are not subject to the requirements of this Statement if the underlying on which the settlement is based is one of the following:
 - (1) A climatic or geological variable or other physical variable
 - (2) The price or value of (a) a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash or (b) a nonfinancial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash

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

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

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

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

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

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

Embedded Derivative Instruments

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

- a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of

the host contract. Additional guidance on applying this criterion to various contracts containing embedded derivative instruments is included in Appendix A of this Statement.

- b. The contract (“the hybrid instrument”) that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.
 - c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6-11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)
13. For purposes of applying the provisions of paragraph 12, an embedded derivative instrument in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following conditions exist:
- a. The hybrid instrument can contractually be settled in a such a way that the investor (holder) would not recover substantially all of its initial recorded investment.
 - b. The embedded derivative could at least double the investor’s initial rate of return on the host contract and could also result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality.

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

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

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

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

Recognition of Derivatives and Measurement of Derivatives and Hedged Items

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

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

- a. No hedging designation. The gain or loss on a derivative instrument not designated as a hedging instrument shall be recognized currently in earnings.
- b. Fair value hedge. The gain or loss on a derivative instrument designated and qualifying as a fair value hedging instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk shall be recognized currently in earnings in the same accounting period, as provided in paragraphs 22 and 23.
- c. Cash flow hedge. The effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraphs 30 and 31. The remaining gain or loss on the derivative instrument, if any, shall be recognized currently in earnings, as provided in paragraph 30.
- d. Foreign currency hedge. The gain or loss on a derivative instrument or nonderivative financial instrument designated and qualifying as a foreign currency hedging instrument shall be accounted for as follows:
 - (1) The gain or loss on the hedging derivative or nonderivative instrument in a hedge of a foreign-currency-denominated firm commitment and the

- offsetting loss or gain on the hedged firm commitment shall be recognized currently in earnings in the same accounting period, as provided in paragraph 37.
- (2) The gain or loss on the hedging derivative instrument in a hedge of an available-for-sale security and the offsetting loss or gain on the hedged available-for-sale security shall be recognized currently in earnings in the same accounting period, as provided in paragraph 38.
 - (3) The effective portion of the gain or loss on the hedging derivative instrument in a hedge of a forecasted foreign-currency-denominated transaction shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraph 41. The remaining gain or loss on the hedging instrument shall be recognized currently in earnings.
 - (4) The gain or loss on the hedging derivative or nonderivative instrument in a hedge of a net investment in a foreign operation shall be reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment to the extent it is effective as a hedge, as provided in paragraph 42.

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

Fair Value Hedges

General

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

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

hedging instrument must be expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship (in accordance with paragraph 20.a. above).

- c. If a written option is designated as hedging a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for gains as a result of a favorable change in the fair value of the combined instruments as exposure to losses from an unfavorable change in their combined fair value. That test is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide at least as much gain as the loss that would be incurred from an unfavorable change in the underlying of the same percentage.

- (1) A combination of options (for example, an interest rate collar) entered into contemporaneously shall be considered a written option if either at inception or over the life of the contracts a net premium is received in cash or as a favorable rate or other term. (Thus, a collar can be designated as a hedging instrument in a fair value hedge without regard to the test in paragraph 20.c. unless a net premium is received.) Furthermore, a derivative instrument that results from combining a written option and any other nonoption derivative shall be considered a written option.

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

The Hedged Item

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

- a. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof).

- (1) If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7 percent to 13 percent would be inconsistent with this provision. In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate: loan type, loan size, nature and location of collateral, interest rate type (fixed or variable) and the coupon interest rate (if fixed), scheduled maturity, prepayment history of the loans (if seasoned), and expected prepayment performance in varying interest rate scenarios.

- (2) If the hedged item is a specific portion of an asset or liability (or of a portfolio of similar assets or a portfolio of similar liabilities), the hedged item is one of the following:

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

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

- b. The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings. The reference to affecting reported earnings does not apply to an entity that does not report earnings as a separate caption in a statement of financial performance, such as a not-for-profit organization, as discussed in paragraph 43.
- c. The hedged item is not (1) an asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings (*for example, if foreign exchange risk is hedged, a foreign-currency-denominated asset for which a foreign currency transaction gain or loss is recognized in earnings*), (2) an investment accounted for by the equity method in accordance with the requirements of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, (3) a minority interest in one or more consolidated subsidiaries, (4) an equity investment in a consolidated subsidiary, (5) a firm commitment either to enter into a business combination or to acquire or dispose of a subsidiary, a minority interest, or an equity method investee, or (6) an equity instrument issued by the entity and classified in stockholders' equity in the statement of financial position.
- d. If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held-to-maturity in accordance with *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*, the designated risk being hedged is the risk of changes in its fair value attributable to changes in the obligor's creditworthiness or if the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component. (The designated hedged risk for a held-to-maturity security may not be the risk of changes in its fair value attributable to changes in market interest rates or foreign exchange rates. If the hedged item is other than an option component that permits its prepayment, the designated hedged risk also may not be the risk of changes in its overall fair value.)
- e. If the hedged item is a nonfinancial asset or liability (other than a recognized loan servicing right or a nonfinancial firm commitment with financial components), the designated risk being hedged is the risk of changes in the fair value of the entire hedged asset or liability (reflecting its actual location if a physical asset). That is, the price risk of a similar asset in a different location or of a major ingredient may not be the hedged risk. Thus, in hedging the exposure to changes in the fair value of gasoline, an entity may not designate the risk of changes in the price of crude oil as the risk being hedged for purposes of determining effectiveness of the fair value hedge of gasoline
- f. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the

designated risk being hedged is (1) the risk of changes in the overall fair value of the entire hedged item, (2) the risk of changes in its fair value attributable to changes in market interest rates, (3) the risk of changes in its fair value attributable to changes in the related foreign currency exchange rates (refer to paragraphs 37 and 38), or (4) the risk of changes in its fair value attributable to changes in *the* obligor's creditworthiness. If the risk designated as being hedged is not the risk in paragraph 21.f.(1) above, two or more of the other risks (market interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged. An entity may not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the fair value of that "prepayment" option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of market interest rate risk.

22. Gains and losses on a qualifying fair value hedge shall be accounted for as follows:
- a. The gain or loss on the hedging instrument shall be recognized currently in earnings.
 - b. The gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized currently in earnings.

If the fair value hedge is fully effective, the gain or loss on the hedging instrument, adjusted for the component, if any, of that gain or loss that is excluded from the assessment of effectiveness under the entity's defined risk management strategy for that particular hedging relationship (as discussed in paragraph 63 in Section 2 of Appendix A), would exactly offset the loss or gain on the hedged item attributable to the hedged risk. Any difference that does arise would be the effect of hedge ineffectiveness, which consequently is recognized currently in earnings. The measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 20.a. Nevertheless, the amount of hedge ineffectiveness recognized in earnings is based on the extent to which exact offset is not achieved. Although a hedging relationship must comply with an entity's established policy range of what is considered "highly effective" pursuant to paragraph 20.b. in order for that relationship to qualify for hedge accounting, that compliance does not assure zero ineffectiveness. Section 2 of Appendix A illustrates assessing hedge effectiveness and measuring hedge ineffectiveness. Any hedge ineffectiveness directly affects earnings because there will be no offsetting adjustment of a hedged item's carrying amount for the ineffective aspect of the gain or loss on the related hedging instrument.

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

24. The adjustment of the carrying amount of a hedged asset or liability required by paragraph 22 shall be accounted for in the same manner as other components of the carrying amount of that asset or liability. For example, an adjustment of the carrying amount of a hedged asset held for sale (such as inventory) would remain part of the carrying amount of that asset until the asset is sold, at which point the entire carrying amount of the hedged asset would be recognized as the cost of the item sold in determining earnings. An adjustment of the carrying amount of a hedged interest-bearing financial instrument shall be amortized to earnings;

amortization shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

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

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

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

26. In general, if a periodic assessment indicates noncompliance with the effectiveness criterion in paragraph 20.b., an entity shall not recognize the adjustment of the carrying amount of the hedged item described in paragraphs 22 and 23 after the last date on which compliance with the effectiveness criterion was established. However, if the event or change in circumstances that caused the hedging relationship to fail the effectiveness criterion can be identified, the entity shall recognize in earnings the changes in the hedged item's fair value attributable to the risk being hedged that occurred prior to that event or change in circumstances. If a fair value hedge of a firm commitment is discontinued because the hedged item no longer meets the definition of a firm commitment, the entity shall derecognize any asset or liability previously recognized pursuant to paragraph 22 (as a result of an adjustment to the carrying amount for the firm commitment) and recognize a corresponding loss or gain currently in earnings.

Impairment

27. An asset or liability that has been designated as being hedged and accounted for pursuant to paragraphs 22-24 remains subject to the applicable requirements in generally accepted accounting principles for assessing impairment for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 22 of this Statement. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment requirements to the hedged asset or liability.

Cash Flow Hedges

General

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

- a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged transaction, the nature of the risk being hedged, and how the hedging instrument's effectiveness in hedging the exposure to the hedged transaction's variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness.

- (1) An entity's defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative's change in fair value from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.
- (2) Documentation shall include all relevant details, including the date on or period within which the forecasted transaction is expected to occur, the specific nature of asset or liability involved (if any), and the expected currency amount or quantity of the forecasted transaction.
 - (a) The phrase expected currency amount refers to hedges of foreign currency exchange risk and requires specification of the exact amount of foreign currency being hedged.
 - (b) The phrase expected . . . quantity refers to hedges of other risks and requires specification of the physical quantity (that is, the number of items or units of measure) encompassed by the hedged forecasted transaction. If a forecasted sale or purchase is being hedged for price risk, the hedged transaction cannot be specified solely in terms of expected currency amounts, nor can it be specified as a percentage of sales or purchases during a period. The current price of a forecasted transaction also should be identified to satisfy the criterion in paragraph 28.b. for offsetting cash flows.

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

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

designated asset and the basis of the other leg of the swap is the same as the basis of the interest payments for the designated liability. In this situation, the criterion in the first sentence in paragraph 29.a. is applied separately to the designated asset and the designated liability.

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

The Hedged Forecasted Transaction

29. A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

- a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.
- b. The occurrence of the forecasted transaction is probable.
- c. The forecasted transaction is a transaction with a party external to the reporting entity (except as permitted by paragraph 40) and presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.
- d. The forecasted transaction is not the acquisition of an asset or incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings (*for example, if foreign exchange risk is hedged, the forecasted acquisition of a foreign-currency-denominated asset for which a foreign currency transaction gain or loss will be recognized in earnings*). However, forecasted sales on credit and the forecasted accrual of royalties on probable future sales by third-party licensees are not considered the forecasted acquisition of a receivable. If the forecasted transaction relates to a recognized asset or liability, the asset or liability is not remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.
- e. If the variable cash flows of the forecasted transaction relate to a debt security that is classified as held-to-maturity under Statement 115, the risk being hedged is the risk of changes in its cash flows attributable to *default or changes in the obligor's creditworthiness*. For those variable cash flows, the risk being hedged cannot be the risk of changes in its cash flows attributable to *changes in market interest rates*.
- f. The forecasted transaction does not involve a business combination subject to the provisions of Opinion 16 and is not a transaction (such as a forecasted purchase, sale, or dividend) involving (1) a parent company's interests in consolidated subsidiaries, (2) a minority interest in a consolidated subsidiary, (3) an equity-method investment, or (4) an entity's own equity instruments.
- g. If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged is (1) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient. Thus, for example, in hedging the exposure to changes in the cash flows relating to the purchase of its bronze bar inventory, an entity may not designate the risk of changes in the cash flows relating to purchasing the copper component in bronze as the risk being hedged for purposes of assessing offset as required by paragraph 28.b..
- h. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or

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

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

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

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

31. Amounts in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings (for example, when a forecasted sale actually occurs). If the hedged transaction results in the acquisition of an asset or the incurrence of a liability, the gains and losses in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the asset acquired or liability incurred affects earnings (such as in the periods that depreciation expense, interest expense, or cost of sales is recognized). However, if an entity expects at any time that continued reporting of a loss in accumulated other comprehensive income would lead to recognizing a net loss on the combination of the hedging instrument and

the hedged transaction (and related asset acquired or liability incurred) in one or more future periods, a loss shall be reclassified immediately into earnings for the amount that is not expected to be recovered. For example, a loss shall be reported in earnings for a derivative that is designated as hedging the forecasted purchase of inventory to the extent that the cost basis of the inventory plus the related amount reported in accumulated other comprehensive income exceeds the amount expected to be recovered through sales of that inventory. (Impairment guidance is provided in paragraphs 34 and 35.)

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

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

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

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

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

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

Foreign Currency Hedges

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

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

The criterion in paragraph 21.c.(1) requires that a recognized asset or liability that may give rise to a foreign currency transaction gain or loss under Statement 52 (such as a foreign-currency-

denominated receivable or payable) not be the hedged item in a foreign currency fair value or cash flow hedge because it is remeasured with the changes in the carrying amount attributable to what would be the hedged risk (an exchange rate change) reported currently in earnings. Similarly, the criterion in paragraph 29.d. requires that the forecasted acquisition of an asset or the incurrence of a liability that may give rise to a foreign currency transaction gain or loss under Statement 52 not be the hedged item in a foreign currency cash flow hedge because, subsequent to acquisition or incurrence, the asset or liability will be remeasured with changes in the carrying amount attributable to what would be the hedged risk reported currently in earnings. A foreign currency derivative instrument that has been entered into with another member of a consolidated group can be a hedging instrument in the consolidated financial statements only if that other member has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge.

Foreign Currency Fair Value Hedges

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

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

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

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

39. **Gains and losses on a qualifying foreign currency fair value hedge** shall be accounted for as specified in paragraphs 22-27. The gain or loss on a nonderivative hedging instrument attributable to foreign currency risk is the foreign currency transaction gain or loss as determined under Statement 52. That foreign currency transaction gain or loss shall be recognized currently in earnings along with the change in the carrying amount of the hedged firm commitment.

Foreign Currency Cash Flow Hedges

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

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

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

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

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

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

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

Disclosures

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

appropriate, an entity is encouraged, but not required, to provide such additional qualitative disclosures.

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

Fair value hedges

- a. For derivative instruments, as well as nonderivative instruments that may give rise to foreign currency transaction gains or losses under Statement 52, that have been designated and have qualified as fair value hedging instruments and for the related hedged items:
 - (1) The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges' ineffectiveness and (b) the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness, and a description of where the net gain or loss is reported in the statement of income or other statement of financial performance
 - (2) The amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge.

Cash flow hedges

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

Hedges of the net investment in a foreign operation

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

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

Reporting Changes in the Components of Comprehensive Income

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

47. As part of the disclosures of accumulated other comprehensive income, pursuant to paragraph 26 of FASB Statement No. 130, Reporting Comprehensive Income, an entity shall separately disclose the beginning and ending accumulated derivative gain or loss, the related net change associated with current period hedging transactions, and the net amount of any reclassification into earnings.

Effective Date and Transition

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

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

50. *At the date of initial application, an entity also shall recognize as an asset or liability in the statement of financial position any embedded derivative instrument that is required pursuant to paragraphs 12-16 to be separated from its host contract if the hybrid instrument in which it is embedded was issued, acquired, or substantively modified by the entity after December 31, 1997. For all of its hybrid instruments that exist at the date of initial application and were issued or acquired before January 1, 1998 and not substantively modified thereafter, an entity may choose either (a) not to apply this Statement to any of those hybrid instruments or (b) to recognize as assets or liabilities all the derivative instruments embedded in those hybrid instruments that would be required pursuant to paragraphs 12-16 to be separated from their host contracts. That choice is not permitted to be applied to only some of an entity's individual hybrid instruments and must be applied on an all-or-none basis.*

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

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

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

- a. If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment shall be reported as a cumulative-effect-type adjustment of accumulated other comprehensive income.
- b. *If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the fair value exposure of an asset, a liability, or a firm commitment, the transition adjustment for the derivative shall be reported as a cumulative-effect-type adjustment of net income. Concurrently, any gain or loss on the hedged item (that is, difference between the hedged item's fair value and its carrying amount) shall be recognized as an adjustment of the hedged item's carrying amount at the date of initial application, but only to the extent of an offsetting transition adjustment for the derivative. That adjustment of the hedged item's carrying amount shall also be reported as a cumulative-effect-type adjustment of net income. The transition adjustment related to the gain or loss reported in accumulated other comprehensive income on a derivative instrument that hedged an available-for-sale security, together with the loss or gain on the related security (to the extent of an offsetting transition adjustment for the derivative instrument), shall be reclassified to earnings as a cumulative-effect-type adjustment of both net income and accumulated other comprehensive income.*
- c. If a derivative instrument had been designated in multiple hedging relationships that addressed both the fair value exposure of an asset or a liability and the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment for the derivative shall be allocated between the cumulative-effect-type adjustment of net income and the cumulative-effect-type adjustment of accumulated other comprehensive income and shall be reported

as discussed in paragraphs 52.a. and 52.b. above. Concurrently, any gain or loss on the hedged item shall be accounted for at the date of initial application as discussed in paragraph 52.b. above.

- d. Other transition adjustments not encompassed by paragraphs 52.a., 52.b. and 52.c. above shall be reported as part of the cumulative-effect-type adjustment of net income.

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

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

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

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

65. FAS 137 provides the following:

Amendments to Statement 133

3. Statement 133 is amended as follows:

a. The first sentence of paragraph 48 is replaced by the following:

This Statement shall be effective for all fiscal quarters of all fiscal years beginning after June 15, 2000.

b. Paragraph 50 is replaced by the following:

At the date of initial application, an entity shall choose to either (a) recognize as an asset or liability in the statement of financial position all embedded derivative instruments that are required pursuant to paragraphs 12-16 to be separated from their host contracts or (b) select either January 1, 1998 or January 1, 1999 as a transition date for embedded derivatives. If the entity chooses to select a transition date, it shall recognize as separate assets and liabilities (pursuant to paragraphs 12-16) only those derivatives embedded in hybrid instruments issued, acquired, or substantively modified by the entity on or after the selected transition date. That choice is not permitted to be applied to only some of an entity's individual hybrid instruments and must be applied on an all-or-none basis.

Effective Date

4. This Statement is effective upon issuance. An entity that has already applied the provisions of Statement 133 and has issued interim or annual financial statements reflecting that application may not revert to a previous method of accounting for derivative instruments and hedging activities.

66. FAS 138 provides the following (certain sections not affecting the excerpted FAS No. 133 guidance excluded):

Amendments to Statement 133

4. Statement 133 is amended as follows:

Amendment Related to Normal Purchases and Normal Sales

a. Paragraph 10.b. is replaced by the following:

Normal purchases and normal sales. Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. However, contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that meets neither of the criteria in paragraphs 15.a. and 15.b. shall not be considered normal purchases and normal sales. Contracts that contain net settlement provisions as described in paragraphs 9.a. and 9.b. may qualify for the normal purchases and normal sales exception if it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery. Net settlement (as described in paragraphs 9.a. and 9.b.) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses or are otherwise settled net on a

periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for this exception. For contracts that qualify for the normal purchases and normal sales exception, the entity shall document the basis for concluding that it is probable that the contract will result in physical delivery. The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract.

Amendments to Redefine Interest Rate Risk

b. Paragraph 21 is amended as follows:

(1) The first sentence of subparagraph (d) is replaced by the following:

If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, the designated risk being hedged is the risk of changes in its fair value attributable to credit risk, foreign exchange risk, or both. If the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component.

(2) In the first parenthetical sentence of subparagraph (d), changes in market interest rates or foreign exchange rates is replaced by interest rate risk.

(3) In subparagraph (f)(2), market interest rates is replaced by the designated benchmark interest rate (referred to as interest rate risk).

(4) In subparagraph (f)(3), (refer to paragraphs 37 and 38) is replaced by (referred to as foreign exchange risk) (refer to paragraphs 37, 37A, and 38).

(5) In subparagraph (f)(4), both is inserted between to and changes and the obligor's creditworthiness is replaced by the obligor's creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (referred to as credit risk).

(6) In the second sentence of subparagraph (f), market is deleted.

(7) In subparagraph (f), the following sentences and footnote are added after the second sentence:

The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In calculating the change in the hedged item's fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on all of the contractual cash flows of the entire hedged item. Excluding some of the hedged item's contractual cash flows (for example, the portion of the interest coupon in excess of the benchmark interest rate) from the calculation is not permitted.

(8) In the fourth sentence of subparagraph (f), overall is inserted between exposure to changes in the and fair value of that.

(9) In the last sentence of subparagraph (f), market is deleted.

- c. Paragraph 29 is amended as follows:
- (1) In the first sentence of subparagraph (e), default or changes in the obligor's creditworthiness is replaced by credit risk, foreign exchange risk, or both.
 - (2) In the last sentence of subparagraph (e), changes in market interest rates is replaced by interest rate risk.
 - (3) In the first sentence of subparagraph (h), (or the interest payments on that financial asset or liability) is added after sale of a financial asset or liability.
 - (4) In subparagraph (h)(1), the risk of changes in the cash flows of the entire asset or liability is replaced by the risk of overall changes in the hedged cash flows related to the asset or liability.
 - (5) In subparagraph (h)(2), market interest rates is replaced by the designated benchmark interest rate (referred to as interest rate risk).
 - (6) In subparagraph (h)(3), (refer to paragraph 40) is replaced by (referred to as foreign exchange risk) (refer to paragraphs 40, 40A, 40B, and 40C).
 - (7) In subparagraph (h)(4), default or changes in the obligor's creditworthiness is replaced by default, changes in the obligor's creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (referred to as credit risk).
 - (8) In subparagraph (h), the following sentences are added after the second sentence:

The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In a cash flow hedge of a variable-rate financial asset or liability, either existing or forecasted, the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the specifically identified benchmark interest rate if the cash flows of the hedged transaction are explicitly based on a different index, for example, based on a specific bank's prime rate, which cannot qualify as the benchmark rate. However, the risk designated as being hedged could potentially be the risk of overall changes in the hedged cash flows related to the asset or liability, provided that the other criteria for a cash flow hedge have been met.

- d. Paragraph 54 is amended as follows:
- (1) In the second sentence, market interest rates, changes in foreign currency exchange rates, is replaced by the designated benchmark interest rate.
 - (2) In the third and fourth (parenthetical) sentences, market is deleted.
 - (3) In the penultimate sentence of footnote 14, market interest rates is replaced by interest rate risk.
- e. In the first sentence of paragraph 90, market is deleted.

Amendments Related to Hedging Recognized Foreign-Currency-Denominated Assets and Liabilities

- f. In paragraph 21.c.(1), (for example, if foreign exchange risk is hedged, a foreign-currency-denominated asset for which a foreign currency transaction gain or loss is recognized in earnings) is deleted.
- g. Paragraph 29.d. is amended as follows:
- 1) In the first sentence, (for example, if foreign exchange risk is hedged, the forecasted acquisition of a foreign-currency-denominated asset for which a foreign currency transaction gain or loss will be recognized in earnings) is deleted.

- (2) The second sentence is deleted.
- h. In paragraph 29.g.(2), (reflecting its actual location if a physical asset) is replaced by 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).
- i. The following subparagraph is added after subparagraph (c) of paragraph 30:
- d. In a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 15 of Statement 52, an amount that will offset the related transaction gain or loss arising from the remeasurement and adjust earnings for the cost to the purchaser (income to the seller) of the hedging instrument shall be reclassified each period from other comprehensive income to earnings.
- j. Paragraph 36 is amended as follows:
- (1) In the first sentence, Consistent with the functional currency concept in Statement 52 is replaced by If the hedged item is denominated in a foreign currency.
- (2) In subparagraph (a), an available-for-sale security is replaced by a recognized asset or liability (including an available-for-sale security).
- (3) Subparagraph (b) is replaced by the following:
A cash flow hedge of a forecasted transaction, an unrecognized firm commitment, the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability, or a forecasted intercompany transaction.
- (4) The first two sentences following subparagraph (c) are replaced by the following:

The recognition in earnings of the foreign currency transaction gain or loss on a foreign-currency-denominated asset or liability based on changes in the foreign currency spot rate is not considered to be the remeasurement of that asset or liability with changes in fair value attributable to foreign exchange risk recognized in earnings, which is discussed in the criteria in paragraphs 21.c.(1) and 29.d. Thus, those criteria are not impediments to either a foreign currency fair value or cash flow hedge of such a foreign-currency-denominated asset or liability or a foreign currency cash flow hedge of the forecasted acquisition or incurrence of a foreign-currency-denominated asset or liability whose carrying amount will be remeasured at spot exchange rates under paragraph 15 of Statement 52.

- k. The following paragraph is added after paragraph 36:
- 36A. The provisions in paragraph 36 that permit a recognized foreign-currency-denominated asset or liability to be the hedged item in a fair value or cash flow hedge of foreign currency exposure also pertain to a recognized foreign-currency-denominated receivable or payable that results from a hedged forecasted foreign-currency-denominated sale or purchase on credit. An entity may choose to designate a single cash flow hedge that encompasses the variability of functional currency cash flows attributable to foreign exchange risk related to the settlement of the foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit. Alternatively, an entity may choose to designate a cash flow hedge of the variability of functional currency cash flows attributable to foreign exchange risk related to a forecasted foreign-currency-denominated sale or purchase on credit and then separately designate a foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable. In that case, the cash flow hedge would terminate (be dedesignated) when the hedged sale or purchase occurs and the foreign-currency-denominated receivable or payable is recognized. The use of the same foreign currency derivative instrument for both the cash flow

hedge and the fair value hedge is not prohibited though some ineffectiveness may result.

- I. The following paragraph is added after paragraph 37:
37A. Recognized asset or liability. A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of a recognized asset or liability. A derivative instrument can be designated as hedging the changes in the fair value of a recognized asset or liability (or a specific portion thereof) for which a foreign currency transaction gain or loss is recognized in earnings under the provisions of paragraph 15 of Statement 52. All recognized foreign-currency-denominated assets or liabilities for which a foreign currency transaction gain or loss is recorded in earnings may qualify for the accounting specified in paragraphs 22-27 if all the fair value hedge criteria in paragraphs 20 and 21 and the conditions in paragraphs 40.a. and 40.b. are met.
- m. Paragraph 40 is amended as follows:
 - (1) The second sentence is replaced by the following:
A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with a forecasted transaction (for example, a forecasted export sale to an unaffiliated entity with the price to be denominated in a foreign currency), a recognized asset or liability, an unrecognized firm commitment, or a forecasted intercompany transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary) qualifies for hedge accounting if all the following criteria are met:
 - (2) The following subparagraph is added:
 - e. If the hedged item is a recognized foreign-currency-denominated asset or liability, all the variability in the hedged item's functional-currency-equivalent cash flows must be eliminated by the effect of the hedge. (For example, a cash flow hedge cannot be used with a variable-rate foreign-currency-denominated asset or liability and a derivative based solely on changes in exchange rates because the derivative does not eliminate all the variability in the functional currency cash flows.)

Amendments Related to Intercompany Derivatives

- n. In the last sentence of paragraph 36, 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 is added after can be a hedging instrument.
- o. The following paragraphs are added after paragraph 40:
40A. Internal derivative. A foreign currency derivative contract that has been entered into with another member of a consolidated group (such as a treasury center) can be a hedging instrument in a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment in the consolidated financial statements only if the following two conditions are satisfied. (That foreign currency derivative instrument is hereafter in this section referred to as an internal derivative.)
 - a. From the perspective of the member of the consolidated group using the derivative as a hedging instrument (hereafter in this section referred to as the hedging affiliate), the criteria for foreign currency cash flow hedge accounting in paragraph 40 must be satisfied.
 - b. The member of the consolidated group not using the derivative as a hedging instrument (hereafter in this section referred to as

the issuing affiliate) must either (1) enter into a derivative contract with an unrelated third party to offset the exposure that results from that internal derivative or (2) if the conditions in paragraph 40B are met, enter into derivative contracts with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts.

- 40B. Offsetting net exposures. If an issuing affiliate chooses to offset exposure arising from multiple internal derivative contracts on an aggregate or net basis, the derivatives issued to hedging affiliates may qualify as cash flow hedges in the consolidated financial statements only if all of the following conditions are satisfied:
- a. The issuing affiliate enters into a derivative contract with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts, and the derivative contract with the unrelated third party generates equal or closely approximating gains and losses when compared with the aggregate or net losses and gains generated by the derivative contracts issued to affiliates.
 - b. Internal derivatives that are not designated as hedging instruments are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative. In addition, nonderivative contracts may not be used as hedging instruments to offset exposures arising from internal derivative contracts.
 - c. Foreign currency exposure that is offset by a single net third-party contract arises from internal derivative contracts that mature within the same 31-day period and that involve the same currency exposure as the net third-party derivative. The offsetting net third-party derivative related to that group of contracts must offset the aggregate or net exposure to that currency, must mature within the same 31-day period, and must be entered into within 3 business days after the designation of the internal derivatives as hedging instruments.
 - d. The issuing affiliate tracks the exposure that it acquires from each hedging affiliate and maintains documentation supporting linkage of each internal derivative contract and the offsetting aggregate or net derivative contract with an unrelated third party.
 - e. The issuing affiliate does not alter or terminate the offsetting derivative with an unrelated third party unless the hedging affiliate initiates that action. If the issuing affiliate does alter or terminate any 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.
- 40C. A member of a consolidated group is not permitted to offset exposures arising from multiple internal derivative contracts on a net basis for foreign currency cash flow exposures related to recognized foreign-currency-denominated assets or liabilities. That prohibition includes situations in which a recognized foreign-currency-denominated asset or liability in a fair value hedge or cash flow hedge results from the occurrence of a specifically identified forecasted transaction initially designated as a cash flow hedge.

Amendments for Certain Interpretations of Statement 133 Cleared by the Board Relating to the Derivatives Implementation Group Process

- p. In the second sentence of paragraph 12, host is inserted between would be required by the and contract, whether unconditional.

Amendments to Implement Guidance in Implementation Issue No. G3, "Discontinuation of a Cash Flow Hedge"

- q. Paragraph 33 is replaced by the following:
The net derivative gain or loss related to a discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income unless it is probable that the forecasted transaction will not occur by the end of the originally specified time period (as documented at the inception of the hedging relationship) or within an additional two-month period of time thereafter, except as indicated in the following sentence. In rare cases, the existence of extenuating circumstances that are related to the nature of the forecasted transaction and are outside the control or influence of the reporting entity may cause the forecasted transaction to be probable of occurring on a date that is beyond the additional two-month period of time, in which case the net derivative gain or loss related to the discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income until it is reclassified into earnings pursuant to paragraph 31. If it is probable that the hedged forecasted transaction will not occur either by the end of the originally specified time period or within the additional two-month period of time and the hedged forecasted transaction also does not qualify for the exception described in the preceding sentence, that derivative gain or loss reported in accumulated other comprehensive income shall be reclassified into earnings immediately.
- r. The following is added at the end of paragraph 45.b.(4):
by the end of the originally specified time period or within the additional period of time discussed in paragraph 33.

Amendments to Implement Guidance in Implementation Issue No. H1, "Hedging at the Operating Unit Level"

- s. In the last sentence of paragraph 37, and the conditions in paragraphs 40.a. and 40(b) is added between paragraphs 20 and 21 and are met.
- t. In the third sentence of paragraph 38, and the conditions in paragraphs 40.a. and 40.b. is added between paragraphs 20 and 21 and are met.
- u. In paragraph 42, provided the conditions in paragraphs 40.a. and 40.b. are met is added to the end of the first sentence.

Amendments to Implement Guidance in Implementation Issue No. H2, "Requirement That the Unit with the Exposure Must Be a Party to the Hedge"

- v. Paragraph 40 is amended as follows:
 - (1) Subparagraph (a) is replaced by the following:
For consolidated financial statements, either (1) the operating unit that has the foreign currency exposure is a party to the hedging instrument or (2) another member of the consolidated group that has the same functional currency as that operating unit (subject to the restrictions in this subparagraph and related footnote) is a party to the hedging instrument. To qualify for applying the guidance in (2) above, there may be no intervening subsidiary with a different functional currency. (Refer to paragraphs 36, 40A, and 40B for conditions for which an intercompany foreign currency derivative can be the hedging instrument in a cash flow hedge of foreign exchange risk.)
 - (2) In subparagraph (b), that is replaced by the hedging.

OTHER SOURCES OF INFORMATION:

67. The Financial Accounting Standards Board established the Derivatives Implementation Group to address execution of FAS No. 133. The Derivatives Implementation Group addressed two issues related to effectiveness that are applicable to this issue paper. The issues have been authored by the FASB staff and represents the staff's views, although FASB has discussed the responses at a public meeting and chosen not to object to dissemination of those responses. Official positions of the FASB are determined only after extensive due process and deliberation. E7: *Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges* and E8: *Hedging—General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach* are included as part of Exhibit A:

RELEVANT LITERATURE:**Statutory Accounting**

- *SSAP No. 31 – Derivative Instruments*
- Minutes of the June 7, 1999 Emerging Accounting Issues (E) Working Group meeting

Generally Accepted Accounting Principles

- *FASB Statement No. 80, Accounting for Futures Contracts*
- *FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities*
- *FASB Statement No. 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133 - an amendment of FASB Statement No. 133*
- *FASB Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities - an amendment of FASB Statement No. 133*
- *EITF 98-10, Accounting for Contracts Involved in Energy Trading and Risk Management Activities*
- *EITF 98-12, Application of Issue No. 96-13 to Forward Equity Sales Transactions*
- *EITF 99-01, Accounting for Debt Convertible into the Stock of a Consolidated Sub*
- *EITF 99-02, Accounting for Weather Derivatives*
- *EITF 99-03, Application of Issue No. 96-13 to Derivative Instruments with Multiple Settlement Alternatives*
- *EITF 99-08, Accounting for Transfers of Assets That Are Derivative Instruments but That Are Not Financial Assets*
- *EITF 99-09, Effect of Derivative Gains and Losses on the Capitalization of Interest*
- *EITF 00-07, Application of Issue No. 96-13 to Equity Derivative Instruments That Contain Certain Provisions That Require Net Cash Settlement If Certain Events outside the Control of the Issuer Occur*
- *EITF 00-09, Classification of a Gain or Loss from a Hedge of Debt That Is Extinguished*
- *FASB Derivatives Implementation Group E7: Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges and E8: Hedging—General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach*

EXHIBIT A - DISCUSSION OF HEDGING EFFECTIVENESS

The Financial Accounting Standards Board established the Derivatives Implementation Group in 1999 to address execution of FAS No. 133. The Derivatives Implementation Group addressed two issues related to effectiveness that are applicable to this issue paper. The issues have been authored by the FASB staff and represents the staff's views, although FASB has discussed the responses at a public meeting and chosen not to object to dissemination of those responses. Official positions of the FASB are determined only after extensive due process and deliberation.

No. E7:Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges

Paragraph references: 20.b., 22, 28.b., 62, 86, 87

Date cleared by Board: May 17, 2000

QUESTION

1. Since Statement 133 provides an entity with flexibility in choosing the method it will use in assessing hedge effectiveness, must an entity use a dollar-offset approach in assessing effectiveness?

BACKGROUND

2. Paragraph 20.b. of Statement 133 states, in part:

Both at inception of the [fair value] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months.

3. Paragraph 28.b. indicates a similar requirement that the hedging relationship be expected to be highly effective in achieving offsetting changes in cash flows attributable to the hedged risk during the period that the hedge is designated.

4. Paragraph 22 of Statement 133 states, in part:

The measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 20.a. Nevertheless, the amount of hedge ineffectiveness recognized in earnings is based on the extent to which exact offset is not achieved.

5. Paragraph 62 emphasizes that each entity must "define at the time it designates a hedging relationship the method it will use to assess the hedge's effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged." It also states, "This Statement does not specify a single method for either assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness."

RESPONSE

6. No. Statement 133 requires an entity to consider hedge effectiveness in two different ways—in prospective considerations and in retrospective evaluations.

a. Prospective considerations

Upon designation of a hedging relationship (as well as on an ongoing basis), the entity must be able to justify an expectation that the relationship will be highly effective over future periods in achieving offsetting changes in fair value or cash flows. That expectation, which is forward-looking, can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information.

b. Retrospective evaluations

At least quarterly, the hedging entity must 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. That assessment can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. If an entity elects at the inception of a hedging relationship to utilize the same regression analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness, then during the term of that hedging relationship those regression analysis calculations should generally incorporate the same number of data points. Electing to utilize 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 as discussed below.

7. Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge's effectiveness. That paragraph also states that ordinarily "an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified." Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity 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 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).

8. If an entity 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 must periodically update its regression analysis (or other statistical analysis). For example, if there is significant ineffectiveness measured and recognized in earnings for a hedging relationship, which is calculated each assessment period, the regression analysis should be rerun to determine whether the expectation of high effectiveness is still valid. 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.

9. In all instances, the actual measurement of hedge ineffectiveness to be recognized in earnings each reporting period is based on the extent to which exact offset is not achieved as specified in paragraph 22 of Statement 133 (for fair value hedges) or paragraph 30 (for cash flow hedges). That requirement applies even if a regression or other statistical analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness supports an expectation that the hedging relationship will be highly effective and demonstrates that it has been highly effective, respectively.

10. 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.

E8: Hedging—General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach

Paragraph references: 20.b., 28.b., 30, 62, 64, 67

Date cleared by Board: June 28, 2000

QUESTION

1. In periodically 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), an entity compares the change in the hedging instrument's fair value (or cash flows) to the change in the hedged item's fair value (or hedged transaction's cash flows) attributable to the hedged risk. If an entity elects at inception of a hedging relationship to utilize the dollar-offset approach for retrospective evaluations of assessing effectiveness, then should that entity base that comparison on (a) the fair value (or cash flow) changes that have occurred during the period being assessed (that is, on a period-by-period basis) or (b) the cumulative fair value (or cash flow) changes to date from the inception of the hedge? Is that entity permitted to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges) under a dollar-offset approach?

BACKGROUND

2. Paragraph 20.b. of Statement 133 states, in part:

Both at inception of the [fair value] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months....All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship.

3. Paragraph 28.b. states, in part:

Both at inception of the [cash flow] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28.d. below. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months....All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

4. Paragraph 30.b. states that "the effective portion of the gain or loss on a derivative designated as a cash flow hedge is reported in other comprehensive income." Paragraph 30.b. specifies how the effective portion to be reported in other comprehensive income should be calculated. The calculation of the

effective portion is, in part, based on “cumulative gain or loss on the derivative from inception of the hedge.”

5. Paragraph 67 of the Statement states, in part:

If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test and also would measure any ineffectiveness during the hedge period. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting.

RESPONSE

6. 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, Statement 133 permits an entity to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges). 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. 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. At inception of the hedge, an entity may choose either approach in designating how effectiveness will be assessed, depending on the nature of the hedge documented in accordance with paragraphs 20.a. and 28.a. 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.

7. Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge’s effectiveness. That paragraph also states that ordinarily “an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.” Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. 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.

8. 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 prior to the period being assessed are not relevant.

9. The foregoing guidance relates to an entity’s periodic retrospective assessment and determining whether a hedging relationship continues to qualify for hedge accounting; it does not relate to the actual measurement of hedge ineffectiveness to be recognized in earnings under hedge accounting. The actual measurement of ineffectiveness is based on the extent to which exact offset is not achieved as specified in paragraph 22 for fair value hedges or paragraph 30 for cash flow hedges.

10. The above response has been authored by the FASB staff and represents the staff’s views, although the Board has discussed the above response at a public meeting and chosen not to object to

dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

EXHIBIT B – ASSESSMENT OF HEDGING EFFECTIVENESS

The following is based on paragraphs 62-70 of FAS 133 to offer additional guidance on assessing hedging effectiveness. The intent of such is to remain consistent with FAS 133 with respect to assessing hedge effectiveness.

1. This issue paper requires that an entity define at the time it designates a hedging relationship the method it will use to assess the hedge's effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged. It also requires that an entity use that defined method consistently throughout the hedge period to assess at inception of the hedge and on an ongoing basis whether it expects the hedging relationship to be highly effective in achieving offset. If the entity identifies an improved method and wants to apply that method prospectively, it must discontinue the existing hedging relationship and designate the relationship anew using the improved method. Although this issue paper suggests a method for assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness, the appropriateness of a given method of assessing hedge effectiveness can depend on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, however, an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.

2. In defining how hedge effectiveness will be assessed, an entity must specify whether it will include in that assessment all of the gain or loss on a hedging instrument. This issue paper permits (but does not require) an entity to exclude all or a part of the hedging instrument's time value from the assessment of hedge effectiveness, as follows:

- a. If the effectiveness of a hedge with an option contract is assessed based on changes in the option's intrinsic value, the change in the time value of the contract would be excluded from the assessment of hedge effectiveness.
- b. If the effectiveness of a hedge with an option contract is assessed based on changes in the option's minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract would be excluded from the assessment of hedge effectiveness.
- c. If the effectiveness of a hedge with a forward or futures contract is assessed based on changes in fair value attributable to changes in spot prices, the change in the fair value of the contract related to the changes in the difference between the spot price and the forward or futures price would be excluded from the assessment of hedge effectiveness.

In each circumstance above, changes in the excluded component would be included in unrealized gains or losses. As noted in paragraph 1, the effectiveness of similar hedges generally should be assessed similarly; that includes whether a component of the gain or loss on a derivative is excluded in assessing effectiveness. No other components of a gain or loss on the designated hedging instrument may be excluded from the assessment of hedge effectiveness.

3. In assessing the effectiveness of a cash flow hedge, an entity generally will need to consider the time value of money if significant in the circumstances. Considering the effect of the time value of money is especially important if the hedging instrument involves periodic cash settlements. An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by

comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

4. Whether a hedging relationship qualifies as highly effective sometimes will be easy to assess. If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be highly effective if:

- a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase.
- b. The fair value of the forward contract at inception is zero.
- c. Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and included directly in unrealized gains and losses pursuant to paragraph 22B or the change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

5. However, assessing hedge effectiveness can be more complex. For example, hedge effectiveness would be reduced by the following circumstances, among others: a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction (such as a Deutsche mark-based hedging instrument and Dutch guilder-based hedged item), to the extent that those bases do not move in tandem. b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in notional amounts, maturities, quantity, location, or delivery dates. Hedge effectiveness also would be reduced if part of the change in the fair value of a derivative is attributable to a change in the counterparty's creditworthiness.

6. A hedge that meets the effectiveness test specified in paragraphs 20.b. and 21.b. (that is, both at inception and on an ongoing basis, the entity expects the hedge to be highly effective at achieving offsetting changes in fair values or cash flows) also must meet the other hedge accounting criteria to qualify for hedge accounting. If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting. The discussions of measuring hedge effectiveness in the examples in the remainder of this Exhibit assume that the hedge satisfied all of the criteria for hedge accounting at inception.

Assuming Effectiveness in a Hedge with an Interest Rate Swap

7. An entity may assume effectiveness in a hedging relationship of interest rate risk involving an interest-bearing asset or liability and an interest rate swap if all of the applicable conditions in the following list are met:

Conditions applicable to both fair value hedges and cash flow hedges

- a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability.
- b. The fair value of the swap at its inception is zero.
- c. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)
- d. The interest-bearing asset or liability is not prepayable.

- e. Any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.

Conditions applicable to fair value hedges only

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

Conditions applicable to cash flow hedges only

- i. All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged.
 - j. There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap's variable rate is LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the asset.)
 - k. The repricing dates match those of the variable-rate asset or liability.
 - l. The index on which the variable rate is based matches the index on which the asset or liability's variable rate is based.
8. The fixed rate on a hedged item need not exactly match the fixed rate on a swap designated as a fair value hedge. Nor does the variable rate on an interest-bearing asset or liability need to be the same as the variable rate on a swap designated as a cash flow hedge. A swap's fair value comes from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount. That is, a swap with a payment based on LIBOR and a receipt based on a fixed rate of 5 percent has the same net settlements and fair value as a swap with a payment based on LIBOR plus 1 percent and a receipt based on a fixed rate of 6 percent.

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

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