Statement of Financial Accounting Standards No. 138

FAS138 Status Page

Accounting for Certain Derivative Instruments and Certain Hedging Activities

an amendment of FASB Statement No. 133

June 2000

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

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FAS 138: Accounting for Certain Derivative Instruments and Certain Hedging Activities

an amendment of FASB Statement No. 133

INTRODUCTION

1. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. This Statement addresses a limited number of issues causing implementation difficulties for numerous entities that apply Statement 133.

2. This Statement amends the accounting and reporting standards of Statement 133 for certain derivative instruments and certain hedging activities as indicated below.

a. The normal purchases and normal sales exception in paragraph 10(b) may be applied to contracts that implicitly or explicitly permit net settlement, as discussed in paragraphs 9(a) and 57(c)(1), and contracts that have a market mechanism to facilitate net settlement, as discussed in paragraphs 9(b) and 57(c)(2).
b. The specific risks that can be identified as the hedged risk are redefined so that in a hedge of interest rate risk, the risk of changes in the benchmark interest rate [1] would be the hedged risk.
c. Recognized foreign-currency-denominated assets and liabilities for which a foreign currency transaction gain or loss is recognized in earnings under the provisions of paragraph 15 of FASB Statement No. 52, *Foreign Currency Translation*, may be the hedged item in fair value hedges or cash flow hedges.
d. Certain intercompany derivatives may be designated as the hedging instruments in cash flow hedges of foreign currency risk in the consolidated financial statements if those intercompany derivatives are offset by unrelated third-party contracts on a net basis.

3. This Statement also amends Statement 133 for decisions made by the Board relating to the Derivatives Implementation Group (DIG) process. Certain decisions arising from the DIG process that required specific amendments to Statement 133 are incorporated in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

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.*
>
> ______________________
>
> *The first sentence of paragraph 21(a) that specifically permits the hedged item to be identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment is not affected by the provisions in this subparagraph.

(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.

l. 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.)
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> *For example, if a dollar-functional, second-tier subsidiary has a Euro exposure, the dollar-functional consolidated parent company could designate its U.S. dollar–Euro derivative as a hedge of the second-tier subsidiary's exposure provided that the functional currency of the intervening first-tier subsidiary (that is, the parent of the second-tier subsidiary) is also the U.S. dollar. In contrast, if the functional currency of the intervening first-tier subsidiary was the Japanese yen (thus requiring the financial statements of the second-tier subsidiary to be translated into yen before the yen-denominated financial statements of the first-tier subsidiary are translated into U.S. dollars for consolidation), the consolidated parent company could not designate its U.S. dollar–Euro derivative as a hedge of the second-tier subsidiary's exposure.

(2) In subparagraph (b), *that* is replaced by *the hedging*.

Amendments to the Transition Guidance, the Implementation Guidance in Appendix A of Statement 133, and the Examples in Appendix B of Statement 133

w. Paragraph 52(b) is replaced by the following:

If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the fair value exposure of an asset, a liability, or a firm commitment, the transition adjustment for the derivative shall be reported as a cumulative-effect-type adjustment of net income. Concurrently, any gain or loss on the hedged item shall be recognized as an adjustment of the hedged item's carrying amount at the date of initial application, but only to the extent of an offsetting transition adjustment for the derivative. Only for purposes of applying the preceding sentence in determining the hedged item's transition adjustment, the gain or loss on the hedged item may be either (1) the overall gain or loss on the hedged item determined as the difference between the hedged item's fair value and its carrying amount on the date of initial application (that is, not limited to the portion attributable to the hedged risk nor limited to the gain or loss occurring during the period of the preexisting hedging relationship) or (2) the gain or loss on the hedged item attributable to the hedged risk (limited to the hedged risks that can be designated under paragraph 21 of this Statement) during the period of the preexisting hedging relationship. That adjustment of the hedged item's carrying amount shall also be reported as a cumulative-effect-type adjustment of net income. The transition adjustment related to the gain or loss reported in accumulated other comprehensive income on a derivative instrument that hedged an available-for-sale security, together with the loss or gain on the related security (to the extent of an offsetting transition adjustment for the derivative instrument), shall be reclassified to earnings as a cumulative-effect-type adjustment of both net income and accumulated other comprehensive income.

x. Paragraph 58 is amended as follows:

(1) In the first sentence of subparagraph (b), *requires* is replaced by *involves* and *that are readily convertible to cash*[17] *and only if there is no market mechanism to facilitate net settlement outside the contract* and footnote 17 are deleted.

(2) The following sentence is added at the end of subparagraph (b):

Also, in order for a contract that meets the net settlement provisions of paragraphs 9(a) and 57(c)(1) and the market mechanism provisions of paragraphs 9(b) and 57(c)(2) to qualify for the exception, it must be probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery.

(3) The following two sentences are added at the end of subparagraph (c)(2):

This exception applies only to nonfinancial assets that are unique and only if a nonfinancial asset related to the underlying is owned by the party that would *not* benefit *under the contract* from an increase in the price or value of the nonfinancial asset. If the contract is a call option contract, the exception applies only if that nonfinancial asset is owned by the party that would not benefit under the contract from an increase in the price or value of the nonfinancial asset above the option's strike price.

y. Paragraph 61 is amended as follows:

(1) The last two sentences of subparagraph (d) are deleted.

(2) In the second sentence of subparagraph (e), *the equity instrument* is replaced by *a publicly traded equity instrument.*

z. Paragraph 68 is amended as follows:

(1) In the second sentence, *an interest-bearing asset or liability* is replaced by *a recognized interest-bearing asset or liability*.

(2) In subparagraph (b), *its inception* is replaced by *the inception of the hedging relationship.*

(3) In subparagraph (d), the following is added at the end of the sentence:

> (that is, able to be settled by either party prior to its scheduled maturity), except as indicated in the following sentences. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option provided that the hedging interest rate swap contains an embedded mirror-image call option. The call option embedded in the swap is considered a mirror image of the call option embedded in the hedged item if (1) the terms of the two call options match (including matching maturities, strike price, related notional amounts, timing and frequency of payments, and dates on which the instruments may be called) and (2) the entity is the writer of one call option and the holder (or purchaser) of the other call option. Similarly, this criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded put option provided that the hedging interest rate swap contains an embedded mirror-image put option.

(4) The following subparagraph and footnote are added after subparagraph (d):

> dd. The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.*

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*For cash flow hedge situations in which the cash flows of the hedged item and the hedging instrument are based on the same index but that index is not the benchmark interest rate, the shortcut method is not permitted. However, the entity may obtain results similar to results obtained if the shortcut method was permitted.

(5) Subparagraph (l) is deleted.

aa. In the third sentence of footnote 19 to paragraph 74*, market* is deleted.

bb. Paragraph 115 is amended as follows:

(1) In the third sentence, *market interest rates* is replaced by *the designated benchmark interest rate.*

(2) The following sentence is added after the third sentence:

> ABC designates changes in LIBOR swap rates as the benchmark interest rate in hedging interest rate risk.

cc. The following example is added after paragraph 120 and before Example 3:

Example 2A: Fair Value Hedge of the LIBOR Swap Rate in a $100,000 BBB-Quality 5-Year Fixed-Rate Noncallable Note

120A. This example illustrates one method that could be used in determining the hedged item's change in fair value attributable to changes in the benchmark interest rate. Other methods could be used in determining the hedged item's change in fair value attributable to changes in the benchmark interest rate as long as those methods meet the criteria in paragraph 21(f).

120B. On January 1, 20X0, GHI Company issues at par a $100,000 BBB-quality 5-year fixed-rate noncallable debt instrument with an annual 10 percent interest coupon. On that date, the issuer enters into a 5-year interest rate swap based on the LIBOR swap rate and designates it as the hedging instrument in a fair value hedge of the $100,000 liability. Under the terms of the swap, GHI will receive fixed interest at 7 percent and pay variable interest at LIBOR. The variable leg of the swap resets each year on December 31 for the payments due the following year. This example has been simplified by assuming that the interest rate applicable to a payment due at any future date is the same as the rate for a payment at any other date (that is, the yield curve is flat). During the hedge period, the gain or loss on the swap will be recorded in earnings. The example assumes that immediately before the interest rate on the variable leg resets on December 31, 20X0, the LIBOR swap rate increased by 50 basis points to 7.50 percent, and the change in fair value of the swap for the period from January 1 to December 31, 20X0 is a loss in value of $1,675.

Changes in the Fair Value of the Hedged Item Attributable to the Changes in the Benchmark Interest Rate for a Specific Period

120C. Under this method, the change in a hedged item's fair value attributable to changes in the benchmark interest rate for a specific period is determined as the difference between two present value calculations as of the end of the period that exclude or include, respectively, the effect of the changes in the benchmark interest rate during the period. The discount rates used for those present value calculations would be, respectively, (a) the discount rate equal to the market interest rate for that hedged item at the inception of the hedge adjusted (up or down) for changes in the benchmark rate (designated as the interest rate risk being hedged) from the inception of the hedge to the beginning date of the period for which the change in fair value is being calculated* and (b) the discount rate equal to the market interest rate for that hedged item at the inception of the hedge adjusted (up or down) for changes in the designated benchmark rate from the inception of the hedge to the ending date of the period for which the change in fair value is being calculated. Both present value calculations are computed using the estimated future cash flows for the hedged item (which typically would be its remaining contractual cash flows).

120D. In GHI's quarterly assessments of hedge effectiveness for each of the first three quarters of year 20X0 in this example, there was zero change in the hedged item's fair value attributable to changes in the benchmark interest rate because there was no change in the LIBOR swap rate. However, in the assessment for the fourth quarter 20X0, the discount rate for the beginning of the period is 10 percent (the hedged item's original market interest rate with an adjustment of zero), and the discount rate for the end of the period is 10.50 percent (the hedged item's original market interest rate adjusted for the change during the period in the LIBOR swap rate [+ 0.50 percent]).

December 31, 20X0

Calculate the present value using the beginning-of-period discount rate of 10 percent:

$10,000pmt, 10%i, 4n, PV =	$ 31,699 (interest payments)
$100,000fv, 10%i, 4n, PV =	68,301 (principal payment)
Total present value	$100,000

Calculate the present value using the end-of-period discount rate of 10.50 percent (that is, the beginning-of-period discount rate adjusted for the change during the period in the LIBOR swap rate of 50 basis points):

$10,000pmt, 10.50%i, 4n, PV =	$31,359 (interest payments)
$100,000fv, 10.50%i, 4n, PV =	67,073 (principal payment)
Total present value	$98,432

The change in fair value of the hedged item attributable to the change in the benchmark interest rate is $100,000 – $98,432 = $1,568 (the fair value decrease in the liability is a gain on debt).

When the change in fair value of the hedged item ($1,568 gain) attributable to the risk being hedged is compared with the change in fair value of the hedging instrument ($1,675 loss), ineffectiveness of $107 results. That ineffectiveness will be reported in earnings, because both changes in fair value are recorded in earnings.

dd. Paragraph 134 is amended as follows:

(1) In the second sentence, *market interest rates* is replaced by *the designated benchmark interest rate.*

(2) The following sentence is added after the second sentence:

XYZ designates changes in LIBOR swap rates as the benchmark interest rate in hedging interest rate risk.

ee. Paragraph 155 is replaced by the following:

Because Swap 1 and the hedged forecasted interest payments are based on the same notional amount, have the same reset dates, and are based on the same benchmark interest rate designated under paragraph 29(h), MNO may conclude that there will be no ineffectiveness in the hedging relationship (absent a default by the swap counterparty).

ff. The last sentence of paragraph 161 is deleted.

gg. Paragraph 169 is amended as follows:

(1) In the third sentence, *is not eligible for cash flow hedge accounting* is replaced by *would separately be eligible to be designated as a fair value hedge of foreign exchange risk or continue to be eligible as a cash flow hedge of foreign exchange risk.*

(2) The fourth sentence and the fifth (parenthetical) sentence are deleted

(3) The sixth sentence is replaced by the following:

Consequently, if the variability of the functional currency cash flows related to the royalty receivable is not being hedged, DEF will dedesignate a proportion of the hedging instrument in the original hedge relationship with respect to the proportion of the forward contract corresponding to the earned royalty.

(4) In the last sentence, *will substantially offset* is replaced by *may substantially offset.*

hh. Paragraph 197 is replaced by the following:

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

> *Scope Application:* Paragraph 10(b) excludes contracts that require future delivery of commodities that are readily convertible to cash from the accounting for derivatives if the commodities will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. However, that paragraph also states that contracts 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. Because the Japanese yen is not the functional currency of either party to the contract and the purchase of corn is transacted internationally in many different currencies, the contract does not qualify for the normal purchases and normal sales exception. The contract is a compound derivative comprising a U.S. dollar-denominated forward contract for the purchase of corn and an embedded foreign currency swap from the purchaser's functional currency (the U.S. dollar) to yen. Consistent with the last sentence of footnote 13 to paragraph 49, the compound derivative cannot be separated into its components (representing the foreign currency derivative and the forward commodity contract) and accounted for separately under this Statement.

ii. Paragraph 200 is amended as follows:

(1) The second bullet is amended as follows:

(a) In the first sentence, *owned by the policyholder and separate* is replaced by *distinct*.

(b) The second sentence is deleted.

(c) In the third sentence, *considered* is inserted between *not* and *a derivative*, and *the policyholder has invested the premiums in acquiring those investments* is replaced by *of the unique attributes of traditional variable annuity contracts issued by insurance companies.*

(d) In the penultimate sentence, *traditional* is inserted between *rather than a* and *variable annuity* in the parenthetical phrase, and *not be viewed as a direct investment because the policyholder does not own those investments, which are assets recorded in the general account of the insurance company* is replaced by *contain an embedded derivative (the equity index-based derivative) that meets all the requirements of paragraph 12 of this Statement for separate accounting: (a) the economic characteristics and risks of the embedded derivative would not be clearly* *and closely related to the economic characteristics and risks of the host contract (that is, the host contract is a debt instrument and the embedded option is equity-indexed), (b) the hybrid instrument would not be remeasured at fair value with changes in fair value reported in earnings as they occur under GAAP, and (c) a separate instrument with the same terms as the embedded derivative instrument would be a derivative instrument pursuant to paragraphs 6–11 of this Statement.*

(e) The last sentence is deleted.

(2) In the third bullet, *an investment owned by the insured* is replaced by *a traditional variable annuity contract issued by an insurance company.*

(3) The following sentences are added to the end of the paragraph after the last bullet:

> The guidance in the second and third bullets above is an exception for traditional variable annuity contracts issued by insurance companies. In determining the accounting for other seemingly similar structures, it would be inappropriate to analogize to the above guidance due to the unique attributes of traditional variable annuity contracts.

Amendments to the Glossary of Statement 133

jj. The following terms and definitions are added to paragraph 540:

Benchmark interest rate

A widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions.

In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate. In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government and, for practical reasons, the LIBOR swap rate are considered to be benchmark interest rates. In each financial market, only the one or two most widely used and quoted rates that meet the above criteria may be considered benchmark interest rates.

LIBOR swap rate

The fixed rate on a single-currency, constant-notional interest rate swap that has its floating-rate leg referenced to the London Interbank Offered Rate (LIBOR) with no additional spread over LIBOR on that floating-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equate to the present value of the floating cash flows.

Effective Date and Transition

5. For an entity that has not adopted Statement 133 before June 15, 2000, this Statement shall be adopted concurrently with Statement 133 according to the provisions of paragraph 48 of Statement 133.

6. For an entity that has adopted Statement 133 prior to June 15, 2000, this Statement shall be effective for all fiscal quarters beginning after June 15, 2000, in accordance with the following transition provisions.

a. At the date of initial application, an entity may elect to derecognize in the balance sheet any derivative instrument that would qualify under this Statement as a normal purchases or normal sales contract and record a cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, *Accounting Changes*. The election to derecognize may not be applied to only some of an entity's normal purchases and normal sales contracts and must be applied on an all-or-none basis. That election to derecognize a derivative instrument may be applied retroactively to the beginning of any fiscal quarter for which interim financial information or financial statements have not been issued.
b. At the date of initial application, an entity must dedesignate the market interest rate as the hedged risk in a hedge of interest rate risk. An entity is permitted to designate anew the benchmark interest rate as the hedged risk in a hedge of interest rate risk.
c. At the date of initial application, an entity may designate a recognized foreign-currency-denominated asset or liability as the hedged item in a hedge of foreign exchange risk pursuant to paragraphs 21 and 29 of Statement 133, as amended by this Statement. An entity may also designate intercompany derivatives that meet the requirements in paragraph 4(l) of this Statement (paragraphs 40A and 40B of Statement 133) as hedging instruments in cash flow hedges of foreign exchange risk when those intercompany derivatives have been offset on only a net basis with third-party derivatives. Any designations permitted by this subparagraph shall be made on a prospective basis.

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

This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Messrs. Foster and Leisenring dissented.

Messrs. Foster and Leisenring dissent from the issuance of this Statement because they believe this Statement does not represent an improvement in financial reporting. The Board concluded in Statement 133, because of anomalies created by a mixed-attribute accounting model, that hedge accounting was appropriate in certain limited circumstances. At the same time, however, it concluded that hedge accounting was appropriate only to the extent that the hedging instrument was effective in offsetting changes in the fair value of the hedged item or the variability of cash flows of the hedged transaction and that any ineffectiveness in achieving that offset should be reflected in earnings. While Statement 133 gave wide latitude to management in determining the method for measuring effectiveness, it is clear that the hedged risk is limited to (a) the risk of changes in the entire hedged item, (b) the risk attributable to changes in market interest rates, (c) the risk attributable to changes in foreign currency exchange rates, and (d) the risk attributable to changes in the obligor's creditworthiness. Those limitations were designed to limit an entity's ability to define the risk being hedged in such a manner as to eliminate or minimize ineffectiveness for accounting purposes. The effect of the provisions in this amendment relating to (1) the interest rate that is permitted to be designated as the hedged risk and (2) permitting the foreign currency risk of foreign-currency-denominated assets and liabilities to be designated as hedges will be to substantially reduce or, in some circumstances, eliminate the amount of hedge ineffectiveness that would otherwise be reflected in earnings. For example, permitting an entity to designate the risk of changes in the LIBOR swap rate curve as the risk being hedged in a fair value hedge when the interest rate of the instrument being hedged is not based on the LIBOR swap rate curve ignores certain effects of basis risk, which, prior to this amendment, would have been appropriately required to be recognized in earnings. Messrs. Foster and Leisenring believe that retreat from Statement 133 is a modification to the basic model of Statement 133, which requires that ineffectiveness of hedging relationships be measured and reported in earnings.

In Statement 133, the Board stated its vision for all financial instruments ultimately to be measured at fair value. If all financial instruments were measured at fair value with changes in fair value recorded currently in earnings, the need for hedge accounting for the risks inherent in existing financial instruments would be eliminated because both the hedging instrument and the hedged item would be measured at fair value. Recognizing and measuring the changes in fair value of all financial instruments using the same criteria and measurement attributes would leave no anomalies related to financial instruments. Consequently, the Board has tentatively concluded in its project on measuring all financial instruments at fair value that all changes in fair value be reflected in earnings. Statement 133 is a step toward achieving the Board's vision because it requires recognizing currently in earnings the amounts for which a hedging instrument is ineffective in offsetting the changes in the fair value of the hedged item or the variability of cash flows of the hedged transaction. Messrs. Foster and Leisenring believe the amendments to Statement 133 referred to in the paragraph above represent steps backward from achieving the Board's vision of reporting all financial instruments at fair value because the result of those amendments is to report the effects of hedging instruments that are not fully effective in offsetting the changes in fair value attributable to the risk being hedged as if they were.

Messrs. Foster and Leisenring believe that even if one accepts the exception that a benchmark interest rate that clearly is not a risk-free rate can be considered to be a risk-free rate, the extension of that exception to permit the benchmark interest rate to be the hedged risk in a financial instrument for which the interest rate is less than the benchmark rate is inappropriate.

There can be no risk to an entity for that portion of the credit spread of the benchmark interest rate that is in excess of the credit spread of the hedged item. Yet that exception requires the change in that portion of the credit spread to be recognized in the basis adjustment of the hedged item, so that the ineffectiveness attributable to the portion of the derivative that hedges a nonexistent risk is not recognized. For example, if there is a change during a period in the value of the portion of the credit spread of the LIBOR swap rate (designated hedged risk) that is in excess of the credit spread of the hedged item, under no circumstances could that change affect the fair value of the hedged item. This Statement, however, mandates that in those circumstances an artificial change in fair value be recognized in the basis of the hedged item.

In this regard, Messrs. Foster and Leisenring observe that permitting the benchmark interest rate to be the hedged risk in a financial instrument that has an interest rate that is less than the benchmark rate creates an anomaly related to the shortcut method. In hedges in which a portion of the derivative is designated as hedging a nonexistent risk (the excess of the benchmark interest rate over the actual interest rate of the hedged item), no ineffectiveness will be recognized when using the shortcut method even though the hedging relationship is clearly not effective. But in certain hedges where there is likely to be little ineffectiveness because the interest rate indexes of the hedged item and the hedging instrument are the same, the shortcut method, in which no ineffectiveness is assumed, is not available.

Members of the Financial Accounting Standards Board:

Edmund L. Jenkins, *Chairman*
Anthony T. Cope
John M. Foster
Gaylen N. Larson
James J. Leisenring
Gerhard G. Mueller
Edward W. Trott

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

CONTENTS

Paragraph Numbers

Appendix A: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

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

Background Information

8. The Board received numerous requests to amend Statement 133. The requests focused mainly on guidance related to specific issues that, if amended, would ease implementation difficulties for a large number of entities. In reviewing those requests, the Board did not discover any new significant information suggesting that the framework of Statement 133 was inappropriate or that major changes should be made. However, after meeting with members of the Derivatives Implementation Group (DIG) in an open meeting, the Board decided to analyze six specific issues, and it developed the following criteria to help in determining which issues, if any, to consider for a possible amendment of Statement 133:

a. Implementation difficulties would be eased for a large number of entities.
b. There would be no conflict with or modifications to the basic model of Statement 133.
c. There would be no delay in the effective date of Statement 133.

9. Of the six issues, the Board determined that it would be appropriate to amend Statement 133 for four of those issues (identified as the normal purchases and normal sales exception, hedging the benchmark interest rate, hedging recognized foreign-currency-denominated debt instruments, and hedging with intercompany derivatives). The Board determined that amending Statement 133 for the remaining two issues (identified as partial-term hedging and purchased option hedges) would conflict with the basic model of Statement 133. The Board also concluded that additional amendments to Statement 133 were warranted to clarify certain provisions of the Statement related to implementation guidance arising from the DIG process and cleared by the Board and posted on its web site.

10. In March 2000, the Board issued an Exposure Draft, *Accounting for Certain Derivative Instruments and Certain Hedging Activities,* for a 31-day comment period. Eighty-two organizations and individuals responded to the Exposure Draft. The Board considered the comments received during its redeliberations of the issues addressed by the Exposure Draft in three public meetings during April and May 2000. The Board concluded that it could reach

informed decisions on the basis of existing information without a public hearing.

Amendments to Statement 133

Normal Purchases and Normal Sales Exception

11. This Statement amends Statement 133 to permit the normal purchases and normal sales exception in paragraph 10(b) of Statement 133 to be applied to certain contracts that meet the net settlement provisions discussed in paragraphs 9(a) and 57(c)(1) and the market mechanism provisions discussed in paragraphs 9(b) and 57(c)(2). The Board received comments that certain contracts, such as purchase orders for which physical delivery was intended and expected in the normal course of business, met the definition of a derivative because of the net settlement provisions in paragraphs 9(a) and 57(c)(1) and the market mechanism provisions in paragraphs 9(b) and 57(c)(2). The Board decided that contracts that require delivery of nonfinancial assets need not be accounted for as derivative instruments under this Statement if the assets constitute normal purchases or normal sales of the reporting entity and the criteria identified in paragraph 4(a) of this Statement were met.

12. The Board believes that the normal purchases and normal sales exception should not be permitted to be applied to contracts that require cash settlements of gains or losses or otherwise settle gains or losses on a periodic basis because those settlements are net settlements. The Board observed that an entity may designate those contracts as a hedged item in an all-in-one hedge, pursuant to Statement 133 Implementation Issue No. G2, "Hedged Transactions That Arise from Gross Settlement of a Derivative ('All in One' Hedges)."

13. Some respondents to the Exposure Draft suggested that a planned series of contracts used in the normal course of business consistent with recognized industry practice should qualify for the normal purchases and normal sales exception. Some respondents in the electric utility industry suggested that the unplanned netting of transactions with the same counterparty (referred to as a "bookout") should also qualify for the normal purchases and normal sales exception. They also noted that because of changes in circumstances, the bookout procedure is common in the electric utility industry as a scheduling convenience when two utilities happen to have offsetting transactions. The Board rejected both notions because those transactions result in a net settlement of the contract. The normal purchases and normal sales exception only relates to a contract that results in gross delivery of the commodity under that contract.

Hedging the Benchmark Interest Rate

14. This Statement amends Statement 133 to permit a *benchmark interest rate* to be designated as the hedged risk in a hedge of interest rate risk. Statement 133 Implementation Issue No. E1, "Hedging the Risk-Free Interest Rate," provided implementation guidance for Statement 133 that indicated that the hedged risk in a hedge of interest rate risk would be the hedged item's *market interest rate,* defined as the risk-free rate plus the credit sector spread appropriate for that hedged

item at the inception of the hedge. Comments received by the Board on Implementation Issue E1 indicated (a) that the concept of market interest rate risk as set forth in Statement 133 differed from the common understanding of interest rate risk by market participants, (b) that the guidance in the Implementation Issue was inconsistent with present hedging activities, and (c) that measuring the change in fair value of the hedged item attributable to changes in credit sector spreads would be difficult because consistent sector spread data are not readily available in the market.

15. The Board decided that, with respect to the separation of interest rate risk and credit risk, the risk of changes in credit sector spread and any credit spread attributable to a specific borrower should be encompassed in credit risk rather than interest rate risk. Under that approach, an entity would be permitted to designate the risk of changes in the risk-free rate as the hedged risk, and any spread above that rate would be deemed to reflect credit risk. The Board concluded that considering all the effects of credit risk together was more understandable and more operational than the distinction between interest rate risk and credit risk in Implementation Issue E1.

16. The Board decided that, in the United States, the interest rate on direct Treasury obligations of the U.S. government provides the best measure of the risk-free rate. Thus, the Board considered defining interest rate risk based only on Treasury rates in the United States. However, the Board decided to make an exception and extend the definition of interest rate risk to include interest rate swap rates based on the London Interbank Offered Rate (LIBOR). The Board had been informed that:

a. LIBOR-based interest rate swaps are the most commonly used hedging instruments in the U.S. financial markets in hedges of interest rate risk.
b. There are technical factors (such as supply and demand) that may affect the rates on direct obligations of any single issuer, even the U.S. government.
c. Financial markets consider LIBOR rates as inherently liquid, stable, and a reliable indicator of interest rates and, if the rate for hedging interest rate risk was limited to U.S. Treasury rates, many common hedging relationships using LIBOR-based swaps might not qualify for hedge accounting.

Because the Board decided to permit a rate that is not fully risk-free to be the designated risk in a hedge of interest rate risk, it developed the general notion of *benchmark interest rate* to encompass both risk-free rates and rates based on the LIBOR swap curve in the United States.

17. In deliberations leading up to the Exposure Draft and in response to comments on the Exposure Draft, the Board considered whether other rates, such as the commercial paper rate and the Fed Funds rate, in the U.S. financial markets should be included in the definition of benchmark interest rate and whether those rates should be permitted to be designated as the hedged risk in a hedge of interest rate risk. The Board also considered the notion of defining the benchmark interest rate as the portion of an instrument's overall rate that is used as the

underlying basis for pricing a financial instrument. (For example, numerous indexes such as the Fed Funds rate, the Prime rate, the FNMA Par Mortgage rate, and the BMA index are used as the underlying basis for pricing a financial instrument.) The Board rejected both notions and decided that allowing more than two benchmark rates to define interest rate risk was unnecessary and would make the resulting financial statements more difficult to understand. Therefore, other such indexes may not be used as the benchmark interest rate in the United States.

18. The Board considered the operationality of the definition of the benchmark interest rate in global financial markets. The Board acknowledged that, in some foreign markets, the rate of interest on sovereign debt is considered the benchmark interest rate; that is, market participants consider that rate free of credit risk. However, in other markets, the relevant interbank offered rate may be the best reflection of the benchmark interest rate.

19. The Board determined that any definition of the benchmark interest rate that may be hedged should be flexible enough to withstand potential future development in financial markets. For example, the Board decided that the current definition would result in the ability to replace the LIBOR swap rate with a more relevant benchmark interest rate should changes in the financial markets render the use of LIBOR swap rates obsolete.

20. Respondents to the Exposure Draft indicated that the Board should revise the proposed amendments to paragraphs 21(f) and 29(h) that stated that the benchmark interest rate being hedged in a hedge of interest rate risk should not reflect greater credit risk than is inherent in the hedged item. They said that many financial instruments are priced based on a positive or negative credit spread to the benchmark rate and that interest rate risk is managed based on the benchmark rate, regardless of whether the rate inherent in the instrument is above or below the benchmark rate. The Board rejected the notion of the existence of negative credit risk, but on an exception basis it decided to remove the prohibition that the benchmark interest rate being hedged in a hedge of interest rate risk should not reflect greater credit risk than is inherent in the hedged item. Thus, the benchmark interest rate can be the designated hedged risk in a hedge of interest rate risk regardless of the credit risk inherent in the hedged item (for example, the LIBOR swap rate could be the designated hedged risk in an AAA-rated security even if the overall market interest rate of the instrument is less than the LIBOR swap rate).

21. This Statement requires that 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 benchmark interest rate if the cash flows of the hedged transaction are explicitly based on a different index. The effectiveness of a cash flow hedge of the variability in interest payments of a variable-rate financial asset or liability, either existing or forecasted, is affected by the interest rate index on which the variability is based and the extent to which the hedging instrument provides offset. Changes in credit sector spreads embodied within the interest rate index on which the variability is based do not affect the assessment and measurement of hedge effectiveness if both the cash flows on the hedging instrument and the hedged cash flows of the existing financial asset or liability or the

variable-rate financial asset or liability that is forecasted to be acquired or issued are based on the same index. However, if the cash flows on the hedging instrument and the hedged cash flows of the existing financial asset or liability or the variable-rate financial asset or liability that is forecasted to be acquired or issued are based on different indexes, the basis difference between those indexes would affect the assessment and measurement of hedge effectiveness.

Shortcut Method

22. Because the shortcut method applies to hedges of interest rate risk with the use of an interest rate swap, the decision to redefine interest rate risk necessitated that the Board address the effect on the shortcut method for fair value hedges and cash flow hedges. For fair value hedges, an assumption of no ineffectiveness, an important premise of the shortcut method, is invalidated when the interest rate index embodied in the variable leg of the interest rate swap is different from the benchmark interest rate being hedged. In situations in which the interest rate index embodied in the variable leg of the swap has greater credit risk than that embodied in the benchmark interest rate, the effect of the change in the swap's credit sector spread over that in the benchmark interest rate would represent hedge ineffectiveness because it relates to an *unhedged* risk (credit risk) rather than to the hedged risk (interest rate risk). In situations in which the interest rate index embodied in the variable leg of the swap has less credit risk than that embodied in the benchmark interest rate, the effect of the change in a certain portion of the hedged item's spread over the swap interest rate would also represent hedge ineffectiveness. The Board decided that in order for an entity to comply with an assumption of no ineffectiveness, the index on which the variable leg of the swap is based should match the benchmark interest rate designated as the interest rate risk being hedged for the hedging relationship.

23. For cash flow hedges of an existing variable-rate financial asset or liability, the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the benchmark interest rate if the cash flows of the hedged item are explicitly based on a different index. In those situations, because the risk of changes in the benchmark interest rate (that is, interest rate risk) cannot be the designated risk being hedged, the shortcut method cannot be applied. The Board's decision to require that the index on which the variable leg of the swap is based match the benchmark interest rate designated as the interest rate risk being hedged for the hedging relationship also ensures that the shortcut method is applied only to interest rate risk hedges. The Board's decision precludes use of the shortcut method in situations in which the cash flows of the hedged item and the hedging instrument are based on the same index but that index is not the designated benchmark interest rate. The Board noted, however, that in some of those situations, an entity easily could determine that the hedge is perfectly effective. The shortcut method would be permitted for cash flow hedges in situations in which the cash flows of the hedged item and the hedging instrument are based on the same index and that index is the designated benchmark interest rate.

Determining the Change in a Hedged Item's Fair Value Attributable to Changes in the Benchmark Interest Rate

24. This Statement provides limited guidance on how the change in a hedged item's fair value attributable to changes in the designated benchmark interest rate should be determined. The Board decided that in calculating the change in the hedged item's fair value attributable to changes in the designated benchmark interest rate, the estimated cash flows used must be based on all of the contractual cash flows of the entire hedged item. That guidance does not mandate the use of any one method, but it precludes the use of a method that excludes some of the hedged item's contractual cash flows (such as the portion of interest payments attributable to the obligor's credit risk above the benchmark rate) from the calculation. The Board concluded that excluding some of the hedged item's contractual cash flows would introduce a new approach to bifurcation of a hedged item that does not currently exist in the Statement 133 hedging model.

Hedging Recognized Foreign-Currency-Denominated Assets or Liabilities

25. This Statement amends Statement 133 to allow a recognized foreign-currency-denominated asset or liability to be the hedged item in a fair value or cash flow hedge. Statement 133 precluded hedge accounting for an asset or liability that is remeasured for changes in price attributable to the risk being hedged when those changes are reported currently in earnings. Statement 133 also precluded fair value or cash flow hedge accounting for foreign currency risk associated with any asset or liability that is denominated in a foreign currency and remeasured into the functional currency under FASB Statement No. 52, *Foreign Currency Translation*. The Board received requests to remove the preclusion for any asset or liability denominated in a foreign currency because, even though the transaction gain or loss on the undesignated asset or liability and the change in fair value of the undesignated derivative were reported currently in earnings, different measurement criteria were used for each instrument, which created volatility in earnings.

26. The Exposure Draft proposed an exception to the general principle to permit both fair value hedges and cash flow hedges of foreign-currency-denominated debt instruments. The exception was applicable to foreign-currency-denominated debt instruments that were either held (assets) or owed (liabilities) and included instruments such as bonds, loans, receivables, and payables. The Board initially decided to limit the hedged items to debt instruments because of uncertainty related to the types of instruments that could possibly be included in the scope if all recognized foreign-currency-denominated assets or liabilities were permitted to be hedged. Respondents to the Exposure Draft requested that the Board expand the scope of the allowable hedged items beyond debt instruments. They noted that the concerns expressed by the Board could be mitigated if the determination of the eligibility of a hedged item was based on whether the item gives rise to a transaction gain or loss under paragraph 15 of Statement 52. The Board concluded that basing the eligibility of the hedged item on the guidance in paragraph 15 of Statement 52 would mitigate the scope concerns. Therefore, the Board decided to permit all recognized foreign-currency-denominated assets and liabilities for which a foreign currency

transaction gain or loss is recognized in earnings to be hedged items.

27. Designated hedging instruments and hedged items qualify for fair value hedge accounting and cash flow hedge accounting under this Statement only if all of the criteria in Statement 133 for fair value hedge accounting and cash flow hedge accounting are met. The Board concluded that fair value hedges could be used for all recognized foreign-currency-denominated asset or liability hedging situations and that cash flow hedges could be used for recognized foreign-currency-denominated asset or liability hedging situations in which all of the variability in the functional-currency-equivalent cash flows are eliminated by the effect of the hedge. Remeasurement of the foreign-currency-denominated assets and liabilities will continue to be based on the guidance in Statement 52, which requires remeasurement based on spot exchange rates, regardless of whether a fair value hedging relationship or a cash flow hedging relationship exists.

28. The Board decided to permit cash flow hedge accounting for recognized foreign-currency-denominated assets and liabilities because it believes that the effects on earnings related to the use of different measurement criteria for the hedged transaction and the hedging instrument will be eliminated. The transaction gain or loss arising from the remeasurement of the foreign-currency-denominated asset or liability would be offset by a related amount reclassified each period from other comprehensive income to earnings. The Board believes that is consistent with the principal purpose of providing special hedge accounting to mitigate the effects on earnings of different existing measurement criteria.

29. The Board's decision to permit fair value hedge accounting for assets and liabilities denominated in a foreign currency relates to the ability of an entity to designate a compound derivative as a hedging instrument in a hedge of both interest rate risk and foreign exchange rate risk. An entity's ability to use a compound derivative would achieve the same result that would be achieved prior to this amendment with the use of an interest rate derivative as a qualifying hedging instrument to hedge interest rate risk and an undesignated foreign currency derivative to hedge exchange rate risk. Permitting use of a compound derivative in a fair value hedge of interest rate risk and foreign exchange risk would result in the value of the foreign currency asset or liability being adjusted for changes in fair value attributable to changes in foreign interest rates before remeasurement at the spot exchange rate. The ability to adjust the foreign currency asset or liability for changes in foreign interest rates effectively eliminates any difference recognized currently in earnings related to the use of different measurement criteria for the hedged item and the hedging instrument. The Board concluded that in the situations in which fair value hedges would be used, remeasurement of the foreign-currency-denominated asset or liability based on the spot exchange rate would result in the same functional currency value that would result if the instrument was remeasured based on the forward exchange rate.

Hedging with Intercompany Derivatives

30. Paragraph 36 of Statement 133 permits a derivative instrument entered into with another

member of the consolidated group to qualify as a foreign currency hedging instrument in the consolidated financial statements only if the member of the consolidated group has entered into an individual offsetting derivative contract with an unrelated third party. Constituents requested that Statement 133 be amended to permit derivative instruments entered into with a member of the consolidated group to qualify as hedging instruments in the consolidated financial statements if those internal derivatives are offset by unrelated third-party contracts on a net basis.

31. Constituents requested that those amendments continue to reflect the practice employed by many organizations of managing risk on a centralized basis. That practice involves transferring risk exposures assumed by various affiliates to a treasury center through internal derivative contracts, which are designated as hedging instruments by the affiliates. The risk exposures assumed by the treasury center by issuing internal derivative contracts to affiliates are offset on a net basis, rather than individually, by contracts with unrelated third parties. In the original deliberations leading to the issuance of Statement 133, the Board determined that the functional currency concepts of Statement 52 necessitated that the operating unit that has exposure to foreign exchange risk be a party to the hedging instrument. That foreign exchange risk exists because the currency in which a transaction is denominated is different from the operating unit's functional currency. The Board also recognized the prevalent use of treasury center operations to centrally manage foreign exchange risk. Because of those factors, the Board decided in its original deliberations of Statement 133 to permit the designation of a derivative issued by a member of the consolidated group as a foreign currency hedging instrument in the consolidated financial statements, provided that the internal derivative was offset on a one-to-one basis with a third party. Constituents said that while paragraph 36 of Statement 133 permits both the designation of internal derivatives as hedges of foreign exchange risk and the use of a treasury center, the requirement to individually offset each internal derivative with a third-party contract negates the efficiency and cost savings provided by a treasury center.

32. In considering the requests for amendment, the Board observed that a fundamental justification for the application of hedge accounting to internal derivative contracts in consolidated financial statements under paragraph 36 of Statement 133 is the existence of an individual offsetting third-party derivative contract that supports each internal derivative. Further, the practice of offsetting multiple internal derivatives with a net third-party contract appears to portray the nonderivative hedged items in various affiliates functioning as hedges of one another. The Board also observed that applying hedge accounting to internal derivatives that are offset on a net basis by a third-party derivative contract could be viewed as macro hedging—using a single derivative to hedge a dissimilar portfolio of assets *and* liabilities—which is not permitted under Statement 133. However, the Board acknowledged that this practice differs from macro hedging because internal derivative contracts establish individual hedging relationships that can be linked to the net third-party contract.

33. In addition, the Board concluded that applying hedge accounting in the consolidated financial statements under Statement 133 to internal derivatives that are offset on a net basis by third-party contracts would conflict with basic consolidation procedures required by paragraph 6

of ARB No. 51, *Consolidated Financial Statements*. The Board determined that such a conflict exists because certain effects related to intercompany balances arising from the application of hedge accounting to internal derivative contracts would not be eliminated in consolidation. For example, for fair value hedges, the adjustment to the carrying amount of the hedged item, as determined by the change in fair value of the hedged item attributable to the hedged risk, results from applying hedge accounting to internal derivatives and would not be eliminated in consolidation. For cash flow hedges, amounts recorded in other comprehensive income, and the timing of reclassification of those amounts into earnings, similarly result from applying hedge accounting to internal derivatives and would not be eliminated in consolidation. For those reasons, the Board determined that, as a general rule, derivatives entered into with a member of the consolidated group should not qualify as hedging instruments in the consolidated financial statements if those internal derivatives are not offset by unrelated third-party contracts on an individual basis.

34. Notwithstanding, the Board decided to permit a limited exception for internal derivatives designated as foreign currency cash flow hedges of forecasted borrowings, purchases, or sales denominated in foreign currency or unrecognized firm commitments, subject to meeting certain criteria. For foreign currency cash flow hedges of those items, the Board decided to permit internal derivatives designated as hedging instruments to be offset on a net basis, rather than individually, by third-party derivative contracts. The Board believes that exception for those foreign currency cash flow hedges is not sufficiently different from the accounting for certain foreign currency items provided for in existing accounting literature.

35. The Board decided that that exception should not be extended to internal derivatives designated either as foreign currency fair value hedges or foreign currency cash flow hedges of recognized foreign-currency-denominated assets or liabilities (as permitted by paragraphs 36(a) and 36(b) of Statement 133, as amended by this Statement). That is, in order to apply hedge accounting to internal derivatives designated as hedges of those hedged items in the consolidated financial statements, the internal derivatives must be offset by third-party contracts on an individual basis rather than on a net basis. In reaching that conclusion, the Board reasoned that permitting internal derivatives that hedge recognized foreign-currency-denominated assets or liabilities in foreign currency fair value or cash flow hedges to be offset on a net basis would result in the consolidated financial statements reflecting those nonderivative hedged items effectively functioning as hedging instruments in hedges of other foreign-currency-denominated assets or liabilities, forecasted borrowings, purchases, or sales or unrecognized firm commitments in various affiliates. The Board decided not to change the prohibition against using a nonderivative instrument as the hedging instrument in a foreign currency cash flow hedge.

36. The Board also decided not to permit internal derivative contracts to be designated as hedging instruments in the consolidated financial statements in fair value or cash flow hedges of interest rate risk, credit risk, or the risk of changes in overall fair value or cash flows. The Board observed that the requirement that the operating unit that has exposure to risk be a party to the

hedging instrument exists only for hedges of foreign exchange risk but not for hedges of risks other than foreign exchange risk. Further, even if internal derivative contracts were permitted to be designated as hedging instruments in the consolidated financial statements in a hedge of interest rate risk, credit risk, or the risk of changes in overall fair value or cash flows, permitting those internal derivatives to be offset on a net basis by a third-party derivative would create a new anomaly with respect to the application of consolidation procedures. However, in hedging interest rate risk, credit risk, or the risk of changes in overall fair value or cash flows, an entity may use internal derivatives as hedging instruments in separate company financial statements.

Amendments to the Transition Provisions and the Examples in Appendix B

37. This Statement amends the transition provisions in paragraph 52(b) of Statement 133 for determining the transition adjustment for the hedged item designated in a preexisting fair-value-type hedging relationship. The Board received comments that the requirements that the overall gain or loss on the hedged item determined based on the difference between the hedged item's fair value and its carrying amount on the date of initial application could result in recognizing the effect of unhedged risks in that transition adjustment. As a result, the Board decided to also allow the determination of the hedged item's transition adjustment to be based on the change in the hedged item's fair value attributable to the hedged risk (limited to the hedged risks that can be designated under paragraph 21 of Statement 133) during the period of the preexisting hedging relationship.

38. This Statement also deletes the last sentence of paragraph 161 because the hedging instrument in Example 8 does not meet the criterion in paragraph 68(b) to qualify for the shortcut method. The hedging instrument does not have fair value of zero at inception of the hedging relationship.

39. Paragraph 155 is also amended because Swap 1 in Example 8 does not qualify for the shortcut method. The swap is designated in a hedge of a series of forecasted interest payments, only one of which relates to a recognized interest-bearing liability; the remainder relate to a forecasted borrowing. The shortcut method is limited to either a fair value or cash flow hedging relationship of interest rate risk involving an existing recognized interest-bearing asset or liability and an interest rate swap. Thus, a cash flow hedge of the variability in interest on a probable forecasted lending or borrowing is not eligible for the shortcut method.

Appendix B: AMENDED PARAGRAPHS OF STATEMENT 133 MARKED TO SHOW CHANGES MADE BY THIS STATEMENT

40. This appendix contains paragraphs of Statement 133 marked to integrate changes from this amendment. The Board plans to issue an amended version of Statement 133 that includes the standards section, the implementation guidance (including examples), and the glossary.

> 10b. *Normal purchases and normal sales*. Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. 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.~~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.~~

> 12. Contracts that do not in their entirety meet the definition of a derivative instrument (refer to paragraphs 6–9), such as bonds, insurance policies, and leases, may contain "embedded" derivative instruments—implicit or explicit terms that affect some or all of

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

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

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

c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

Fair Value Hedges

The Hedged Item

21(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.

21(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 credit risk, foreign exchange risk, or both. If the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component.~~the 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 interest rate risk~~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.)

21(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 the designated benchmark interest rate (referred to as interest rate risk)~~market interest rates~~,

(3) the risk of changes in its fair value attributable to changes in the related foreign currency exchange rates (referred to as foreign exchange risk) (refer to paragraphs 37, 37A, and 38)~~(refer to paragraphs 37 and 38)~~, or

(4) the risk of changes in its fair value attributable to both changes in the obligor's creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (referred to as credit risk)~~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. The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In calculating the change in the hedged item's fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on all of the contractual cash flows of the entire hedged item. Excluding some of the hedged item's contractual cash flows (for example, the portion of the interest coupon in excess of the benchmark interest rate) from the calculation is not permitted.* An entity may not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the overall fair value of that "prepayment" option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of ~~market~~ interest rate risk.

*The first sentence of paragraph 21(a) that specifically permits the hedged item to be identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment is not affected by the provisions in this subparagraph.

Cash Flow Hedges

The Hedged Forecasted Transaction

29(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.

29(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 credit risk, foreign exchange risk, or both~~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 interest rate risk~~changes in market interest rates~~.

29(g)(2). the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset ~~(~~reflecting its actual location if a physical asset~~)~~ (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient. Thus, for example, in hedging the exposure to changes in the cash flows relating to the purchase of its bronze bar inventory, an entity may not designate the risk of changes in 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).

29(h). If the hedged transaction is the forecasted purchase or sale of a financial asset or liability (or the interest payments on that financial asset or liability) or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is

(1) the risk of overall changes in the hedged cash flows ~~of~~related to 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 (referred to as interest rate risk)~~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 (referred to as foreign exchange risk) (refer to paragraphs 40, 40A, 40B, and 40C)~~(refer to paragraph 40)~~, or

(4) the risk of changes in its cash flows attributable to 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)~~default or changes in the obligor's creditworthiness~~.

Two or more of the above risks may be designated simultaneously as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In a cash flow hedge of a variable-rate financial asset or liability, either existing or forecasted, the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the specifically identified benchmark interest rate if the cash flows of the hedged transaction are explicitly based on a different index, for example, based on a specific bank's prime rate, which cannot qualify as the benchmark rate. However, the risk designated as being hedged could potentially be the risk of overall changes in the hedged cash flows related to the asset or liability, provided that the other criteria for a cash flow hedge have been met. An entity may not designate prepayment risk as the risk being hedged (refer to paragraph 21(f)).

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.

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.

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.

33. The net derivative gain or loss related to a discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income unless it is probable that the forecasted transaction will *not* occur by the end of the originally specified time

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

Foreign Currency Hedges

36. ~~Consistent with the functional currency concept in Statement 52~~If the hedged item is denominated in a foreign currency, an entity may designate the following types of hedges of foreign currency exposure, as specified in paragraphs 37–42:

a. A fair value hedge of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale security)~~.~~
b. A cash flow hedge of a forecasted ~~foreign-currency-denominated~~ transaction, an unrecognized firm commitment, the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability, or a forecasted intercompany ~~foreign-currency-denominated~~ transaction
c. A hedge of a net investment in a foreign operation.

The recognition in earnings of the foreign currency transaction gain or loss on a foreign-currency-denominated asset or liability based on changes in the foreign currency spot rate is not considered to be the remeasurement of that asset or liability with changes in fair value attributable to foreign exchange risk recognized in earnings, which is discussed in the criteria~~The criterion~~ in paragraphs 21(c)(1) and 29(d).~~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.~~ 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.~~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 a fair value hedge or in a cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment hedge in the consolidated financial statements only if that other member has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge.

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.

Foreign Currency Fair Value Hedges

37. *Unrecognized firm commitment*. A derivative instrument or a nonderivative financial instrument [11] 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 and the conditions in paragraphs 40(a) and 40(b) are met.

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.

38. *Available-for-sale security.* A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of an available-for-sale security. A derivative instrument can be designated as hedging the changes in the fair value of an available-for-sale *debt* security (or a specific portion thereof) attributable to changes in foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in paragraphs 22–27 if all the fair value hedge criteria in paragraphs 20 and 21 and the conditions in paragraphs 40(a) and 40(b) are met. An available-for-sale *equity* security can be hedged for changes in the fair value attributable to changes in foreign currency exchange rates and qualify for the accounting specified in paragraphs 22–27 only if the fair value hedge criteria in paragraphs 20 and 21 are met and the following two conditions are satisfied:

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.

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), a recognized asset or liability, an unrecognized firm commitment, 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. 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.) ~~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~~the hedging unit's functional currency.

c. All of the criteria in paragraphs 28 and 29 are met, except for the criterion in paragraph 29(c) that requires that the forecasted transaction be with a party external to the reporting entity.

d. If the hedged transaction is a group of individual forecasted foreign-currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.

e. If the hedged item is a recognized foreign-currency-denominated asset or liability, all the variability in the hedged item's functional-currency-equivalent cash flows must be eliminated by the effect of the hedge. (For example, a cash flow hedge cannot be used with a variable-rate foreign-currency-denominated asset or liability and a derivative based solely on changes in exchange rates because the derivative does not eliminate all the variability in the functional currency cash flows.)

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*For example, if a dollar-functional, second-tier subsidiary has a Euro exposure, the dollar-functional consolidated parent company could designate its U.S. dollar–Euro derivative as a hedge of the second-tier subsidiary's exposure provided that the functional currency of the intervening first-tier subsidiary (that is, the parent of the second-tier subsidiary) is also the U.S. dollar. In contrast, if the functional currency of the intervening first-tier subsidiary was the Japanese yen (thus requiring the financial statements of the second-tier subsidiary to be translated into yen before the yen-denominated financial statements of the first-tier subsidiary are translated into U.S. dollars for consolidation), the consolidated parent company could not designate its U.S. dollar–Euro derivative as a hedge of the second-tier subsidiary's exposure.

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 the offsetting third-party derivative (which should be rare), the hedging affiliate must prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative.

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.

42. A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging the foreign currency exposure of a net investment in a foreign operation provided the conditions in paragraphs 40(a) and 40(b) are met. 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.

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

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 by the end of the originally specified time period or within the additional period of time discussed in paragraph 33.

Effective Date and Transition

52(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. Only for purposes of applying the preceding sentence in determining the hedged item's transition adjustment, the gain or loss on the hedged item may be either (1) the overall gain or loss on the hedged item determined as the difference between the hedged item's fair value and its carrying amount on the date of initial application (that is, not limited to the portion attributable to the hedged risk nor limited to the gain or loss occurring during the period of the preexisting hedging relationship) or (2) the gain or loss on the hedged item attributable to the hedged risk (limited to the hedged risks that can be designated under paragraph 21 of this Statement) during the period of the preexisting hedging relationship. That adjustment of the hedged item's carrying amount shall also be reported as a cumulative-effect-type adjustment of net income. The transition adjustment related to the gain or loss reported in accumulated other comprehensive income on a derivative instrument that hedged an available-for-sale security, together with the loss or gain on the related security (to the extent of an offsetting transition adjustment for the derivative instrument), shall be reclassified to earnings as a cumulative-effect-type adjustment of both net income and accumulated other comprehensive income.

54. At the date of initial application, an entity may transfer any held-to-maturity security into the available-for-sale category or the trading category. An entity will then be able in the future to designate a security transferred into the available-for-sale category as the hedged item, or its variable interest payments as the cash flow hedged transactions, in a hedge of the exposure to changes in the designated benchmark interest rate~~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.[14]

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[14]EITF Topic No. D-51, "The Applicability of FASB Statement No. 115 to Desecuritizations of Financial Assets," indicates that certain financial assets received or retained in a desecuritization must be held to maturity to avoid calling into question the entity's intent to hold other debt securities to maturity in the future. In conjunction with the initial adoption of this Statement, the held-to-maturity restriction on those financial assets held on the date of initial application is removed, and those financial assets that had been received or retained in a previous desecuritization are available in the future to be designated as the hedged item, or their variable interest payments as the hedged transaction, in a hedge of the exposure to changes in <u>interest rate risk</u>~~market interest rates~~. Consequently, the sale of those financial assets before maturity would not call into question the entity's intent to hold other debt securities to maturity in the future.

Appendix A—Implementation Guidance

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

a. *"Regular-way" security trades*. The exception in paragraph 10(a) applies only to a contract that requires delivery of securities that are readily convertible to cash.[16] To qualify, a contract must require delivery of such a security within the period of time after the trade date that is customary in the market in which the trade takes place. For example, a contract to purchase or sell a publicly traded equity security in the United States customarily requires settlement within three business days. If a contract for purchase of that type of security requires settlement in three business days, the regular-way exception applies, but if the contract requires settlement in five days, the regular-way exception does not apply. This Statement does not change whether an entity recognizes regular-way security trades on the trade date or the settlement date. However, trades that do not qualify for the regular-way exception are subject to the requirements of this Statement regardless of the method an entity uses to report its security trades.

b. *Normal purchases and normal sales.* The exception in paragraph 10(b) applies only to a contract that ~~requires~~<u>involves</u> future delivery of assets (other than financial instruments or derivative instruments)~~ that are readily convertible to cash[17] and only if there is no market mechanism to facilitate net settlement outside the contract~~. To qualify for the exception, a contract's terms also must be consistent with the terms of an entity's normal purchases or normal sales, that is, the quantity purchased or sold must be reasonable in relation to the entity's business needs. Determining whether or not the terms are consistent will require judgment. In making those judgments, an entity should consider all relevant factors, such as (1) the quantities provided under the contract and the entity's need for the related assets, (2) the locations to which delivery of the items will be made, (3) the period of time between entering into the contract and delivery, and (4) the entity's prior practices with regard to such contracts. Evidence such as past trends, expected future demand, other contracts for delivery of similar items, an entity's and industry's customs for acquiring and storing the related commodities, and an entity's operating locations should help in identifying contracts that qualify as normal purchases or normal sales. Also, in order for a contract that meets the net settlement provisions of paragraphs 9(a) and 57(c)(1) and the market mechanism provisions of paragraphs 9(b) and 57(c)(2) to qualify for the exception, it must be probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery.

c. *Certain contracts that are not traded on an exchange.* A contract that is not traded on an exchange is not subject to the requirements of this Statement if the underlying is:

(1) A climatic or geological variable or other physical variable. Climatic, geological, and other physical variables include things like the number of inches of rainfall or snow in a particular area and the severity of an earthquake as measured by the Richter scale.

(2) The price or value of (a) a nonfinancial asset of one of the parties to the contract unless that asset is readily convertible to cash or (b) a nonfinancial liability of one of the parties to the contract unless that liability requires delivery of an asset that is readily convertible to cash. This exception applies only to nonfinancial assets that are unique and only if a nonfinancial asset related to the underlying is owned by the party that would *not* benefit *under the contract* from an increase in the price or value of the nonfinancial asset. If the contract is a call option contract, the exception applies only if that nonfinancial asset is owned by the party that would not benefit under the contract from an increase in the price or value of the nonfinancial asset above the option's strike price.

(3) Specified volumes of sales or service revenues by one of the parties. That exception is intended to apply to contracts with settlements based on the volume of items sold or services rendered, for example, royalty agreements. It is not intended to apply to contracts based on changes in sales or revenues due to changes in market prices.

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

~~[17]Contracts that require delivery of assets that are not readily convertible to cash are not subject to the requirements of this Statement unless there is a market mechanism outside the contract to facilitate net settlement.~~

61(d). *Calls and puts on debt instruments.* Call options (or put options) that can accelerate the repayment of principal on a debt instrument are considered to be clearly and closely related to a debt instrument that requires principal repayments unless both (1) the debt involves a substantial premium or discount (which is common with zero-coupon bonds) and (2) the put or call option is only contingently exercisable. Thus, if a substantial premium or discount is not involved, embedded calls and puts (including contingent call or put options that are not exercisable unless an event of default occurs) would *not* be separated from the host contract. However, for contingently exercisable calls and puts to be considered clearly and closely related, they can be indexed only to interest rates or credit risk, not some extraneous event or factor. In contrast, call options (or put options) that do not accelerate the repayment of principal on a debt instrument but instead require a cash settlement that is equal to the price of the option at the date of exercise would *not* be considered to be clearly and closely related to the debt instrument in which it is embedded and would be separated from the host contract. ~~In certain unusual situations, a put or call option may have been subsequently added to a debt instrument in a manner that causes the investor (creditor) to be exposed to performance risk (default risk) by different parties for the embedded option and the host debt instrument, respectively. In those unusual situations, the embedded option and the host debt instrument are *not* clearly and closely related.~~

61(e). *Calls and puts on equity instruments.* A put option that enables the holder to require the issuer of an equity instrument to reacquire that equity instrument for cash or other assets is *not* clearly and closely related to that equity instrument. Thus, such a put option embedded in a publicly traded~~the~~ equity instrument to which it relates should be separated from the host contract by the holder of the equity instrument. That put option also should be separated from the host contract by the issuer of the equity instrument except in those cases in which the put option is not considered to be a derivative instrument pursuant to paragraph 11(a) because it is classified in stockholders' equity. A purchased call option that enables the issuer of an equity instrument (such as common stock) to reacquire that equity instrument would not be considered to be a derivative instrument by the issuer of the equity instrument pursuant to paragraph 11(a). Thus, if the call option were embedded in the related equity instrument, it would not be separated from the host contract by the issuer. However, for the holder of the related equity instrument, the embedded written call option would *not* be considered to be clearly and closely related to the equity instrument and should be separated from the host contract.

68. An assumption of no ineffectiveness is especially important in a hedging relationship involving an interest-bearing financial instrument and an interest rate swap because it significantly simplifies the computations necessary to make the accounting entries. An entity may assume no ineffectiveness in a hedging relationship of interest rate risk involving a recognized~~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 the inception of the hedging relationship~~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 (that is, able to be settled by either party prior to its scheduled maturity), except as indicated in the following sentences. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option provided that the hedging interest rate swap contains an embedded mirror-image call option. The call option embedded in the swap is considered a mirror image of the call option embedded in the hedged item if (1) the terms of the two call options match (including matching maturities, strike price, related notional amounts, timing and frequency of payments, and dates on which the instruments may be called) and (2) the entity is the writer of one call option and the holder (or purchaser) of the other call option. Similarly, this criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded put option provided that the hedging interest rate swap contains an embedded mirror-image put option.

dd. The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.*

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

Conditions applicable to fair value hedges only

f. The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.

g. There is no floor or 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.~~

<u>*For cash flow hedge situations in which the cash flows of the hedged item and the hedging instrument are based on the same index but that index is not the benchmark interest rate, the shortcut method is not permitted. However, the entity may obtain results similar to results obtained if the shortcut method was permitted.</u>

[19]The use of a hedging instrument with a different underlying basis than the item or transaction being hedged is generally referred to as a *cross-hedge.* The principles for cross-hedges illustrated in this example also apply to hedges involving other risks. For example, the effectiveness of a hedge of ~~market~~ interest rate risk in which one interest rate is used as a surrogate for another interest rate would be evaluated in the same way as the natural gas cross-hedge in this example. [Paragraph 74 to which this footnote relates has not been amended by this Statement.]

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

Appendix B—Examples

115. On July 1, 20X1, ABC Company borrows $1,000,000 to be repaid on June 30, 20X3. On that same date, ABC also enters into a two-year receive-fixed, pay-variable interest rate swap. ABC designates the interest rate swap as a hedge of the changes in the fair value of the fixed-rate debt attributable to changes in the designated benchmark interest rate~~market interest rates~~. ABC designates changes in LIBOR swap rates as the benchmark interest rate in hedging interest rate risk. The terms of the interest rate swap and the debt are as follows:

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

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

Example 2A: Fair Value Hedge of the LIBOR Swap Rate in a $100,000 BBB-Quality 5-Year Fixed-Rate Noncallable Note

120A. This example illustrates one method that could be used in determining the hedged item's change in fair value attributable to changes in the benchmark interest rate. Other methods could be used in determining the hedged item's change in fair value attributable to changes in the benchmark interest rate as long as those methods meet the criteria in paragraph 21(f).

120B. On January 1, 20X0, GHI Company issues at par a $100,000 BBB-quality 5-year fixed-rate noncallable debt instrument with an annual 10 percent interest coupon. On that date, the issuer enters into a 5-year interest rate swap based on the LIBOR swap rate and designates it as the hedging instrument in a fair value hedge of the $100,000 liability. Under the terms of the swap, GHI will receive fixed interest at 7 percent and pay variable interest at LIBOR. The variable leg of the swap resets each year on December 31 for the payments due the following year. This example has been simplified by assuming that the interest rate applicable to a payment due at any future date is the same as the rate for a payment at any other date (that is, the yield curve is flat). During the hedge period, the gain or loss on the swap will be recorded in earnings. The example assumes that immediately before the interest rate on the variable leg resets on December 31, 20X0, the LIBOR swap rate increased by 50 basis points to 7.50 percent, and the change in fair value of the swap for the period from January 1 to December 31, 20X0 is a loss in value of $1,675.

Changes in the Fair Value of the Hedged Item Attributable to the Changes in the Benchmark Interest Rate for a Specific Period

120C. Under this method, the change in a hedged item's fair value attributable to changes in the benchmark interest rate for a specific period is determined as the difference between two present value calculations as of the end of the period that exclude or include, respectively, the effect of the changes in the benchmark interest rate during the period. The discount rates used for those present value calculations would be, respectively, (a) the discount rate equal to the market interest rate for that hedged item at the inception of the hedge adjusted (up or down) for changes in the benchmark rate (designated as the interest rate risk being hedged) from the inception of the hedge to the beginning date of the period for which the change in fair value is being calculated* and (b) the discount rate equal to the market interest rate for that hedged item at the inception of the hedge adjusted (up or down) for changes in the designated benchmark rate from the inception of the hedge to the ending date of the period for which the change in fair value is being calculated. Both present value calculations are computed using the estimated future cash flows for the hedged item (which typically would be its remaining contractual cash flows).

120D. In GHI's quarterly assessments of hedge effectiveness for each of the first three quarters of year 20X0 in this example, there was zero change in the hedged item's fair value attributable to changes in the benchmark interest rate because there was no change in the LIBOR swap rate. However, in the assessment for the fourth quarter 20X0, the discount rate for the beginning of the period is 10 percent (the hedged item's original market interest rate with an adjustment of zero), and the discount rate for the end of the period is 10.50 percent (the hedged item's original market interest rate adjusted for the change during the period in the LIBOR swap rate [+ 0.50 percent]).

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*This Statement does not provide specific guidance on the discount rate that must be used in the calculation. However, the method chosen by GHI and described in this illustration requires that the discount rate be based on the market interest rate for the hedged item at the inception of the hedging relationship.

December 31, 20X0

Calculate the present value using the beginning-of-period discount rate of 10 percent:

$10,000pmt, 10%i, 4n, PV =	$ 31,699 (interest payments)
$100,000fv, 10%i, 4n, PV =	$ 68,301 (principal payment)
Total present value	$100,000

Calculate the present value using the end-of-period discount rate of 10.50 percent (that is, the beginning-of-period discount rate adjusted for the change during the period in the LIBOR swap rate of 50 basis points):

$10,000pmt, 10.50%i, 4n, PV =	$31,359 (interest payments)
$100,000fv, 10.50%i, 4n, PV =	$67,073 (principal payment)
Total present value	$98,432

The change in fair value of the hedged item attributable to the change in the benchmark interest rate is $100,000 – $98,432 = $1,568 (the fair value decrease in the liability is a gain on debt).

When the change in fair value of the hedged item ($1,568 gain) attributable to the risk being hedged is compared with the change in fair value of the hedging instrument ($1,675 loss), ineffectiveness of $107 results. That ineffectiveness will be reported in earnings, because both changes in fair value are recorded in earnings.

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

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

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

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

155. Because Swap 1 and the hedged forecasted interest payments are based on the same notional amount, have the same reset dates, and are based on the same benchmark interest rate designated under paragraph 29(h)~~meets all of the conditions discussed in paragraph 68~~, MNO may conclude~~is permitted to assume~~ that there will be no ineffectiveness in the hedging relationship ~~and to use the shortcut method illustrated in Example 2~~(absent a default by the swap counterparty).

161. Rather than liquidate Swap 1 and obtain a separate derivative to hedge the variability of the prime-rate-based interest payments, MNO enters into a pay-LIBOR, receive-prime basis swap. The basis swap has a $5 million notional amount and a 3-year term and requires a settlement every 90 days. MNO designates Swap 1 and the basis swap in combination as the hedging instrument in a cash flow hedge of the variable interest payments on the three-year note. On the three-year note, MNO pays interest at prime. On the basis swap, MNO receives interest at prime and pays interest at LIBOR. On Swap 1, MNO receives interest at LIBOR and pays interest at 6.5 percent. Together, the cash flows from the two derivatives are effective at offsetting changes in the interest payments on the three-year note. Changes in fair values of the two swaps are recognized in other comprehensive income and are reclassified to earnings when the hedged

forecasted transactions (the variable interest payments) affect earnings (as required by paragraph 31).~~ Because the two swaps in combination meet the conditions discussed in paragraph 68, MNO is permitted to assume no ineffectiveness and use the shortcut method illustrated in Example 5.~~

169. As each royalty is earned, DEF recognizes a receivable and royalty income. The forecasted transaction (the earning of royalty income) has occurred. The receivable is an asset, not a forecasted transaction, and would separately be eligible to be designated as a fair value hedge of foreign exchange risk or continue to be eligible as a cash flow hedge of foreign exchange risk~~is not eligible for cash flow hedge accounting~~. ~~Nor is it eligible for fair value hedge accounting of the foreign exchange risk because changes in the receivable's fair value due to exchange rate changes are recognized immediately in earnings. (Paragraph 21(c) prohibits hedge accounting in that situation.)~~ Consequently, if the variability of the functional currency cash flows related to the royalty receivable is not being hedged, DEF will dedesignate a proportion of the hedging instrument in the original hedge relationship with respect to the proportion of the forward contract corresponding to the earned royalty. As the royalty is recognized in earnings and each proportion of the derivative is dedesignated, the related derivative gain or loss in accumulated other comprehensive income is reclassified into earnings. After that date, any gain or loss on the dedesignated proportion of the derivative and any transaction loss or gain on the royalty receivable[26] will be recognized in earnings and may~~will~~ substantially offset each other.

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

Scope Application: Paragraph 10(b) excludes contracts that require future delivery of commodities that are readily convertible to cash from the accounting for derivatives if the commodities will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. However, that paragraph also states that contracts 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.~~the corn purchase contract must be examined to determine whether it contains an embedded derivative that warrants separate accounting.~~ Because the Japanese yen is not the functional currency of either party to the contract and the purchase of corn is transacted internationally in many different currencies, the contract does not qualify for the normal purchases and normal sales exception. The contract is a compound derivative comprising~~The corn purchase contract can be viewed as~~ a U.S. dollar-denominated forward contract for the purchase of corn and an embedded foreign currency swap from the purchaser's functional currency (the U.S. dollar) to yen. Consistent with the last sentence of footnote 13 to paragraph 49, the compound derivative cannot be separated into its components (representing the foreign currency derivative and the forward commodity contract) and accounted for separately under this Statement.~~Because the yen is the functional currency of neither party to the transaction and the purchase of corn is transacted internationally in many different currencies, the contract does not qualify for the exception in paragraph 15 that precludes separating the embedded foreign currency derivative from the host contract. The embedded foreign currency swap should be separated from the host contract and accounted for as a derivative for purposes of this Statement because a separate instrument with the same terms would meet the definition of a derivative instrument in paragraphs 6–11.~~

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

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

- *Death benefit component.* Paragraph 10(c)(1) excludes a death benefit from the scope of this Statement because the payment of the death benefit is the result of an identifiable insurable event instead of changes in an underlying. The death benefit in this example is limited to the floor guarantee of the investment account, calculated as the premiums paid into the investment account plus a guaranteed rate of return, less the account market value. Statement 60 remains the applicable guidance for the insurance-related liability accounting.
- *Investment component.* The policyholder directs certain premium investments in the investment account that includes equities, bonds, or both, which are held in separate accounts that are distinct~~owned by the policyholder and separate~~ from the insurer's general account assets.~~ This component is viewed as a direct investment because the policyholder directs and owns these investments.~~ This component is not considered a derivative because of the unique attributes of

traditional variable annuity contracts issued by insurance companies~~the policyholder has invested the premiums in acquiring those investments~~. Furthermore, any embedded derivatives within those investments should not be separated from the host contract by the insurer because the separate account assets are already marked-to-market under Statement 60. In contrast, if the product were an equity-index-based interest annuity (rather than a traditional variable annuity), the investment component would contain an embedded derivative (the equity index-based derivative) that meets all the requirements of paragraph 12 of this Statement for separate accounting: (a) the economic characteristics and risks of the embedded derivative would not be clearly and closely related to the economic characteristics and risks of the host contract (that is, the host contract is a debt instrument and the embedded option is equity-indexed), (b) the hybrid instrument would not be remeasured at fair value with changes in fair value reported in earnings as they occur under GAAP, and (c) a separate instrument with the same terms as the embedded derivative instrument would be a derivative instrument pursuant to paragraphs 6–11 of this Statement.~~not be viewed as a direct investment because the policyholder does not own those investments, which are assets recorded in the general account of the insurance company. As a result, the host contract would be a debt instrument, and the equity-index-based derivative should be separated and accounted for as a derivative instrument.~~

- *Investment account surrender right at market value.* Because this right is exercised only at the fund market value (without the insurer's floor guarantee) and relates to a traditional variable annuity contract issued by an insurance company~~an investment owned by the insured~~, this right is not within the scope of this Statement.
- *Payment alternatives at the end of the accumulation period.* Payment alternatives are options subject to the requirements of this Statement if interest rates or other underlying variables affect the value.

The guidance in the second and third bullets above is an exception for traditional variable annuity contracts issued by insurance companies. In determining the accounting for other seemingly similar structures, it would be inappropriate to analogize to the above guidance due to the unique attributes of traditional variable annuity contracts.

Appendix F—Glossary

540. This appendix contains definitions of terms or phrases as used in this Statement.

Benchmark interest rate

A widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions.

In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate. In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government and, for practical reasons, the LIBOR swap rate are considered to be benchmark interest rates. In each financial market, only the one or two most widely used and quoted rates that meet the above criteria may be considered benchmark interest rates.

Comprehensive income

The change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners (FASB Concepts Statement No. 6, *Elements of Financial Statements,* paragraph 70).

Derivative instrument

Refer to paragraphs 6–9.

Fair value

The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using discount rates commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring assets and liabilities should be consistent with the objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring forward contracts, such as foreign currency forward contracts, at fair value by discounting estimated future cash flows, an entity should base the estimate of future cash flows on the changes in the forward rate (rather than the spot rate). In measuring financial liabilities and nonfinancial derivatives that are liabilities at fair value by discounting estimated future cash flows (or equivalent outflows of other assets), an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

Financial instrument

Cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation* (1) to deliver cash or another financial instrument† to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity
b. Conveys to that second entity a contractual right‡ (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

Firm commitment

An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield.
b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable.

Forecasted transaction

A transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

**Contractual obligations* encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of *liability* set forth in Concepts Statement 6, although some may not be recognized as liabilities in financial statements—may be "off-balance-sheet"—because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

†The use of the term *financial instrument* in this definition is recursive (because the term *financial instrument* is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

‡*Contractual rights* encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of *asset* set forth in Concepts Statement 6, although some may not be recognized as

assets in financial statements—may be “off-balance-sheet”—because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity.

LIBOR swap rate

The fixed rate on a single-currency, constant-notional interest rate swap that has its floating-rate leg referenced to the London Interbank Offered Rate (LIBOR) with no additional spread over LIBOR on that floating-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equate to the present value of the floating cash flows.

Notional amount

A number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument.

Underlying

A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

Footnotes

FAS 138, Footnote1—Benchmark interest rate is defined in paragraph 4(jj) of this Statement.

FAS138, Par. 4(cc) Footnote *--This Statement does not provide specific guidance on the discount rate that must be used in the calculation. However, the method chosen by GHI and described in this illustration requires that the discount rate be based on the market interest rate for the hedged item at the inception of the hedging relationship.