Statement 133 Implementation Issues
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As of June 12, 2009

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FASB Staff Interim Guidance

Title:	Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets
Paragraph references:	12–14, 310, Implementation Issue B36
Date cleared by Board:	June 28, 2000
Date latest revision posted to website:	June 16, 2006
Affected by:	FASB Statements No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,* No. 155, *Accounting for Certain Hybrid Financial Instruments,* and No. 156, *Accounting for Servicing of Financial Assets* Revised June 16, 2006

Note: See Effective Date and Transition section for restrictions on the applicability of the interim guidance on this Implementation Issue.

QUESTIONS

The FASB staff has received the following inquiries regarding the application of the exception in paragraph 14 of Statement 133 to certain beneficial interests issued in securitization transactions subject to FASB Statement No. 125 (now FASB Statement No. 140), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities:*

1. What types of instruments qualify for the exception in paragraph 14 of Statement 133? Does that exception apply to only certain interest-only and principal-only strips, or does it apply to other types of beneficial interests in securitized financial assets? Paragraph 14 of Statement 133 states:

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

2. If the exception in paragraph 14 does not apply to some types of beneficial interests issued in securitization transactions, do those beneficial interests meet the definition of a derivative in paragraph 6 of Statement 133?

3. If it is determined pursuant to Question 2 that some beneficial interests meet the definition of a derivative in paragraph 6 of Statement 133, how would that conclusion be reconciled to paragraph 3 of FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise?*

RESPONSE

With respect to Question 1, the staff believes that the exception in paragraph 14 of Statement 133 for interest-only and principal-only strips could be interpreted narrowly. That is, the notion in paragraph 14(b) that the interest-only and principal-only strips do not incorporate any terms not present in the original securitized financial asset could be interpreted to relate only to situations where the allocation of interest flows and principal flows is based on *all or a specified proportion* of those respective cash flows of the original instrument. However, the staff recognizes that some may have interpreted paragraph 14(b) more broadly to encompass certain beneficial interests other than interest-only and principal-only strips, because they view securitization transactions generally as a reallocation of the cash flows of the original securitized assets. For example, some may have interpreted the scope exception in paragraph 14 to encompass those beneficial interests that involve prioritization of cash flows due to prepayment risk or credit risk, because those risks are present in the original securitized assets. The staff understands that use of the phrase *any terms not present* in paragraph 14(b) has created some confusion.

The staff further understands that some may have interpreted paragraph 14 as excluding all interests that continue to be held by a transferor (previously referred to as *retained interests*) from Statement 133 because of the reference to retained interests in paragraph 310 in the basis for conclusions. Paragraph 310 states, in part, "Accordingly, the Board decided to exclude from the scope of this Statement interest-only and principal-only strips that meet the criteria in paragraph 14 and further consider the accounting for them in conjunction with its consideration of accounting for retained interests in securitizations." The staff observes that the language in paragraph 14 of Statement 133 makes no comments that distinguish between interests that continue to be held by a transferor in a securitization transaction and those that are held by third-party investors.

A narrow interpretation of paragraph 14 could require many beneficial interests in securitized financial assets to be assessed to determine whether they meet the definition of a derivative in its entirety pursuant to paragraph 6 of Statement 133. With respect to Question 2, the staff is aware

that questions have arisen about how the characteristics of a derivative in paragraph 6 of Statement 133 should be applied to beneficial interests that are subordinated to other interests. [1a]

With respect to Question 3, the staff acknowledges that some perceive a conflict between the scope of Statement 133 and the provisions of paragraph 3 of Statement 134, which permits mortgage-backed securities that continue to be held by a transferor after the securitization of mortgage loans held for sale to be classified in accordance with the provisions of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*—guidance that is analogous to the provisions of paragraph 14 of Statement 125 (now Statement 140).[1] Statement 133 amended paragraph 14 of Statement 125 to add the following introductory phrase: "Except for instruments that are within the scope of Statement 133." However, the language in paragraph 3 of Statement 134, which amends FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* omitted that introductory phrase. Thus, a conclusion that some mortgage-backed securities that continue to be held by a transferor (beneficial interests from a securitization) meet the definition of a derivative in their entirety would create a conflict with the amending language in paragraph 3 of Statement 134.

Given the issues outlined above, the staff believes the interpretation of the scope exception in paragraph 14 of Statement 133 and the determination of whether beneficial interests in securitized financial assets meet the definition of a derivative are complex issues that warrant further study. Further, if it is determined that some of those beneficial interests do not meet the definition of a derivative in its entirety, the staff believes further study may be required to determine whether the guidance in Statement 133 Implementation Issue No. B12, "Beneficial Interests Issued by Qualifying Special-Purpose Entities," is adequate to determine whether the beneficial interest has an embedded derivative that must be accounted for separately under paragraph 12 of Statement 133.

The FASB staff plans to discuss at a future Board meeting whether the Board should undertake a project to interpret Statement 133, Statement 125 (now Statement 140), or both. That project

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[1a] The guidance in Statement 133 Implementation Issue No. A9, "Prepaid Interest Rate Swaps," also contributed to those questions, particularly with respect to the application of paragraphs 8 and 9(a). Implementation Issue A9 was superseded by the issuance of Statement 133 Implementation Issue No. A23, "Prepaid Interest Rate Swaps," which does not affect the interim guidance in this Implementation Issue.

[1] As a result of Statement 134, in practice, certain mortgage-backed securities that continue to be held by a transferor have been classified as available-for-sale. Paragraph 20 of Statement 134 states that the Board expects that many mortgage-backed securities that continue to be held by a transferor would not be classified as held-to-maturity because Statement 125 amended Statement 115 to indicate that a security may not be classified as held-to-maturity if that security can contractually be prepaid or settled in such a way that the holder of the security would not recover substantially all of its recorded investment. In addition, paragraph 3 of Statement 134 indicates that the securitizer must classify as trading any mortgage-backed securities that continue to be held by a transferor and that it commits to sell before or during the securitization process.

would resolve (1) which types of instruments qualify for the exception in paragraph 14 of Statement 133 and (2) whether beneficial interests in securitized financial assets that are subordinated to other interests meet the definition of a derivative in paragraph 6 of Statement 133.

Pending further guidance on those questions, entities may continue to apply the guidance related to accounting for beneficial interests in paragraph 14 and paragraph 362 of Statement 140. Paragraph 14 (as amended) states, "Interest-only strips, other interests that continue to be held by a transferor in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of Statement 133, shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115...." [2] Paragraph 362 of Statement 140 amends Statement 115 similarly to indicate that any security that can be contractually prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment may not be classified as held-to-maturity. The interim guidance is not limited to securitizations involving qualifying special-purpose entities.

Because paragraphs 14 and 362 of Statement 140 require the majority of beneficial interests for which the various differing views on the application of Statement 133 are relevant to be measured like investments in securities classified as either available-for-sale or trading, the staff believes that the primary issue ultimately focuses on whether changes in the fair value of those interests can continue to be recorded in other comprehensive income or must be recorded in earnings. However, holders of beneficial interests in securitized financial assets that are not subject to paragraph 14 or paragraph 362 of Statement 140 are not required to apply Statement 133 to those beneficial interests until further guidance is issued.

For entities that have not yet adopted Statement 133, the interim guidance herein applies to all beneficial interests in securitized financial assets. An entity that has previously adopted Statement 133 and has accounted for a beneficial interest as either a derivative in its entirety or a hybrid instrument with an embedded derivative that is required to be accounted for separately shall not change its accounting for that beneficial interest. However, an entity in that situation is permitted to apply the interim guidance described herein to beneficial interests purchased after June 28, 2000, and to interests that continue to be held by a transferor in securitization

[2] As indicated in paragraph 295 of the basis for conclusions, the provisions of paragraph 14 of Statement 140 do not apply to situations in which only events that are not the result of contractual provisions, for example, borrower default or changes in the value of an instrument's denominated currency relative to the entity's functional currency, might cause a beneficial interest holder not to recover substantially all of its recorded investment. Pending resolution of the issues described herein, entities are not required to account for those kinds of beneficial interests in securitized financial assets under Statement 133.

transactions occurring after June 28, 2000. Alternatively, that entity is permitted to apply an interpretation of Statement 133 that the beneficial interest is either a derivative in its entirety or a hybrid instrument with an embedded derivative that must be accounted for separately.

At its June 28, 2000 meeting, the Board reached the above answer. Absent that, the staff would not have been able to provide interim guidance that would permit beneficial interests in securitized financial assets to be accounted for in accordance with paragraphs 14 and 362 of Statement 140 until the issues described herein are resolved.

EFFECTIVE DATE AND TRANSITION

Statement 155, which was issued in February 2006, addresses issues on the evaluation of beneficial interests issued in securitization transactions under Statement 133. Specifically, Statement 155 amends Statement 133 to establish a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. The FASB staff interim guidance in this Implementation Issue remains effective only for instruments recognized prior to the effective date of Statement 155.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation

Title:	Hedging—General: Hedging the Risk-Free Interest Rate
Date cleared by Board:	February 17, 1999
Superseded by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*

Title: Hedging—General: Combinations of Options
Paragraph references: 18, 20(c)(1), 28(c), 396–401
Date cleared by Board: March 31, 1999

QUESTION

Must the written option component and the purchased option component of a combination of options be based on the same underlying and have identical terms (such as number of units and maturity dates) to be considered a net purchased option or zero cost collar and therefore not subject to the effectiveness test in paragraphs 20(c) and 28(c)?

BACKGROUND

Statement 133 addresses when a combination of options (that is, a combination of a written option and a purchased option, whether in separate option contracts or embodied in a single contract) must be viewed as a written option subject to the effectiveness test in paragraph 20(c) for fair value hedges and in paragraph 28(c) for cash flow hedges. Paragraph 20(c)(1) states:

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

Paragraph 28(c) effectively incorporates the requirements of paragraph 20(c)(1) by a specific reference to that subparagraph.

RESPONSE

For a combination of options in which the strike price and the notional amount in both the written option component and the purchased option component remain constant over the life of the respective component, that combination of options would be considered a net purchased option or a zero cost collar (that is, considered not to be a net written option subject to the requirements of paragraphs 20(c) and 28(c)) provided all of the following four conditions are met:

1. No net premium is received.
2. The components of the combination of options are based on the same underlying.
3. The components of the combination of options have the same maturity date.
4. The notional amount of the written option component is not greater than the notional amount of the purchased option component.

If the combination of options does not meet all of those conditions, it is subject to the test in paragraph 20(c) for fair value hedges and in paragraph 28(c) for cash flow hedges. For example, under this guidance, a combination of options having different underlying indices, such as a collar containing a written floor based on three-month Treasury rates and a purchased cap based on three-month LIBOR, may *not* be considered a net purchased option or a zero cost collar even though those rates may be highly correlated.

The above response does not address a combination of options in which either the strike price or the notional amount in either the written option component or the purchased option component can fluctuate over the life of the respective component and whether that combination of options should be considered a net purchased option or a zero cost collar. Consequently, the above four conditions for concluding that a combination of options would be considered a net purchased option or a zero cost collar are not intended to apply to such options.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Hedging—General: Hedging with Intercompany Derivatives
Paragraph references:	36, 40(a), 40A
Date cleared by Board:	March 31, 1999
Affected by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*

Revised September 25, 2000

QUESTION

May an entity use an intercompany derivative as a hedging instrument in consolidated financial statements? A derivative instrument contract between two members of a consolidated group is referred to in this issue as an *intercompany derivative*, even though it is referred to in paragraph 40A of Statement 133 as an *internal derivative* (as noted below).

BACKGROUND

Paragraph 36 of Statement 133 states that "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."

Paragraph 40A of Statement 133 states:

> 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.

RESPONSE

Whether an intercompany derivative can be designated as a hedging instrument in consolidated financial statements depends on the risk being hedged. If the hedged risk is either the risk of changes in fair value or cash flows attributable to changes in a foreign currency exchange rate or the foreign exchange risk for a net investment in a foreign operation, then an intercompany derivative can be designated as the hedging instrument provided that (1) in a fair value hedge or in a cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment hedge in the consolidated financial statements the counterparty (that is, the other member of the consolidated group) has entered into a contract with an unrelated third party that offsets the intercompany derivative completely, thereby hedging the exposure it acquired from issuing the intercompany derivative instrument to the affiliate that designated the hedge or (2) in a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment the counterparty has entered into a derivative contract with an unrelated third party to offset the exposure that results from that internal derivative or if the conditions in paragraph 40B of Statement 133 are met, entered 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.

The Board decided to permit the designation of intercompany derivatives as hedging instruments for hedges of foreign exchange risk to enable companies to continue using a central treasury function for derivative contracts with third parties and still comply with the requirement in paragraph 40(a) that the operating unit with the foreign currency exposure be a party to the hedging instrument. (As used in this response, the term *subsidiary* refers only to a consolidated subsidiary. The response should not be applied directly or by analogy to an equity-method investee.)

In contrast, an intercompany derivative cannot be designated as the hedging instrument if the hedged risk is (1) the risk of changes in the overall fair value or cash flows of the entire hedged item or transaction, (2) the risk of changes in its fair value or cash flows attributable to changes in the designated benchmark interest rate, or (3) the risk of changes in its fair value or cash flows attributable to changes in credit risk. Similarly, an intercompany derivative (that is, a derivative instrument contract between operating units within a single legal entity) cannot be designated as the hedging instrument in a hedge of those risks. Only a derivative instrument with an unrelated third party can be designated as the hedging instrument in a hedge of those risks in consolidated financial statements.

There is no requirement in Statement 133 that the operating unit with the interest rate, market price, or credit risk exposure be a party to the hedging instrument. Thus, for example, a parent company's central treasury function can enter into a derivative contract with a third party and designate it as the hedging instrument in a hedge of a subsidiary's interest rate risk for purposes of the consolidated financial statements. However, if the subsidiary wishes to qualify for hedge accounting of the interest rate exposure in its separate-company financial statements, the subsidiary (as the reporting entity) must be a party to the hedging instrument, which can be an

intercompany derivative obtained from the central treasury function. Thus, an intercompany derivative for interest rate risk can qualify for designation as the hedging instrument in separate company financial statements but not in consolidated financial statements.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Hedging—General: Application of the Shortcut Method
Paragraph references:	68–70, 114, 132
Date cleared by Board:	July 28, 1999
Date latest revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities* FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTIONS

1. Can the shortcut method be applied if most but not all of the applicable conditions in paragraph 68 are met?
2. Can the shortcut method be applied to hedging relationships that involve hedging instruments other than interest rate swaps or that involve hedged risks other than interest rate risk?
3. Can the shortcut method be applied to a fair value hedge of a callable interest-bearing debt instrument if the hedging interest rate swap has matching call provisions?

BACKGROUND

The conditions for assuming no ineffectiveness and thus being able to apply the shortcut method are listed in paragraph 68, which states in part:

> An entity may assume no ineffectiveness in a hedging relationship of interest rate risk involving an interest-bearing asset or liability and an interest rate swap if all of the applicable conditions in the following list are met.

Paragraphs 114 and 132 discuss the steps to be used in applying the shortcut method to Examples 2 and 5, respectively.

RESPONSE

Question 1

No. The shortcut method can be applied only if all of the applicable conditions in paragraph 68 are met. That is, all the conditions applicable to fair value hedges must be met to apply the shortcut method to a fair value hedge, and all the conditions applicable to cash flow hedges must be met to apply the shortcut method to a cash flow hedge. A hedging relationship cannot qualify for application of the shortcut method based on an assumption of no ineffectiveness justified by applying other criteria.

Given the potential for not recognizing hedge ineffectiveness in earnings under the shortcut method, Statement 133 intentionally limits its application only to hedging relationships that meet each and every applicable condition in paragraph 68. Thus, if the interest rate swap at the inception of the hedging relationship has a positive or negative fair value, the shortcut method cannot be used even if all the other conditions are met. (Refer to condition 68(b).) Similarly, because a callable financial instrument is prepayable, the shortcut method cannot be applied to a debt instrument that contains an embedded call option (unless the hedging interest rate swap in a fair value hedge contains a mirror-image call option, as discussed in Question 3). (Refer to condition 68(d).) The verb *match* is used in the specified conditions in paragraph 68 to mean *be exactly the same* or *correspond exactly.*

Question 2

No. Because paragraph 68 specifies a hedging relationship that involves only an interest rate swap as the hedging instrument, the shortcut method cannot be applied to relationships hedging interest rate risk that involve hedging instruments other than interest rate swaps. Similarly, the shortcut method described in paragraphs 114 and 132 cannot be applied to hedging relationships that involve hedged risks other than the risk of changes in fair value (or cash flows) attributable to changes in the designated benchmark interest rate. However, the inability to apply the shortcut method to a hedging relationship does not suggest that that relationship must result in some ineffectiveness. Paragraph 65 points out a situation in which a hedging relationship involving a commodities forward contract would be considered to result in no ineffectiveness.

Question 3

An entity is not precluded from applying the shortcut method to a fair value hedging relationship of interest rate risk involving an interest-bearing asset or liability that is prepayable 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 (a) the terms of the two call options match exactly (including matching maturities, strike price, related notional amounts, timing and frequency of payments, and dates on which the instruments may be called) and (b) the entity is the writer of one call option and the holder (or purchaser) of the other call option.

Similarly, an entity is not precluded from applying the shortcut method to a fair value hedging relationship of interest rate risk involving an interest-bearing asset or liability that is prepayable due to an embedded put option provided the hedging interest rate swap contains an embedded mirror-image put option.

In instances where the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option, paragraph 68(b), as amended by Statement 149, requires that the premium for the mirror-image call or put option must be paid or received in the same manner as the premium on the call or put option embedded in the hedged item. Specifically, if the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition of the instrument, the fair value of the hedging

instrument at the inception of the hedging relationship must be equal to the fair value of the mirror-image call or put option. If instead the implicit premium for the call or put option embedded in the hedged item is principally being paid over the life of the hedged item, the fair value of the hedging instrument at the inception of the hedging relationship must be zero.

General Comments

Statement 133 acknowledges in paragraph 70 that a hedging relationship that meets all of the applicable conditions in paragraph 68 may nevertheless involve some ineffectiveness (notwithstanding the supposed "assumption of no ineffectiveness"). Yet Statement 133 permits application of the shortcut method, which does not recognize such ineffectiveness currently in earnings. For example, the change in the fair value of an interest rate swap may not offset the change in the fair value of a fixed-rate receivable attributable to the hedged risk (resulting in hedge ineffectiveness) due to a change in the creditworthiness of the counterparty on the swap. Although an expectation of such hedge ineffectiveness potentially could either (a) preclude fair value hedge accounting at inception or (b) trigger current recognition in earnings under regular fair value hedge accounting, the shortcut method masks that ineffectiveness and does not require its current recognition in earnings. In fact, the shortcut method does not even require that the change in the fair value of the hedged fixed-rate receivable attributable to the hedged risk be calculated.

Although a hedging relationship may not qualify for the shortcut method, the application of regular fair value hedge accounting may nevertheless result in recognizing no ineffectiveness. For example, the characteristics of the hedged item and the hedging derivative may, in some circumstances, cause an entity's calculation of the change in the hedged item's fair value attributable to the hedged risk to be an amount that is equal and offsetting to the change in the derivative's fair value. In those circumstances, because there is no ineffectiveness that needs to be reported, the result of the fair value hedge accounting would be the same as under the shortcut method.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Hedging—General: Complex Combinations of Options
Paragraph references: 20(c)(1), 28(c)
Date cleared by Board: November 23, 1999

QUESTION

If the strike prices, the notional amounts, or both of either the written option component or the purchased option component within a combination of options do not remain constant over the life of the respective component, how should the combination of options be evaluated when applying the criteria for determining whether the combination of options can be considered *not* to be a written option (that is, be considered to be a net purchased option or zero cost collar)?

BACKGROUND

Statement 133 addresses when a combination of options (that is, a combination of a written option and a purchased option, whether in separate option contracts or embodied in a single contract) must be viewed as a written option, in which case it is subject to the effectiveness test in paragraph 20(c) of Statement 133 for fair value hedges and in paragraph 28(c) of Statement 133 for cash flow hedges. Paragraph 20(c)(1) of Statement 133 states:

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

Paragraph 28(c) of Statement 133 effectively incorporates the requirements of paragraph 20(c)(1) of Statement 133 by a specific reference to that subparagraph.

FASB staff guidance presented in Statement 133 Implementation Issue No. E2, "Hedging—General: Combinations of Options," addresses whether the written and purchased components of a combination of options must be based on the same underlying and have identical terms (such as number of units and maturity dates) to be considered not to be a written option (that is, be considered to be a net purchased option or zero cost collar). However, the response does not address a combination of options in which either the strike price or the notional amount in either the written option component or the purchased option component can fluctuate over the life of the respective component.

The following examples illustrate contracts with such fluctuations. For purposes of the illustration, assume a company wishes to hedge its forecasted sales of a commodity by entering

into a five-year commodity-price collar. Under the collar, the company will (a) purchase commodity-price put option components (a floor) and (b) write commodity-price call option components (a cap). Assume that each of the alternative collars discussed otherwise meets the criteria established in Implementation Issue E2. That is, for each collar:

1. No net premium is received at inception of the combination of options. (This question considers, in part, whether a net premium is received at any point during the life of the combination of options that the strike price or notional amount is changed.)
2. The components of the combination of options are based on the same underlying (that is, the same commodity price).
3. The components of the combination of options have the same maturity date.
4. The notional amount of the written option component is not greater than the notional amount of the purchased option component. (This question considers, in part, whether criterion 4 should be applied to only the entire contractual term to maturity or to some part thereof.)

Example 1—Changes in Strike Prices

The following table presents (1) commodity prices implied by the forward price curve based on market prices and (2) the strike prices of two alternative collars. The "minimum" prices for each collar represent the strike prices of the purchased put options. The "maximum" prices for each collar represent the strike prices of the written call options. (Assume that the notional amounts of the two option components are identical and constant over the life of the option components.)

(Cents Per Unit)						**5-Year**
	20X2	**20X3**	**20X4**	**20X5**	**20X6**	**Average**
Forward price	100.0	103.9	105.6	106.4	106.7	104.5
Collar 1						
Minimum	98.3	98.3	98.3	98.3	98.3	98.3
Maximum	110.6	110.6	110.6	110.6	110.6	110.6
Collar 2						
Minimum	108.5	108.5	91.5	91.5	91.5	98.3
Maximum	108.5	108.5	108.5	110.4	117.2	110.6

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

Example 2—Changes in Notional Amounts

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

(Notional Units)						**Total Notional Amount**	**5-Year Average**
	20X2	**20X3**	**20X4**	**20X5**	**20X6**		
Collar 3							
Minimum	750	750	750	750	750	3,750	750
Maximum	750	750	750	750	750	3,750	750
Collar 4							
Minimum	1,240	1,240	1,240	15	15	3,750	750
Maximum	250	250	250	1,500	1,500	3,750	750

Note that both the sum and average of the notional amounts of the written option component for all periods are not greater than the sum and average of the notional amounts of the purchased option component for all periods.

RESPONSE

If either the written option component or the purchased option component for a combination of options has either strike prices or notional amounts that do not remain constant over the life of the respective component, the assessment to determine whether that combination of options can be considered *not* to be a written option under paragraph 20(c)(1) should be evaluated with respect to each date that either the strike prices or the notional amounts change within the contractual term from inception to maturity. Even though that assessment is made on the date that a combination of options is designated as a hedging instrument (to determine the applicability of paragraphs 20(c) and 28(c)), it must consider the receipt of a net premium (in cash or as a favorable rate or other term) from that combination of options at each point in time that either the strike prices or the notional amounts change.

When strike prices fluctuate over the life of a combination of options and no net premium is received at inception, a net premium will typically be received as a favorable term in one or more reporting periods within the contractual term from inception to maturity. For Collar 2 in Example 1, premiums are received in early periods as consideration for entering into net written options in later periods. Specifically, the (higher-than-average) strike prices in years 20X2 and 20X3 are received (that is, receipt of a "net premium") in return for accepting less favorable (lower-than-average) strike prices in years 20X4 through 20X6 (that is, net written options). Thus, at the inception of the hedge and over its life, Collar 2 would be subject to the provisions of paragraphs 20(c) and 28(c).

When notional amounts fluctuate over the life of a combination of options and no net premium is received at inception, a net premium or a favorable term will typically be received in one or more periods within the contractual term from inception to maturity. For Collar 4 in Example 2, favorable terms are received in early periods (net purchased options) as consideration for entering into net written options in later periods. Specifically, the (higher-than-average) notional amounts on the purchased put option in years 20X2 through 20X4 are received in return for accepting a less favorable notional amount in years 20X5 and 20X6. Thus, at the inception of the hedge and over its life, Collar 4 would be subject to the provisions of paragraphs 20(c) and 28(c).

In addition, a combination of options in which either the written option component or the purchased option component has either strike prices or notional amounts that do not remain constant over the life of the respective component must satisfy the four conditions in Implementation Issue E2 to be considered *not* to be a written option (that is, to be considered to be a net purchased option or zero cost collar) under paragraph 20(c)(1). For example, if the notional amount of the written option component is greater than the notional amount of the purchased option component at any date that the notional amount changes within the contractual term from inception to maturity, the combination of options should be considered to be a written option under paragraph 20(c)(1) and, thus, subject to the criteria in paragraphs 20(c) and 28(c).

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Hedging—General: The Shortcut Method and the Provisions That Permit the Debtor or Creditor to Require Prepayment
Paragraph reference:	68(d)
Date cleared by Board:	May 17, 2000
Date latest revision posted to website:	June 16, 2006

Revised June 16, 2006

QUESTION

When should an interest-bearing asset or liability be considered *prepayable* under the provisions of paragraph 68(d) of Statement 133? Specifically, do each of the illustrative debt instruments below contain terms and provisions that cause the instrument to be prepayable under paragraph 68(d)?

BACKGROUND

Paragraph 68 of Statement 133 describes the conditions that must be present in order for an entity to assume no ineffectiveness and thus be permitted to apply the shortcut method. The condition in paragraph 68(d) stipulates that the interest-bearing asset or liability is not prepayable, except in a hedge of an interest-bearing asset or liability that is prepayable due to an embedded call or put option provided that the hedging interest rate swap contains an embedded mirror-image call or put option. Paragraph 68(d) (as amended) lists several criteria that must be met in order for the call or put option embedded in the swap to be considered a mirror image of the call or put option embedded in the hedged item.

A debt instrument may contain various terms and provisions that permit either the debtor or the creditor to cause prepayment of the debt (that is, cause the payment of principal prior to the scheduled payment dates), including the terms in the following illustrative instruments.

Illustrative Debt Instrument 1

Some fixed-rate debt instruments include a typical call option that permits the debt instrument to be called for prepayment by the debtor at a fixed amount, for example, at par or at a specified premium over par. In some instruments, the prepayment amount varies based on when the call option is exercised.

Illustrative Debt Instrument 2

Some debt instruments include contingent acceleration clauses that permit the lender to accelerate the maturity of an outstanding note only if a specified event related to the debtor's credit deterioration or other change in the debtor's credit risk occurs (for example, the debtor's failure to make timely payment, thus making it delinquent; its failure to meet specific covenant ratios; its disposition of specific significant assets [such as a factory]; a declaration of cross-

default; or a restructuring by the debtor). A common example is a clause in a mortgage note secured by certain property that permits the lender to accelerate the maturity of the note if the borrower sells the property.

Illustrative Debt Instrument 3

Some fixed-rate debt instruments include a call option that permits the debtor to repurchase the debt instrument from the creditor at an amount equal to its then fair value.

Illustrative Debt Instrument 4

Some fixed-rate debt instruments, typically issued in private markets, include an option (frequently referred to as a "make-whole provision") that gives the debtor (that is, the issuer) the right to pay off the debt before maturity at a significant premium over the fair value of the debt at the date of settlement. A make-whole provision differs from a typical call option, which enables the issuer to benefit by prepaying the debt when market interest rates decline. In a declining interest rate market, the settlement amount of a typical call option is less than what the fair value of the debt would have been absent the call option. In contrast, a make-whole provision involves settlement at a variable amount typically determined by discounting the debt's remaining contractual cash flows at a specified small spread over the current Treasury rate. That calculation results in a settlement amount significantly above the debt's current fair value based on the issuer's current spread over the current Treasury rate. The make-whole provision contains a premium settlement amount to penalize the debtor for prepaying the debt and to compensate the investor (that is, to approximately make the investor whole) for its being forced to recognize a taxable gain on the settlement of the debt investment. In some debt instruments, the prepayment option under a make-whole provision will not be exercisable during an initial "lock-out" period.

- For example, Private Company A borrows from Insurance Company B under a 10-year loan with fixed periodic coupon payments. The spread over the Treasury rate for Company A at issuance of the debt is 275 basis points. The loan agreement contains a make-whole provision that if Company A prepays the debt, it will pay Insurance Company B an amount equal to all the future contractual cash flows discounted at the current Treasury rate plus 50 basis points.

Illustrative Debt Instrument 5

Some variable-rate debt instruments include a call option that permits the debtor to repurchase the debt instrument from the creditor at each interest reset date at an amount equal to par.

Illustrative Debt Instrument 6

Some fixed-rate debt instruments include both a call option as described in illustrative debt instrument 1 and a contingent acceleration clause as described in illustrative debt instrument 2.

Illustrative Debt Instrument 7

Some debt instruments contain an investor protection clause (which is standard in substantially all debt issued in Europe) that provides that, in the event of a change in tax law that would subject the investor to additional incremental taxation by tax jurisdictions other than those entitled to tax the investor at the time of debt issuance, the coupon interest rate of the debt increases so that the investor's yield, net of the incremental taxation effect, is equal to the investor's yield before the tax law change. The debt issuance also contains an issuer protection clause (which is standard in substantially all debt issued in Europe) that provides that, in the event of a tax law change that triggers an increase in the coupon interest rate, the issuer has the right to call the debt obligation at par. There would be no market for the debt were it not for the prepayment and interest rate adjustment clauses that protect the issuer and investors.

RESPONSE

An interest-bearing asset or liability should be considered *prepayable* under the provisions of paragraph 68(d) when one party to the contract has the right to cause the payment of principal prior to the scheduled payment dates unless (1) the debtor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always greater than the then fair value of the contract absent that right or (2) the creditor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always less than the then fair value of the contract absent that right. A right to cause a contract to be prepaid at its then fair value would not cause the interest-bearing asset or liability to be considered prepayable under paragraph 68(d) since that right would have a fair value of zero at all times and essentially would provide only liquidity to the holder. Notwithstanding the above, any term, clause, or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent upon the occurrence of a specific event related to the debtor's credit deterioration or other change in the debtor's credit risk (for example, the debtor's failure to make timely payment, thus making it delinquent; its failure to meet specific covenant ratios; its disposition of specific significant assets [such as a factory]; a declaration of cross-default; or a restructuring by the debtor) should not be considered a prepayment provision under the provisions of paragraph 68(d). Likewise, any term, clause, or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent upon the occurrence of a specific event that (a) is not probable at the time of debt issuance, (b) is unrelated to changes in benchmark interest rates or any other market variable, and (c) is related either to the debtor's or creditor's death or to regulatory actions, legislative actions, or other similar events that are beyond the control of the debtor or creditor, should not be considered a prepayment provision under the provisions of paragraph 68(d). Application of this guidance to specific debt instruments is provided below.

Illustrative Debt Instrument 1

Yes. Fixed-rate debt instruments that provide the borrower with the option to prepay at a fixed amount are considered prepayable under paragraph 68(d), since those contracts permit settlement

at an amount that is potentially below the contract's fair value (absent the effect of the call provision) as of the date of settlement. Such clauses can be exercised based on an economic advantage related to changes in the designated benchmark interest rate.

Illustrative Debt Instrument 2

No. Debt instruments that include contingent acceleration clauses that permit the lender to accelerate the maturity of an outstanding note only upon the occurrence of a specified event related to the debtor's credit deterioration or other changes in the debtor's credit risk are not considered prepayable under paragraph 68(d).

Illustrative Debt Instrument 3

No. Fixed-rate debt instruments that provide the debtor with the option to repurchase from the creditor the debt at an amount equal to the then fair value of the contract are not considered prepayable under paragraph 68(d), since that right would have a fair value of zero at all times. Such clauses, which provide the debtor with the discretionary opportunity to settle its obligation prior to maturity, are not exercised based on an economic advantage related to changes in the designated benchmark interest rate because the repurchases are done at fair value.

Illustrative Debt Instrument 4

No. Fixed-rate debt instruments that include a make-whole provision (as previously described) are not considered prepayable under paragraph 68(d), since it involves settlement of the entire contract by the debtor before its stated maturity at an amount greater than (rather than an amount less than) the then fair value of the contract.

Illustrative Debt Instrument 5

Although illustrative debt instrument 5, a variable-rate debt instrument, does have a fair value exposure between the date of a change in the benchmark interest rate and the reset date, a swap would not be an appropriate hedging instrument to hedge that fair value exposure. Thus, a fair value hedge of illustrative debt instrument 5 could not qualify for the shortcut method discussed in paragraph 68, which requires the hedging instrument to be an interest rate swap. In cash flow hedges, if the reset provisions always result in the instrument's par amount being equal to its fair value at a reset date, then an option for the debtor to prepay the variable-rate debt instrument at par at that reset date would not be considered prepayable under paragraph 68(d). However, if the reset provisions can result in the instrument's par amount not being equal to its fair value at those reset dates, then an option for the debtor to prepay the variable-rate debt instrument at par at a reset date would be considered prepayable under paragraph 68(d). (Because the reset provisions typically do not adjust the variable interest rate for changes in credit sector spreads and changes in the debtor's creditworthiness, the variable-rate debt instrument's par amount could seldom be expected to be equal to its fair value at each reset date.) Furthermore, in order to qualify for cash flow hedge accounting, the hedging relationship must meet the applicable conditions in

Statement 133 and the entity designating the hedge (that is, the debtor or creditor) must conclude it is probable that future interest payments will be made during the term of the interest rate swap. If the creditor's counterparty (that is, the debtor) on a recognized variable-rate asset related to the hedged forecasted interest payments can cause that asset to be prepaid, then that creditor would likely be unable to conclude that all the forecasted interest payments on its recognized interest-bearing asset are probable and, thus, the cash flow hedging relationship would not qualify for the shortcut method. (Even though the creditor believes it could immediately obtain a replacement variable-rate asset if prepayment occurs and thus could conclude that the forecasted variable interest inflows are probable, the only hedged forecasted interest inflows that are eligible for application of the shortcut method are those related to a recognized interest-bearing asset at the inception of the hedge.) However, paragraph 68(d) indicates that its criterion that prohibits a prepayment option in the interest-bearing asset or liability does not apply to a hedging relationship if the hedging interest rate swap contains an embedded mirror-image option. In that latter case, if both the prepayment option and the mirror-image option in the swap were exercised, there would be no future hedged interest cash flows related to the recognized interest-bearing asset or liability and no future cash flows under the swap and, thus, the existence of the prepayment option would not preclude the use of the shortcut method.

Illustrative Debt Instrument 6

Yes. The same conclusions reached relative to illustrative debt instrument 1 also apply to illustrative debt instrument 6.

Illustrative Debt Instrument 7

No. Debt instruments that include contingent acceleration clauses that permit the debtor to accelerate the maturity of an outstanding note only upon the occurrence of a specified event that (a) is not probable at the time of debt issuance, (b) is unrelated to changes in benchmark interest rates or any other market variable, and (c) is related to regulatory actions, legislative actions, or other similar events are beyond the control of the debtor or creditor should not be considered a prepayment provision under the provisions of paragraph 68(d).

General Comments

An entity is not precluded from applying the shortcut method to a fair value hedging relationship of interest rate risk involving illustrative debt instruments 1 and 6 that are prepayable due to an embedded purchased call option *provided that* the hedging interest rate swap contains an embedded mirror-image written call option. In addition, an entity is not precluded from applying the shortcut method to a fair value hedging relationship of interest rate risk involving illustrative debt instruments 2, 3, 4, and 7 that are not considered prepayable provided that the hedging interest rate swap *does not* contain an embedded purchased or written call option related to changes in the designated benchmark interest rate. However, an entity would likely be precluded from applying the shortcut method to a cash flow hedging relationship of interest rate risk

involving illustrative debt instrument 5 since the entity would likely be unable to conclude that all the forecasted interest payments on the recognized interest-bearing asset or liability are probable.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges
Paragraph references: 20(b), 22, 28(b), 62, 86, 87
Date cleared by Board: May 17, 2000

QUESTION

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

BACKGROUND

Paragraph 20(b) of Statement 133 states, in part:

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

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

Paragraph 22 of Statement 133 states, in part:

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

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

RESPONSE

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

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

b. ***Retrospective evaluations***
At least quarterly, the hedging entity must determine whether the hedging relationship ***has been*** highly effective in having achieved offsetting changes in fair value or cash flows through the date of the periodic assessment. That assessment can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. If an entity elects at the inception of a hedging relationship to utilize the same regression analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness, then during the term of that hedging relationship those regression analysis calculations should generally incorporate the same number of data points. Electing to utilize a regression or other statistical analysis approach instead of a dollar-offset approach to perform retrospective evaluations of assessing hedge effectiveness may affect whether an entity can apply hedge accounting for the current assessment period as discussed below.

Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge's effectiveness. That paragraph also states that ordinarily "an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified." Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity elects at the inception of a hedging relationship to utilize a regression analysis approach for prospective considerations of assessing effectiveness and the dollar-offset method to perform retrospective evaluations of assessing effectiveness, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Thus, in its retrospective evaluation, an entity might conclude that, under a dollar-offset approach, a designated hedging relationship does not qualify for hedge accounting for the period just ended, but that the hedging relationship may continue because, under a regression analysis approach, there is an expectation that the relationship will be highly effective in achieving offsetting changes in fair value or cash flows in future periods. In its retrospective evaluation, if that entity concludes that, under a dollar-offset approach, the hedging relationship has not been highly effective in having achieved offsetting changes in fair value or cash flows, hedge accounting may not be applied in the current period. Whenever a hedging relationship fails to qualify for hedge accounting in a certain assessment period, the overall change in fair

value of the derivative for that current period is recognized in earnings (not reported in other comprehensive income for a cash flow hedge) and the change in fair value of the hedged item would not be recognized in earnings for that period (for a fair value hedge).

If an entity elects at the inception of a hedging relationship to utilize a regression analysis (or other statistical analysis) approach for either prospective considerations or retrospective evaluations of assessing effectiveness, then that entity must periodically update its regression analysis (or other statistical analysis). For example, if there is significant ineffectiveness measured and recognized in earnings for a hedging relationship, which is calculated each assessment period, the regression analysis should be rerun to determine whether the expectation of high effectiveness is still valid. As long as an entity reruns its regression analysis and determines that the hedging relationship is still expected to be highly effective, then it can continue to apply hedge accounting without interruption.

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

The application of a regression or other statistical analysis approach to assessing effectiveness is complex. Those methodologies require appropriate interpretation and understanding of the statistical inferences.

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Title:	Hedging—General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach
Paragraph references:	20(b), 28(b), 30, 62, 64, 67
Date cleared by Board:	June 28, 2000

QUESTION

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

BACKGROUND

Paragraph 20(b) of Statement 133 states, in part:

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

Paragraph 28(b) states, in part:

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

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

Paragraph 67 of the Statement states, in part:

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

RESPONSE

In periodically (that is, at least quarterly) assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows) under a dollar-offset approach, Statement 133 permits an entity to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges). The period-by-period approach involves comparing the changes in the hedging instrument's fair values (or cash flows) that have occurred during the period being assessed to the changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged that have occurred during the same period. The cumulative approach involves comparing the cumulative changes (to date from inception of the hedge) in the hedging instrument's fair values (or cash flows) to the cumulative changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged. At inception of the hedge, an entity may choose either approach in designating how effectiveness will be assessed, depending on the nature of the hedge documented in accordance with paragraphs 20(a) and 28(a). For example, an entity may decide that the cumulative approach is generally preferred, yet may wish to use the period-by-period approach in certain circumstances.

Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge's effectiveness. That paragraph also states that ordinarily "an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified." Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity elects at inception of a hedging relationship to base its comparison of changes in fair value (or cash flows) on a cumulative approach, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Electing to utilize a period-by-period approach instead of a cumulative approach (or

vice versa) to perform retrospective evaluations of assessing hedge effectiveness under the dollar-offset method may affect whether an entity can apply hedge accounting for the current assessment period.

If an entity elects to base its comparison of changes in fair value (or cash flows) on a period-by-period approach, the period cannot exceed three months. Fair value (or cash flow) patterns of the hedging instrument or the hedged item (or hedged transaction) in periods prior to the period being assessed are not relevant.

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

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Hedging—General: Is Changing the Method of Assessing Effectiveness through Dedesignation of One Hedging Relationship and the Designation of a New One a Change in Accounting Principle?
Paragraph references:	62, 386–390
Date cleared by Board:	June 28, 2000
Date revision posted to website:	July 13, 2007
Affected by:	FASB Statement No. 154, *Accounting Changes and Error Corrections*

Revised June 1, 2005

QUESTION

Would the change in the method of assessing hedge effectiveness by an entity be considered a change in accounting principle as defined in FASB Statement No. 154, *Accounting Changes and Error Corrections*?

BACKGROUND

Paragraph 62 of Statement 133 requires that an entity define at the time it designates a hedging relationship the method it will use to assess the hedge's effectiveness in achieving offsetting changes in fair value or cash flows attributable to the risk being hedged. The entity should apply this defined method consistently throughout the hedge period to assess at inception of the hedge and on an ongoing basis whether it expects the hedging relationship to be highly effective in achieving offset and to measure the ineffective part of the hedge. (Statement 133 Implementation Issue No. E7, "Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges," points out that an entity's consideration of hedge effectiveness has two aspects – in prospective considerations and in retrospective evaluations.) Paragraph 62 further states that when an entity identifies an improved method and wants to apply that method prospectively, it must discontinue the existing hedging relationship and designate the relationship anew using the improved method. Accordingly, the new method of assessing hedge effectiveness must be applied prospectively and must also be applied to similar hedges unless the use of a different method for similar hedges is justified. Examples of changes in the types of methods an entity may use in assessing hedge effectiveness could include the following:

- A change from the dollar-offset method to the use of regression analysis or vice versa
- A change between any one of the three methods discussed in Statement 133 Implementation Issue No. G7, "Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method Is Not Applied," (for example, a change from the change in variable cash flows method to either the hypothetical derivative method or change in fair value method)

- A change from excluding certain components of a derivative gain or loss to including such components or vice versa (for example, a change from measuring effectiveness based on changes in intrinsic value to the entire change in an option's fair value)
- A change from assessing hedge effectiveness on a period-by-period basis to a cumulative basis or vice versa.

Paragraph 2(c) of Statement 154 defines a change in accounting principle as follows:

> A change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply or when the accounting principle formerly used is no longer generally accepted. A change in the *method* of applying an accounting principle also is considered a change in accounting principle.

RESPONSE

No, a change in the method of assessing hedge effectiveness by an entity would not be considered a change in accounting principle as defined in Statement 154. Statement 133 permits a hedging relationship to be dedesignated (that is, discontinued) at any time. If an entity wishes to change any of the critical terms of the hedging relationship (including the method designated for use in assessing hedge effectiveness), as documented at inception, the mechanism provided in Statement 133 to accomplish that change is the dedesignation of the original hedging relationship and the designation of a new hedging relationship that incorporates the desired changes. The dedesignation of an original hedging relationship and the designation of a new hedging relationship represents the application of Statement 133 and is not a change in accounting principle under Statement 154, even though the new relationship may differ from the original relationship only with respect to the method designated for use in assessing the hedge effectiveness of that relationship.

Although paragraph 62 refers to discontinuing an existing hedging relationship and then designating and documenting a new hedging relationship using an improved method for assessing effectiveness, that reference was not meant to imply that the perceived improved method had to be justified as a *preferable* method of applying an accounting principle under Statement 154. However, any change in the method of assessing hedge effectiveness would need to comply with the requirements of paragraph 62, which also states, "Ordinarily, however, an entity should assess hedge effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified."

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Title: Hedging—General: Application of the Shortcut Method to Hedges of a Portion of an Interest-Bearing Asset or Liability (or Its Related Interest) or a Portfolio of Similar Interest-Bearing Assets or Liabilities
Paragraph references: 21(a), 68
Date cleared by Board: June 28, 2000

Revised September 25, 2000

QUESTIONS

Question 1A

May the shortcut method be applied to fair value hedges of a proportion of the principal amount of the interest-bearing asset or liability if the notional amount of the interest rate swap designated as the hedging instrument (discussed in paragraph 68(a)) matches the portion of the asset or liability being hedged, and all other criteria for applying the shortcut method are satisfied?

Question 1B

May the shortcut method similarly be applied to cash flow hedges of the interest payments on only a portion of the principal amount of the interest-bearing asset or liability if the notional amount of the interest rate swap designated as the hedging instrument (discussed in paragraph 68(a)) matches the principal amount of the portion of the asset or liability on which the hedged interest payments are based, and all other criteria for applying the shortcut method are satisfied?

Question 2A

May the shortcut method be applied to fair value hedges of portfolios (or proportions thereof) of similar interest-bearing assets or liabilities if the notional amount of the interest rate swap designated as the hedging instrument (discussed in paragraph 68(a)) matches the notional amount of the aggregate portfolio? How should the other criteria in paragraph 68 be applied when the hedged item is a portfolio of similar assets or liabilities?

Question 2B

May the shortcut method be applied to a cash flow hedge in which the hedged forecasted transaction is a group of individual transactions if the notional amount of the interest rate swap designated as the hedging instrument (discussed in paragraph 68(a)) matches the notional amount of the aggregate group that is the hedged transaction? How should the other criteria in paragraph 68 be applied when the hedged forecasted transaction is a group of individual transactions (such as the interest payments on several interest-bearing assets or liabilities)?

BACKGROUND

The criteria for the shortcut method do not determine which hedging relationships qualify for hedge accounting; rather, those criteria determine which hedging relationships qualify for a "shortcut" version of hedge accounting that does not immediately recognize hedge ineffectiveness.

Paragraph 68 of Statement 133 identifies criteria that an entity must satisfy in order to assume no ineffectiveness in a hedging relationship (the shortcut method). The criterion in paragraph 68(a) is that "the notional amount of the swap matches the principal amount of the interest-bearing asset or liability." Some believe it is unclear whether that criterion can be satisfied for hedges of a designated proportion of the contractual principal or hedges of portfolios of similar interest-bearing assets or liabilities.

For example, an entity that issues $100 million of fixed-rate debt may wish to hedge 50 percent of its fair value exposure to interest rate risk, as permitted by paragraph 21(a)(2) of Statement 133. To accomplish that, the entity enters into an interest rate swap with a notional amount of $50 million. Assuming all other criteria for applying the shortcut method are met, it is unclear whether the hedging relationship meets the requirement of paragraph 68(a) that the notional amount of the swap must match the principal amount of the interest-bearing liability.

Similarly, if the $100 million of fixed-rate debt were issued in increments of $1,000 individual bonds, the entity may wish to aggregate 50,000 of those individual bonds as a portfolio to equal the notional amount of the swap, as permitted by paragraph 21(a)(1) of Statement 133 (for the purposes of this example, it is assumed that the hedge satisfies the portfolio requirements of paragraph 21(a)(1)). Some believe it is unclear whether the hedging relationship meets the requirement of paragraph 68(a) that the notional amount of the swap must match the principal amount of the interest-bearing liability and how the other criteria in paragraph 68 should be applied when the hedged item is a portfolio of similar assets or liabilities.

RESPONSE

Question 1A

Yes. Assuming all other criteria for applying the shortcut method are satisfied, the shortcut method may be applied to fair value hedges of a proportion of the principal amount of the interest-bearing asset or liability if the notional amount of the interest rate swap designated as the hedging instrument (discussed in paragraph 68(a)) matches the portion of the asset or liability being hedged. In the example in the background section, the paragraph 68(a) criterion is satisfied because the entity has designated as a fair value hedge 50 percent of the contractual principal amount as the hedged item and has entered into an interest rate swap with a notional amount that matches the hedged principal amount.

Question 1B

Yes. Assuming all other criteria for applying the shortcut method are satisfied, the shortcut method can be applied to cash flow hedges of the interest payments on only a portion of the principal amount of the interest-bearing asset or liability if the notional amount of the interest rate swap designated as the hedging instrument (discussed in paragraph 68(a)) matches the principal amount of the portion of the asset or liability on which the hedged interest payments are based.

Question 2A

Yes, provided that all other criteria for applying the shortcut method are satisfied. However, a restrictive interaction exists between the requirements for portfolio hedging in paragraph 21(a)(2) and the criteria for the shortcut method in paragraph 68, thereby making it more difficult to qualify for the shortcut method. The shortcut method may be applied for fair value hedges of portfolios (or proportions thereof) of similar interest-bearing assets or liabilities if the notional amount of the interest rate swap designated as the hedging instrument (discussed in paragraph 68(a)) matches the *aggregate* notional amount of the hedged item (whether it is all or a proportion of the total portfolio), and the remaining criteria for the shortcut method are met with respect to the interest rate swap and the *individual* assets or liabilities in the portfolio. That is, in addition to meeting the requirements of paragraph 21(a)(2) for portfolio hedging, each individual asset or liability in the portfolio must meet the criteria for the shortcut method in the following paragraphs:

- Paragraph 68(d) — that the interest-bearing asset or liability is not prepayable (as amended by FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*)
- Paragraph 68(e) — that any other terms in the interest-bearing asset or liability are typical of those instruments and do not invalidate the assumption of no ineffectiveness
- Paragraph 68(f) — that the expiration date of the swap matches the maturity date of the asset or liability.

The requirements of paragraph 21(a)(1) ensure that the individual items in a portfolio share the same risk exposure and have fair value changes attributable to the hedged risk that are expected to respond in a generally proportionate manner to the overall fair value changes of the entire portfolio. That requirement restricts the types of portfolios that can qualify for portfolio hedging; however, it also permits the existence of a certain amount of ineffectiveness in portfolios that do qualify. As a result, the assumption of no ineffectiveness required for the shortcut method generally would be inappropriate for portfolio hedges of similar assets or liabilities that are not also nearly identical (except for their notional amounts). Therefore, application of the shortcut method to portfolios that meet the requirements of paragraph 21(a)(1) is appropriate *only* if the assets or liabilities in the portfolio meet the same stringent criteria in paragraphs 68(d), 68(e), and 68(f) as required for hedges of individual assets and liabilities. Thus, portfolio hedging cannot be used to circumvent the application of the criteria in paragraph 68 to the hedge of an individual interest-bearing asset or liability. A portfolio of interest-bearing assets or interest-bearing liabilities cannot qualify for the shortcut method if it contains an interest-bearing asset or liability that individually cannot qualify for the shortcut method.

Question 2B

Yes, provided that all other criteria for applying the shortcut method are satisfied. For a cash flow hedge in which the hedged forecasted transaction is a group of individual transactions (as permitted by paragraph 29(a)), the shortcut method may be applied if the notional amount of the

interest rate swap designated as the hedging instrument (discussed in paragraph 68(a)) matches the notional amount of the *aggregate* group of hedged transactions and the remaining criteria for the shortcut method are met with respect to the interest rate swap and the *individual* transactions that make up the group. For example, the interest rate repricing dates for the variable-rate assets or liabilities whose interest payments are included in the group of forecasted transactions must match (that is, be exactly the same as) the reset dates for the interest rate swap.

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Title: Hedging—General: Hedged Exposure Is Limited but Derivative's Exposure Is Not
Paragraph references: 20(b), 28(b)
Date cleared by Board: December 6, 2000

QUESTION

If the hedged item or hedged forecasted transaction has a risk exposure that is limited, may an entity designate as the hedging instrument in a fair value or cash flow hedge a derivative that does not have comparable limits with respect to that same hedged risk exposure?

BACKGROUND

Paragraphs 20(b) and 28(b) require that, to qualify for fair value or cash flow hedge accounting, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value (or cash flows) attributable to the hedged risk during the period that the hedge is designated. Paragraph 20(b) states, "If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, the increases (or decreases) in the fair value of the hedging instrument must be expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item." Paragraph 28(b) contains a similar provision for options that provide only one-sided offset of the hedged risk in a cash flow hedge.

The following examples illustrate situations where the hedged item or hedged forecasted transaction may have a risk exposure that is limited, but the derivative that the entity desires to designate as a hedging instrument does not have comparable limits. (For the purposes of these examples, it is assumed that the shortcut method may not be applied.)

Example 1—Fair Value Hedge

Company A issues 10-year fixed-rate debt that is callable at the end of the fifth year. It decides to convert the interest payments on the bond from fixed-rate to floating-rate by entering into a 10-year receive-fixed, pay-floating interest rate swap. The interest rate swap is not cancelable at the end of the fifth year. From Company A's perspective, if interest rates increase, there is a gain on the debt (the liability's fair value decreases) and a loss on the swap (fair value either decreases as an asset or increases as a liability). If interest rates decrease, there is a loss on the debt (the liability's fair value increases) and a gain on the swap (fair value either increases as an asset or decreases as a liability). However, during the first five years, if interest rates decrease, the gain on the swap will exceed the loss on the debt because the debt's fair value change will consider the impact of the call feature, which is in-the-money when interest rates fall below the stated rate on the debt. Company A wishes to designate the interest rate swap as the hedging instrument in a fair value hedge of interest rate risk of the fixed-rate debt.

Example 2—Cash Flow Hedge

Company B issues 10-year, floating-rate debt that reprices based on 6-month LIBOR. The interest rate on the debt is capped at 9 percent. Company B decides to convert the interest payments on the debt from floating-rate to fixed-rate by entering into a receive-floating, pay-fixed interest rate swap. There is no cap on the floating rate leg of the interest rate swap. From Company B's perspective, if interest rates decrease, there will be a cumulative reduction in the expected future cash outflows on the debt and a cumulative reduction in the expected future cash inflows on the swap. If interest rates increase, there will be a cumulative increase in the expected future cash outflows on the debt and a cumulative increase in the expected future cash inflows on the swap. However, if interest rates increase such that the floating rate on the swap would be greater than 9 percent, the cumulative increase in the expected future cash inflows on the swap will exceed the cumulative increase in the expected future cash outflows on the debt because of the interest rate cap on the debt, which is in-the-money if interest rates increase such that the floating rate on the debt would exceed 9 percent. Company B wishes to designate the interest rate swap as the hedging instrument in a cash flow hedge of interest rate risk of the floating-rate debt.

RESPONSE

It depends. An entity may designate as the hedging instrument in a fair value or cash flow hedge a derivative that does not have a limited exposure comparable to the limited exposure of the hedged item to the risk being hedged. However, in order to make that designation, in accordance with paragraph 20(b) of Statement 133, the entity must establish that the hedging relationship is *expected* to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated. The assessment of hedge effectiveness must consider the possible changes in fair value or cash flows of the derivative and may not be limited to the likely or expected changes in fair value or cash flows of the derivative for the period used to assess whether the requirement for expectation of highly effective offset is satisfied. Generally, the process of formulating an expectation regarding the effectiveness of a proposed hedging relationship involves a probability-weighted analysis of the possible changes in fair value or cash flows of the derivative for the hedge period. Therefore, a probable change in fair value or cash flows will be more heavily weighted than a reasonably possible change. That calculation technique is consistent with the definition of the term *expected cash flow* in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. The glossary of terms in Concepts Statement 7 defines expected cash flow as "the sum of probability-weighted amounts in a range of possible estimated amounts; the estimated mean or average."

Under the guidance in Statement 133 Implementation Issue No. F5, "Basing the Expectation of Highly Effective Offset on a Shorter Period Than the Life of the Derivative," in accordance with its documented risk management strategy for a fair value hedge, an entity may consider the possible changes in the fair value of the derivative and the hedged item over a shorter period than

the remaining life of the derivative in formulating its expectation that the hedging relationship will be highly effective in achieving offsetting changes in fair value for the risk being hedged.

It is inappropriate under Statement 133 for an entity to designate a derivative as the hedging instrument when the entity expects that the derivative will not be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated, unless the entity has documented undertaking a dynamic hedging strategy in which it has committed itself to an ongoing repositioning strategy for its hedging relationship. Statement 133 cites the following examples:

a. For fair value hedges, in a delta-neutral dynamic hedging strategy, the entity commits to constant monitoring of the option's "delta"—the ratio of changes in the option's price to changes in the price of the hedged item. As the delta ratio changes, that entity must rebalance the portfolio of options (that is, buy or sell options) so that the next change in the fair value of all of the options held can be expected to counterbalance or offset the next change in the value of the hedged item. Thus, in a delta-neutral hedging strategy, the hedging instrument is constantly being changed and the assessment of effectiveness considers only the next change in fair value. (Refer to paragraphs 86 and 87.)
b. For cash flow hedges, in a tailing strategy, the entity commits to adjusting the size or contract amount of futures contracts used as the hedging instrument so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures do not distort the results of the hedge. (Refer to paragraph 64.)

For the examples in the background section, the entity must assess, based on an appropriate methodology, whether the changes in fair value or cash flows of the interest rate swap could be expected to be highly effective in offsetting changes in fair value or cash flows of the debt attributable to interest rate risk taking into account the impact of the embedded call option (Example 1) or the impact of the interest rate cap (Example 2). As required by paragraph 21(f), "the effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk." Therefore, if the options in Example 1 and Example 2 are expected to be out-of-the-money based on a probability-weighted analysis of the range of possible changes in interest rates, then those options would be expected to have a minimal impact on changes in fair value or cash flows of the debt, and the hedging relationships could meet the requirement for an expectation of high effectiveness.

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Title: Hedging—General: How Paragraph 68(c) Applies to an Interest Rate Swap That Trades at an Interim Date
Paragraph reference: 68(c)
Date cleared by Board: December 6, 2000

QUESTION

Does a swap that involves a stub period violate the paragraph 68(c) requirement that "the formula for computing net settlements under the interest rate swap is the same for each net settlement" such that the shortcut method may not be applied?

BACKGROUND

Paragraph 68 of Statement 133 sets forth the requirements that must be met to assume no ineffectiveness in a hedge with an interest rate swap (the shortcut method). Paragraph 68(c) states, "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.)"

Interest rate swaps with floating rates based on LIBOR typically reset at three-month or six-month intervals. Often, swaps may trade on interim dates that do not correspond to a swap reset date. Calendar dates that are swap reset and payment dates are set by market convention. A swap that resets quarterly may have a first payment period that is shorter than a full quarter, such as 30 days versus 90 days. Because the first payment period is not equal to a full quarter, it is referred to as a "stub period." That stub period is the period that begins on the date coupon payments begin to accrue and ends on the first payment date. The floating rate set for that shorter period is the "stub rate." The stub rate is the floating rate that corresponds to the length of the stub period. It is unclear whether the existence of the stub rate would violate the requirement in paragraph 68(c) that the "…variable rate is based on the same index and includes the same constant adjustment or no adjustment."

RESPONSE

No. The existence of a stub period and stub rate is not a violation of paragraph 68(c) that would preclude application of the shortcut method provided that the stub rate is the floating rate that corresponds to the length of the stub period. It is acknowledged that the stub rate presents an apparent inconsistency with the requirement in paragraph 68(c) that the "…variable rate is based on the same index and includes the same constant adjustment or no adjustment," because the stub rate is a floating rate that is adjusted to reflect the number of the days in the stub period, and is therefore not reflective of a floating rate that is applicable to a full reset period similar to the floating rates that would be in effect for the remaining periods of the swap. However, the

existence of the stub rate is a market convention that is necessary for determining the prices of interest rate swaps that are traded on dates that do not coincide with swap reset dates. Because many swaps are traded on interim dates, the existence of a stub rate for a single period is a necessary adjustment in a significant number of contracts. The objective of the conditions in paragraph 68 for qualifying for the shortcut method is to ensure that the hedging relationship does not violate the assumption of no ineffectiveness necessary for applying the shortcut method. The adjustment of the swap's floating rate in a stub period as a necessary pricing adjustment does not present an inconsistency with the assumption of no ineffectiveness in a hedging relationship.

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Title:	Hedging—General: Continuing the Shortcut Method after a Purchase Business Combination
Paragraph reference:	68
Date cleared by Board:	March 21, 2001
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Affected by:	FASB Statement No. 141 (revised 2007), *Business Combinations*

Revised December 4, 2007

Note: On May 1, 2002, the FASB issued the Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,* which proposed certain changes to Statement 133 that would have effectively superseded the guidance in this Issue. In its redeliberations following an analysis of comments received on the Exposure Draft, the Board withdrew the proposed changes that would have affected this Issue. Consequently, the guidance in this Issue is not affected by the issuance of FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities.*

QUESTION

Assuming it has already adopted Statement 133, can the acquiror in a business combination continue to use the shortcut method of accounting for the hedging relationships of the acquiree that were being accounted for by the acquiree under the shortcut method of accounting at the date of the business combination? (In part, this question entails a determination of whether the business combination results in a new inception date for the combined entity for hedging relationships entered into by the acquiree prior to the consummation of the business combination that remain ongoing at the date of the business combination.)

BACKGROUND

Company A acquires Company B in a business combination. Company A and Company B both adopted Statement 133 prior to the date of the business combination. At the date of the business combination, Company A and Company B both have certain hedging relationships that have met the requirements in paragraph 68 of Statement 133 and that are being accounted for by the respective companies under the shortcut method of accounting. A business combination is accounted for as the acquisition of one enterprise by another enterprise. The acquiring enterprise, Company A, records the assets acquired and liabilities assumed at fair value. Assume that, at the date of the business combination, the fair value of the hedging swaps in Company B's hedging relationships is other than zero.

RESPONSE

No, unless the applicable hedging relationships meet the requirements in paragraph 68 of Statement 133 *at the date of the business combination* (which would be highly unlikely since the swap's fair value would rarely be zero at that date) and the combined organization chooses to designate the swaps and the hedged items as hedging relationships to be accounted for under the shortcut method. Company A is acquiring the individual assets and liabilities of Company B at the date of the business combination and accordingly any pre-existing hedging relationships of old Company B must be designated anew by the combined entity at the date of the business combination in accordance with the relevant requirements of Statement 133. The concept of purchase accounting follows the accounting for acquisitions of individual assets and liabilities. That is, the combined entity should account for the assets and liabilities acquired in the business combination consistent with how it would be required to account for those assets and liabilities if they were acquired individually in separate transactions. The acquisition method is based on the premise that in an acquisition, the acquired entity (Company B) ceases to exist and only the acquiring entity (Company A) survives. Thus, the post-acquisition hedging relationship designated by Company A is a new relationship that has a new inception date. Even in the unlikely circumstance that the new hedging relationship qualifies for the shortcut method, there would be no "continuation" of the shortcut method of accounting that had been applied by the acquired entity.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Hedging—General: Application of the Shortcut Method for an Interest Rate Swap-in-Arrears
Paragraph reference:	68
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001

QUESTION

Can the shortcut method be applied to a hedging relationship that involves the use of an interest rate swap-in-arrears?

BACKGROUND

Plain-vanilla interest rate swaps are contractual arrangements that require the periodic exchange of two cash flows (usually settled net) – one relating to an interest calculation involving a fixed interest rate, and the other relating to an interest calculation involving a floating interest rate. In plain-vanilla interest rate swaps, the fixed interest rate does not change, while the floating interest rate is determined (that is, reset) at the beginning of each period; thus, on that date, the scheduled net cash flow for the period will be known. The net cash flow does not actually occur, however, until the payment date, which is at the end of the period. That is, if the swap interest rates are reset every three months, the cash flows occur at the end of each three-month period based upon the interest rates determined at the beginning of the three-month period. Thus, for plain-vanilla interest rate swaps, the floating interest rate is applied *prospectively*.

An interest rate swap-in-arrears works the same way as a plain-vanilla swap except that the floating interest rate for a swap-in-arrears is applied *retrospectively*. With an interest rate swap-in-arrears, the net cash flow occurs immediately at the interest rate reset date (which is at the end of the reset period). That is, if the swap interest rates are reset every three months, the cash flows occur at the end of each three-month period based upon the interest rates determined at that same time applied to the three-month period just ended. Note that generally, both plain-vanilla swaps and swaps-in-arrears are initiated with market values equal to zero. At any given time, however, there will be some difference between the fixed interest rates on the two respective swaps or between the variable interest rates on the two respective swaps unless the yield curve is perfectly flat.

RESPONSE

Yes. The shortcut method may be applied to a hedging relationship that involves the use of an interest rate swap-in-arrears provided all of the applicable conditions in paragraph 68 are met. Paragraphs 68–70, 114, and 132 of Statement 133 set forth the requirements and guidance concerning use of the shortcut method to account for fair value or cash flow hedges involving interest rate swaps. For cash flow hedging transactions accounted for under the shortcut method,

paragraph 68(k) requires that the repricing dates of the variable rate asset or liability that is the hedged item match the repricing dates of the interest rate swap that is the hedging instrument.

Pursuant to the guidance in question 1 of Statement 133 Implementation Issue No. E4, "Application of the Shortcut Method", the verb *match* is used in the specified conditions in paragraph 68 to mean *be exactly the same* or *correspond exactly*. Therefore, for purposes of paragraph 68(k), if the repricing dates of the hedged item occur on the same dates as the repricing dates of the hedging instrument but the repricing calculation for the hedged item is *prospective* whereas the repricing calculation for the hedging instrument is *retrospective*, those repricing dates do not match. In order to match for purposes of paragraph 68(k), the repricing dates of the hedged item and the hedging instrument must occur on the same dates and be calculated the same way (that is, both must be either *prospective* or *retrospective*).

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Title:	Hedging—General: Designating a Normal Purchase Contract or a Normal Sales Contract as the Hedged Item in a Fair Value Hedge or Cash Flow Hedge
Paragraph references:	10(b), footnote 8 to Paragraph 21
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001

QUESTION

If an entity has entered into a purchase contract that is a derivative instrument but, as a normal purchase, that contract is not subject to Statement 133 pursuant to the normal purchases and normal sales exception in paragraph 10(b) (as amended), may that contract be the hedged item in a fair value hedge or may the purchase under that contract be the hedged transaction in a cash flow hedge?

BACKGROUND

An entity enters into a purchase contract that is a derivative instrument under the criteria in paragraphs 6–9. However, the contract meets the conditions for the normal purchases and normal sales exception in paragraph 10(b). The introduction to paragraph 10 states that "notwithstanding the conditions in paragraphs 6-9, the following contracts are not subject to the requirements of this Statement…."

Footnote 8 to paragraph 21 states that "a firm commitment that represents an asset or liability that a specific accounting standard prohibits recognizing…may nevertheless be designated as the hedged item in a fair value hedge."

RESPONSE

Yes. A contract that is not subject to the requirements of Statement 133 because it qualifies for the normal purchases and normal sales exception may be designated as a hedged item in a fair value hedge, provided that the provisions of paragraph 21 are met. Similarly, the purchase under that contract may be the hedged transaction in a cash flow hedge, provided that the provisions of paragraph 29 are met. As the hedged item, the contract would be accounted for under fair value hedge accounting as specified in Statement 133. (For cash flow hedges, the special accounting applies to the hedging instrument, not to the purchase contract that is related to the hedged forecasted transaction.) In emphasizing the conditions in the definition of a derivative instrument in paragraphs 6–9, paragraph 10 essentially exempts contracts that meet the definition of a derivative from the requirements of Statement 133 applicable to derivative instruments. However, paragraph 10 is not intended to preclude such contracts from being subject to the requirements of Statement 133 applicable to the hedged item in a fair value hedge.

A contract that qualifies for the normal purchases and normal sales exception will typically satisfy the criteria for a firm commitment and will not be recognized on an entity's financial statements because of the exclusion from recognition under Statement 133 or other accounting literature. Footnote 8 to paragraph 21 acknowledges that such unrecognized firm commitments may be the hedged item in a fair value hedge. The transaction under a contract that qualifies for the normal purchases and normal sales exception but does not satisfy the criteria for a firm commitment because the contract does not contain a fixed price may be the hedged transaction in a cash flow hedge.

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Title:	Hedging—General: Designating a Zero-Cost Collar with Different Notional Amounts as a Hedging Instrument
Paragraph references:	20, 21
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001
Date revision posted to website:	December 10, 2001 Revised November 21, 2001

QUESTION

In a hedging relationship in which a collar that is comprised of a purchased option and a written option that have different notional amounts is designated as the hedging instrument and the hedge's effectiveness is assessed based on changes in the collar's intrinsic value, may the hedged item be specified as two different proportions of the same asset based on the upper and lower rate or price range of the asset referenced in the collar?

- In Example 1 in the background section, may Company A designate as the hedged risk the change in fair value of 1,000 shares of XYZ stock (100 percent of the portfolio) resulting from price changes below $100 per share and the change in fair value of 70 percent of each of the 1,000 shares in the portfolio resulting from price changes above $120 per share?

- In Example 2 in the background section, may Company B, whose functional currency is the U.S. dollar, designate as the hedged risk the variability in U.S. dollar-equivalent cash flows on FC100 million (100 percent of the forecasted foreign-currency-denominated purchase price of inventory) resulting from changes in the U.S. dollar-FC exchange rate above $0.885 per FC1 and the variability in U.S. dollar-equivalent cash flows on FC50 million (50 percent of the forecasted FC100 million purchase price of inventory) resulting from changes in the U.S. dollar-FC exchange rate below $0.80 per FC1?

BACKGROUND

Example 1—Equity Collar

During January 1999, Company A issued a $100,000 debt instrument at a fixed interest rate of 8 percent that contains an embedded combination of options. The combination of options is comprised of the following:

- A purchased put option with a notional amount equal to 1,000 shares of XYZ stock and a strike price of $100 per share. The purchased put option provides Company A a return of $1,000 for each dollar that the price of XYZ stock falls below $100.
- A written call option with a notional amount equal to 700 shares of XYZ stock and a strike price of $120 per share. The written call option obligates Company A to pay $700 for each dollar that the price of XYZ stock increases above $120.

Overall, the collar provides the investor with a potential gain equal to 70 percent of the share price of XYZ stock in excess of $120 per share at maturity and exposes the investor to a potential loss in principal to the extent that the share price of XYZ stock is below $100 per share at maturity. (For both options, the underlying is the same—the share market price of XYZ stock.) Company A also has 1,000 shares of XYZ stock classified as available-for-sale. The current market value of XYZ stock at the debt issuance date is $100 per share. The debt issuance is intended to eliminate the risk of a decrease in the market value in Company A's investment in XYZ stock.

According to paragraph 50 of Statement 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, at the initial adoption of Statement 133, Company A must separately account for the embedded derivative in its debt issuance. (The "grandfathering" provision related to embedded derivatives cannot be applied in this case.) Based on the guidance in Statement 133 Implementation Issue No. B15, "Separate Accounting for Multiple Derivative Features Embedded in a Single Hybrid Instrument," that embedded combination of options may not be separated into its components.

Statement 133 Implementation Issue No. E2, "Combinations of Options," includes the following criteria, which must be met in order for a combination of option contracts, including the combination of a single purchased option contract and a single written option contract, to result in a net purchased option or a zero-cost collar.

1. No net premium is received.
2. The components of the combination of options are based on the same underlying.
3. The components of the combination of options have the same maturity date.
4. The notional amount of the written option component is not greater than the notional amount of the purchased option component.

Pursuant to the guidance in Implementation Issue E2, the combination of options should be accounted for as a net purchased option. As a result, if Company A chooses to use the combination of options as a hedging instrument, it is not required to comply with the provisions contained in paragraph 20(c) related to written options.

Upon adoption of Statement 133, Company A would like to designate the combination of options as a fair value hedge of its investment in XYZ stock. Assume Company A specifies in the hedge effectiveness documentation that the collar's time value would be excluded from the assessment of hedge effectiveness.

Example 2—Currency Collar

Company B forecasts that it will purchase inventory that will cost 100 million foreign currency (FC) units. Company B's functional currency is the U.S. dollar. To limit the variability in U.S. dollar-equivalent cash flows associated with changes in the U.S. dollar-FC exchange rate, Company B constructs a currency collar as follows:

- A purchased call option providing Company B the right to purchase FC100 million at an exchange rate of $0.885 per FC1.
- A written put option obligating Company B to purchase FC50 million at an exchange rate of $0.80 per FC1.

The purchased call option provides Company B with protection when the U.S. dollar-FC exchange rate increases above $0.885 per FC1. The written put option partially offsets the cost of the purchased call option and obligates Company B to give up some of the foreign currency gain related to the forecasted inventory purchase as the U.S. dollar-FC exchange rate decreases below $0.80 per FC1. (For both options, the underlying is the same—the U.S. dollar-FC exchange rate.) Assuming that a net premium was not received for the combination of options and all the other criteria in Implementation Issue E2 have been met, if Company B chooses to use the combination of options as a hedging instrument, it is not required to comply with the provisions contained in paragraph 20(c) related to written options.

Company B would like to designate the combination of options as a hedge of the variability in U.S. dollar-equivalent cash flows of its forecasted purchase of inventory denominated in FC. Assume Company B specifies in the hedge effectiveness documentation that the collar's time value would be excluded from the assessment of hedge effectiveness.

RESPONSE

Yes. In a hedging relationship in which a collar that is comprised of a purchased option and a written option that have different notional amounts is designated as the hedging instrument and the hedge's effectiveness is assessed based on changes in the collar's intrinsic value, the hedged item may be specified as two different proportions of the same asset referenced in the collar, based on the upper and lower price ranges specified in the two options that comprise the collar. (That is, the quantities of the asset designated as being hedged may be different based on those price ranges in which the collar's intrinsic value is other than zero.)

The application of the guidance in this Issue is permitted only for collars that are a combination of a single written option and a single purchased option for which the underlying in both options is the same. The guidance in this Issue may not be applied by analogy to other derivatives designated as hedging instruments.

While the quantities of the asset designated as being hedged may be different based on the upper and lower price ranges in the collar, the actual assets that are the subject of the hedging relationship may not change. The quantities that are designated as hedged for a specific price or rate change must be specified at the inception of the hedging relationship and may not be changed unless the hedging relationship is dedesignated and a new hedging relationship is redesignated. Since the hedge's effectiveness is based on changes in the collar's intrinsic value, the assessment of hedge effectiveness must compare the actual change in intrinsic value of the collar to the change in value of the pre-specified quantity of the hedged asset that occurred during the hedge period.

In Example 1 in the background section, the hedging relationship involving the equity collar and the shares of XYZ stock owned by Company A qualifies for fair value hedge accounting. In that case, the hedged risk is changes in the overall fair value of the hedged item. The hedged item is expressed as 100 percent of 1,000 shares of XYZ stock for price changes below $100 per share and 70 percent of each of the *same* 1,000 shares of stock for price changes above $120 per share. Fair value hedge accounting will be applied for those changes in the underlying (market price of XYZ stock) that cause changes in the collar's intrinsic value (that is, decreases below $100 per share and increases above $120 per share). Since the hedge's effectiveness is based on changes in the collar's intrinsic value, hedge effectiveness must be assessed based on the actual price change of XYZ stock by comparing the change in intrinsic value of the collar to the change in fair value of the specified quantity of shares for those changes in the underlying.

In Example 2 in the background section, the hedging relationship involving the currency collar designated as a hedge of the effect of fluctuations in the U.S. dollar-FC exchange rate qualifies for cash flow hedge accounting. In that example, the hedged risk is the risk of changes in U.S. dollar-equivalent cash flows attributable to foreign currency risk (specifically, the risk of fluctuations in the U.S. dollar-FC exchange rate). The foreign currency collar is hedging the variability in U.S. dollar-equivalent cash flows for 100 percent of the forecasted FC100 million purchase price of inventory for U.S. dollar-FC exchange rate movements above $0.885 per FC1 and variability in U.S. dollar-equivalent cash flows for 50 percent of the forecasted FC100 million purchase price of inventory for U.S. dollar-FC exchange rate movements below $0.80 per FC1. Cash flow hedge accounting will be applied for those changes in the underlying (the U.S. dollar-FC exchange rate) that cause changes in the collar's intrinsic value (that is, changes below $0.80 per FC1 and above $0.885 per FC1). Since the hedge's effectiveness is based on changes in the collar's intrinsic value, hedge effectiveness must be assessed based on the actual exchange rate changes by comparing the change in intrinsic value of the collar to the change in the specified quantity of the forecasted transaction for those changes in the underlying.

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Title:	Hedging—General: Methods of Assessing Hedge Effectiveness When Options Are Designated as the Hedging Instrument
Paragraph references:	30(a), 63
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001
Date latest revision posted to website:	December 17, 2004
Affected by:	FASB Statement No. 123 (revised 2004), *Share-Based Payment* Revised December 15, 2004

QUESTIONS

In documenting a hedging relationship that involves an option contract designated as the hedging instrument:

1. May an entity exclude from the assessment of hedge effectiveness a component of the *change* in an option's time value in a manner other than the method specified in paragraph 63(b) of Statement 133? For example, may a company exclude changes in an option's time value attributable to the passage of time (theta) from the assessment of hedge effectiveness? (The remaining components of changes in the option's time value would be included in the assessment of hedge effectiveness.)
2. May an entity assess hedge effectiveness based on the difference *at a point in time* between the strike price and forward price (undiscounted) of the referenced asset? (The remaining components of an option's time value at a point in time would be excluded from the assessment of hedge effectiveness and included currently in earnings.)

BACKGROUND

Paragraph 63 of Statement 133 states, in part:

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

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

Background Specific to Question 1

Some entities may wish to assess hedge effectiveness based on the change in an option's value *excluding* a certain aspect of the change in the option's time value. For example, some entities may wish to exclude the change in time value attributable to the passage of time (theta) from the assessment of hedge effectiveness, while assessing hedge effectiveness based on the remaining components of changes in an option's value. As an illustration, when out-of-the-money options are designated as hedging instruments, changes in value of the option are primarily driven by the change, if any, in the value of the underlying (delta). If the price of the underlying asset changes, in effective hedging strategies involving out-of-the-money options, the hedge gain or loss due to delta would offset the change in value of the hedged item; however, if the price of the underlying does not change, there is no change in fair value attributable to changes in delta. In that case, the only change in the option's value is attributable to the passage of time (theta), or to changes in other market variables such as volatilities or interest rates. Accordingly, for those hedging relationships to qualify for hedge accounting, an entity may need to exclude the change in value attributable to theta from the assessment of hedge effectiveness.

Other entities may wish to exclude changes in time value attributable to certain market variables—volatility (vega) or interest rates (rho)—from the assessment of hedge effectiveness. An entity may wish to exclude changes in time value attributable to volatility (vega) from the assessment of hedge effectiveness because the fair value measurement of the hedged item does not incorporate a measure of implied volatility. Similarly, an entity may seek to exclude changes in time value attributable to interest rates (rho) from the assessment of hedge effectiveness. For example, in a foreign currency hedge involving a country in which interest rates are volatile, a substantial portion of the change in value of the option may be attributable to fluctuations in those interest rates, while the fair value of the hedged item is not affected correspondingly. Accordingly, for these hedging relationships to qualify for hedge accounting, an entity may need to exclude the change in value attributable to the relevant market variable from the assessment of hedge effectiveness.

In summary, the exclusion of a certain aspect of the change in an option's time value from the assessment of hedge effectiveness is driven by the fact that, in certain circumstances, the measurement of changes in fair value of the hedged item or changes in the cash flows of the hedged transaction does not depend upon or incorporate that aspect. Option valuation models are capable of isolating the various aspects of changes in an option's time value.

Background Specific to Question 2

The total value of an option *at a point in time* can be separated into two components: time value and intrinsic value. As reflected in paragraph 30(a) of Statement 133, an option's time value is the difference between the total option value and its intrinsic value. While Statement 133 does not define intrinsic value, FASB Statement No. 123 (revised 2004), *Share-Based Payment*, provides the following definition of intrinsic value: "The amount by which the fair value of the underlying stock exceeds the exercise price of an option. For example, an option with an exercise price of $20 on a stock whose current market price is $25 has intrinsic value of $5.…"

Market convention considers there to be different "measures" of intrinsic value of an option, as described below:

1. The difference between the strike price and the spot price of the underlying asset. (That measure is described in paragraph 63(a) as assessing hedge effectiveness based on *intrinsic value.*)
2. The present value of the difference between the strike price and the forward price of the underlying asset. (That measure is described in paragraph 63(b) as assessing hedge effectiveness based on *minimum value.*)
3. The difference between the strike price and the forward price of the underlying, undiscounted. (Paragraph 63 does not recognize use of that measure as a method of assessing hedge effectiveness.)

RESPONSE

Question 1

Yes, entities may exclude one or more of the following *components* of the *change* in an option's time value from the assessment of hedge effectiveness:

1. The portion of the change in time value attributable to the passage of time (theta)
2. The portion of the change in time value attributable to changes due to volatility (vega)
3. The portion of the change in time value attributable to changes due to interest rates (rho).

However, entities may not exclude from the assessment of hedge effectiveness the portion of the change in time value attributable to changes in other market variables (that is, other than rho and vega).

In computing the changes in an option's time value that would be excluded from the assessment of hedge effectiveness, entities must use a technique that appropriately isolates those aspects of the change in time value. Generally, in order to allocate the total change in an option's time value to its different aspects—the passage of time and the market variables—the change in time value attributable to the first aspect to be isolated is determined by holding all other aspects constant as of the beginning of the period. Each remaining aspect of the change in time value is then determined in turn in a specified order based on the ending values of the previously isolated aspects.

Based on that general methodology, in cases where only one aspect of the change in time value is excluded from the assessment of hedge effectiveness (for example, theta), that aspect must be the first aspect for which the change in time value is computed and would be determined by holding all other parameters constant for the period used for assessing hedge effectiveness. However, in cases where more than one aspect of the change in time value is excluded from the assessment of hedge effectiveness (for example, theta and vega), entities must determine the amount of that change in time value by isolating each of those two aspects in turn in a pre-specified order (one first, the other second). The second aspect to be isolated would be based on the ending value of the first isolated aspect and the beginning values of the remaining aspects. The portion of the change in time value that is included in the assessment of effectiveness is determined by deducting from the total change in time value the portion of the change in time value attributable to excluded components.

In accordance with paragraph 63, changes in the excluded component of the change in an option's time value must be included currently in earnings. Also, entities may not exclude any aspect of a change in an option's value from the assessment of hedge effectiveness that is not one of the permissible components of the change in an option's time value. In addition, the requirement in paragraph 62 that the effectiveness of similar hedges generally should be assessed similarly requires that entities consistently exclude a specific component of option time value in assessing effectiveness for similar hedges. As part of that requirement, the mechanics of isolating the change in time value discussed in the paragraphs above must be applied consistently.

Question 2

Yes, but for cash flow hedges only. That is, with respect to an option designated as the hedging instrument in a cash flow hedge, an entity may assess hedge effectiveness based on a measure of the difference, as of the end of the period used for assessing hedge effectiveness, between the strike price and forward price of the underlying, undiscounted. In the area of cash flow hedge accounting, there is flexibility in the measurement of the change in value of the hedged cash flow. That is, while Statement 133 requires that the measurement of cash flow hedge effectiveness be performed by comparing the changes in present value of the expected future cash flows of the forecasted transaction to the change in fair value of the derivative (aside from any excluded component under paragraph 63), that measure of changes in the expected future cash flows of the forecasted transaction based on forward rates, *undiscounted*, is not prohibited. Accordingly, assessing hedge effectiveness based on a similar measure with respect to the hedging instrument eliminates any difference that the effect of discounting may have on the hedging instrument and the hedged transaction.

As part of the overall documentation for each hedging relationship, entities must document the measure of intrinsic value that will be used in the assessment of hedge effectiveness. That measure must be used consistently for each period following designation of the hedging relationship.

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Title:	Hedging—General: The Strike Price for Determining When a Swap Contains Mirror-Image Call Provision
Paragraph reference:	68(d)
Date cleared by Board:	June 27, 2001
Date posted to website:	July 10, 2001

QUESTION

Prior to entering a hedge, the carrying amount of a debt instrument is often different from its redemption amount at maturity, perhaps because of an issuance premium or discount or deferred debt issuance costs, and, if the debt instrument is callable, different from the strike price of the call option. How does this carrying amount impact the determination of whether a swap contains a mirror-image call option under paragraph 68(d)?

BACKGROUND

Paragraph 68 of Statement 133 (as amended) lists the requirements that must be met in order to apply the shortcut method. Paragraph 68(d) states:

> 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. [Emphasis added.]

RESPONSE

The debt's carrying amount has no direct impact on the determination of whether a swap contains a mirror-image call option under paragraph 68(d). The phrase *strike price* in paragraph 68(d)(1)

should be read to mean the actual amount for which the debt instrument could be called. Typically, the call price is greater than the par or face amount of the debt instrument. [1]

The carrying amount of the debt is economically unrelated to the amount the issuer would be required to pay to exercise the call embedded in the debt. Any discount or premium in carrying amount (including any related deferred issuance costs) is therefore irrelevant in the determination of whether a call option meets the mirror-image requirements of paragraph 68(d). Thus, for example, to meet the requirements of paragraph 68(d) regarding embedded mirror-image call options, a swap is not permitted to contain a termination payment equal to the deferred debt issuance costs that remain unamortized on the date the debt is called.

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after July 10, 2001, the date that the Board-cleared guidance was posted on the FASB website.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

[1] It is common to quote the call prices (strike prices) on debt as a percentage of par value. In contrast, the strike prices of options embedded in interest rate swaps are generally quoted as a rate or current yield (the current fixed-rate coupon on a non-callable/non-puttable swap having zero fair value at inception). One means of determining whether these strike prices are the same would be to (a) impute the yield to maturity at a price equal to the call price for a non-callable/non-puttable debt instrument that is otherwise identical to the hedged debt instrument and (b) compare that yield to the call or put yield embedded in the swap.

Title:	Hedging—General: Accounting for the Discontinuance of Hedging Relationships Arising from Changes in Consolidation Practices Related to Applying FASB Interpretation No. 46 or 46(R)
Paragraph references:	31, 32, 68
Date cleared by Board:	November 5, 2003
Date posted to website:	November 10, 2003
Date latest revision posted to website:	February 10, 2004

Revised February 10, 2004

QUESTION

If upon the initial application of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, or No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, an entity is required to consolidate another entity (or remove an entity from its consolidated financial statements) and consequently must discontinue a pre-existing hedging relationship, what adjustments are made with respect to the previous hedge accounting?

BACKGROUND

Transition Provisions in Interpretation 46(R)

Paragraph 37 of Interpretation 46(R) states, in part:

> If initial application of the requirements of this Interpretation results in initial consolidation of an entity created before December 31, 2003, the consolidating enterprise shall initially measure the assets, liabilities, and noncontrolling interests of the variable interest entity at their carrying amounts at the date the requirements of this Interpretation first apply. In this context, *carrying amounts* refers to the amounts at which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if this Interpretation had been effective when the enterprise first met the conditions to be the primary beneficiary.

The transition provisions in paragraph 28 of Interpretation 46 mirror the above except that the provisions in paragraph 28 pertain to entities created before February 1, 2003.

Selected Provisions in Statement 133

Paragraph 25 for fair value hedges and paragraph 32 for cash flow hedges require that a hedging relationship be discontinued when any criterion for fair value hedge accounting (in paragraphs 20 and 21) or for cash flow hedge accounting (in paragraphs 28 and 29) is no longer met. Consequently, a pre-existing hedging relationship may need to be discontinued when a change in

consolidation practices causes either (a) a hedged transaction with a third party to become an intercompany transaction that is not eligible for cash flow hedge accounting in the consolidated financial statements or (b) a hedged item to cease being an asset or liability of the consolidated entity.

Paragraphs 31–33 discuss the accounting for the net derivative gain or loss that is initially reported in accumulated other comprehensive income (OCI). Paragraph 33, as amended, states:

> 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.

Statement 133 does not permit retroactive designation of hedging relationships to achieve hedge accounting for fair value changes occurring prior to the designation and documentation of those hedging relationships.

Example 1—Discontinued Cash Flow Hedge Arising from Consolidation

A special-purpose leasing entity is established based on a $3,000 equity contribution by an independent equity participant. The leasing entity borrows $97,000 with LIBOR-based interest payable quarterly and principal repayable as a lump sum at maturity and purchases a $100,000 asset. Company A leases the asset for a variable quarterly lease payment equal to the sum of (a) the leasing entity's LIBOR-based quarterly interest payment, (b) a fixed return to the equity participant that is paid quarterly, and (c) a fixed amount to cover the leasing entity's insurance, maintenance, and other costs. Assume that the due dates for the quarterly interest payments and the quarterly lease payments are the same. Company A enters into a receive-LIBOR, pay-fixed interest rate swap (with a notional amount not exceeding $97,000) and designates the swap as a cash flow hedge of all or a portion of its exposure to the variability of its LIBOR-based cash

outflows under the lease. Prior to the initial application of Interpretation 46 or 46(R), Company A had not been consolidating the special-purpose leasing entity.

Upon initial application of Interpretation 46 or 46(R), the special-purpose leasing entity is considered a variable interest entity; assume that it must be consolidated by Company A. The original cash flow hedge must be discontinued because the hedged forecasted transactions (the LIBOR-based lease payments) are no longer eligible forecasted transactions of the consolidated entity with a third party (because they are now intercompany transactions that are eliminated in consolidation). Assume that upon consolidation of the variable interest (leasing) entity, the noncontrolling interest in the newly consolidated leasing entity will be reported as equity (minority interest).

At issue is the accounting upon consolidation for the net gain or loss that had been reported in accumulated OCI related to that discontinued cash flow hedge.

Example 2—Discontinued Cash Flow Hedge Arising from Consolidation

A special-purpose leasing entity is established based on a $3,000 equity contribution by an independent equity participant whose terms are mandatorily redeemable for a fixed amount. The leasing entity borrows $97,000 with LIBOR-based interest payable quarterly and principal repayable as a lump sum at maturity and purchases a $100,000 asset. Company A leases the asset for a variable quarterly lease payment equal to the sum of (a) the leasing entity's LIBOR-based quarterly interest payment, (b) a LIBOR-based return to the equity participant that is paid quarterly, and (c) a fixed amount to cover the leasing entity's insurance, maintenance, and other costs. Company A enters into a receive-LIBOR, pay-fixed interest rate swap (with a $100,000 notional amount) and designates the swap as a cash flow hedge of all of its exposure to the variability of its LIBOR-based cash outflows under the lease. Prior to the initial application of Interpretation 46 or 46(R), Company A had not been consolidating the special-purpose leasing entity.

Upon initial application of Interpretation 46 or 46(R), the special-purpose leasing entity is considered a variable interest entity; assume that it must be consolidated by Company A. The original cash flow hedge must be discontinued because the hedged forecasted transactions (the LIBOR-based lease payments) are no longer eligible forecasted transactions of the consolidated entity with a third party (because they are now intercompany transactions that are eliminated in consolidation). Assume that upon consolidation of the variable interest (leasing) entity, the noncontrolling interest in the newly consolidated leasing entity will be reported as a liability in the consolidated financial statements.

At issue is the accounting upon consolidation for the net gain or loss that had been reported in accumulated OCI related to that discontinued cash flow hedge.

Example 3—Discontinued Fair Value Hedge Arising from Deconsolidation
Bank B establishes a special-purpose trust to issue preferred stock to investors. The preferred stock is mandatorily redeemable on a specified date and specifies a fixed periodic (such as quarterly or annual) dividend. The proceeds of the issuance are paid to Bank B and the bank records a liability to the trust. However, because Bank B consolidates the trust, the bank's liability to the trust is eliminated in its consolidated financial statements. Assume that the trust's mandatorily redeemable preferred stock is reported as a "trust preferred certificates" liability in the consolidated financial statements.

Bank B enters into a receive-fixed, pay-LIBOR interest rate swap (with a $100,000 notional amount) and designates the swap as a fair value hedge of its exposure to changes in the fair value of the liability for the trust preferred certificates. (Had the trust's mandatorily redeemable preferred stock not been reported as a liability in the consolidated financial statements, the preferred stock could not have been designated as the hedged item in a fair value hedge under Statement 133.)

Assume that upon initial application of Interpretation 46 or 46(R), Bank B concludes that the special-purpose trust is a variable interest entity and that the bank is not the primary beneficiary of the trust; consequently, Bank B deconsolidates the trust, thereby excluding the trust preferred certificates from the consolidated financial statements. However, Bank B would report its liability to the trust in the consolidated financial statements. The original fair value hedge must be discontinued because the hedged item (that is, the liability for the trust preferred certificates) no longer exists as a liability in Bank B's consolidated financial statements.

At issue is the accounting upon deconsolidation for the net effect of fair value hedge accounting adjustments on the carrying amount of the hedged item and whether that net effect on the date of deconsolidation can be reported as an adjustment of the carrying amount for the bank's liability to the trust.

RESPONSE

If a reporting entity is required to discontinue a pre-existing hedging relationship upon the initial application of Interpretation 46 or 46(R) due to the required consolidation of another entity in (or the deconsolidation of that entity from) the reporting entity's consolidated financial statements, the adjustments of the reporting entity's financial statements must reflect the ongoing effect of the previous hedge accounting for those discontinued relationships in a manner consistent with the reporting entity's risk management policy and the objectives of those discontinued hedging relationships. Reflecting that ongoing effect of those discontinued relationships will involve identification and designation of surrogate hedged items for discontinued fair value hedges and surrogate hedged forecasted transactions for discontinued cash flow hedges. The surrogate hedged items and hedged forecasted transactions would need to have met (on a retroactive basis) the qualifying criteria applicable to those items and transactions (other than the requirement for contemporaneous documentation).

The identification of surrogate hedged items and hedged transactions relates solely to reflecting the ongoing effect of the discontinued hedging relationships, that is, how the basis adjustments arising from fair value hedge accounting and the amounts in OCI arising from cash flow hedge accounting should affect earnings in future periods.

Example 1—Discontinued Cash Flow Hedge Arising from Consolidation

Because the hedged forecasted transactions (that is, the LIBOR-based lease payments to the special-purpose leasing entity) on the discontinued cash flow hedge were related to the LIBOR-based interest payments on the leasing entity's LIBOR-based variable-rate debt, Company A should, upon consolidation of the variable interest (leasing) entity, designate the LIBOR-based interest payments on that newly consolidated debt as the surrogate hedged forecasted transactions for purposes of the subsequent accounting for the amounts in accumulated OCI related to the discontinued cash flow hedge at the date the hedge was discontinued.

Under that surrogate designation, the amounts in accumulated OCI related to the discontinued cash flow hedge would be reclassified into earnings in the same period or periods during which the hedged LIBOR-based interest payments on the newly consolidated debt affects earnings, pursuant to the provisions of paragraph 31 of Statement 133. The amounts in accumulated OCI related to the discontinued cash flow hedge would not be reclassified into earnings immediately upon consolidation.

The provisions of paragraph 28 of Interpretation 46 and paragraph 37 of Interpretation 46(R) do not specifically address the amounts in OCI because those paragraphs address the carrying amounts of only the assets, liabilities, and noncontrolling interests of the variable interest (leasing) entity. But the notion in those paragraphs about measurement in the consolidated financial statements being determined as if the Interpretation had been effective when the reporting entity first met the conditions to be the primary beneficiary is relevant to the subsequent accounting for the amounts in OCI related to the discontinued cash flow hedge. The accounting under Statement 133 should be based on the assumption that if the leasing entity had been consolidated, that entity's receive-LIBOR, pay-fixed interest rate swap would have likely been designated as the hedging instrument in a cash flow hedge of all or a portion of the consolidated entity's exposure to the variability of the LIBOR-based cash outflows related to the interest payments on the leasing entity's debt.

Example 2—Discontinued Cash Flow Hedge Arising from Consolidation

Because the hedged forecasted transactions (that is, the LIBOR-based lease payments to the special-purpose leasing entity) on the discontinued cash flow hedge were related to (a) the quarterly LIBOR-based interest payments on the leasing entity's LIBOR-based variable-rate debt and (b) the LIBOR-based return to the equity participant that is being paid quarterly, Company A should, upon consolidation of the variable interest (leasing) entity, designate both the quarterly LIBOR-based interest payments on that newly consolidated debt and the quarterly payments on the newly consolidated liability to the equity participant as the surrogate hedged forecasted

transactions for purposes of the subsequent accounting for the amounts in accumulated OCI related to the discontinued cash flow hedge at the date the hedge was discontinued.

Under that surrogate designation, only 97 percent of the amounts in accumulated OCI related to the discontinued cash flow hedge would relate to the LIBOR-based interest payments (on that newly consolidated debt) that are being designated as the surrogate hedged forecasted transactions (for 97 percent of the hedging swap). Because the noncontrolling interest is reported as a liability, the remaining 3 percent of the amounts in accumulated OCI related to the discontinued cash flow hedge would relate to the LIBOR-based payments to that noncontrolling interest (the equity participant), which would be designated as the surrogate hedged forecasted transactions (for 3 percent of the hedging swap). (In contrast, if the noncontrolling interest would have been reported as equity [minority interest] in the consolidated financial statements, the LIBOR-based payments to that noncontrolling interest would not be eligible under paragraph 29(f) of Statement 133 for designation as the hedged forecasted transaction, in which case the remaining 3 percent of the amounts in accumulated OCI related to the discontinued cash flow hedge would be removed from accumulated OCI and recognized as part of the cumulative effect of an accounting change.) If any timing difference exists between the LIBOR-based lease payments to the special-purpose leasing entity (the original hedged transaction) and the LIBOR-based interest payments on the leasing entity's variable-rate debt (the surrogate hedged transaction) that creates ineffectiveness with respect to the surrogate hedged transaction that would have been recognized under paragraph 30 of Statement 133, that ineffectiveness should be recognized as part of the cumulative effect of an accounting change and should adjust the 97 percent of the amounts in accumulated OCI related to the discontinued cash flow hedge.

For the 97 percent of the amounts in accumulated OCI related to the discontinued cash flow hedge, they would be reclassified into earnings in the same period or periods during which the LIBOR-based interest payments on the newly consolidated debt affect earnings, pursuant to the provisions of paragraph 31 of Statement 133. Similarly, for the remaining 3 percent of those amounts in accumulated OCI, they would be reclassified into earnings in the same period or periods during which the LIBOR-based payments on the liability to the equity participant affect earnings. The amounts in accumulated OCI related to the discontinued cash flow hedge would not all be reclassified into earnings immediately upon consolidation.

Example 3—Discontinued Fair Value Hedge Arising from Deconsolidation

Because the hedged item (that is, the liability for the trust preferred certificates) on the discontinued fair value hedge was related to Bank B's liability to the trust, Bank B should, upon deconsolidation of the variable interest entity (the trust), designate its liability to the trust as the surrogate hedged item for purposes of removing the trust from the consolidated financial statements. The net basis adjustment of the liability for the trust preferred certificates made under fair value hedge accounting and remaining at the date the fair value hedge is discontinued should be used to adjust the carrying amount of Bank B's liability to the trust. Although the classification of trust preferred certificates is addressed in FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, at the time

this Implementation Issue was cleared, the Board had deferred the effective date for aspects of the guidance in Statement 150 with respect to certain instruments, including certain trust preferred certificates. Refer to FASB Staff Position No. FAS 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*."

Special Application of the Shortcut Method

If the initial application of Interpretation 46 or 46(R) causes the discontinuance of a pre-existing hedging relationship for which effectiveness was being assessed under the shortcut method in paragraph 68 of Statement 133 and the company designates a new hedging relationship, the new hedging relationship can qualify for the shortcut method if the following criteria are met:

1. The new hedging relationship meets all conditions in paragraph 68 other than the condition in paragraph 68(b).
2. The designation of the new hedging relationship was completed at the same time that the pre-existing hedging relationship was discontinued.
3. The hedging derivative in the new hedging relationship is all or a proportion of the hedging derivative used in the discontinued pre-existing hedging relationship.
4. The hedged item or the hedged transaction in the new hedging relationship is the surrogate for the discontinued pre-existing hedging relationship.
5. The discontinued pre-existing hedging relationship had qualified for and had been accounted for under the shortcut method.

If an entity had already applied Interpretation 46 and had designated a new hedging relationship (that meets all of the above criteria) contemporaneous with the discontinuance of a pre-existing hedging relationship due to the change in consolidation practices, the entity is allowed to apply the shortcut method to that new hedging relationship even though the use of the shortcut method had not been documented at the inception of that new hedging relationship. That entity should report the accounting effects of initially applying the shortcut method to the new hedging relationship as a cumulative change in accounting principles in the first fiscal quarter that ends after November 10, 2003 (as discussed in the effective date and transition section below).

Application of This Guidance

The guidance in this Issue applies to the adjustments made with respect to the previous hedge accounting for a pre-existing hedging relationship that was discontinued because of the consolidation or deconsolidation of another entity due to the initial application of Interpretation 46 or 46(R). The guidance in this Issue should also be applied by analogy to situations in which the issuance of new authoritative guidance results in a reporting entity becoming a primary beneficiary under Interpretation 46(R) and, therefore, must consolidate the related VIE. The guidance does not address the discontinuance of hedging relationships

attributable to the consolidation or deconsolidation of another entity due to a change in ownership, control, or other circumstances.

The guidance in this Issue does not affect the designation of new hedging relationships on or after the date of initial application of Interpretation 46 or 46(R). Such new hedging relationships need to comply with all applicable requirements of Statement 133 (as amended) except with respect to the special use of the shortcut method as previously discussed.

At its November 5, 2003 meeting, the Board reached the above answer. Absent that, the staff would not have been able to provide guidance that permits (a) the identification of a surrogate hedged item or hedged transaction that would impact the ongoing effect of the previous hedge accounting for those hedging relationships discontinued due to a change in consolidation practices related to application of Interpretation 46 or 46(R) and (b) the new hedging relationship to qualify for the shortcut method without meeting the conditions in paragraph 68(b) at the inception of that hedging relationship.

EFFECTIVE DATE(S) AND TRANSITION

The effective date(s) of the implementation guidance in this Issue for each reporting entity is the date of initial application of Interpretation 46 and/or 46(R). Consequently, the identification and designation of the surrogate hedged items and hedged transactions may need to be made retroactively as of that date(s). If an entity has already applied Interpretation 46 and issued financial statements for the period that reported the resulting change in accounting principle, that entity should report the accounting effects of initially applying the guidance in this Implementation Issue as a cumulative effect of an accounting change in its first fiscal quarter that ends after November 10, 2003, the date that the Board-cleared guidance was posted on the FASB website.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Hedging—General: Issues Involving the Application of the Shortcut Method under Paragraph 68
Paragraph references:	63, 68–70, 114, 132
Date cleared by Board:	December 20, 2007
Date posted to website:	January 10, 2008

INTRODUCTION

This Implementation Issue addresses two issues that have caused implementation difficulties in the application of paragraph 68 of Statement 133 (the shortcut method). This Implementation Issue amends the accounting and reporting standards of Statement 133, paragraph 68, as indicated below.

STATEMENT 133 IMPLEMENTATION ISSUE GUIDANCE

Paragraph 68 (Introductory Paragraph)

1. The shortcut method may be applied to a qualifying fair value hedge when the relationship is designated on the trade date of both the swap and the hedged item (for example, debt), even though the hedged item is not recognized for accounting purposes until the transaction settles (that is, until its settlement date), provided that the period of time between the trade date and the settlement date of the hedged item is within established conventions for that marketplace.

Paragraph 68(b)

2. Paragraph 68(b) is met for an interest rate swap that has a non-zero fair value at the inception of the hedging relationship provided that the swap was entered into at the hedge's inception for a transaction price of zero and the non-zero fair value is due solely to the existence of a bid-ask spread in the entity's principal market (or most advantageous market, as applicable) under FASB Statement No. 157, *Fair Value Measurements*. The interest rate swap would be reported at its fair value as determined under Statement 157.

AMENDMENTS TO STATEMENT 133

Paragraph 68 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is amended as follows: [Added text is underlined and deleted text is ~~struck out~~.]

> 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. If all of the applicable conditions in the following subparagraphs are met, ~~A~~an entity may assume no

ineffectiveness in a hedging relationship of interest rate risk involving a recognized interest-bearing asset or liability (or a firm commitment arising on the trade [pricing] date to purchase or issue an interest-bearing asset or liability) and an interest rate swap (or a compound hedging instrument composed of an interest rate swap and a mirror-image call or put option as discussed in paragraph 68(d) below) provided that, in the case of a firm commitment, the trade date of the asset or liability differs from its settlement date due to generally established conventions in the marketplace in which the transaction is executed. ~~if all of the applicable conditions in the following list are met:~~

Conditions applicable to both fair value hedges and cash flow hedges

b. If the hedging instrument is solely an interest rate swap, the fair value of that swap at the inception of the hedging relationship must be ~~is~~ zero, with one exception. The fair value of the swap may be other than zero at the inception of the hedging relationship only if the swap was entered into at the relationship's inception, the transaction price of the swap was zero in the entity's principal market (or most advantageous market), and the difference between transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction.[18b1] If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in paragraph 68(d), the premium for the mirror-image call or put option must be paid or received in the same manner as the premium on the call or put option embedded in the hedged item. That is, the reporting entity must determine whether the implicit premium for the purchased call or written put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium) or is being paid over the life of the hedged item (through an adjustment of the interest rate). If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition, the fair value of the hedging instrument at the inception of the hedging relationship must be equal to the fair value of the mirror-image call or put option. In contrast, if the implicit premium for the call or put option embedded in the hedged item is principally being paid over the life of the hedged item, fair value of the hedging instrument at the inception of the hedging relationship must be zero (except as discussed previously regarding differing prices due to the existence of a bid-ask spread).

[18b1] This guidance is applicable only to transactions considered "at market" (that is, transaction price is zero exclusive of commissions and other transaction costs, as discussed in paragraph 9 of FASB Statement No. 157, *Fair Value Measurements*).

[Note: Because subparagraphs (a), (c), (d), (dd), and (e–k) are not amended by this Implementation Issue, they have been omitted.]

EFFECTIVE DATE AND TRANSITION

The implementation guidance in this Issue is effective for hedging relationships designated on or after January 1, 2008.

At adoption, an entity shall assess preexisting hedging relationships to determine whether they met the requirements of this Implementation Issue as of the inception of the hedging relationship. An entity that had designated a qualifying hedging relationship utilizing the shortcut method that does not qualify for the shortcut method based on this amendment must dedesignate that hedging relationship prospectively (that is, the hedging relationship must be dedesignated at the effective date). If the hedging relationship had been a fair value hedge, the recognition in earnings due to adjustment of the carrying amount of the hedged asset or liability for the period prior to the effective date shall not be reversed. If the hedging relationship had been a cash flow hedge, the derivative's gain or loss for the period prior to the effective date shall remain in accumulated other comprehensive income and be reclassified into earnings when the hedged transaction affects earnings in accordance with paragraph 33 of Statement 133.

Under this transition, a hedging relationship that does not qualify for the shortcut method based on this Implementation Issue could be redesignated without application of the shortcut method in paragraph 68 if that hedging relationship meets the applicable requirements of Statement 133.

The above response has been unanimously approved by the Board by written ballot.

BASIS FOR CONCLUSIONS

At the February 15, 2006 Board meeting, the Board agreed to add a project to its agenda that would provide clarifying language to Statement 133 in response to inquiries received involving the application of the shortcut method. The objective of this Implementation Issue is to improve financial reporting by addressing uncertainty in practice about when an entity qualifies for the shortcut method.

Settlement of Hedged Item Occurs Subsequent to Swap Trade Date

It is customary for a debtor or investor to enter into an at-market interest rate swap at the date the issuance or purchase of an interest-bearing asset or liability is firmly committed to and priced (referred to herein as the trade date), because at that date the debtor or investor begins to be exposed to changes in interest rates. The debt obligation often is not recognized for financial reporting purposes until it is issued several days later (on the settlement date). Consequently, if a hedging relationship is designated on the trade date, the hedged item may not yet be a recognized asset or liability. Given that the practice described above is common, concern has arisen as to whether the fair value hedging relationship meets the requirement in paragraph 68 (that the hedged item must be a recognized asset or liability). The Board decided that such market realities should not disqualify the use of the shortcut method provided that the difference between the trade date and the settlement date are in accordance with normal market terms and conventions.

Application of Paragraph 68(b) When the Transaction Price of Interest Rate Swap Is Zero

Paragraph 68(b) of Statement 133 requires the fair value of an interest rate swap at the inception of the hedging relationship to be zero to meet that requirement for the shortcut method. Prior to the issuance of Statement 157, the fair value of a derivative that was entered into in the reporting entity's principal market was generally considered to be the transaction price (which is an entry price). Upon adoption of Statement 157, the fair value of an interest rate swap at initial recognition would be based on an exit price, as discussed in paragraph 31 of Statement 157, which might be other than zero due to the existence of a bid-ask spread. As a result, an entity might not pay or receive an amount at inception of the interest rate swap, but due to differences in the bid-ask spread in its principal market, the fair value at inception of the hedging relationship may be other than zero. The Board decided in this Implementation Issue that when a company enters into an interest rate swap with a transaction price of zero in its principal (or most advantageous) market, a difference between transaction price and fair value that is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction would not preclude the application of the shortcut method.

Board Redeliberations on the Exposure Draft to E23

The exposure draft (that is, the Proposed Implementation Issue) for Implementation Issue E23 included the following proposed guidance on other issues in addition to the issues discussed above:

Paragraph 68(a)

1. Paragraph 68(a) is met if (a) the notional amount of the swap and the principal amount of the hedged item match for each hedged interest payment for a cash flow hedge or match over the entire term of the hedged item for a fair value hedge, and (b) the notional amount of the fixed leg of the swap matches the notional amount of the variable leg of the swap throughout the life of the hedging relationship.

Paragraph 68(e)

1. Paragraph 68(e) is met if the terms of the interest rate swap and the interest-bearing financial instrument **both** are typical for those instruments **and** do not invalidate the assumption of no ineffectiveness.
2. The par value of the hedged item is not required to equal its fair value at inception of the hedging relationship provided that the difference (a discount or premium) is attributable solely to the market convention of rounding the coupon rate.
3. A fair value hedging relationship that begins subsequent to initial recognition of the hedged item would not meet paragraph 68(e).
4. A hedge of a zero-coupon financial instrument fails paragraph 68(e) because the interest rate swap contains a financing element (fixed payments on the fixed leg of the swap are being financed); it also fails paragraph 68(a) because the notional amount of the fixed leg of the swap does not match the notional amount of the variable leg of the swap throughout the life of the hedging relationship.

The Board decided to provide guidance in this Implementation Issue about (a) the circumstance in which the settlement of the hedged item occurs subsequent to the swap's trade date and (b) the application of paragraph 68(b) when the transaction price of interest rate swap is zero. However, the Board decided not to address the other issues that had been included in the Proposed Implementation Issue because the Board believes those issues to be less pressing and because the Board is actively considering, in another project, an approach to simplify hedge accounting that would involve eliminating all use of the shortcut method described in paragraph 68 of Statement 133.

Title:	Fair Value Hedges: Stratification of Servicing Assets
Paragraph references:	21(a), footnote 9 (to paragraph 21), 56
Date cleared by Board:	February 17, 1999
Date revision posted to website:	June 16, 2006
Affected by:	FASB Statement No. 156, *Accounting for Servicing of Financial Assets*

Revised March 17, 2006

QUESTION

Can an entity use different stratification criteria for the impairment test for servicing assets subsequently measured using the amortization method permitted by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (as amended by Statement 156), and for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge under Statement 133?

RESPONSE

Yes. An entity may use different stratification criteria for the purposes of Statement 140, as amended by Statement 156, impairment testing and for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge under Statement 133. An entity is not required to change the stratification criteria used for the purposes of impairment testing under Statement 140 as a result of using different stratification criteria for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge. However, upon adoption of Statement 133, an entity is permitted to restratify its servicing assets pursuant to paragraph 63(f) of Statement 140 such that the risk strata specified for Statement 133 fair value hedging purposes would also be used for Statement 140 impairment testing purposes.

In order to qualify as a portfolio of similar assets that may be designated as a hedged item in a fair value hedge under Statement 133, servicing assets may be grouped using risk strata that meet the criteria in paragraph 21(a). Specifically, paragraph 21(a) requires that if the hedged item in a fair value hedge is a portfolio of similar assets, such as a portfolio of existing mortgage servicing assets, the individual assets must share the risk exposure for which they are designated as being hedged. Also, the change in fair value attributable to the hedged risk for each individual item in the hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. Footnote 9 to paragraph 21(a)(1) of the Statement states:

> Mortgage bankers and other servicers of financial assets that designate a hedged portfolio by aggregating servicing rights within one or more risk strata used under paragraph 63(f) of Statement 140 would not necessarily comply with the requirement in this paragraph for portfolios of similar assets. The risk strata under paragraph 63)f) of Statement 140 can be based on any predominant risk characteristic, including date of origination or geographic location.

Because the existing risk strata used for Statement 140 impairment testing may not be sufficient to satisfy the requirements of paragraph 21 of Statement 133, paragraph 56 permits restratification of servicing assets under Statement 140 for fair value hedging purposes upon the adoption of Statement 133. Paragraph 56 states, "...mortgage bankers and other servicers of financial assets may choose to restratify their servicing rights pursuant to paragraph 63(f) of Statement 140 in a manner that would enable individual strata to comply with the requirements of this Statement regarding what constitutes 'a portfolio of similar assets.'"

If an entity chooses not to restratify servicing assets for Statement 140 impairment testing consistent with any restratification done for compliance with Statement 133 hedging criteria, the entity would be required to record any adjustments resulting from a fair value hedge to the risk strata used for impairment testing under paragraph 63(f) of Statement 140.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Fair Value Hedges: Partial-Term Hedging
Paragraph references: 21(a)(2)(b), 349, 350, 434, footnote 32 (to paragraph 435)
Date cleared by Board: July 28, 1999

Revised September 25, 2000

QUESTION

May a company designate an interest rate swap with a term of 3 years and a notional amount equal to the principal amount of its 10-year nonamortizing fixed-rate debt as the hedging instrument in a hedge of the exposure to changes in fair value, attributable to changes in the designated benchmark interest rate, of the company's obligation to make interest payments during the first 3 years of the debt? For example, a company that has issued $100 million of 10-year nonamortizing fixed-rate debt with a coupon rate of 8.25 percent may wish to enter into a 3-year receive-fixed, pay-variable interest rate swap with a notional amount of $100 million. The company believes that interest rates will decline during the first three years of the debt's term and it wishes to hedge its exposure for only that three-year period.

BACKGROUND

Paragraph 21(a)(2)(b) of Statement 133 indicates that if the hedged item in a fair value hedge is a specific portion of an asset or liability (or a portfolio of similar assets or a portfolio of similar liabilities), the hedged item may be the right to receive or obligation to pay one or more selected contractual cash flows (such as the portion of the asset or liability representing the present value of the interest payments in the first two years of a four-year debt instrument).

Paragraph 434 of the basis for conclusions, which relates to the qualifying criteria for fair value hedges, states:

> The Board was reluctant to permit identification of a selected portion (rather than proportion) of an asset or liability as the hedged item because it believes that, in many cases, partial-term hedge transactions would fail to meet the offset requirement. For example, the changes in the fair value of a two-year interest rate swap cannot be expected to offset the changes in fair value attributable to changes in market interest rates of a four-year fixed-rate debt instrument. For offset to be expected, a principal repayment on the debt (equal to the notional amount on the swap) would need to be expected at the end of year two. The Board decided to remove the prohibition against partial-term hedging and other designations of a portion of an asset or liability to be consistent with the modification to the Exposure Draft to require an entity to define how the expectation of offsetting changes in fair value or cash flows would be assessed. However, removal of that criterion does not necessarily result in qualification for hedge accounting for partial-term or other hedges of part of an asset or a liability.

Footnote 32 to paragraph 435, which relates to paragraph 21(a)(2)(b), states, "However, as noted in paragraph 434, it likely will be difficult to find a derivative that will be effective as a fair value hedge of selected cash flows."

RESPONSE

No. A company may not designate a 3-year interest rate swap with a notional amount equal to the principal amount of its nonamortizing debt as the hedging instrument in a hedge of the exposure to changes in fair value, attributable to changes in the designated benchmark interest rate, of the company's obligation to make interest payments during the first 3 years of its 10-year fixed-rate debt instrument. There would be no basis for expecting that the change in that swap's fair value would be highly effective in offsetting the change in fair value of the liability for only the interest payments to be made during the first three years. Even though under certain circumstances a partial-term fair value hedge can qualify for hedge accounting under Statement 133, the provisions of that Statement do not result in reporting a fixed-rate 10-year borrowing as having been effectively converted into a 3-year floating-rate and 7-year fixed-rate borrowing as was previously accomplished under synthetic instrument accounting prior to Statement 133. Synthetic instrument accounting is no longer acceptable under Statement 133, as discussed in paragraphs 349 and 350.

By indicating that the hedged item in a fair value hedge may be one or more selected contractual cash flows, paragraph 21(a)(2)(b) permits a company to hedge one or more individual interest payments during a selected portion of the term of a debt instrument. For example, a company may hedge the fair value of its obligation to make the interest payments occurring during the first 3 years of a 10-year debt instrument, as described in the example in the question. The derivative selected as the hedging instrument in a partial-term fair value hedge must be highly effective at offsetting changes in fair value of the group of selected individual cash flows designated as being hedged. A partial-term fair value hedge of one or more selected contractual cash flows may be achieved under paragraph 21(a)(2)(b) by designating an appropriate derivative instrument (or instruments) as the hedging instrument. For example, the instrument designated as hedging those individual coupon payments could be described as a derivative that can hedge the changes in the fair value of a zero-coupon bond that corresponds to the timing and amount of each individual interest payment.

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Title:	Fair Value Hedges: Firm Commitments —Statutory Remedies for Default Constituting a Disincentive for Nonperformance
Paragraph references:	440–442
Date cleared by Board:	November 23, 1999

QUESTION

Would the requirement that a firm commitment "includes a disincentive for nonperformance that is sufficiently large to make performance probable" be met if the agreement includes no explicit monetary penalty for nonperformance, but the legal jurisdiction that governs the agreement provides remedies for default equivalent to the damages suffered in the event of nonperformance?

BACKGROUND

Statement 133, paragraph 540, defines a firm commitment as follows:

> 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.

At issue is whether the disincentive for nonperformance that is sufficiently large to make performance probable can exist outside the agreement.

For example, Company A enters into an agreement to purchase 4,000 barrels of a common solvent from a chemical company at $200 per barrel on June 1, 2000. The provisions of the agreement do not include a specific disincentive for nonperformance that is sufficiently large to make performance probable. However, the laws of the legal jurisdiction to which the agreement is subject provide a disincentive for nonperformance if Company A does not take delivery of the barrels pursuant to the agreement. The solvent is not readily convertible to cash.

RESPONSE

Yes. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and

of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment. The binding provisions of an agreement are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject.

Therefore, because the governing legal jurisdiction provides statutory rights to pursue remedies for default equivalent to the damages suffered, the example agreement described above includes a disincentive for nonperformance that is sufficiently large to make performance probable for purposes of applying the definition of a firm commitment.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Fair Value Hedges: Interaction of Statement 133 and Statement 114
Paragraph references:	18, 27
Date cleared by Board:	November 23, 1999
Affected by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*
	Revised September 25, 2000

QUESTION

Because fair value hedge accounting under Statement 133 requires the carrying amount of a hedged loan to be adjusted for changes in fair value attributable to the hedged risk, does Statement 133 implicitly affect the measurement of impairment under FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, by requiring the present value of expected future cash flows to be discounted by the new effective rate (based on the adjusted recorded investment) rather than by the old effective rate?

BACKGROUND

Company A formally documents a qualifying fair value hedge (for fair value changes attributable to changes in the designated benchmark interest rate) between a fixed-rate loan receivable from Company B and an interest rate swap. The 5-year, fixed-rate loan to Company B has a principal amount of $1,000,000 payable at maturity and interest payable annually at a 10 percent rate. One year after inception of the hedging relationship, the change in the hedged item's fair value attributable to changes in the LIBOR swap rate (the designated benchmark interest rate) is a gain of $16,022. (Refer to Row B in the following exhibit, which presents calculations—at the end of the first year of the loan's term—of the net present value of contractual cash flows based on the loan's original effective interest rate adjusted for a 50 basis point decrease in the LIBOR swap rate.) In addition, one year after inception of the hedging relationship, (1) the market interest rates for debtors of Company B's original credit sector have decreased to 9.2 percent (50 basis points related to changes in the LIBOR swap rate and 30 basis points related to changes in sector spread) and (2) there has been an adverse change to Company B's creditworthiness.

Assume that the repayment of the loan is not dependent on the underlying collateral. In applying the requirements of Statement 114 to the loan, Company A determines that the loan is impaired and that the present value of expected future cash flows discounted at the loan's effective interest rate at inception of the loan is $930,000. (Refer to Row C in the following exhibit, which presents calculations—at the end of the first year of the loan's term—of the net present value of current estimates of expected future cash flows based on the loan's original effective interest rate.)

Paragraph 27 of Statement 133 states:

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

Statement 133 gives an entity flexibility in deciding when to begin the amortization to earnings of the adjustments of the loan's carrying amount arising from fair value hedge accounting. Paragraph 24 states, in part:

> An adjustment of the carrying amount of a hedged interest-bearing financial instrument shall be amortized to earnings; amortization shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

RESPONSE

Yes. Statement 133 has implicitly affected the measurement of impairment under Statement 114 by requiring the present value of expected future cash flows to be discounted by the new effective rate based on the adjusted recorded investment in a hedged loan. When the recorded investment of a loan has been adjusted under fair value hedge accounting, the effective rate is the discount rate that equates the present value of the loan's future cash flows with that adjusted recorded investment. The adjustment under fair value hedge accounting of the loan's carrying amount for changes in fair value attributable to the hedged risk under Statement 133 should be considered to be an adjustment of the loan's recorded investment.

The loan's original effective interest rate becomes irrelevant once the recorded amount of the loan is adjusted for any changes in its fair value. Since paragraph 27 requires that the loan's carrying amount be adjusted for hedge accounting before the impairment requirements of Statement 114 are applied, Statement 133 implicitly supports using the new effective rate and the adjusted recorded investment.

After adjusting the carrying amount of the hedged loan by $16,022 (pursuant to paragraph 22 of Statement 133) for the increase in the hedged item's fair value attributable to changes in the benchmark interest rate, Company A should apply the requirements of paragraph 13 of Statement 114 by:

a. Comparing the recorded investment of the loan after the effect of the fair value hedge, or $1,016,022, to the $944,901 present value of expected future cash flows discounted using

the rate that reflects the rate of return implicit in the loan after adjusting the carrying amount of the hedged loan pursuant to paragraph 22 of Statement 133 (that is, 9.5 percent), then

b. Recognizing an impairment by creating a valuation allowance (with the offsetting entry charged to expense) for the difference of $71,121 ($1,016,022 - $944,901).

The above guidance applies to all entities applying Statement 114 to financial assets that are hedged items in a fair value hedge, regardless whether those entities have delayed amortizing to earnings the adjustments of the loan's carrying amount arising from fair value hedge accounting until the hedging relationship is dedesignated. The guidance in this Issue on recalculating the effective rate is not intended to be applied to all other circumstances that result in an adjustment of a loan's carrying amount.

EXHIBIT

Following are calculations (at the end of the first year of the loan's term) of the net present value (NPV) of the contractual cash flows and the creditor's best estimate of expected future cash flows based on the loan's original effective interest rate and the new implicit rate.

		NPV at End	Assumed Cash Flow in Year			
	Rate	of Year 1	2	3	4	5
A. Original Cash Flows and Original Effective Rate	10.0%	$1,000,000	$100,000	$100,000	$100,000	$1,100,000
B. Original Cash Flows and New Implicit Rate	9.5%	$1,016,022	$100,000	$100,000	$100,000	$1,100,000
C. Expected Future Cash Flows and Original Effective Rate	10.0%	$930,000	$93,000	$93,000	$93,000	$1,023,000
D. Expected Future Cash Flows and New Implicit Rate	9.5%	$944,901	$93,000	$93,000	$93,000	$1,023,000

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Fair Value Hedges: Basing the Expectation of Highly Effective Offset on a Shorter Period Than the Life of the Derivative
Paragraph references: 20(a), 20(b), 386–390
Date cleared by Board: November 23, 1999

QUESTION

If a derivative with a five-year term is designated as the hedging instrument in a fair value hedge of a financial asset that also has a five-year term, may an entity base its expectation that the hedging relationship will be highly effective in achieving offsetting changes in fair value for the risk being hedged by considering the possible changes in value occurring only over a shorter period than the life of the derivative, for example, over only the first three months of the derivative's five-year life?

BACKGROUND

To qualify for fair value hedge accounting, Statement 133 requires that an entity must expect the hedging relationship to be highly effective in achieving offsetting changes in fair value for the risk being hedged. The Statement does not specify the method to be used in assessing the hedge's effectiveness in achieving offsetting changes in fair values nor does it specify how the expectation of highly effective offset should be determined. However, the Statement requires that the assessment of effectiveness be consistent with the risk management strategy documented for that particular hedging relationship. Furthermore, an assessment of effectiveness is required whenever financial statements or earnings are reported and at least every three months.

RESPONSE

Yes. In documenting its risk management strategy for a fair value hedge, an entity may specify an intent to consider the possible changes (that is, not limited to the likely or expected changes) in value of the hedging derivative and the hedged item only over a shorter period than the derivative's remaining life in formulating its expectation that the hedging relationship will be highly effective in achieving offsetting changes in fair value for the risk being hedged. The entity does not need to contemplate the offsetting effect for the entire term of the hedging instrument.

Thus, in the example cited above involving a five-year derivative hedging a five-year financial asset in a fair value hedge, an entity may specify, in documenting its risk management strategy, that every three months (a) it will assess the effectiveness of the existing hedging relationship for the past three-month period and (b) it intends to consider possible changes in value of the hedging derivative and the hedged item over the next three months in deciding whether it has an expectation that the hedging relationship will continue to be highly effective at achieving offsetting changes in fair value.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Fair Value Hedges: Concurrent Offsetting Matching Swaps and Use of One as Hedging Instrument
Paragraph references: 17, 20
Date cleared by Board: December 6, 2000

QUESTION

An entity that is the issuer of fixed-rate debt enters into an interest rate swap (Swap 1) and designates it as a hedge of the fair value exposure of the debt to interest rate risk. The fair value hedge of the fixed-rate debt involving Swap 1 meets the required criteria in paragraphs 20 and 21 of Statement 133 to qualify for hedge accounting. The entity simultaneously enters into a second interest rate swap (Swap 2) with the same counterparty with the exact mirror terms as Swap 1 and does not designate Swap 2 as part of that hedging relationship. Is the entity required to view the two swaps as a unit, and is it, therefore, precluded from applying fair value hedge accounting to swap 1, by analogy to Statement 133 Implementation Issue No. K1, "Determining Whether Separate Transactions Should Be Viewed as a Unit"?

BACKGROUND

Implementation Issue K1 addresses situations in which individual transactions that do not meet the definition of a derivative should be combined and viewed as a unit in order to determine whether the combination of the transactions meets the definition of a derivative for purposes of applying Statement 133. The Response in Implementation Issue K1 states, in part:

> If two or more separate transactions may have been entered into in an attempt to circumvent the provisions of Statement 133, the following indicators should be considered in the aggregate and, if present, should cause the transactions to be viewed as a unit and not separately:
>
> a. The transactions were entered into contemporaneously and in contemplation of one another.
> b. The transactions were executed with the same counterparty (or structured through an intermediary).
> c. The transactions relate to the same risk.
> d. There is no apparent economic need nor substantive business purpose for structuring the transactions separately that could *not* also have been accomplished in a single transaction.

RESPONSE

Generally, no. Statement 133 is a transaction-based standard. It generally does not provide for the combination of separate financial instruments to be evaluated as a unit, unless two or more

derivatives in combination are designated as a hedging instrument. The guidance in Implementation Issue K1 is an exception to the fundamental principle that Statement 133 is a transaction-based standard. However, the guidance in that issue is meant to be applied in circumstances in which there is an attempt to circumvent accounting for a derivative contract. In the example in the question section, the swaps were not entered into to circumvent the definition of a derivative in Statement 133.

However, similar to the reasoning in Implementation Issue K1, if certain indicators are present, those indicators should be considered in determining whether the overall intent of a transaction is to circumvent generally accepted accounting principles. That is, if separate derivative contracts are entered into contemporaneously and in contemplation of one another, if they are entered into with the same counterparty, if they relate to the same risk, and if there is no substantive business purpose for structuring the transactions separately, judgment should be applied to determine whether the separate derivative contracts have been entered into in lieu of a structured transaction in an effort to circumvent generally accepted accounting principles. In instances where such a determination is made, the derivative contracts should be viewed as a unit.

In the example in the question section (in which Swaps 1 and 2 were entered into contemporaneously with the same counterparty), if Swap 2 was entered into in contemplation of Swap 1 and the overall transaction was executed for the sole purpose of obtaining fair value accounting treatment for the debt, it should be concluded that the purpose of the transaction was not to enter into a bona fide hedging relationship involving Swap 1. In that case, the two swaps should be viewed as a unit and the entity would not be permitted to adjust the carrying value of the debt to reflect changes in fair value attributable to interest rate risk.

However, if Swap 2 was not entered into in contemplation of Swap 1 or there is a substantive business purpose for structuring the transactions separately, and if both Swap 1 and Swap 2 were entered into in arms-length transactions (that is, at market rates), then the swaps should not be viewed as a unit. For example, some entities have a policy that requires a centralized dealer subsidiary to enter into third-party derivative contracts on behalf of other subsidiaries within the organization to hedge the subsidiaries' interest rate risk exposures. The dealer subsidiary also enters into internal derivative contracts with those subsidiaries in order to operationally track those hedges within the organization. (In accordance with Statement 133 Implementation Issue No. J2, "Hedging with Intercompany Derivatives," internal derivatives do not qualify in consolidated financial statements as hedging instruments for risks other than foreign exchange risk.)

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Fair Value Hedges: Application of Written-Option Test in Paragraph 20(c) to Collar-Based Hedging Relationships
Paragraph reference: 20(c)
Date cleared by Board: December 6, 2000

QUESTIONS

The following questions involve the use of collar-based hedging instruments in fair value hedge transactions:

1. In applying paragraph 20(c), does an entity have the flexibility to exclude the time value of the hedging written option (or net written option) and consider only the change in its intrinsic value in measuring the potential gain or loss on the combination of the written option (or net written option) and the hedged item?
2. Must the special written-option test in paragraph 20(c) be applied both at inception and throughout the entire term of the hedging relationship?

BACKGROUND

An entity enters into an equity price collar with an investment bank to hedge the fair value exposure of an equity security that it holds as an available-for-sale security. That collar is indexed to the price of the equity security held and consists of a purchased put with the strike price equal to $40 per share (whereby the holder can put the equity security to the investment bank for $40 per share) and a written call with the strike price equal to $60 per share (whereby the investment bank can call the equity security from the holder for $60 per share). The collar has the effect of insulating the equity security holder from any losses caused by equity price decreases below $40 per share, but the holder must sacrifice any unrealized gains caused by equity price increases above $60 per share. The hedged equity security has a fair value of $50 per share at inception of the collar. If the underlying increases by 50 percent to $75, the intrinsic value of the collar will decrease from zero to a loss of $15 per share ($75 - $60). If the underlying decreases by 50 percent to $25, the intrinsic value of the collar will increase from zero to a gain of $15 per share ($40 - $25). Despite the symmetrical changes in the intrinsic value of the collar in response to an upward and a downward change in the equity index by the same percentage, the market views the likelihood that the underlying equity price will increase as greater than the likelihood that it will decrease. Accordingly, the investment bank is willing to pay a premium to the equity security holder.

The following table shows the calculation of the gain and loss for a market price move of 50 percent. (The special written-option test in paragraph 20(c) requires consideration of

all possible percentage favorable changes in the underlying [from zero percent to 100 percent] and *all* possible percentage unfavorable changes in the underlying.)

Table: Potential Gain and Loss on the Combination of the Hedged Item and the Net Written Option If the Market Moves Each Direction by the Same Percentage

(The time values of the options were selected to emphasize importance of the Issue.)

	Inception	Price Move up 50%	Price Move down 50%
Purchased Put			
Intrinsic Value	-	-	$15
Time Value	$4	$2	1
Fair Value	4	2	16
Written Call			
Intrinsic Value	-	(15)	-
Time Value	(6)	(4)	(4)
Fair Value	(6)	(19)	(4)
Equity Security	50	75	25
Combined Fair Value	$48	$58	$37

	Gain	Loss
Change in Fair Value of Combination from Inception	$10	$(11)
Percentage Change in Fair Value of Combination from Inception	21%	-23%

Paragraph 20(c) discusses the use of written options in fair value hedges and states the following:

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

Subparagraph 20(c)(1) states in part the following:

> A combination of options…entered into contemporaneously shall be considered a written option if either at inception or over the life of the contracts a net premium is received in cash or as a favorable rate or other term. (Thus, a collar can be designated

as a hedging instrument in a fair value hedge without regard to the test in paragraph 20(c) unless a net premium is received.)

RESPONSE

Question 1

Yes. The time value of the written option (or net written option) may be excluded from the special written-option test in paragraph 20(c) provided that, in defining how hedge effectiveness will be assessed, the entity specifies that it will base that assessment on only changes in the option's intrinsic value. Therefore, the change in the time value of the options would be excluded from the assessment of hedge effectiveness in accordance with paragraph 63(a). Accordingly, when applying the special written-option test to determine whether there is symmetry of the gain and loss potential of the combined hedged position for all possible percentage changes in the underlying, an entity is permitted to measure the change in the intrinsic value of the written option (or net written option) combined with the change in fair value of the hedged item.

Pursuant to paragraph 20(c)(1) and the guidance in Statement 133 Implementation Issue No. E2, "Combinations of Options," the combination of options in the example collar in the background section is a net written option from the equity security holder's perspective. Therefore, the special written-option test in paragraph 20(c) must be applied to determine whether the hedging relationship between the equity security and the collar qualifies for fair value hedge accounting. That test requires consideration of the potential gain and loss on the combined collar and equity security for all percentage changes in the equity index. Performance of that analysis demonstrates that the combination of the hedged item's price change and the net written option's intrinsic value change provides at least as much potential for gains as a result of a favorable change in their respective prices as exposure to losses from an unfavorable change in their respective prices.

The calculations in the table in the background section demonstrate that the example hedging relationship would fail the written-option test in paragraph 20(c) if the time value were required to be considered. The amount of the gain and the loss on the combination of the net written option (both time value and intrinsic value) and the equity security when the underlying equity price increases and decreases by the same percentage is not equivalent or symmetrical. That outcome is due to the fact that the purchased put and written call have different time values, and for a specific change in the underlying, the relative change in time value for each option will be different.

Question 2

No. The special written-option test in paragraph 20(c) must be applied only at inception of the hedging relationship. Otherwise, collar-based hedging relationships would generally fail the symmetry test as the underlying moves in a manner that causes the written-option portion of the collar to approach having intrinsic value. Therefore, a requirement to apply the symmetry test in paragraph 20(c) on an ongoing basis would effectively prohibit collar-based hedging relationships from receiving hedge accounting for the written-option portion of the collar.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Fair Value Hedges: Hedging Mortgage Servicing Right Assets Using Preset Hedge Coverage Ratios
Paragraph references:	20, 21, 369
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001
Date revision posted to website:	June 16, 2006
Affected by:	FASB Statement No. 156, *Accounting for Servicing of Financial Assets*

Revised March 17, 2006

QUESTION

In a fair value hedge of a portion of a recognized servicing right asset subsequently measured using the amortization method, may a company designate the hedged item at the inception of the hedge by initially specifying a series of possible percentages of the servicing right asset (that is, preset hedge coverage ratios) that each correspond to a specified independent variable? Under that approach, at the end of the hedge assessment period, the company would determine the hedged item and measure hedge ineffectiveness by determining retrospectively which hedge coverage ratio would be applied to the servicing right asset to identify the hedged item for that period. (That approach is in contrast to designating the hedged item at the inception of the hedge by specifying a single percentage of that recognized servicing right asset as the hedged item.)

BACKGROUND

Paragraph 21(a)(2) of Statement 133 states, in part, "If the hedged item is a specific portion of an asset or liability (or of a portfolio of similar assets or a portfolio of similar liabilities), the hedged item is one of the following: (a) *A percentage* of the entire asset or liability (or of the entire portfolio)…(emphasis added). Paragraph 21(a) begins by stating "The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability…." Paragraph 20(b) states, in part, "An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months."

Servicing rights are contracts to service loans, receivables, or other financial assets under which the servicer is obligated to perform specific administration functions and is compensated with contractually specified servicing fees. Servicing rights are separately recognized as either servicing assets or servicing liabilities when an entity undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations as stated in paragraph 13 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (as amended by Statement 156):

a. A transfer of the servicer's financial assets that meets the requirements for sale accounting
b. A transfer of the servicer's financial assets to a qualifying SPE [special-purpose entity] in a **guaranteed mortgage securitization** in which the transferor retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates.

An entity that transfers its financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as debt securities held-to-maturity in accordance with Statement 115 may either separately recognize its servicing assets or servicing liabilities or report those servicing assets or servicing liabilities together with the asset being serviced.

Statement 140, as amended by Statement 156, requires that if an entity subsequently measures servicing assets and servicing liabilities using the amortization method, any impairment of servicing assets, which is the amount by which the carrying amount of the servicing assets for an individual stratum exceeds their fair value, must be recognized in current earnings. However, an increase in the fair value over the carrying amount of servicing assets for an individual stratum may not be recognized in current earnings.

Companies that service certain types of financial assets may wish to designate as the hedged item in a fair value hedge a pre-specified percentage of the total change in fair value of those servicing rights (attributable to the hedged risk) that varies based on changes in a specified independent variable. (Because the pre-specified percentage for each specified independent variable can be presented in a rectangular array, that method of determining the hedged item retroactively based on the actual independent variable is sometimes referred to as the matrix method.) For example, mortgage banking companies may wish to use that methodology in designating hedges of mortgage servicing right assets (MSRs) for the following reasons:

- If servicing assets are subsequently measured using the amortization method and its related impairment analysis, companies are not able to achieve substantial offset in earnings of gains and losses of those servicing assets and a forward contract when economically hedging those assets with forward contracts unless special hedge accounting could be applied. Absent the application of special hedge accounting, a decrease in the fair value of the MSR below its carrying amount will be recognized in current earnings as an impairment charge and the increase in the fair value of a derivative functioning as an economic hedge is available to offset some or all of that impairment charge. However, in accordance with Statement 140, an increase in the fair value of the MSR above its carrying amount is not recorded in earnings, while the corresponding decrease in the fair value of the derivative would be recognized in current earnings.

- The fair values of MSRs do not change in a linear fashion as interest rates increase or decrease. MSR fair values are most significantly impacted by changes in interest rates and the corresponding effect of those changes on prepayment speed estimates and other interest-rate-based assumptions. Decreases in interest rates generally increase prepayment speed estimates on the underlying loans, which reduces the expected cash flows to be received over the life of the MSR and in turn reduces the MSR's fair value. (Increases in interest rates have the opposite effect.) However, when interest rates fall, prepayment speeds increase at a faster pace than they decrease when interest rates rise. When interest rates decrease, prepayment speeds accelerate until they reach a certain threshold, beyond which they accelerate at a slower pace. Therefore, the effect of changes in interest rates on the fair value of MSRs could be significantly different depending upon the extent of the movement in interest rates because of the asymmetrical rate of prepayment and because they lose value at a faster pace when rates fall than they gain when rates rise (that is, they exhibit negative convexity). As a result, if required to establish a single hedge coverage ratio over a time horizon of any length, companies may be unable to establish at the inception of the hedging relationship that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk, and, as such, the hedging relationship may not be able to qualify for fair value hedge accounting under Statement 133.

- Because there are no individual derivative products that exactly offset the risk profile of the MSR, mortgage banks generally use combinations of derivatives to hedge MSRs. The negative convexity of MSRs necessitates that the combination of derivatives must have an option-like profile; however, companies typically do not seek to fully replicate the inverse of the MSR risk profile with a combination of derivatives because it is not cost effective.

RESPONSE

No. In a fair value hedge of a portion of a recognized servicing right asset subsequently measured using the amortization method and its related impairment analysis, a company may not designate the hedged item at the inception of the hedge by initially specifying a series of possible percentages of the servicing right asset and then determining at the end of the assessment period what specific percentage of the servicing right asset is the actual hedged item for that period based on the change in a specified independent variable during that period. Thus, the matrix method would *not* be a valid application of the provisions of Statement 133. The reference in paragraph 21(a)(2)(a) of Statement 133 to "a percentage of the entire asset or liability (or of the entire portfolio)" means that only *a single percentage* (that is, "a specific portion") can be designated at the inception of the hedge as the hedged item. Paragraph 21(a)(2)(a) does not permit expressing the hedged item as multiple percentages of a recognized asset or liability and then retroactively determining the hedged item based on an independent matrix of those multiple percentages and the actual scenario that occurred during the period for which hedge effectiveness is being assessed. (However, refer to the limited exception under Statement 133 Implementation Issue No. E18, "Designating a Zero-Cost Collar with Different Notional Amounts as a Hedging

Instrument," in which a collar that is comprised of one purchased option and one written option that have different notional amounts is designated as the hedging instrument, and the hedged item is specified as two different proportions of the same asset based on the upper and lower rate or price range of the asset referenced in those two options.)

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Fair Value Hedges: Hedging a Portion of a Portfolio of Fixed-Rate Loans
Paragraph references:	21, 432
Date released:	January 2001

QUESTIONS

1. If an entity wishes to hedge its exposure to changes in the fair value of only the right to receive repayment of principal (and not the fair value of the interest payments) for a portfolio of fixed-rate loans that *are not* prepayable, may the entity designate a percentage (for example, 60 percent) of the contractually required principal repayment as the hedged item in a fair value hedge in accordance with paragraph 21(a)(2)(b) of Statement 133?
2. If an entity wishes to hedge its exposure to changes in the fair value of only the right to receive repayment of principal (and not the fair value of the interest payments) for a portfolio of fixed-rate loans that *are* prepayable, may the entity designate a percentage (to be determined retrospectively) of the contractually required principal repayment as the hedged item in a fair value hedge in accordance with paragraph 21(a)(2)(b) of Statement 133? (Note that this percentage would be adjusted retrospectively at each assessment date to result in a hedge of an identical amount of principal for each assessment period over the term of the loans.)
3. If an entity wishes to hedge its exposure to changes in the fair value of its right to receive both all remaining interest payments and the repayment of principal for a portfolio of fixed-rate loans that *are* prepayable, may the entity designate a percentage (to be determined retrospectively) of the original loan portfolio principal balance, bearing interest at a fixed rate until the balloon repayment date, as the hedged item in a fair value hedge in accordance with paragraph 21(a)(2)(a) of Statement 133? (Note that this percentage would be adjusted retrospectively at each assessment date to result in a hedge of an identical amount of principal, bearing interest at the loans' contractual rate, for each assessment period over the term of the loans)?

BACKGROUND

An entity holds a portfolio of fixed-rate loans that contractually require repayment of the original principal balance ($100 million) 5 years from the date of origination. The changes in fair values (both overall and attributable to changes in the benchmark interest rate) of loans that are not prepaid can be expected to move proportionately with each other and with the portfolio as a whole. Assume for purposes of this Issue that all of the other criteria in paragraph 21(a)(1) of Statement 133 have been met (including the aggregation criteria). Therefore, the entity concludes the portfolio of loans (which all mature on the same date) meets the criteria for portfolio hedging in paragraph 21(a)(1) of Statement 133.

The entity wishes to reduce its fair value exposure for $60 million of the total principal repayment of the loan portfolio at maturity. Paragraph 21(a)(2) of Statement 133 specifies the criteria for hedging a portion of an asset or liability or a portion of a portfolio of similar assets and liabilities. It requires the hedged item to be (a) a percentage of the entire asset or liability or of the entire portfolio, (b) one or more selected contractual cash flows of the asset or liability or portfolio, (c) a put option, a call option, an interest rate cap, or an interest rate floor embedded in an existing asset or liability that is not an embedded derivative accounted for separately under the provisions of paragraph 12, or (d) the residual value in a lessor's net investment in a direct financing or sales-type lease. Paragraph 432 states that if an entity hedges a specified portion of a portfolio of similar assets or similar liabilities, "that portion should relate to every item in the portfolio. If an entity wishes to hedge only certain items in a portfolio, it should first identify a smaller portfolio of only the items to be hedged."

For questions 2 and 3, assume the loans in the portfolio, which *are* prepayable, have similar expected prepayment performance. Based on historical experience, the entity estimates that some of the loans will be prepaid either in full or in part. The entity is unable to determine, however, which specific loans will be prepaid. The entity estimates that at least 60 percent of the original portfolio principal balance of $100 million will remain outstanding until the contractual repayment date of the loans in the portfolio.

RESPONSE

Question 1

Yes. An entity may designate as the hedged item a percentage of a selected contractual cash flow (such as the repayment of principal at maturity), even though paragraph 21(a)(2) of Statement 133 makes reference to the hedged item being "a percentage" only in subparagraph 21(a)(2)(a), which relates to the entire recognized asset or liability (or entire portfolio), and not in subparagraph 21(a)(2)(b), which relates to one or more selected contractual cash flows. By indicating that the hedged item in a fair value hedge may be one or more selected contractual cash flows, paragraph 21(a)(2)(b) permits a company to hedge one or more individual contractual payments of the loans in the portfolio. The derivative selected as the hedging instrument must be highly effective at offsetting changes in fair value of the group of selected individual cash flows designated as being hedged. If the loans meet the criteria in paragraph 21(a)(1) of Statement 133 for portfolio hedging, it is reasonable to conclude that a percentage of each of those selected individual cash flows will reflect fair value changes that are proportionate to the fair value changes of the entire group of selected individual cash flows. Assuming the derivative selected as the hedging instrument would be highly effective at offsetting changes in the fair value of the selected individual cash flows (provided the notional amount of the derivative was sufficient), there would be a basis for expecting that the change in that derivative's fair value (with a proportionately reduced notional amount) would be highly effective in offsetting the change in fair value of the designated percentage of each of those selected individual cash flows.

Questions 2 and 3

No. An entity may not designate a percentage (to be determined retrospectively at periodic dates) of either the original loan portfolio principal balance or of the contractually required principal repayment as the hedged item in a fair value hedge in accordance with paragraph 21(a)(2) of Statement 133 to result in a hedge of an identical amount of principal for each assessment period over the term of the loans. Since the entity cannot determine which loans will prepay, it cannot reduce the portfolio to a smaller subset (of loans that will not have been prepaid at the end of the five-year period) as required by paragraph 432 of Statement 133. As a result, it cannot specify a hedged item that consists of a specified portion of every loan in the portfolio and therefore cannot satisfy the requirements of paragraph 21(a)(2). Statement 133 distinguishes between fair value and cash flow hedges with respect to prepayment activity since paragraph 21(f) specifically requires that an entity consider the effect of an embedded prepayment option in designating a fair value hedge of interest rate risk. The corresponding paragraph discussing the requirements surrounding hedging individual risks in a cash flow hedge (that is, paragraph 29(h), which addresses bifurcation by risk) does not contain a comparable discussion about considering the effect of prepayments in a cash flow hedge. Along the same lines, paragraph 21(a)(1) contains a specific condition that when hedging a portfolio of similar assets or liabilities under a fair value hedge, the prepayment history and expected prepayment performance in varying interest rate scenarios must be similar. The corresponding paragraph discussing the requirements for hedging groups of forecasted transactions under a cash flow hedge (paragraph 29(a)) does not contain any discussion about prepayment activity.

The guidance in those paragraphs reflects the fundamental difference that prepayment activity has on a fair value hedge as compared to a cash flow hedge. A typical prepayment option can have a significant impact on the fair value of a fixed-rate financial instrument whereas it does not generally have much impact on the cash flows from a floating rate financial instrument (since there is no significant economic difference, and impact on cash flows, between repricing due to interest rate reset or due to return of principal and reinvestment at the then-current floating rate). Hedge accounting under the scenarios in Questions 2 and 3 would result in circumvention of the requirement in paragraphs 21(a)(1) and 21(f) to consider prepayment risk in a fair value hedge of interest rate risk.

Prepayment risk is integrally related to the change in fair value of the loans due to changes in the benchmark interest rate. Fair value hedge accounting for $60 million of the portfolio using, for example, a plain-vanilla interest rate swap could only be accomplished by erroneously assuming that the prepayment option has been eliminated for that portion of the portfolio. However, if an entity can obtain a hedging instrument with fair value characteristics that can be expected to result in fair value changes for the hedging instrument that offset those of the loan portfolio (such as an interest rate swap with an embedded call provision that is a mirror image of the prepayment

option embedded in the loans in the portfolio), that hedging relationship could meet the Statement 133 criteria for fair value hedge accounting.

The above response represents a tentative conclusion. The status of the guidance herein will remain tentative until it is formally cleared by the FASB and incorporated in an FASB staff implementation guide. Constituents should send their comments, if any, to James J. Leisenring, Derivatives Implementation Group Chairman, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116 (or by e-mail to derivatives@fasb.org) by February 23, 2001.

Title:	Fair Value Hedges: Definition of Firm Commitment in Relation to Long-Term Supply Contracts with Embedded Price Caps or Floors
Paragraph references:	20, 21, 540
Date cleared by Board:	June 27, 2001
Date posted to website:	July 10, 2001
Date revision posted to website:	May 1, 2003
Affected by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* Revised March 26, 2003

QUESTIONS

Many contracts to supply materials on a long-term basis include a provision whereby the selling price is subject to a cap, a floor, or both, even though the holder of the related option does not pay to receive the option. Is a supply contract for which the contract price is fixed only under certain circumstances (such as when market prices are above an embedded price cap) a firm commitment for purposes of designating the hedged item in a fair value hedge? Is either party to the contract eligible to apply fair value hedge accounting in a hedge of the fair value exposure of the cap or floor in such contracts?

BACKGROUND

Entity A enters into a long-term supply contract with a customer to sell a specified amount of a certain material. The selling price is the current monthly average list price for the quantity delivered each month but not to exceed $15 per pound. The current list price at the contract signing date is $12 per pound. The contract can be settled only by physical delivery. The contract also includes a penalty provision that is sufficiently large to make performance probable. The customer is not required to make an up-front cash payment for the written option (that is, the price cap) in the supply contract. Consequently, the supply contract is neither a recognized asset nor a recognized liability at inception.

The supply contract in its entirety does not meet the definition of a derivative due to the absence of a net settlement characteristic (that is, the contract does not permit or require net settlement [paragraph 9(a)], there is no market mechanism [paragraph 9(b)], and it does not require delivery of an asset that is readily convertible to cash [paragraph 9(c)]). Pursuant to the guidance in Statement 133 Implementation Issue No. B14, "Purchase Contracts with a Selling Price Subject to a Cap and a Floor," the embedded cap on the selling price is an option that does not warrant separate accounting under Statement 133 because it is clearly and closely related to the host supply contract. In addition, because the supply contract is not remeasured with changes in fair

value reported currently in earnings, it meets the criteria in paragraph 21(c) of Statement 133 to qualify as a hedged item in a fair value hedge.

Entity A wishes to enter into a transaction to hedge the risk of changes in the fair value of the embedded written price cap in the supply contract. Accordingly, it purchases a cash-settled call option with a strike price of $15 per pound and a notional amount equal to the quantity specified in the supply contract.

Paragraph 21 of Statement 133 and related footnote 8, which was amended by Statement 149, states, in part,

> An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following criteria are met:
> a. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment.8

[8]A firm commitment (as defined in paragraph 540) that represents an asset or liability that a specific accounting standard prohibits recognizing (such as a noncancelable operating lease or an unrecognized mortgage servicing right) may nevertheless be designated as the hedged item in a fair value hedge. A mortgage banker's unrecognized "interest rate lock commitment" (IRLC) does not qualify as a firm commitment (because as an option it does not obligate both parties) and thus is not eligible for fair value hedge accounting as the hedged item. (However, a mortgage banker's "forward sale commitments," which are derivatives that lock in the prices at which the mortgage loans will be sold to investors, may qualify as hedging instruments in cash flow hedges of the forecasted sales of mortgage loans.) A supply contract for which the contract price is fixed only in certain circumstances (such as when the selling price is above an embedded price cap or below an embedded price floor) meets the definition of a firm commitment for purposes of designating the hedged item in a fair value hedge. Provided the embedded price cap or floor is considered clearly and closely related to the host contract and therefore is not accounted for separately under paragraph 12, either party to the supply contract can hedge the fair value exposure arising from the cap or floor.

Paragraph 540 of Statement 133 defines the term *firm commitment* as follows:

> 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.

RESPONSE

In accordance with the guidance of paragraph 21(a), footnote 8, as amended by Statement 149, a supply contract for which the contract price is fixed only under certain circumstances (such as when market prices are above an embedded price cap) meets the definition of a firm commitment for purposes of designating the hedged item in a fair value hedge. Therefore, when the selling price in a supply contract is subject to a cap, a floor, or both, either party to the contract is eligible to apply fair value hedge accounting in a hedging relationship to hedge the fair value exposure of the cap or floor.

In the example above, for the range of monthly average list prices above $15 per pound, the contract has a fixed $15 per pound price. Thus, Entity A may designate the written cap embedded in the supply contract as the hedged item in a fair value hedging relationship provided the other criteria for a fair value hedge are met.

The criterion in paragraph 21(a) of Statement 133 specifies that "The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment." Paragraph 21(a)(2)(c), as amended by Statement 149, further stipulates that the hedged item in a fair value hedge can be a specific portion of an asset or liability—a put option or call option (including an interest rate or price cap as well as an interest rate or price floor) embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 12 of this Statement. The embedded written cap in the example is a specific portion of the contract that is subject to the risk of changes in fair value due to changes in the list price of the underlying materials. Since it is not accounted for separately from the supply contract, the embedded written cap may be designated as the hedged item in a fair value hedge.

Footnote 2 to paragraph 4(a) of Statement 133 states that "subsequent references to an asset or a liability in this Statement include a firm commitment." Accordingly, the reference to "an existing asset or liability" in paragraph 21 of Statement 133 also includes an unrecognized firm commitment. Paragraph 21 allows a non-bifurcated call option that is embedded in a supply contract to be the hedged item in a fair value hedge regardless of whether that supply contract is a recognized asset or liability or an unrecognized firm commitment.

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after July 10, 2001, the date that the Board-cleared guidance was posted on the FASB website. The revisions made on March 26, 2003, do not affect the effective date.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Fair Value Hedges: Hedging a Portfolio of Loans
Paragraph references: 20(b), 21(a)(1), 445
Date cleared by Board: September 19, 2001
Date posted to website: October 10, 2001

QUESTIONS

Company A has a portfolio of seasoned, 1–4 family, fixed-rate mortgages that it wishes to designate as the hedged item in a fair value hedge of the benchmark interest rate (LIBOR). Each loan within the portfolio has similar settlement terms, is collateralized by property in the same geographic region, and has similar scheduled maturities. The loans are all within a specified interest rate band and are prepayable at par; each of the loans contained in the portfolio is expected to react in a generally proportionate manner to changes in the benchmark interest rate based on calculations performed by Company A. Company A enters into a pay-fixed, receive-LIBOR swap with a fair value of zero at the inception of the hedging relationship. The stated maturity of the swap is consistent with the stated maturities of the loans. The notional amount of the swap amortizes based on a schedule that is expected to approximate the principal repayments of the loans (excluding prepayments). There is no optionality included in the swap. As part of its documented risk management strategy associated with this hedging relationship, on a quarterly basis, Company A intends to (a) assess effectiveness of the existing hedging relationship for the past three-month period and (b) consider possible changes in value of the hedging derivative and the hedged item over the next three months in deciding whether it has an expectation that the hedging relationship will continue to be highly effective at achieving offsetting changes in fair value.

1. Does Company A's portfolio of loans satisfy the requirements of paragraph 21(a)(1) regarding the grouping of similar assets?

2. Does the documented hedging strategy described above meet the requirements of paragraph 20(b)?

BACKGROUND

Paragraph 21(a)(1), states:

> If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the

> change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7 percent to 13 percent would be inconsistent with this provision. In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate: loan type, loan size, nature and location of collateral, interest rate type (fixed or variable) and the coupon interest rate (if fixed), scheduled maturity, prepayment history of the loans (if seasoned), and expected prepayment performance in varying interest rate scenarios. [Footnote reference omitted.]

Paragraph 445 indicates that the Board intended the listing of characteristics at the end of paragraph 21(a)(1) to be only an indication of factors than an entity may find helpful in determining whether individual assets or liabilities qualify as similar.

Paragraph 20(b), in part, states:

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

Statement 133 Implementation Issue No. F5, "Basing the Expectation of Highly Effective Offset on a Shorter Period Than the Life of the Derivative," as cleared by the Board and clarified by Statement 133 Implementation Issue No. E11, "Hedged Exposure Is Limited but Derivative's Exposure Is Not," indicates that in documenting its risk management strategy for a fair value hedge, an entity may consider the possible changes in the fair value of the derivative and the hedged item over a shorter period than the remaining life of the derivative in formulating its expectation that the hedging relationship will be highly effective in achieving offsetting changes in fair value for the risk being hedged. The entity does not need to contemplate the offsetting effect for the entire term of the hedging instrument.

RESPONSE

Question 1

Yes, Company A's portfolio of loans satisfies the requirements of paragraph 21(a)(1) regarding the grouping of similar assets because the portfolio of loans has been defined in a restrictive manner and Company A determined, by calculation, that each of the loans contained in the portfolio is expected to react in a generally proportionate manner to changes in the benchmark interest rate. Even though certain of the loans may prepay, each loan still may be considered to have the same exposure to prepayment risk since each loan has a similar prepayment option. When aggregating loans in a portfolio, an entity is permitted to consider among other things

prepayment history of the loans (if seasoned) and expected prepayment performance in varying interest rate scenarios.

Question 2

Yes, the documented hedging strategy described in the question meets the requirements of paragraph 20(b) for a prospective assessment of effectiveness provided the entity established that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. That prospective assessment of hedge effectiveness must consider all reasonably possible changes in fair value of the derivative and the hedged items for the period used to assess whether the requirement for expectation of highly effective offset is satisfied; that assessment may not be limited only to the likely or expected changes in fair value of the derivative or the hedged items. Generally, the process of formulating an expectation regarding the effectiveness of a proposed hedging relationship involves a probability-weighted analysis of the possible changes in fair value of the derivative and the hedged items for the hedge period. Therefore, a probable future change in fair value will be more heavily weighted than a reasonably possible future change.

For example, Company A could assign a probability weighting to each possible future change in value of the hedged portfolio. Depending where market interests rate levels are and the expected prepayment rates for the types of loans in the hedged portfolio, Company A may reach a conclusion that the change in fair value of the swap will be highly effective at offsetting the change in the value of the portfolio of loans, inclusive of the prepayment option. As a result of this analysis, management would conclude that hedge accounting is permitted for the hedging relationship for the next three-month period; however, any ineffectiveness related to the current period must be reflected currently in earnings. (That is, management is required to assess the effectiveness of the existing hedging relationship for the past three-month period.) The amount of ineffectiveness related to the current period will be the difference between the change in fair value of the swap (which could have a notional amount different than the hedged portfolio) and the change in fair value of the existing hedged portfolio. If necessary, the notional amount of the swap in excess of the portfolio balance at the end of each three-month period must be dedesignated and a new hedging relationship designated (with a smaller percentage of the swap as the hedging instrument) going forward to allow high effectiveness to continue in the future.

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after October 10, 2001, the date that the Board-cleared guidance was posted on the FASB website.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Cash Flow Hedges: Hedging an SAR Obligation
Paragraph references:	11(a), 21(c)(1), 30, 31
Date cleared by Board:	February 17, 1999
Date posted to website:	March 24, 1999
Date latest revision posted to website:	December 17, 2004
Affected by:	FASB Statements No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* and No. 123 (revised 2004), *Share-Based Payment*

Revised December 15, 2004

QUESTION

May a public company designate a cash-settled purchased call option indexed to its own stock (that is classified as an asset) as a hedging instrument in a cash flow hedge of the exposure to variability in expected future cash flows associated with unrecognized, nonvested stock appreciation rights (SARs)?

BACKGROUND

An SAR is an award entitling employees to receive cash, stock, or a combination of cash and stock in an amount equivalent to any excess of the fair value of a stated number of shares of the employer's stock over a stated price. Various factors, including the method of settlement, determine whether the issuer accounts for the SAR under FASB Statement No. 123 (revised 2004), *Share-Based Payment*, as a liability or an equity instrument. For a public company, an SAR that is a liability is adjusted to fair value each reporting period rather than to an amount equivalent to the excess of the then current fair value of the stated number of shares over a stated price (that is, the intrinsic value). An SAR generally has vesting provisions, for example, pro rata vesting over a requisite service period. Compensation cost is recognized over the service period for the portion of the SAR that is not yet vested (that is, for which the requisite service period has not been rendered) based on changes in the fair value of the SAR during that period.

RESPONSE

Yes, to the extent that vesting of the SARs is probable, a purchased call option indexed to a company's own stock that is recorded as an asset and accounted for as a derivative under Statement 133 may be designated as the hedging instrument in a hedge of cash flow variability of expected future obligations associated with unrecognized, nonvested SARs. (An unrecognized, nonvested SAR relates to the portion of the SAR liability that has not yet been accrued. It does not refer to future fair value changes in the recognized liability for the vested portion of the SAR.) Presumably, when using this strategy, hedge effectiveness typically would be assessed based on changes in the entire value of the purchased call option, rather than just the intrinsic

value of the option because the fair value of the unrecognized, nonvested SARs likewise consists of a time value portion and an intrinsic value portion.

A purchased call option on a company's own stock may be designated as a hedge of the cash flow variability of expected future obligations associated with unrecognized, nonvested SARs if the option is classified as an asset in the company's financial statements and the option is a derivative contract subject to Statement 133. Paragraph 11(a) of Statement 133 indicates that contracts that are issued or held by an entity that are both indexed to its own stock and classified in stockholders' equity in its statement of financial position are not considered to be derivative instruments for the purposes of the Statement. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," as partially nullified by Statement 150, contain the relevant guidance for determining whether a contract indexed to a company's own stock involving a choice of settlement methods is classified as an asset or liability or an equity instrument. Only contracts that are classified as an asset or liability as required by Statement 150 or Issue 00-19 and are accounted for as derivative contracts under Statement 133 are permitted to be designated as hedging instruments in a cash flow hedge of unrecognized, nonvested SARs. Other types of contracts covered by Issue 00-19 are initially measured at fair value and may be either reported in permanent equity with an amount equal to the required cash redemption amount transferred to temporary equity or reported in permanent equity (without such a transfer to temporary equity). Because of their equity classification, those contracts would not be considered derivatives under Statement 133 and would not be eligible to be designated as hedging instruments.

Because an unrecognized, nonvested SAR results in exposure to cash flow variability of expected future obligations that affects reported earnings, it is eligible to be designated as being hedged. An SAR that is recognized as a liability may not be designated as being hedged in a cash flow hedge because the hedged cash flow variability in a recognized SAR relates to a liability that is remeasured with changes in fair value reported currently in earnings.

The hedge of exposure to cash flow variability in an unrecognized, nonvested SAR could be expected to be highly effective. The company's stock price is the underlying for both the unrecognized, nonvested SAR and the option on the company's own stock. Changes in fair value of the purchased call option on the company's own stock would be recorded in other comprehensive income consistent with paragraph 30 of Statement 133. As required by paragraph 31, the amount in other comprehensive income would be reclassified into earnings concurrent with the recognition in earnings of compensation cost on the SAR that relates to those fair value changes that occurred during the hedge period over the requisite service period.

EFFECTIVE DATE

The revisions made on December 15, 2004, reflect the issuance of Statement 123(R). The effective date of the December 15, 2004, revisions to the implementation guidance in this Issue for each reporting entity is the first day of the fiscal quarter in which that entity initially adopts Statement 123(R).

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Cash Flow Hedges: Hedged Transactions That Arise from Gross Settlement of a Derivative ("All-in-One" Hedges)
Paragraph references: 9, 28, 29, 540
Date cleared by Board: March 31, 1999

QUESTION

May a derivative instrument that is expected to be settled gross be designated as the hedging instrument in a cash flow hedge of the forecasted transaction that will be consummated upon gross settlement of the derivative contract itself? If a derivative instrument also satisfies the definition of a firm commitment, how does that affect the accounting for the instrument?

BACKGROUND

Settling a forward contract *gross* involves delivery of an asset in exchange for the payment of cash or other assets and is differentiated from settling *net*, which typically involves a payment for the change in a contract's value as the method of settling the contract.

The following are examples of transactions covered by this Issue.

Example 1
Company A plans to purchase a nonfinancial asset. To fix the price to be paid (that is, to hedge the price), Company A enters into a contract that meets Statement 133's definition of a *firm commitment* with an unrelated party to purchase the asset at a fixed price at a future date. Assume that the terms of the contract (such as net settlement under the default provisions) or the nature of the asset cause the contract to meet Statement 133's definition of a *derivative instrument* and the contract is not excluded by paragraph 10 from the scope of Statement 133. As such, Company A has entered into a derivative contract under which it is expected to take delivery of the asset. The issue is whether Company A may designate the fixed-price purchase contract (that is, the derivative instrument) as a cash flow hedge of the variability of the consideration to be paid for the purchase of the asset (that is, the forecasted transaction) given that the derivative instrument is the same contract under which the asset itself will be acquired.

Example 2
Company B plans to purchase U.S. government bonds and expects to classify those bonds in its available-for-sale portfolio. To fix the price to be paid (that is, to hedge the price), Company B enters into a contract that meets Statement 133's definition of a *firm commitment* with an unrelated party to purchase the bonds at a fixed price at a future date. Assume the contract meets Statement 133's definition of a *derivative instrument* and is not excluded by paragraph 10 from the scope of Statement 133. As such, Company B has entered into a derivative contract under which it is expected to take delivery of the asset. The issue is whether Company B may designate the fixed-price purchase contract (that is, the derivative instrument) as a cash flow hedge of the variability of the consideration to be paid for the purchase of the bonds (that

is, the forecasted transaction) given that the derivative instrument is the same contract under which the asset itself will be acquired.

RESPONSE

Yes, assuming other cash flow hedge criteria are met, a derivative instrument that will involve gross settlement may be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the forecasted transaction that will occur upon gross settlement of the derivative contract itself.

If a contract meets the definition of both a *derivative instrument* and a *firm commitment* under Statement 133, then an entity must account for the contract as a derivative instrument unless one of the exceptions in Statement 133 applies. A forecasted purchase or sale meets the definition of *forecasted transaction* in paragraph 540 of Statement 133 and, if it is probable, meets the criteria of paragraph 29 of Statement 133 for designation as a hedged transaction. An entity concerned about variability in cash flows from its forecasted purchases or sales can economically fix the price of those purchases or sales by entering into a fixed-price contract. Since the fixed-price purchase or sale contract is a derivative instrument, it is eligible for use as a hedging instrument. (The forecasted purchase or sale at a fixed price is eligible for cash flow hedge accounting because the total consideration paid or received is variable. The total consideration paid or received for accounting purposes is the sum of the fixed amount of cash paid or received and the fair value of the fixed price purchase or sale contract, which is recognized as an asset or liability, and which can vary over time.)

As demonstrated in the examples in the background section, (1) the forecasted transaction and the derivative used to hedge it can, in certain circumstances, be with the same counterparty and (2) the derivative instrument can be the same contract under which the entity executes the forecasted transaction. The above guidance applies to fixed-price contracts to acquire or sell a nonfinancial or financial asset that are accounted for as derivative instruments under Statement 133 provided the criteria for a cash flow hedge are met.

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Title: Cash Flow Hedges: Discontinuation of a Cash Flow Hedge
Paragraph references: 33, 492–494
Date cleared by Board: March 31, 1999
Affected by: FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*
Revised September 25, 2000

QUESTION

Should an entity continue to report in accumulated other comprehensive income a net derivative gain or loss related to a discontinued cash flow hedge of a forecasted transaction if the entity determines that it is probable that the forecasted transaction will not occur by the end of the originally specified time period but will occur shortly thereafter?

For example, on January 1, an entity enters into a cash flow hedge of the forecasted sale of the first 100 units of a specified product during the 3-month period from February 1 to April 30. Gains and losses on the hedging instrument are accumulated in other comprehensive income and reclassified into earnings as sales occur. However, as of March 10, only 60 units of the product have been sold and the entity determines that it is probable that the sale of the remaining 40 units will not occur by April 30. As a result, the entity must discontinue cash flow hedge accounting under the originally designated hedging relationship as of March 10 (pursuant to paragraph 32(a)). The entity determines that it is probable that the sale of the remaining 40 units will occur by June 20. (Based on this new information, the entity is permitted to designate a new cash flow hedge under which subsequent derivative gains and losses would receive cash flow hedge accounting.) The issue focuses on the derivative gains and losses that have been accumulated in other comprehensive income at March 10 with respect to the remaining 40 unsold units.

RESPONSE

The net derivative gain or loss related to the discontinued cash flow hedge should 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 or within an additional two-month period of time thereafter, except as indicated in the following sentence. In rare circumstances, 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 should 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 should be immediately reclassified into earnings.

In the example described in the question section, the derivative gains or losses accumulated in other comprehensive income related to the sale of the remaining 40 units should not be reclassified into earnings as of March 10 because the entity determined on that date that it is at least reasonably possible that the forecasted transactions will occur within the two-month period following April 30 (the end of the originally specified time period).

In contrast, had the example indicated that the entity had determined on March 10 that it is probable that the sale of the remaining 40 units will not occur by June 30 but it was reasonably possible that the sale would occur in July or August, the accounting would be different. Under that revised example, the derivative gains or losses accumulated in other comprehensive income related to the sale of the remaining 40 units must be reclassified into earnings as of March 10 because the entity would have determined on that date that it is probable that the forecasted transactions will not occur by the end of the originally specified time period (that is, April 30) nor within the allowable additional two-month period of time (ending on June 30). Furthermore, the example indicates no extenuating circumstances that could justify applying the exception related to a forecasted transaction that is probable of occurring on a date beyond the additional two-month period of time. (Paragraph 45(b)(4) also requires disclosure of the amount of gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges due to it being probable that the original forecasted transactions will not occur.)

Derivative gains and losses that had initially been reported in other comprehensive income as a result of a cash flow hedge and then reclassified to earnings (because the entity subsequently concluded that it was probable that the forecasted transaction would not occur within the originally specified time period or the additional period of time described above) cannot later be reclassified out of earnings and back into accumulated other comprehensive income due to a reassessment of probabilities.

As indicated in paragraph 494 of Statement 133, a pattern of determining that hedged forecasted transactions are probable of not occurring by the end of the originally specified time period or within the additional two-month period of time thereafter will call into question an entity's ability to accurately predict forecasted transactions and the propriety of applying hedge accounting for similar forecasted transactions in the future.

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Title: Cash Flow Hedges: Hedging Voluntary Increases in Interest Credited on an Insurance Contract Liability
Paragraph references: 21(a)(2)(c), 29(b), 463
Date cleared by Board: July 28, 1999

Revised September 25, 2000

QUESTION

Can an insurance company (the issuer) qualify to apply cash flow hedge accounting under Statement 133 if it is hedging the possibility that it may need to voluntarily increase the interest rate used to credit interest on certain contract liabilities?

BACKGROUND

Some insurance contracts (for example, certain whole life policies, universal life policies, repetitive premium variable annuities, and single premium deferred annuities) contain an option allowing the policyholder to put (surrender) the contract to the issuer at contract value. Those contracts, which are not carried at fair value by the issuer, bear interest at a fixed rate.

The issuer is exposed to the risk that an increase in market interest rates will cause the policyholder to exercise its put. Accordingly, the issuer may voluntarily increase the contractual rate on the contract to forestall the policyholder's exercising its put. As a result, the issuer wants to hedge the risk of an increase in future interest cash flows due to an increase in interest rates associated with either of the following two circumstances: (1) the issuer's voluntary increase in the contractual interest rate on existing fixed-rate contracts or (2) the policyholder's exercise of its put option and the insurance company's issuance of new higher fixed-rate contracts to new policyholders. To hedge the risk of having to pay higher interest rates in the future, the issuer chooses to purchase an option on interest rates.

RESPONSE

Yes. Statement 133 would permit an insurance company to qualify for cash flow hedge accounting if it is hedging the possibility that it may need to voluntarily increase the interest rate used to credit interest on certain contract liabilities. Under the Statement's cash flow hedging model, the hedged forecasted transactions would be the future interest credited on its then existing contracts. The hedged forecasted transactions for each interest crediting date could include both the future interest credited on older contracts whose contractual rate has been voluntarily increased and the future interest credited on new contracts with the current higher interest rate issued to new policyholders (which will have replaced older contracts that have been surrendered). In defining the forecasted transactions, the insurance company must ensure that the hedged interest relates to a volume of contracts whose existence at the future interest crediting dates is probable.

In designating the hedged risk, the insurance company must decide whether it is hedging the total variability in those future interest payments or just the variability in the future interest attributable to changes in the designated benchmark interest rate. Although the occurrence of the forecasted transactions (that is, the crediting of interest) must be probable, the cash flow hedging model does not require that it be probable that any variability in the hedged transaction will actually occur—that is, in a cash flow hedge, the variability in future cash flows must be a possibility, but not necessarily a probability. However, the hedging derivative must be highly effective at achieving offsetting cash flows attributable to the hedged risk whenever that variability in future interest does occur.

An insurance company may find it difficult to identify a derivative that will qualify for cash flow hedge accounting, which requires that the hedging relationship be expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk. Because the decision to adjust the interest rate to match the change in interest rates is at the discretion of the insurance company, it may be difficult to conclude that the changes in the hedged interest payments attributable to the hedged risk will be sufficiently correlated with changes in the cash flows of the hedging derivative.

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Title: Cash Flow Hedges: Hedging the Variable Price Component
Paragraph references: 29, 440–442
Date cleared by Board: November 23, 1999

QUESTION

In a contract that requires the buyer to pay $100 per unit adjusted for a portion of the change in the average market price of sugar, a major ingredient in the item purchased, may the buyer use a derivative whose underlying is the price of sugar in a cash flow hedge of its purchases under the contract in a hedge of its exposure to changes in the price of sugar? Assume the purchase contract does not meet the definition of a freestanding derivative and does not contain an embedded derivative that warrants separate accounting under Statement 133.

BACKGROUND

Statement 133 permits an entity to use hedge accounting in a hedge of the variability of cash flows in a forecasted transaction provided the transaction is probable of occurring and all hedging criteria are met.

Paragraph 29(g) requires that if the hedged transaction is the forecasted purchase or sale of a nonfinancial asset (as in the above example), the designated risk being hedged must be the risk of changes in the cash flows relating to all changes in the purchase or sales price of the asset, not the risk of changes in the cash flows relating to the purchase or sale of a major ingredient.

RESPONSE

Because of the limitations in paragraph 29(g), the buyer must designate as the risk being hedged the risk of changes in the cash flows relating to *all changes* in the purchase price of the items being acquired under the contract. If the only variability in the items' purchase price under this peculiar contract relates to changes in the average market price of sugar, the buyer may use a derivative whose underlying is the price of sugar in a cash flow hedge of its purchases under the contract. The buyer must determine that all the criteria for cash flow hedges are satisfied, including that the hedging relationship is highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge.

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Title:	Cash Flow Hedges: Impact of Implementation Issue E1 on Cash Flow Hedges of Market Interest Rate Risk
Date cleared by Board:	May 17, 2000
Superseded by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*

Title: Cash Flow Hedges: Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method Is Not Applied
Paragraph references: 30, 68, 70
Date cleared by Board: May 17, 2000

Revised July 11, 2000

QUESTION

How should paragraph 30(b)(2) of Statement 133 be applied to calculate the amount of ineffectiveness to be recognized in earnings for a cash flow hedge that does not meet the requirements for use of the shortcut method and that involves either (a) a receive-floating, pay-fixed interest rate swap designated as a hedge of the variable interest payments on an existing floating-rate liability or (b) a receive-fixed, pay-floating interest rate swap designated as a hedge of the variable interest receipts on an existing floating-rate asset?

BACKGROUND

When the requirements for the shortcut method in paragraph 68 of Statement 133 are not satisfied, it cannot be assumed that the hedge results in zero ineffectiveness, thereby resulting in reporting the entire change in fair value of the derivative designated as the hedging instrument in a cash flow hedge in other comprehensive income (OCI). In those situations, the requirements of paragraph 30 must be applied. Paragraph 30 requires that the effective portion of the gain or loss on a derivative designated as a cash flow hedge be reported in OCI and the ineffective portion be reported in earnings. To determine the adjustment to accumulated OCI for changes in value of a derivative designated as a cash flow hedge, paragraph 30(b) requires the comparison of the following:

1. The cumulative gain or loss on the derivative from inception of the hedge (less any excluded components and any gains or losses previously reclassified from accumulated OCI into earnings)
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 the inception of the hedge (less any gains or losses previously reclassified from accumulated OCI into earnings).

Accumulated OCI associated with the hedged transaction should be adjusted to a balance that reflects the lesser of the two foregoing amounts (in absolute amounts).

Depending on the interest rate index (or indices) involved and the expected effectiveness of the hedging swap, the hedging relationships covered by the question above encompass (a) hedges of interest rate risk (pursuant to paragraph 29(h)(2)) or (b) hedges of the risk of overall changes in

the hedged cash flows related to the asset or liability (pursuant to paragraph 29(h)(1)). An example of a hedge of interest rate risk that would be covered by the scope of this issue is a hedging relationship that does not qualify for the shortcut method that involves an interest rate swap with its floating-rate index based on the LIBOR swap rate (a benchmark interest rate) designated as a hedge of a variable-rate asset or liability with an interest-rate index also based on the LIBOR swap rate. An example of a hedge of the risk of overall changes in the hedged cash flows related to the asset or liability that would be covered by this issue is a hedging relationship involving an interest-rate swap with its floating-rate index based on a bank's prime rate designated as a hedge of a variable-rate asset or liability with an interest-rate index also based on the same prime rate. That hedging relationship may not qualify for the shortcut method because the shortcut method applies only to hedges of interest rate risk, and the designated floating-rate index giving rise to variability in cash flows is not a benchmark interest rate as defined by Statement 133, as amended.

RESPONSE

Three methods for calculating the ineffectiveness of a cash flow hedge that involves either (a) a receive-floating, pay-fixed interest rate swap designated as a hedge of the variable interest payments on an existing floating-rate liability or (b) a receive-fixed, pay-floating interest rate swap designated as a hedge of the variable interest receipts on an existing floating-rate asset are discussed below. As noted in the last section of the response, Method 1 (Change in Variable Cash Flows Method) may not be used in certain circumstances. Under all three methods, an entity must consider the risk of default by counterparties that are obligors with respect to the hedging instrument (the swap) or hedged transaction, pursuant to the guidance in Statement 133 Implementation Issue No. G10, "Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative." An underlying assumption in this response is that the likelihood of the obligor not defaulting is assessed as being probable.

Method 1: Change in Variable Cash Flows Method

For the types of cash flow hedges described in the question section, the measurement of hedge ineffectiveness may be based on a comparison of the floating-rate leg of the swap and the hedged floating-rate cash flows on the asset or liability (herein referred to as the "change in variable cash flows" method). The change in variable cash flows method is consistent with the cash flow hedge objective of effectively offsetting the changes in the hedged cash flows attributable to the hedged risk. The method is based on the premise that only the floating-rate component of the swap provides the cash flow hedge, and any change in the swap's fair value attributable to the fixed-rate leg is not relevant to the variability of the hedged interest payments (receipts) on the floating-rate liability (asset).

Under this method, the interest rate swap designated as the hedging instrument would be recorded at fair value on the balance sheet. The calculation of ineffectiveness involves a comparison of the present value of the cumulative change in the expected future cash flows on the variable leg of the swap and the present value of the cumulative change in the expected future

interest cash flows on the floating-rate asset or liability. (Because the focus of a cash flow hedge is on whether the hedging relationship achieves offsetting changes in cash flows, if the variability of the hedged cash flows of the floating-rate asset or liability is based solely on changes in a floating-rate index, the present value of the cumulative changes in expected future cash flows on both the floating-rate leg of the swap and the floating-rate asset or liability should be calculated using the discount rates applicable to determining the fair value of the swap.) If hedge ineffectiveness exists, accumulated OCI would be adjusted to a balance that reflects the difference between the overall change in fair value of the swap since the inception of the hedging relationship and the amount of ineffectiveness that must be recorded in earnings.

The change in variable cash flows method will result in no ineffectiveness being recognized in earnings if the following conditions are met: (1) the floating-rate leg of the swap and the hedged variable cash flows of the asset or liability are based on the same interest rate index (for example, three-month LIBOR), (2) the interest rate reset dates applicable to the floating-rate leg of the swap and to the hedged variable cash flows of the asset or liability are the same, (3) the hedging relationship does not contain any other basis differences (for example, ineffectiveness could be created if the variable leg of the swap contains a cap and the floating-rate asset or liability does not), and (4) the likelihood of the obligor not defaulting is assessed as being probable. However, ineffectiveness would be expected to result if any basis differences existed. For example, ineffectiveness would be expected to result from a difference in the indices used to determine cash flows on the variable leg of the swap (for example, the three-month Treasury rate) and the hedged variable cash flows of the asset or liability (for example, three-month LIBOR) or a mismatch between the interest rate reset dates applicable to the variable leg of the swap and the hedged variable cash flows of the hedged asset or liability.

To demonstrate the application of the change in variable cash flows method to an example hedging relationship, an entity designates a receive-floating, pay-fixed interest rate swap with a zero fair value as a hedge of variable interest rate payments on a debt instrument. The variable leg of the swap is based on the three-month Treasury rate, and the variable cash flows of the debt are based on three-month LIBOR. Assume that the overall change in fair value of the swap from inception of the hedge is $16,300, the present value of the cumulative change in the cash flow on the variable leg of the swap is a gain (increased cash inflow) of $16,596, and the present value of the cumulative change in the expected future interest cash flows on the floating-rate liability due to changes in the cash flows expected for the remainder of the hedge term is a loss (increased cash outflow) of $16,396. (The cumulative changes in expected future cash flows on both the variable leg of the swap and the floating-rate debt are discounted using the rates applicable to determining the fair value of the derivative.) The entity would report in earnings a gain of $200 as ineffectiveness, representing the amount by which the present value of the cumulative change in the cash flows on the variable leg of the swap exceeds the present value of the cumulative change in the expected cash flows on the floating-rate debt. The swap would be recorded at fair value on the balance sheet (asset of $16,300), and the balance in accumulated OCI would be adjusted to a credit of $16,100. In accordance with the requirements of paragraph 30(b), there is

no reported ineffectiveness when the present value of the cumulative change in the future expected cash flows on the floating-rate debt exceeds the present value of the cumulative change in the future cash flows on the variable leg of the swap.

Method 2: Hypothetical Derivative Method

For the types of cash flow hedges described in the question section, the measurement of hedge ineffectiveness may be based on a comparison of the change in fair value of the actual swap designated as the hedging instrument and the change in fair value of a hypothetical swap (herein referred to as the "hypothetical derivative" method). That hypothetical swap would have terms that identically match the critical terms of the floating-rate asset or liability (that is, the same notional amount, same repricing dates, the index on which the hypothetical swap's variable rate is based matching the index on which the asset or liability's variable rate is based, mirror image caps and floors, and a zero fair value at the inception of the hedging relationship). Essentially, the hypothetical derivative would need to satisfy all of the applicable conditions in paragraph 68 (as amended) necessary to qualify for use of the shortcut method except criterion 68(dd). Thus, the hypothetical swap would be expected to perfectly offset the hedged cash flows. The change in the fair value of the "perfect" hypothetical swap can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction as described in paragraph 30(b)(2).

Under the hypothetical derivative method, the actual swap would be recorded at fair value on the balance sheet, and accumulated OCI would be adjusted to a balance that reflects the lesser of either the cumulative change in the fair value of the actual swap or the cumulative change in the fair value of a "perfect" hypothetical swap. The determination of the fair value of both the "perfect" hypothetical swap and the actual swap should use discount rates based on the relevant swap curves. The amount of ineffectiveness, if any, recorded in earnings would be equal to the excess of the cumulative change in the fair value of the actual swap over the cumulative change in the fair value of the "perfect" hypothetical swap. Paragraph 30(b) indicates that hedge ineffectiveness in a cash flow hedge occurs only if the cumulative gain or loss on the derivative hedging instrument exceeds the cumulative change in the expected future cash flows on the hedged transaction.

Method 3: Change in Fair Value Method

For the types of cash flow hedges described in the question section, the measurement of hedge ineffectiveness may be based on a calculation that compares the present value of the cumulative change in expected variable future interest cash flows that are designated as the hedged transactions and the cumulative change in the fair value of the swap designated as the hedging instrument (herein referred to as the "change in fair value" method). The discount rates applicable to determining the fair value of the swap designated as the hedging instrument should also be applied to the computation of present values of the cumulative changes in the hedged cash flows.

Application of the Methods

If, at the inception of the hedge, the fair value of the swap designated as the hedging instrument is zero or is somewhat near zero, any of the three methods discussed above may be applied. In contrast, if, at the inception of the hedge, the fair value of the swap is not somewhat near zero, the change in variable cash flows method (Method 1) may not be applied because that method does not require entities to recognize in income currently the ineffectiveness related to the interest element of the change in fair value of a hedging instrument that incorporates a financing element; instead, either the hypothetical derivative method (Method 2) or the change in fair value method (Method 3) should be applied. Those latter two methodologies require entities to recognize in income currently the ineffectiveness related to the interest element of the change in fair value of a hedging instrument that incorporates a financing element that is not somewhat near zero, such as when the swap has been structured to be significantly in-the-money at the inception of the hedge.

Statement 133 requires that an entity define and document, at the time it designates a hedging relationship, the method it will use to measure the hedge's effectiveness in achieving offsetting cash flows. It also requires that an entity use that defined method consistently throughout the hedge period to measure the ineffective part of the hedge. In addition, in deciding which of the above methods to use, an entity must comply with paragraph 62, which states, "Ordinarily, however, an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified."

Regardless of which method is used for the measurement of cash flow hedge effectiveness, an entity must meet the requirements of paragraph 28(b) of Statement 133 for *designation* of a cash flow hedging relationship. That is, in designating a cash flow hedging relationship, an entity must have the expectation, both at the inception of the hedge and ongoing, that the relationship will be highly effective at achieving offsetting changes in cash flows.

Although the question in this Implementation Issue addresses a cash flow hedge of the variable interest receipts on an existing floating-rate asset or liability, the guidance in this Implementation Issue also applies to cash flow hedges of the variability of future interest payments on interest-bearing assets to be acquired or interest-bearing liabilities to be incurred (such as the rollover of an entity's short-term debt as described in Example 8 in paragraphs 153–161).

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Title:	Cash Flow Hedges: Hedging Interest Rate Risk of Foreign-Currency-Denominated Floating-Rate Debt
Date cleared by Board:	May 17, 2000
Superseded by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*

Title: Cash Flow Hedges: Assuming No Ineffectiveness When Critical Terms of the Hedging Instrument and the Hedged Transaction Match in a Cash Flow Hedge
Paragraph references: 28(a), 28(b), 65, 127, 128
Date cleared by Board: June 28, 2000

QUESTION

In a cash flow hedge of a forecasted transaction (for example, a forecasted purchase or sale of a commodity), if the critical terms of the hedging instrument and of the hedged forecasted transaction are the same such that the entity may conclude, based on paragraph 65 of Statement 133, that the changes in cash flows attributable to the risk being hedged are expected to completely offset at the inception of the hedging relationship and on an ongoing basis, what type of assessment of hedge effectiveness must be performed and what are the documentation requirements for that assessment of hedge effectiveness?

BACKGROUND

Paragraph 65 of Statement 133 states:

> If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecasted transaction are the same, the entity could conclude that changes in the fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be highly effective and that there will be no ineffectiveness to be recognized in earnings if:
>
> a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase.
> b. The fair value of the forward contract at inception is zero.
> c. Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and included directly in earnings pursuant to paragraph 63 or the change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

Example 4 in Appendix B (paragraphs 127-130) illustrates a cash flow hedge of the forecasted sale of a commodity inventory. Paragraph 127 states, in part: "The terms of the hedging derivative have been negotiated to match the terms of the forecasted transaction. *Thus, there is no ineffectiveness*" (emphasis added).

Paragraph 128 states:

> ABC Company decides to hedge the risk of changes in its cash flows relating to a forecasted sale of 100,000 bushels of Commodity A by entering into a derivative contract, Derivative Z. ABC expects to sell the 100,000 bushels of Commodity A on the last day of period 1. On the first day of period 1, ABC enters into Derivative Z and designates it as a cash flow hedge of the forecasted sale. ABC neither pays nor receives a premium on Derivative Z (that is, its fair value is zero). The hedging relationship qualifies for cash flow hedge accounting. *ABC expects that there will be no ineffectiveness from the hedge* because (a) the notional amount of Derivative Z is 100,000 bushels and the forecasted sale is for 100,000 bushels, (b) the underlying of Derivative Z is the price of the same variety and grade of Commodity A that ABC expects to sell (assuming delivery to ABC's selling point), and (c) the settlement date of Derivative Z is the last day of period 1 and the forecasted sale is expected to occur on the last day of period 1. [Emphasis added.]

RESPONSE

If the critical terms of the hedging instrument and of the hedged forecasted transaction are the same so that the changes in cash flows attributable to the risk being hedged are expected to completely offset at the inception of the hedging relationship and on an ongoing basis, an entity is still required to perform and document an assessment of hedge effectiveness at the inception of the hedging relationship and on an ongoing basis throughout the hedge period. The shortcut method may not be applied in a cash flow hedge of a forecasted transaction, even if an entity determines that all critical terms of the hedging instrument and the hedged forecasted transaction are matched. As indicated in Statement 133 Implementation Issue No. E4, "Application of the Shortcut Method," the shortcut method can be applied only if all of the applicable conditions in paragraph 68 are met and the hedging relationship involves only an interest rate swap.

However, based on the fact that, at inception, the critical terms of the hedging instrument and the hedged forecasted transaction are the same, the entity can conclude that changes in cash flows attributable to the risk being hedged are expected to be completely offset by the hedging derivative. Therefore, subsequent assessments can be performed by verifying and documenting whether the critical terms of the hedging instrument and the forecasted transaction have changed during the period in review. Because the assessment of hedge effectiveness in a cash flow hedge involves assessing the likelihood of the counterparty's compliance with the contractual terms of the derivative designated as the hedging instrument, the entity must also assess whether there have been adverse developments regarding the risk of counterparty default, particularly if the entity planned to obtain its cash flows by liquidating the derivative at its fair value. If there are no such changes in the critical terms or adverse developments regarding counterparty default, the entity may conclude that there is no ineffectiveness to be recorded. In that case, the change in fair value of the derivative can be viewed as a proxy for the present value of the change in cash flows attributable to the risk being hedged.

However, if the critical terms of the hedging instrument or the hedged forecasted transaction have changed or if there have been adverse developments regarding the risk of counterparty default, the entity must measure the amount of ineffectiveness that must be recorded currently in earnings pursuant to the guidance in Statement 133 Implementation Issue No. G7, "Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method Is Not Applied." In addition, the entity must assess whether the hedging relationship is expected to continue to be highly effective (using either a dollar-offset test or a statistical method such as regression analysis).

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Cash Flow Hedges: Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative
Paragraph references: 28(b), 29(b), 68
Date cleared by Board: June 28, 2000

QUESTION

To comply with the requirements of paragraph 28(b) of Statement 133 on an ongoing basis, must an entity consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative that require the counterparty to make cash payments to the entity?

BACKGROUND

Paragraph 28(b) of Statement 133 states, in part, the following criterion to qualify for cash flow hedge accounting:

> Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28(d) below.

Paragraph 28(d) provides a special criterion for hedging with "basis" swaps.

RESPONSE

Yes, an entity must consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity. For an entity to conclude on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows, the entity cannot ignore whether it will collect the payments it would be owed under the contractual provisions of the derivative. In complying with the requirements of paragraph 28(b), the entity must assess the possibility of whether the counterparty to the derivative will default by failing to make any contractually required payments to the entity as scheduled in the derivative instrument. In making that assessment, the entity should also consider the impact of any related collateralization or financial guarantees.

The entity must be aware of the counterparty's creditworthiness (and changes therein) in determining the fair value of the derivative. Although a change in the counterparty's creditworthiness would not necessarily indicate that the counterparty would default on its obligations, such a change would warrant further evaluation. If the likelihood that the counterparty will not default ceases to be probable, an entity would be unable to conclude that the hedging relationship in a cash flow hedge is expected to be highly effective in achieving

offsetting cash flows. In contrast, a change in the creditworthiness of the derivative's counterparty in a fair value hedge would have an immediate impact because that change in creditworthiness would affect the change in the derivative's fair value, which would immediately affect both the assessment whether the relationship qualifies for hedge accounting and the amount of ineffectiveness recognized in earnings under fair value hedge accounting. (A change in the creditworthiness of the derivative's counterparty in a cash flow hedge of interest rate risk would also have an immediate impact if ineffectiveness were measured under the Change in Fair Value Method discussed in Statement 133 Implementation Issue No. G7, "Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method Is Not Applied.")

In applying the shortcut method for hedges of interest rate risk with interest rate swaps (as discussed in paragraphs 68, 114, and 132), an entity must similarly consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity. Implicit in the criteria for the shortcut method is the requirement that a basis exists for concluding on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair values or cash flows.

In addition to assessing the creditworthiness of the derivative's counterparty, an entity using a cash flow hedge must also assess the creditworthiness of the counterparty to the hedged forecasted transaction in determining whether the forecasted transaction is probable, as required by paragraph 29(b), particularly if the hedged transaction involves payments pursuant to a contractual obligation of the counterparty.

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Title:	Cash Flow Hedges: Defining the Risk Exposure for Hedging Relationships Involving an Option Contract as the Hedging Instrument
Paragraph reference:	63
Date cleared by Board:	June 28, 2000
Date posted to website:	July 11, 2000
Date revision posted to website:	December 10, 2001 Revised November 21, 2001

QUESTION

When a purchased option is designated as a hedging instrument, may the time value component of that option be included in defining limited parameters for the hedged risk exposure? Specifically, may a company define its risk exposure as currency exchange rate changes above the sum of the strike price and the time value component at the inception of the hedging relationship (that is, in the example in the background section, as currency exchange rate changes above $1.65 per pound sterling)?

BACKGROUND

XYZ Company, a U.S. dollar functional currency company, forecasts the purchase of goods with the payment denominated in pound sterling. To hedge the foreign currency exposure from the forecasted purchase, XYZ Company purchases an at-the-money call option on pound sterling. The notional amount of the option equals the forecasted value of goods to be purchased, and the option exercise date is the date the purchase consummates. At inception of the hedging relationship the strike price and the forward market exchange rate for 1 pound sterling are both $1.50. The time value component on the option is $0.15 per pound sterling.

RESPONSE

No. When a purchased option is designated as a hedging instrument, an entity cannot define only limited parameters for the risk exposure designated as being hedged that would include the time value component of that option. The foreign currency option in the above example could be effective as a hedging instrument only if (a) effectiveness for that hedging relationship were based solely on changes in the option's intrinsic value or (b) effectiveness for that hedging relationship were based solely on changes in the option's entire fair value. When an entity has documented that the effectiveness of a cash flow hedge will be assessed based on changes in the hedging option's intrinsic value pursuant to paragraph 63(a), that assessment (and the related cash flow hedge accounting) must be performed for all changes in intrinsic value—that is, for all periods of time when the option has an intrinsic value, such as when the underlying is above the strike price of the call option in the above example. Therefore, in the above example, it is inappropriate to assert that only limited risk exposures are being hedged, such as exposures related only to currency exchange rate changes above $1.65 per pound

sterling. An entity cannot arbitrarily exclude some portion of an option's intrinsic value from the hedge effectiveness assessment simply through an articulation of the risk exposure definition.

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Title: Cash Flow Hedge: Use of Shortcut Method for Cash Flow Hedge of Variable-Rate Operating Lease
Paragraph references: 68, 438
Date cleared by Board: December 6, 2000

QUESTION

Paragraph 68 of Statement 133 (as amended) allows the application of the shortcut method (as discussed in paragraphs 114 and 132) to a hedging relationship of interest rate risk involving a recognized interest-bearing *asset or liability* and an interest rate swap that meets the criteria in paragraph 68. Can an entity apply the shortcut method to a cash flow hedge of the variability in lease payments for an interest-rate-indexed operating lease?

BACKGROUND

An entity leases property under a lease agreement that provides for rental payments indexed to changes in interest rates and accounted for as an operating lease. The payments on the lease agreement are reset quarterly based on changes in three-month LIBOR. To hedge the variability in expected future cash flows attributable to interest rate risk, the entity enters into a pay-fixed, receive-variable interest rate swap based on three-month LIBOR and designates the swap as the hedging instrument in a cash flow hedge of the variability in the lease payments. Assume that the term, notional amounts, repricing dates, and maturity on the operating lease and the interest rate swap match, and the fair value of the interest rate swap at the inception of the hedge is zero.

The conditions that are required to be met to apply the shortcut method are listed in paragraph 68 (as amended), which states, in part:

> 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* interest-bearing asset or liability and an interest rate swap if all of the applicable conditions in the following list are met.… [Emphasis added.]

RESPONSE

No, the shortcut method may not be applied to a cash flow hedge of the variability in lease payments for an interest-rate-indexed operating lease because, under current generally accepted accounting principles, that lease is not a recognized interest-bearing asset or liability. Although a capital lease is reported as a leased asset and an interest-bearing obligation under FASB Statement No. 13, *Accounting for Leases,* (and thus the shortcut method could potentially be

applied to a fair value hedge of a capital lease's exposure to interest rate risk), an operating lease is accounted for as an executory contract that is not recognized as an interest-bearing asset or liability. The shortcut method may not be applied to a hedging relationship that does not involve a recognized interest-bearing asset or liability. In the above example, the contract is a lease agreement with an escalation clause whose rental payments are dependent on LIBOR-based interest rate levels; the contract is not a recognized interest-bearing financial instrument for accounting purposes. Thus, the shortcut method cannot be applied to the operating lease in the example. The guidance in Statement 133 Implementation Issue No. G7, "Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method Is Not Applied," would then be relevant.

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Title:	Cash Flow Hedges: Hedging the Variable Interest Payments on a Group of Floating-Rate Interest-Bearing Loans
Paragraph references:	28, 29, 32, 68, 131–139, 153–161, 459–462, 494
Date cleared by Board:	December 20, 2000

QUESTIONS

Company A and Company B both make to their respective customers LIBOR-indexed floating-rate loans for which interest payments are due at the end of each calendar quarter, and the LIBOR-based interest rate resets at the end of each quarter for the interest payment that is due at the end of the following quarter. Both companies determine that they will each always have at least $100 million of those LIBOR-indexed floating-rate loans outstanding throughout the next 3 years, even though the composition of those loans will likely change to some degree due to prepayments, loan sales, and potential defaults.

1. Company A wishes to hedge its interest rate exposure to changes in the quarterly interest receipts on $100 million principal of those LIBOR-indexed floating-rate loans by entering into a 3-year interest rate swap that provides for quarterly net settlements based on Company A receiving a fixed interest rate on a $100 million notional amount and paying a floating LIBOR-based rate on a $100 million notional amount. In identifying the hedged forecasted transactions in cash flow hedges of interest rate risk, can Company A designate the hedging relationships as hedging the risk of changes (attributable to interest rate risk) in Company A's first LIBOR-based interest payments received during each 4-week period that begins 1 week before each quarterly due date for the next 3 years that, in the aggregate for each quarter, are interest payments on $100 million principal of its then existing LIBOR-indexed floating-rate loans?

2. Company B wishes to hedge its interest rate exposure to changes in the quarterly interest receipts on $100 million principal of those LIBOR-indexed floating-rate loans by entering into a 3-year interest rate swap that provides for quarterly net settlements based on Company B receiving a fixed interest rate on a $100 million notional amount and paying a floating LIBOR-based rate on a $100 million notional amount. If Company B initially designates cash flow hedging relationships of interest rate risk and identifies as the related hedged forecasted transactions each of the variable interest receipts on a specified group of individual LIBOR-indexed floating-rate loans aggregating $100 million principal but then some of those loans (a) experience prepayments, (b) are sold, or (c) experience credit difficulties, can the original cash flow hedging relationships remain intact if the composition of the group of loans whose interest payments are the hedged forecasted transactions is changed by replacing the principal amount of the specified loans with *similar* floating-rate interest-bearing loans?

This Issue does not address cash flow hedging relationships in which the hedged risk is the risk of overall changes in the hedged cash flows related to an asset or liability, as discussed in paragraph 29(h)(1).

BACKGROUND

Paragraph 28(a) of Statement 133 states, in part:

> At inception of the hedge, there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged transaction, the nature of the risk being hedged, and how the hedging instrument's effectiveness in hedging the exposure to the hedged transaction's variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness.…
>
> (2) Documentation shall include all relevant details, including the date on or period within which the forecasted transaction is expected to occur, the specific nature of asset or liability involved (if any), and the expected currency amount or quantity of the forecasted transaction.
> (a) The phrase *expected currency amount* refers to hedges of foreign currency exchange risk and requires specification of the exact amount of foreign currency being hedged.
> (b) The phrase *expected…quantity* refers to hedges of other risks and requires specification of the physical quantity (that is, the number of items or units of measure) encompassed by the hedged forecasted transaction. If a forecasted sale or purchase is being hedged for price risk, the hedged transaction cannot be specified solely in terms of expected currency amounts, nor can it be specified as a percentage of sales or purchases during a period. The current price of a forecasted transaction also should be identified to satisfy the criterion in paragraph 28(b) for offsetting cash flows.
>
> The hedged forecasted transaction shall be described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. Thus, the forecasted transaction could be identified as the sale of either the first 15,000 units of a specific product sold during a specified 3-month period or the first 5,000 units of a specific product sold in each of 3 specific months, but it could not be identified as the sale of the last 15,000 units of that product sold during a 3-month period (because the last 15,000 units cannot be identified when they occur, but only when the period has ended).

Paragraph 28(b) of Statement 133 states, "Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge.…"

Paragraph 29 of Statement 133 (as amended) states, in part:

a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged.…
b. The occurrence of the forecasted transaction is probable.…
h. …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.

Paragraphs 459–462 in the basis for conclusions of Statement 133 state, in part:

> The Board decided to require an entity to identify the hedged forecasted transaction with sufficient specificity to make it clear whether a particular transaction is a hedged transaction when it occurs. An entity should not be able to choose when to reclassify into earnings a gain or loss on a hedging instrument in accumulated other comprehensive income after the gain or loss has occurred by asserting that the instrument hedges a transaction that has or has not yet occurred. However, the Board does not consider it necessary to require that an entity be able to specify at the time of entering into a hedge the date on which the hedged forecasted transaction will occur to prevent such after-the-fact designation.
>
> The following example illustrates the requirement for specific identification of the hedged transaction. Company A determines with a high degree of probability that it will issue $5,000,000 of fixed-rate bonds with a 5-year maturity sometime during the next 6 months, but it cannot predict exactly when the debt issuance will occur. That situation might occur, for example, if the funds from the debt issuance are needed to finance a major project to which Company A is already committed but the precise timing of which has not yet been determined. To qualify for cash flow hedge accounting, Company A might identify the hedged forecasted transaction as, for example, the first issuance of five-year, fixed-rate bonds that occurs during the next six months.
>
> The Board understands that it sometimes will be impractical (perhaps impossible) and not cost-effective for an entity to identify each individual transaction that is being hedged. An example is a group of sales or purchases over a period of time to or from one or more parties. The Board decided that an entity should be permitted to aggregate individual forecasted transactions for hedging purposes in some circumstances. As for a hedge of a single forecasted transaction, an entity must identify the hedged transactions with sufficient specificity that it is possible to determine which transactions are hedged transactions when they occur. For example, an entity that

> expects to sell at least 300,000 units of a particular product in its next fiscal quarter might designate the sales of the first 300,000 units as the hedged transactions. Alternatively, it might designate the first 100,000 sales in each month as the hedged transactions. It could not, however, simply designate any sales of 300,000 units during the quarter as the hedged transaction because it then would be impossible to determine whether the first sales transaction of the quarter was a hedged transaction. Similarly, an entity could not designate the last 300,000 sales of the quarter as the hedged transaction because it would not be possible to determine whether sales early in the quarter were hedged or not.
>
> To qualify for hedging as a group rather than individually, the aggregated transactions must share the risk exposure for which they are being hedged. If a forecasted transaction does not share the risk exposure for which the group of items is being hedged, it should not be part of the group being hedged. The Board considers that requirement to be necessary to ensure that a single derivative will be effective as a hedge of the aggregated transactions. To illustrate, under the guidance in this Statement, a single derivative of appropriate size could be designated as hedging a given amount of aggregated forecasted transactions such as the…forecasted interest payments on several variable-rate debt instruments within a specified time period. However, the transactions…must share the risk exposure for which they are being hedged. For example, the interest payments…must vary with the same index to qualify for hedging with a single derivative.

Paragraph 29(a) of Statement 133 requires that:

> The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.

RESPONSE

Question 1

Yes. In a cash flow hedge of interest rate risk, Company A may identify the hedged forecasted transactions as the *first* LIBOR-based interest payments received by Company A during each 4-week period that begins 1 week before each quarterly due date for the next 3 years that, in the aggregate for each quarter, are payments on $100 million principal of its then existing LIBOR-indexed floating-rate loans. The LIBOR-based interest payments received by Company A after it has received payments on $100 million aggregate principal would be unhedged interest payments for that quarter.

The hedged forecasted transactions for Company A in the above scenario are described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. Because Company A has designated the hedging relationship as hedging the risk of changes attributable to changes in the LIBOR benchmark interest rate in Company A's first LIBOR-based interest payments received, any prepayment, sale, or credit difficulties related to an individual LIBOR-indexed floating-rate loan would not affect the designated hedging relationship. Provided Company A determines it is probable that it will continue to receive interest payments on at least $100 million principal of its then existing LIBOR-indexed floating-rate loans, Company A can conclude that the hedged forecasted transactions in the documented cash flow hedging relationships are probable of occurring.

An entity may not assume no ineffectiveness in such a hedging relationship as described in paragraph 68 of Statement 133 because the hedging relationship does not involve hedging the interest payments related to the same recognized interest-bearing loan throughout the life of the hedging relationship. Consequently, at a minimum, Company A must consider the timing of the hedged cash flows vis-à-vis the swap's cash flows when assessing effectiveness and calculating ineffectiveness.

Question 2

No. Company B cannot conclude that the original cash flow hedging relationships have remained intact if the composition of the group of loans whose interest payments are the hedged forecasted transactions is changed by replacing the principal amount of the originally specified loans with *similar* floating-rate interest-bearing loans. Paragraph 29(a) of Statement 133 requires that for a cash flow hedge, the forecasted transaction should be *specifically identified* as a single transaction or group of transactions. At inception, the entity designated cash flow hedging relationships for each of the variable interest receipts on a specified group of benchmark-interest-rate-based floating-rate loans. If a loan within the group experiences a prepayment, has been sold, or experiences an unexpected change in its expected cash flows due to credit difficulties, the remaining hedged interest payments to Company B specifically related to that loan are now no longer probable of occurring. Pursuant to paragraph 32, Company B must discontinue the hedging relationships with respect to the hedged forecasted transactions that are now no longer probable of occurring. However, had the hedged forecasted transactions been designated in a manner similar to that described in Question 1, the consequences of a loan's prepayment, a loan sale, or an unexpected change in a loan's expected cash flows due to credit difficulties would not have been the same. How the forecasted transaction in a cash flow hedge is designated can have a significant impact on the application of Statement 133.

Changing the composition of the specified individual loans within the group of floating-rate interest-bearing loans due to prepayment, a loan sale, or an unexpected change in a loan's expected cash flows due to credit difficulties reflects a change in the probability of the identified hedged forecasted transactions for the hedging relationships related to the individual loans removed from the group of floating-rate interest-bearing loans. Consequently, the hedging relationships for future interest payments that are no longer probable of occurring must be

terminated. Paragraph 33 of Statement 133 (as amended) states that "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 [that paragraph], that derivative gain or loss reported in accumulated other comprehensive income shall be reclassified into earnings immediately." (Note that the provisions related to immediately reclassifying a derivative's gain or loss out of accumulated other comprehensive income (OCI) into earnings are based on the hedged forecasted transaction being *probable that it will not occur*—not *no longer being probable of occurring*—and includes consideration of an additional two-month period of time.) Subsequent to the discontinuation of the hedging relationships for interest payments related to the individual loans removed from the group of floating-rate interest-bearing loans and the reclassification into earnings of the net gain or loss in accumulated OCI related to those hedging relationships, the derivative (or a proportion thereof) specifically related to the hedging relationships that have been terminated is eligible to be redesignated as the hedging instrument in a new cash flow hedging relationship. However, paragraph 494 warns that "a pattern of determining that hedged forecasted transactions probably will not occur would call into question both entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions."

The guidance on Question 2 above does not conflict with the guidance to Example 8 in paragraphs 153–161. In Example 8, MNO Company plans to borrow $5 million for an overall period of 5 years and, because MNO Company does not plan to initially enter into a 5-year fixed-rate debt obligation, the interest payments over that 5-year period have variability. In Example 8, MNO Company obtains a LIBOR-based interest rate swap to hedge the variability in the quarterly interest payments on the five-year borrowing program attributable to changes in the LIBOR benchmark rate. Initially, MNO Company plans to accomplish its 5-year borrowing program by sequentially issuing 90-day notes over the total period, though it is aware that changes in market conditions may prompt it to accomplish its 5-year borrowing program by other means, such as a fixed-rate borrowing for the remainder of the 5-year period.

In Scenario 1 of Example 8, MNO Company discontinues at the end of the second year its practice of issuing 90-day notes and instead issues a 3-year fixed-rate $5 million note. Paragraph 156 notes that in Scenario 1, "The variability of the payments has been eliminated, but it still is probable that they will occur." This is true because MNO Company has still continued its 5-year borrowing program with a mechanism that still requires quarterly interest payments on a $5 million debt. Scenario 1 illustrates the provisions of paragraphs 32 and 33. The hedging relationships for the future hedged quarterly interest payments must be discontinued under paragraph 32 because the variability has ceased. Paragraph 156 clarifies paragraph 154 and indicates that the originally designated hedged transactions are the future interest payments under MNO Company's five-year borrowing program. In other words, MNO Company originally documented that it was hedging its interest rate risk exposure to changes in the quarterly interest payments on its $5 million borrowing over the next 5 years. Because MNO Company will continue to be obligated to make quarterly interest payments on its $5 million borrowing for the

remainder of the 5-year period, no immediate reclassification of amounts from OCI into earnings is required (or permitted) under paragraph 33. [1]

In contrast, in the example in Question 2, the hedged quarterly interest payments were directly linked to Company B's existing LIBOR-indexed floating-rate assets. When those existing assets are later prepaid or sold, the future quarterly interest payments on those specific assets are no longer probable of occurring (that is, no longer probable of being received by Company B). Consequently, the hedging relationships for those future quarterly interest payments fail to meet the criterion in paragraph 29(b) and must be discontinued under paragraph 32. Because it is probable that the hedged quarterly interest payments that were directly linked to assets that were prepaid or sold will not occur, the related derivative net gain or loss in OCI must be immediately reclassified into earnings pursuant to paragraph 33.

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[1]How the hedged forecasted transaction is designated and documented in a cash flow hedge is critically important in determining whether it is probable that the hedged forecasted transaction will occur. In the cash flow hedge in Example 8, had the hedged forecasted transaction been narrowly limited to the interest payments on specific future debt issuances rather than on the five-year borrowing program, the failure to engage in those future debt issuances would cause the related derivative net gain or loss in OCI to be immediately reclassified into earnings pursuant to paragraph 33 because it would have been probable that the hedged forecasted transactions would not occur. Furthermore, that failure, if part of a pattern of having hedged forecasted transactions cease being probable of occurring, would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions, pursuant to paragraph 494.

Title:	Cash Flow Hedges: Assessing the Probability of the Forecasted Acquisition of a Marketable Security Hedged by a Purchased Option or Warrant
Paragraph references:	28, 29, 463–465
Date cleared by Board:	December 6, 2000

QUESTION

An entity holds a purchased option or warrant and seeks to designate it as a cash flow hedge of the forecasted acquisition of the marketable security to which the option or warrant relates. If the entity has elected to assess the effectiveness of the hedge based solely on changes in the option's (or warrant's) intrinsic value and thus that assessment is relevant only for those periods in which the option or warrant has an intrinsic value other than zero, may the probability of the forecasted transaction likewise be evaluated only during those periods in which the option or warrant has an intrinsic value other than zero? (Assume that all changes in time value will be recorded directly in earnings.)

BACKGROUND

An entity seeking to reduce the variability of the price at which it will acquire a marketable security in the future might use a forward contract to fix the price today, or a warrant or purchased option to lock in a ceiling on the price it will eventually pay. With a forward, the typical settlement is the delivery of the marketable security at a later date at the pre-fixed price. With a warrant or purchased option, the typical settlement might be the delivery of the marketable security at the ceiling price, or the holder may allow the warrant or purchased option to expire unexercised.

Paragraph 28(b) of Statement 133 requires that if a hedging instrument, such as an at-the-money option contract provides only one-sided offset against the hedged risk, the cash inflows (outflows) from the hedging instrument must be expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction. Paragraph 29(b) states that the occurrence of the hedged forecasted transaction must be "probable." Paragraph 464 states that "probable" means that the future event or events are likely to occur. Paragraph 463 also states that the transaction's probability should be supported by observable facts and the attendant circumstances and that consideration should be given to the following circumstances in assessing the likelihood that a transaction will occur:

a. The frequency of similar past transactions
b. The financial and operational ability of the entity to carry out the transaction
c. Substantial commitments of resources to a particular activity
d. The extent of loss or disruption of operations that could result if the transaction does not occur

e. The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to a common stock offering).

RESPONSE

No. In determining whether an option or warrant designated as a hedge of the forecasted acquisition of a marketable security may qualify for cash flow hedge accounting, the probability of the forecasted transaction being consummated must be evaluated without consideration of whether the option or warrant designated as the hedging instrument has an intrinsic value other than zero. The evaluation of whether the forecasted acquisition of the marketable security is probable of occurring must be independent of the terms and nature of the derivative designated as the hedging instrument.

In order to qualify for cash flow hedge accounting for an option or warrant designated as a hedge of the forecasted acquisition of a marketable security, an entity must be able to establish at the inception of the hedging relationship that the acquisition of the marketable security is probable, without regard to the means of acquiring it. In documenting the hedging relationship, the entity must specify the date on or period within which the forecasted acquisition of the security will occur. Therefore, to qualify for cash flow hedge accounting in this case, the entity must be able to establish that it is probable that it will acquire the security by (a) exercising the option or warrant designated as the hedging instrument if it is in-the-money or (b) purchasing the security in the marketplace at its prevailing market price if the option or warrant is out-of-the-money. If the entity expects to acquire the marketable security only by exercising the option or warrant and only if the option or warrant were in-the-money, a cash flow hedging relationship typically would not be designated because acquisition of the security is contingent and thus would not be considered probable.

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Title: Cash Flow Hedges: Combinations of Options Involving One Written Option and Two Purchased Options
Paragraph reference: 29
Date cleared by Board: December 6, 2000

QUESTIONS

For a hedging relationship in which a combination of options (deemed to be a net purchased option) is designated as the hedging instrument and the effectiveness of the hedge is assessed based only on changes in intrinsic value of the combination of options, may the assessment of effectiveness be based only on changes in the underlying that cause a change in the intrinsic value of the hedging instrument (the combination of options)? In other words, may the assessment of effectiveness exclude ranges of changes in the underlying for which there is no change in the hedging instrument's intrinsic value? Specifically, is the example hedging relationship illustrated in the background section involving a combination of options considered effective at offsetting the change in cash flows due to foreign currency exchange rate movements related to the forecasted transaction?

BACKGROUND

JPN is a Japanese subsidiary of a U.S. company. JPN's functional currency is the Japanese yen. JPN has forecasted inventory purchases to be paid in U.S. dollars (US$). As a result, JPN is exposed to changes in the yen-US$ exchange rate: its functional currency cash outflows will increase (loss) if the yen weakens versus the US$ and decrease (gain) if the yen strengthens versus the US$. JPN would like to hedge the foreign currency exposure related to the forecasted transaction by entering into a combination of foreign-currency-denominated option contracts designated as a single hedging instrument. For purposes of this discussion, it is assumed that JPN has met the qualifying criteria regarding forecasted transactions eligible for designation as hedged transactions pursuant to paragraph 29 of Statement 133 and that the options are entered into contemporaneously with the same counterparty and can be transferred independently of each other. Also, assume that the combination of foreign currency option contracts meets all of the conditions in Statement 133 Implementation Issue No. E2, "Combinations of Options," to be considered a net purchased option (that is, considered not to be a net written option subject to the requirements of paragraph 28(c)).

JPN employs the following hedging strategy:

- The forecasted transaction is estimated at $150,000,000. The at-the-money forward rate is 120 yen per US$ (¥120/US$1).

- JPN's documented hedge objective is to offset the foreign exchange risk to the functional currency equivalent cash flows at levels above ¥125/US$1 and in the range from ¥113/US$1 to ¥108/US$1. In the range ¥113/US$1 to ¥125/US$1 and at levels below ¥108/US$1, JPN chooses not to offset the foreign exchange risk to the functional currency equivalent cash flows.
- To implement this hedge objective, JPN enters into the following option contracts and jointly designates them as the hedging instrument:

    1) One purchased option that gives JPN the right to purchase $150,000,000 at an exchange rate of ¥125/US$1. Premium paid: $1,536,885.
    2) One sold (written) option that, if exercised, obligates JPN to purchase $150,000,000 at an exchange rate of ¥113/US$1. Premium received: $1,536,885.
    3) One purchased option that gives JPN the right to sell $150,000,000 at an exchange rate of ¥108/US$1. Premium paid: $737,705.

The time value of the combination of options is to be excluded from the assessment of effectiveness and, therefore, effectiveness is based only on changes in intrinsic value related to the combination of options.

The purpose of Option 1 is to protect JPN when the yen-US$ exchange rate increases above ¥125/US$1. As the yen-US$ exchange rate increases, JPN will be required to purchase the $150,000,000 inventory at a greater yen-equivalent cost. As the yen-US$ exchange rate increases above ¥125/US$1, the intrinsic value of the option increases as the option is increasingly in-the-money. That increase in the option's intrinsic value is expected to offset the increase in the yen-equivalent expenditure on the forecasted transaction.

JPN also writes an option (Option 2) that obligates JPN to purchase US$ from the counterparty at an exchange rate of ¥113/US$1. The counterparty will exercise the option whenever the yen-US$ exchange rate is below ¥113/US$1. As the yen-US$ exchange rate decreases, JPN will be required to purchase the $150,000,000 inventory at a lesser yen-equivalent cost. As the yen-US$ exchange rate decreases below ¥113/US$1, JPN's losses related to increases in the intrinsic value of the written option are expected to offset the decrease in the yen-equivalent expenditure on the forecasted transaction.

JPN also purchases an option to sell US$ (Option 3) for a notional amount equal to the notional of the written option (Option 2) with a strike price of ¥108/US$1. JPN will exercise Option 3 whenever the yen-US$ exchange rate is below ¥108/US$1. When the exchange rate is below ¥108/US$1, although JPN will be obligated to make a payment in relation to Option 2, it will also receive a payment in relation to Option 3. As a result of purchasing Option 3, JPN will be exposed to exchange rate fluctuations on Option 2 only when the exchange rate is between ¥113/US$1 and ¥108/US$1. Hence, with Options 2 and 3, JPN has effectively limited its hedge offset to changes in cash flows on the forecasted item to levels between ¥113/US$1 and ¥108/US$1. Changes in the exchange rate below ¥108/US$1 result in no change in the intrinsic

value of the combination of options because the change in Option 2 offsets the change in Option 3. However, when the exchange rate is below ¥108/US$1, the combination of options has an intrinsic value other than zero.

In summary, potential changes in intrinsic value related to this combination option hedge construct (Options 1, 2 and 3) would limit the hedge offset to corresponding changes in functional currency cash flows on the forecasted transaction only at levels above ¥125/US$1 and in the range ¥108/US$1 to ¥113/US$1, consistent with JPN's documented hedge objective.

RESPONSE

Yes. In a hedging relationship in which a combination of options (deemed to be a net purchased option) is designated as the hedging instrument and the effectiveness of the hedge is assessed based only on changes in intrinsic value of the hedging instrument (the combination of options), the assessment of effectiveness may be based only on changes in the underlying that cause a change in the intrinsic value of the hedging instrument (the combination of options). Thus, the assessment can exclude ranges of changes in the underlying for which there is no change in the hedging instrument's intrinsic value.

The example cash flow hedging relationship illustrated in the background section involving a combination of options may be considered effective at offsetting the change in cash flows due to foreign currency exchange rate movements related to the forecasted transaction. Specifically, JPN may assess the effectiveness of the hedge based only on changes in the underlying that cause a change in the intrinsic value of the combination of options. Thus, in that case, JPN would assess effectiveness of the hedge only when the yen-US$ exchange rate is above ¥125/US$1 and between ¥113/US$1 and ¥108/US$1. Likewise, JPN's assessment would exclude changes in the yen-US$ exchange rate between ¥113/US$1 and ¥125/US$1 and below ¥108/US$1.

The combination of options used by JPN as a hedging instrument is deemed to be a net purchased option based on the provisions in Statement 133 and the guidance in Implementation Issue E2. Therefore, the hedging relationship avoids being subject to the special hedge effectiveness test for written options in paragraph 28(c). In particular, as it relates to Condition 1 of Implementation Issue E2, the aggregate premium (that is, the time values) for the three options comprising the hedging instrument results in JPN paying a net premium. The evaluation of whether a net premium has been received (Implementation Issue E2, Condition 1) must include consideration of only the time value components of the options designated as the hedging instrument. That evaluation must not include the intrinsic value, if any, of the options.

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Title:	Cash Flow Hedges: Designating the Hedged Forecasted Transaction When Its Timing Involves Some Uncertainty within a Range
Paragraph references:	28, 30, 33, 64, 65, 460
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001

QUESTION

How should the requirements of paragraphs 28, 29, and 33 be applied to a forecasted transaction that is expected (probable) to occur on a specific date but whose timing involves some uncertainty within a range?

BACKGROUND

A general contractor enters into a long-term contract to build a power plant. The long-term contract is to be completed within five years. As part of the construction project, the general contractor expects to subcontract a portion of the construction to a foreign company with a functional currency different from its own. Because the subcontractor will be paid in its functional currency, the general contractor will have a foreign currency exposure that it desires to hedge.

At the start of the project, the general contractor concludes it is probable that the subcontract work will be completed and paid for at the end of year two. However, the general contractor knows that the timing of a subcontractor's work, and thus the foreign-currency-denominated payment for its work, may possibly be delayed by a period of more than two months, even though it is probable that the overall project will remain on schedule in meeting the ultimate completion date.

The contractor intends to hedge the exposure by using a forward contract with a maturity date that coincides with the current expected date of payment (that is, a two-year foreign currency forward) and the expected notional amount of the forecasted transaction.

Paragraph 28(a)(2) states, in part, that the "documentation [of the hedged forecasted transaction] shall include all relevant details, including the date on or period within which the forecasted transaction is expected to occur….The hedged forecasted transaction shall be described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction."

Paragraph 33 (as amended) states:

> 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.

Paragraph 30 states, in part:

> 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: …
>
> 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.

RESPONSE

Paragraph 28(a)(2) of Statement 133 requires that documentation of the cash flow hedging relationship and the entity's risk management objective and strategy for undertaking the hedge include documentation specifying either the date on or period within which the forecasted transaction is expected to occur.

For forecasted transactions whose timing involves some uncertainty within a range, that range could be documented as the "originally specified time period," provided that the hedged forecasted transaction is described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. That is, the general contractor could document (as required by paragraph 28(a)(2)) that the hedged forecasted transaction is the foreign-currency-denominated payment to the foreign subcontractor to be paid *within the five-year contract period of the overall project* (which is the "originally specified time period" referred to in paragraph 33). As long as it remains probable that the forecasted transaction will occur by the end of the originally projected five-year period of the overall project, cash flow hedge accounting for that hedging relationship would continue. Consequently, if the subcontractor's payment is delayed by more than two months, but less than three years and two months, then the forecasted transaction would still be considered probable of occurrence within the "originally specified time period."

This response is consistent with the example provided in paragraph 460, which states:

> The following example illustrates the requirement for specific identification of the hedged transaction. Company A determines with a high degree of probability that it will issue $5,000,000 of fixed-rate bonds with a 5-year maturity sometime during the next 6 months, but it cannot predict exactly when the debt issuance will occur. That situation might occur, for example, if the funds from the debt issuance are needed to finance a major project to which Company A is already committed but the precise timing of which has not yet been determined. To qualify for cash flow hedge accounting, Company A might identify the hedged forecasted transaction as, for example, the first issuance of five-year, fixed-rate bonds that occurs during the next six months.

Although documenting only the period within which the forecasted transaction will occur is sufficient to comply with the requirements of paragraph 28(a), compliance with paragraphs 28(b) and 30 requires that the best estimate of the forecasted transaction's timing be both documented and used in assessing hedge effectiveness. As explained in paragraphs 64 and 65, the time value of money is likely to be important in the assessment of cash flow hedge effectiveness, especially if Company A plans to use a rollover or tailing strategy to hedge its forecasted transaction. The use of time value of money requires information about the timing of cash flows.

If the expected timing of the forecasted transaction changes, the contractor must first apply the requirements of paragraph 30 using its originally documented hedging strategy and the *newly revised* best estimate of the cash flows,[1] and then reevaluate whether continuing hedge accounting is appropriate, pursuant to the requirements of paragraph 32. If hedge accounting is discontinued prospectively, the derivative's gains or losses in other comprehensive income after the application of paragraph 30(b) should be accounted for pursuant to paragraph 31 (unless paragraph 33 requires reclassification into earnings).

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[1] Note that paragraph 30 requires recognition of *cumulative* ineffectiveness for overhedges. This could result in an entity reporting a significant amount of ineffectiveness in income (in essence a catch-up adjustment) in the period that a change is made in the expected future cash flows on the hedged forecasted transaction from the inception of the hedge. That is, the final measurement under paragraph 30(b)(2) should be based on the most recent best estimate of the hedged forecasted transaction as of the date that a cash flow hedge is discontinued prospectively. If the assessment of effectiveness is based on changes in forward rates, the most recent best estimate would be based on the current forward rate for the hedged transaction relevant for the probable date that the transaction will occur. If the assessment of effectiveness is based on changes in spot rates, the best estimate would be based on the current spot rate.

Title:	Cash Flow Hedges: Impact on Accumulated Other Comprehensive Income of Issuing Debt with a Term That Is Shorter Than Originally Forecasted
Paragraph references:	29(a), 29(b), 33, 156
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001

QUESTION

Assume that Company A expects to borrow $100 million over a 10-year period beginning in 6 months. Company A initially plans to issue $100 million of 10-year fixed-rate debt at or near par at the then current market interest rate; consequently, Company A will be exposed to variability in cash flows in the future quarterly interest payments on the debt due to changes in credit risk and interest rate risk that occur during this 6-month period prior to issuance. In order to hedge the risk of changes in these 40 quarterly interest payments attributable to changes in the benchmark interest rate for the 6-month period, the entity enters into a derivative contract (for example, a forward-starting interest rate swap) and documents that it is hedging the variability in the 40 future quarterly interest payments, attributable to changes in the benchmark interest rate, over the next 10 years related to its 10-year $100 million borrowing program that begins in 6 months. The entity documents that it will assess the effectiveness of the hedging relationship semi-monthly. Six months after inception of the hedging relationship, the entity issues debt. However, due to market conditions, the entity decides in the week before issuance that it will issue $100 million of fixed-rate debt with a 5-year maturity and quarterly interest payments. Should the entity immediately reclassify the entire net gain or loss related to the derivative contract in accumulated other comprehensive income into earnings?

BACKGROUND

Paragraphs 29(a) and 29(b) state the forecasted transaction must be specifically identified and its occurrence must be probable.

Paragraph 33 (as amended) states, in part:

> 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.…

When using an interest rate swap to hedge the risk of changes in cash flows attributable to changes in the benchmark interest rate, paragraph 156 describes the effects of terminating this type of cash flow hedging relationship, even though the occurrence of the forecasted transactions

remains probable. Specifically, it states that at termination of the hedging relationship, any net gain or loss on the swap in accumulated other comprehensive income is not reclassified to earnings immediately. Immediate reclassification is required (and permitted) only if it becomes probable that the hedged transactions (future interest payments) will not occur. Even though the variability of future interest payments has been eliminated, the net gain or loss on the swap in accumulated other comprehensive income is reclassified to earnings in the same period or periods during which the hedged transaction affects earnings, as required by paragraph 31. The conclusions in paragraph 156 relate to an original hedging relationship involving a five-year swap being used to hedge the variable interest payments of the forecasted rollover of debt for five years. When three-year, fixed-rate debt is issued at the end of the second year, the variability of the future interest payments has been eliminated and the swap must be dedesignated as the hedging instrument, thereby terminating the original hedging relationship. Although the original relationship related to five years of future interest payments, three years of the hedged future interest payments continue to remain. The net gain or loss in accumulated other comprehensive income relating to the terminated hedging relationship is not immediately reclassified into earnings because the remaining hedged future interest payments in the original forecasted transaction are now a contractual obligation and will continue to be probable of occurring. Footnote 25 to paragraph 156 states, "If the term of the fixed rate note had been longer than three years, the amounts in accumulated other comprehensive income still would have been reclassified into earnings over the next three years, which was the term of the designated hedging relationship."

RESPONSE

No. When the entity decides that the term of the debt to be issued will differ from the term of the debt originally expected to be issued, the entity should not immediately reclassify into earnings the *entire* net gain or loss in accumulated other comprehensive income related to the derivative contract. Instead, the entity must first apply the requirements of paragraph 30 using its originally documented hedging strategy and the *newly revised* best estimate of the cash flows[1].

The entity's strategy is a cash flow hedge of 40 individual probable quarterly interest payments. A cash flow hedge of future interest payments is a hedge of a series of forecasted transactions; consequently, an entity must first determine the likelihood of whether and when each forecasted transaction in the series will occur. If at any time during the hedging relationship the entity determines that it is no longer probable that any of the forecasted transactions in the series will occur by the date (or within the time period) originally specified, it must terminate the original

[1] Note that paragraph 30 requires recognition of *cumulative* ineffectiveness for overhedges. This could result in an entity reporting a significant amount of ineffectiveness in income (in essence a catch-up adjustment) in the period that a change is made in the expected future cash flows on the hedged forecasted transaction from the inception of the hedge. That is, the final measurement under paragraph 30(b)(2) should be based on the most recent best estimate of the hedged forecasted transaction as of the date that a cash flow hedge is discontinued prospectively.

hedging relationship for each of those specific non-probable forecasted transactions (even if the forecasted transaction will occur within an additional two-month period of time after that originally specified date). At the time that the entity decides that the term of the fixed-rate debt to be issued will be changed from 10 years to 5 years, the impact of that decision on the cumulative change in the hedged future interest payments from the inception of the hedge will be reflected in the application of paragraph 30(b). (When the entity performs its semi-monthly assessment of effectiveness for the half-month period immediately preceding the issuance of the debt, it could also possibly conclude that the hedging relationship is no longer considered highly effective under paragraph 28(b) because the actual variability in the hedged interest payments for years 1–5 is now based on the 5-year borrowing rate—not on 10-year rates as expected at the inception of the hedge when the entity selected the hedging derivative. In that case, the hedging relationship is terminated, and the requirements of paragraph 30 must be applied.) After the hedging relationship is terminated, the entity must determine whether it is probable that any or all of those specific non-probable forecasted transactions will *not* occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter (refer to paragraph 33 as amended).

In the example case, when the entity originally documented the hedging relationship, it was hedging 40 forecasted transactions (forecasted quarterly interest payments) that would begin in 6 months' time and continue over a 10-year period. In the example case, the entity terminates the hedging relationship no later than on the date it issues the five-year debt (because the variability of the first 20 hedged payments ceases on that date) and must determine the amount, if any, to be reclassified into earnings from accumulated other comprehensive income related to the net derivative gain or loss of the terminated cash flow hedge. Since the entity issued a 5-year debt instrument, the entity would determine that it is probable that the first 20 forecasted transactions would occur since they are now contractual obligations. The entity must determine that it is not probable that any of the last 20 forecasted transactions will not occur in order to continue reporting the net derivative gain or loss related to these forecasted transactions in accumulated other comprehensive income. At issue is whether it is probable that the five-year debt will not be replaced by new borrowings that will involve the quarterly payment of interest. Provided that the entity determines that it is not probable that any of the original 40 forecasted transactions will not occur, the entity must apply paragraph 30 and continue to report an amount in accumulated other comprehensive income based on the most recent best estimate of the hedged forecasted transactions related to all 40 forecasted transactions and reclassify an appropriate amount into earnings when each hedged forecasted transaction affects earnings. If the entity determines that it is probable that any of those forecasted transactions will *not* occur either by the end of the date (or within the time period) originally specified or within an additional two-month period of time thereafter (refer to paragraph 33 as amended), the entity should reclassify into earnings from accumulated other comprehensive income the amount of the net derivative gain or loss related to those specific "non-occurring" forecasted transactions. That amount should be equivalent to the portion of the present value of the derivative's cash flows intended to offset the changes in the original forecasted transactions for which the entity has determined it is probable that they will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter.

Paragraph 494 of Statement 133 states:

> A pattern of determining that hedged forecasted transactions probably will not occur would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.

Thus, the nonoccurrence of one of the hedged forecasted transactions described in that example case could potentially jeopardize the entity's ability to use cash flow hedge accounting in the future for the situation described.

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Title:	Cash Flow Hedges: Impact on Accumulated Other Comprehensive Income from Issuing Debt at a Date That Is Not the Same as Originally Forecasted
Paragraph references:	29(a), 29(b), 33, 156
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001

QUESTIONS

1. Assume that Company A expects to borrow $100 million over a 10-year period beginning in 6 months. Company A initially plans to issue $100 million of 10-year fixed-rate debt at or near par at the then current market interest rate; consequently, Company A will be exposed to variability in cash flows for the future quarterly interest payments on the debt due to changes in credit risk and interest rate risk that occur during this six-month period prior to issuance. In order to hedge the risk of changes in these 40 quarterly interest payments attributable to changes in the benchmark interest rate for the 6-month period, the entity enters into a derivative contract (for example, a forward-starting interest rate swap) and documents that it is hedging the variability in the 40 future quarterly interest payments, attributable to changes in the benchmark interest rate, over the next 10 years related to its 10-year $100 million borrowing program that begins in 6 months. The entity documents that it will assess the effectiveness of the hedging relationship semi-monthly. Six months after inception of the hedging relationship, the entity decides to delay the issuance of the 10-year debt for 3 months. Should the entity immediately reclassify the entire net gain or loss related to the derivative contract in accumulated other comprehensive income into earnings?
2. Assume that Company B expects to issue $100 million of 10-year, 9 percent debt in 6 months. Because the debt will have a fixed interest rate of 9 percent, Company B will not be exposed to variability in the future quarterly interest payments at 9 percent, but it will be exposed to variability in the cash flows received as proceeds on the debt due to changes in credit risk and interest rate risk that occur during the 6-month period prior to issuance. In order to hedge the risk of changes in the total proceeds attributable to changes in the benchmark interest rate, the entity enters into a derivative contract (for example, a short position in U.S. Treasury note futures contracts) and documents that it is hedging the variability in the cash proceeds attributable to changes in the benchmark interest rate to be received from the 9 percent fixed-rate debt it will issue in 6 months. (Because the entity plans to issue $100 million of 10-year, 9 percent debt regardless of the then current interest rate environment, the effect of increases or decreases in interest rates will be reflected in issuing the debt at a discount or a premium, respectively.) Six months after inception of the hedging relationship, the entity decides to delay the issuance of the debt for three months. Should the entity immediately reclassify the entire net gain or loss related to the derivative contract in accumulated other comprehensive income into earnings?

BACKGROUND

Paragraphs 29(a) and 29(b) state the forecasted transaction must be specifically identified and its occurrence must be probable.

Paragraph 33 (as amended) states, in part:

> 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….

When using an interest rate swap to hedge the risk of changes in cash flows attributable to changes in the benchmark interest rate, paragraph 156 describes the effects of terminating this type of cash flow hedging relationship, even though the occurrence of the forecasted transactions remains probable. Specifically, it states that at termination of the hedging relationship, any net gain or loss on the swap in accumulated other comprehensive income is not automatically reclassified to earnings immediately. Immediate reclassification is required (and permitted) only if it becomes probable that the hedged transactions (future interest payments) will not occur. Even though the variability of future interest payments has been eliminated, the net gain or loss on the swap in accumulated other comprehensive income is reclassified to earnings in the same period or periods during which the hedged transaction affects earnings, as required by paragraph 31. The conclusions in paragraph 156 relate to an original hedging relationship involving a five-year swap being used to hedge the variable interest payments of the forecasted rollover of debt for five years. When three-year, fixed-rate debt is issued at the end of the second year, the variability of the future interest payments has been eliminated and the swap must be dedesignated as the hedging instrument, thereby terminating the original hedging relationship. Although the original relationship related to five years of future interest payments, three years of the hedged future interest payments continue to remain. The net gain or loss in accumulated other comprehensive income relating to the terminated hedging relationship is not immediately reclassified into earnings because the remaining hedged future interest payments in the original forecasted transaction are now a contractual obligation and will continue to be probable of occurring. Footnote 25 to paragraph 156 states, "If the term of the fixed rate note had been longer than three years, the amounts in accumulated other comprehensive income still would have been reclassified into earnings over the next three years, which was the term of the designated hedging relationship."

RESPONSE

Question 1

No. When the entity decides to delay the issuance of the 10-year debt for 3 months, the entity should not immediately reclassify into earnings the *entire* net gain or loss in accumulated other

comprehensive income related to the derivative contract. The entity's strategy is a cash flow hedge of 40 individual probable quarterly interest payments. A cash flow hedge of future interest payments is a hedge of a series of forecasted transactions; consequently, an entity must first determine the likelihood of whether and when each forecasted transaction in the series will occur. If at any time during the hedging relationship the entity determines that it is no longer probable that any of the forecasted transactions in the series will occur by the date (or within the time period) originally specified, it must terminate the original hedging relationship for each of those specific non-probable forecasted transactions (even if the forecasted transaction will occur within an additional two-month period of time after that originally specified date). (It need not terminate the original hedging relationship for those specific forecasted transactions that remain probable of occurring by the date or within the time period originally specified.) After the hedging relationship is terminated, the entity must determine whether it is probable that any or all of those specific non-probable forecasted transactions will *not* occur either by the date (or within the time period) originally specified or within an additional two-month period of time thereafter (refer to paragraph 33 as amended). The entity should reclassify into earnings from accumulated other comprehensive income the amount of the net derivative gain or loss related to those specific non-probable forecasted transactions for which it is probable they will not occur. That amount should be equivalent to the present value of the derivative's cash flows intended to offset the changes in the original forecasted transactions for which the entity has determined it is probable that they will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter.

In the example case, when the entity originally documented the hedging relationship, it was hedging 40 forecasted transactions (forecasted interest payments) that would begin in 6 months' time and continue over a 10-year period. Since the entity did not issue the debt instrument as originally documented, the entity would determine that it is probable that the first forecasted transaction will not occur at the time forecasted; consequently, the entity must terminate the original hedging relationship with respect to that first forecasted transaction. However, the entity would also determine that it is probable that the other 39 forecasted transactions will occur at the time forecasted. After the hedging relationship is terminated for the specific non-probable first forecasted transaction, the entity must determine whether it is probable that specific non-probable first forecasted transaction will *not* occur by the forecasted date or within an additional two-month period of time thereafter. In the example, the entity determines that it is probable that the first hedged quarterly interest payment will not occur within two months of its specified date. The amount reclassified into earnings from accumulated other comprehensive income is the portion of the swap's net gain or loss equivalent to the present value of the cash flows from the swap intended to offset the changes in the first forecasted transaction that is probable not to occur.

Paragraph 494 of Statement 133 states:

> A pattern of determining that hedged forecasted transactions probably will not occur would call into question both an entity's ability to accurately predict forecasted

> transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.

Thus, the nonoccurrence of one of the hedged forecasted transactions described in that example case could potentially jeopardize the entity's ability to use cash flow hedge accounting in the future for the situation described.

Question 2

Yes. This strategy is a cash flow hedge of the variability in proceeds attributable to changes in the benchmark interest rate to be received from the issuance of debt in six months. A cash flow hedge of the proceeds attributable to changes in the benchmark interest rate is a hedge of a single forecasted transaction specified to occur in six months; consequently, when the single forecasted transaction is no longer probable of occurring by the date (or within the time period) originally specified, the entity must terminate the hedging relationship. After the hedging relationship is terminated, the entity must determine whether it is probable that the specific non-probable forecasted transaction will *not* occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter. Since in the example case the entity decided to delay the issuance of the debt for a three-month period of time, the entity concludes that it is probable that the forecasted transaction will *not* occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter. Consequently, the entity should immediately reclassify into earnings the entire net gain or loss related to the derivative contract in accumulated other comprehensive income.

Paragraph 494 of Statement 133 states:

> A pattern of determining that hedged forecasted transactions probably will not occur would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.

Thus, the nonoccurrence of the hedged forecasted transactions described in that example case could potentially jeopardize the entity's ability to use cash flow hedge accounting in the future for the situation described.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Cash Flow Hedges: Hedging Interest Rate Risk for the Forecasted Issuances of Fixed-Rate Debt Arising from a Rollover Strategy
Paragraph references:	29(h), 153–161
Date cleared by Board:	March 21, 2001
Date revision posted to website:	January 8, 2007
Affected by:	Statement 133 Implementation Issue No. G26, "Hedging Interest Cash Flows on Variable-Rate Assets and Liabilities That Are Not Based on a Benchmark Interest Rate" Revised December 13, 2006

QUESTION

If an entity plans to sequentially issue a series of fixed-rate debt instruments as part of the planned roll-over of short-term debt at different fixed rates (thereby resulting in a variable interest expense pattern), is a cash flow hedge of those forecasted issuances of *fixed-rate* debt subject to the restriction at the end of paragraph 29(h) that does not permit interest rate risk to be the hedged risk if the cash flows of the hedged transactions are explicitly based on an index other than a benchmark interest rate index?

BACKGROUND

Paragraph 29(h) of Statement 133 (as amended by FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*) states, in part:

> 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 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.

The last sentence of paragraph 21 of Statement 138 states:

> …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.

Paragraphs 153–161 of Statement 133 present an example of hedging the changes in a cash flow hedge of forecasted interest payments with an interest rate swap. Paragraph 154 describes the scenario as follows:

> MNO Company enters into an interest rate swap … and designates it as a hedge of the variable interest payments on a series of $5 million notes with 90-day terms. MNO plans to continue issuing new 90-day notes over the next five years as each outstanding note matures. The interest on each note will be determined based on LIBOR at the time each note is issued. [The swap] requires a settlement every ninety days, and the variable interest rate is reset immediately following each payment. MNO pays a fixed rate of interest (6.5%) and receives interest at LIBOR. MNO neither pays nor receives a premium at inception of [the swap]. The notional amount of the contract is $5 million, and it expires in 5 years.

Paragraph 155 of Statement 133 (as amended) describes the application of hedge accounting as follows:

> Because [the swap] 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). [Emphasis added.]

Example 8 of Statement 133 illustrates that an entity may hedge the risk of changes in the coupon payments attributable to changes in the benchmark interest rate related to the forecasted issuance of fixed-rate debt when the interest rate at the issuance of the fixed rate debt is based on the benchmark interest rate.

Commercial Paper

Commercial paper and similar markets present an opportunity for highly rated borrowers, or those with high quality collateral, to consistently obtain low-cost short-term financing. Similarly, investments in these instruments provide a high-quality short-term investment vehicle. Frequently, derivative contracts (typically interest rate swaps, or purchased caps or floors) are used to hedge the forecasted interest payments or receipts arising from future issuances or future investments.

Commercial paper and similar instruments are issued on a fixed-rate discounted basis with relatively short contractual maturities (for example, from 7 to 270 days). That is, the issuer receives a single discounted amount as proceeds of the issuance and makes a single payment of the stated amount at maturity. There are no periodic interest payments; thus, those instruments are effectively zero-coupon instruments. In this Issue, the phrase *issuance of fixed-rate debt* includes the issuance of a zero-coupon instrument because the interest element in a zero-coupon instrument is fixed at its issuance.

The interest rate is established for each issuer based on market conditions that exist at the time of issuance. Although commercial paper interest rate indices exist, they represent the average rates paid by selected issuers at a point in time. In other cases, the depth of the markets and the consistency of collateral lead to very tight bid-ask interest rate quotes. In any of these cases, however, the actual rate paid by any particular issuer reflects the market's perception of the liquidity, credit, and other risks that are unique to the issuer or the transaction on any given day.

Issuers and investors in commercial paper typically issue and invest in very large volumes and actively manage their funding programs. A typical commercial paper program will involve daily issuances of a broad range of maturities of paper so as to balance the objectives of achieving the lowest cost of funds and a target average maturity of the portfolio of outstanding commercial paper.

A company with a rolling commercial paper program may wish to hedge the risk of changes in the interest element of the final cash flows at maturity attributable to changes in the benchmark interest rate related to each of the forecasted issuances of fixed-rate commercial paper (that is, zero-coupon instruments).

Certificates of Deposit

Certificates of Deposit (CDs) are an important source of funds for banks and savings institutions. CDs generally have a stipulated maturity and a fixed interest rate that is payable either periodically or at maturity. A bank with CDs may wish to hedge the risk of changes in the coupon payments (or the interest element of the final cash flow if interest is paid only at maturity) attributable to changes in the benchmark interest rate related to the forecasted issuance of fixed-rate CDs. The interest rate of the CDs actually issued will be based on market conditions that exist at the time of issuance. Influences such as market appetite, the bank's liquidity and needs, and other CD rates at other banks may have an effect on the actual fixed interest rate on the date of issuance.

RESPONSE

No. The restriction against hedging interest rate risk in paragraph 29(h) of Statement 133 is not intended to apply to scenarios whereby the cash flow hedging model is being applied to the forecasted issuance of fixed-rate debt. Provided the entity meets all the other cash flow hedging criteria, an entity may hedge the risk of changes in either (a) the coupon payments (or the interest element of the final cash flow if interest is paid only at maturity) or (b) the total proceeds attributable to changes in the benchmark interest rate related to the forecasted issuance of fixed-rate debt. It should be noted that the derivative used to hedge either of these risks must provide offsetting cash flows in order for the hedging relationship to be effective in accordance with paragraph 30 of Statement 133.

Paragraph 29(h) of Statement 133 (as amended) states, "the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the specifically identified

benchmark rate if the cash flows of the hedged transaction are explicitly based on a different index." Since the contractually fixed interest rate established at the issuance of the *fixed-rate* debt is based on current market interest rates for that debtor and the debt's future interest payments will not be variable explicitly based on any index, the prohibition does not apply. As indicated in paragraph 29(h), the prohibition is applicable to variable-rate debt for which the hedged interest payments are explicitly based on an index other than a benchmark interest rate index. (The restriction against hedging interest rate risk in paragraph 29(h) of Statement 133 is similarly not intended to apply to scenarios whereby the cash flow hedging model is being applied to the forecasted purchase of fixed-rate debt.)

Some entities may wish to characterize their variable-rate debt as fixed-rate debt that, at each interest reset date, is effectively rolled over to another issuance of fixed-rate debt that has a new fixed interest rate until the next reset date. Such a characterization cannot justify not applying the restriction against hedging interest rate risk in paragraph 29(h) to variable-rate debt. For example, consider an entity with existing variable-rate debt that is prepayable, resets monthly based on a specified bank's prime rate plus 1 percent as of the beginning of each month, and matures in 5 years. Although the variable-rate debt does, after each reset, have a fixed rate for each monthly period, it is inappropriate to characterize that debt as a series of fixed-rate debt instruments whose issuances would not be subject to the restriction against hedging interest rate risk in paragraph 29(h). When each reset occurs, it is not a new issuance of fixed-rate debt based on current market interest rates for that debtor; instead, it is a contractual continuation of a debtor-creditor relationship and the "fixed rate" for each month is explicitly (and contractually) based on a specific index (a specified bank's prime rate) that is different from a designated benchmark interest rate. Thus, the restriction against hedging interest rate risk in paragraph 29(h) must be applied to the variable-rate debt instrument.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Cash Flow Hedges: Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge
Paragraph references:	28(b), 30(b), 63, 140
Date cleared by Board:	June 27, 2001
Date posted to website:	August 10, 2001

QUESTIONS

When designating a purchased option (including a combination of options that comprise either a net purchased option or a zero-cost collar) as hedging the exposure to variability in expected future cash flows attributable to a particular rate or price beyond a specified level (or levels), an entity documents that the assessment of effectiveness will be based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in fair value—its entire gain or loss), rather than documenting that the assessment of effectiveness will be based on only the changes in the hedging instrument's intrinsic value as permitted by paragraph 63(a).

1. For a cash flow hedging relationship documented as described above, can an entity focus on the hedging instrument's terminal value (that is, its expected future pay-off amount at its maturity date) in determining under paragraph 28(b) of Statement 133 whether the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge?
2. For a cash flow hedging relationship documented as described above, how should an entity calculate the amount of ineffectiveness to be recognized in earnings for that hedging relationship in applying paragraph 30(b) of Statement 133?
3. When should the portion of the hedging instrument's gain or loss that is reported in accumulated other comprehensive income (OCI) be reclassified out of accumulated OCI into earnings?

BACKGROUND

Paragraph 28 of Statement 133 states, in part:

> An entity may designate a derivative instrument as hedging the exposure to variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction (such as a forecasted purchase or sale).…
>
> b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge.…If the hedging instrument, such as

> an at-the-money option contract, provides only one-sided offset against the hedged risk, the cash inflows (outflows) from the hedging instrument must be expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

Paragraph 30 states, in part:

> 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: …
>
> 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.

Paragraph 63 states, in part:

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

Example

A company forecasts that 1 year later it will purchase 1,000 ounces of gold at then current market prices for use in its operations. The company wishes to protect itself against

increases in the cost of gold above the current market price of $275 per ounce. The company purchases a 1-year cash-settled at-the-money gold option on 1,000 ounces of gold, paying a premium of $10,000. If the price of gold is above $275 at the maturity (settlement) date, the counterparty will pay the company 1,000 times the difference. If the price of gold is $275 or below at the maturity date, the contract expires worthless. The option cannot be exercised prior to its contractual maturity date. The company designates the purchased option contract as a hedge of the variability in the purchase price (cash outflow) of the 1,000 ounces of gold for prices above $275 per ounce.

RESPONSE

Question 1

Yes. If (a) the hedging instrument in a cash flow hedge is a purchased option or a combination of only options that comprise either a net purchased option or a zero-cost collar, (b) the exposure being hedged is the variability in expected future cash flows attributed to a particular rate or price beyond (or within) a specified level (or levels), and (c) the assessment of effectiveness is documented as being based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in fair value, not just changes in intrinsic value), an entity may focus on the hedging instrument's terminal value (that is, its expected future pay-off amount at its maturity date) in determining under paragraph 28(b) of Statement 133 whether the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. At the onset of each cash flow hedging relationship, an entity must document how it will assess effectiveness, such as whether the assessment will be based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in fair value—its entire gain or loss) as discussed in paragraph 63 of Statement 133, rather than based, for example, on only the changes in the hedging instrument's intrinsic value. The documented method must be applied consistently when assessing effectiveness throughout the hedging relationship. An entity's focus on the hedging instrument's terminal value is not an impediment to the entity's subsequently deciding to dedesignate that cash flow hedge prior to the occurrence of the hedged transaction. (Refer to paragraph 494 of Statement 133 for potential consequences when an entity determines the original hedged transaction probably will not occur.)

If the hedging instrument is a purchased cap consisting of a series of purchased caplets that are each hedging an individual hedged transaction in a series of hedged transactions (such as caplets hedging a series of hedged interest payments at different monthly or quarterly dates), the entity may focus on the terminal value of each caplet (that is, the expected future pay-off amount at the maturity date of each caplet) in determining under paragraph 28(b) whether each of those hedging relationships is expected to be highly effective in achieving offsetting cash flows.

The above guidance applies to a purchased option regardless of whether at the inception of the cash flow hedging relationship it is at-the-money, in-the-money, or out-of-the-money.

In the example, in assessing the effectiveness of the cash flow hedge, the company would determine that since the change in the expected future pay-off amount of the purchased option completely offsets the change in the expected future cash flows on the purchase of 1,000 ounces of gold above $275 per ounce, the hedging relationship is expected to be highly effective under paragraph 28(b).

Question 2

For a cash flow hedge in which (a) the hedging instrument is a purchased option or a combination of only options that comprise either a net purchased option or a zero-cost collar, (b) the exposure being hedged is the variability in expected future cash flows attributed to a particular rate or price beyond (or within) a specified level (or levels), and (c) the assessment of effectiveness will be based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in fair value), the hedging relationship may be considered to be perfectly effective (resulting in recognizing no ineffectiveness in earnings) if the following conditions are met:

1. The critical terms of the hedging instrument (such as its notional amount, underlying, and maturity date, etc.) completely match the related terms of the hedged forecasted transaction (such as, the notional amount, the variable that determines the variability in cash flows, and the expected date of the hedged transaction, etc.).
2. The strike price (or prices) of the hedging option (or combination of options) matches the specified level (or levels) beyond (or within) which the entity's exposure is being hedged.
3. The hedging instrument's inflows (outflows) at its maturity date completely offset the change in the hedged transaction's cash flows for the risk being hedged.
4. The hedging instrument can be exercised only on a single date—its contractual maturity date. (This condition is consistent with the entity's focus on the hedging instrument's terminal value, as discussed under Question 1. If the holder of the option chooses to pay for the ability to exercise the option at dates prior to the maturity date [for example, by acquiring an American-style option], the potential for recognizing ineffectiveness exists.)

If the entity concludes that the hedging relationship may be considered to be perfectly effective, the entity would simply record all changes in the hedging option's fair value (including changes in the option's time value) in OCI.

If those four conditions are not met, the entity must determine whether ineffectiveness must be recognized in earnings by comparing the change in fair value of the actual hedging instrument and the change in fair value of a "perfectly effective" hypothetical hedging instrument. That hypothetical hedging instrument should have terms that meet the four conditions listed above. The change in fair value of that hypothetical hedging instrument can be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction(s) as described in paragraph 30(b)(2).

When ineffectiveness is required to be recognized, accumulated OCI would be adjusted to a balance that reflects the lesser of either the cumulative change in the fair value of the actual hedging instrument or the cumulative change in the fair value of the hypothetical derivative. (Consistent with paragraph 30(b)(1), that comparison excludes the effect of the hedging instrument's gains or losses previously reclassified from accumulated OCI into earnings pursuant to paragraph 31.) The amount of ineffectiveness, if any, recorded in earnings would be equal to the excess of the cumulative change in the fair value of the actual hedging derivative over the cumulative change in the fair value of the hypothetical derivative. Paragraph 30(b) indicates that hedge ineffectiveness in a cash flow hedge occurs only if the cumulative gain or loss on the derivative hedging instrument exceeds the cumulative change in the expected future cash flows on the hedged transactions.

In the example, since (1) all the critical terms of the hedging derivative completely match the hedged forecasted transaction, (2) the strike price of the hedging instrument matches the specified level ($275) beyond which the company's exposure is being hedged, (3) the hedging derivative's inflows at expiration completely offset the hedged transaction's outflows for any increase in the price of gold above $275 per ounce, and (4) the hedging option cannot be exercised prior to its contractual maturity date, the company would conclude there is no ineffectiveness to be recognized in earnings.

Question 3

The portion of the gain or loss that is reported in accumulated OCI would be reclassified out of OCI consistent with the provisions in paragraph 31. For example, the fair value of a single cap at the inception of a hedging relationship of interest rate risk on variable-rate debt with quarterly interest payments over the next two years for which the entity determines that the relationship will not result in any ineffectiveness should be allocated to the respective "caplets" within the single cap on a fair value basis at the inception of the hedging relationship. The change in each respective allocated fair value amount should be reclassified out of accumulated OCI into earnings when each of the hedged forecasted transactions (the eight interest payments) impacts earnings. Because the amount in accumulated OCI is a net amount composed of both derivative gains and derivative losses, the change in the respective allocated fair value amount for an individual caplet that is reclassified out of accumulated OCI into earnings may possibly be greater than the net amount in accumulated OCI.

In the example, the company would reclassify the purchased option's gain or loss that is reported in accumulated OCI in earnings when the cost of the gold affects earnings (such as being included in cost of goods sold).

The guidance in this Issue has no effect on the accounting for fair value hedging relationships. In addition, in determining the accounting for seemingly similar cash flow hedging relationships, it would be inappropriate to analogize to the above guidance.

General Observation

If an entity had designated any cash flow hedging relationship but had not documented the single basis on which effectiveness would be assessed, then the designation of that hedging relationship would have been incomplete and thus invalid, and no cash flow hedge accounting would be permitted under Statement 133 for the changes in the hedging derivative's fair value during the period that the documentation was incomplete. Similarly, no fair value hedge accounting would be permitted under Statement 133 for the changes in the hedged item's fair value during the period that the documentation was incomplete. The guidance on cash flow hedge accounting in this Issue does not apply to hedging relationships with incomplete documentation.

EFFECTIVE DATE

The effective date of implementation guidance in this Issue is the first day of the first fiscal quarter after August 10, 2001, the date that the Board-cleared guidance was posted on the FASB website. Earlier application as of the first day of an earlier fiscal quarter (or the date that hedge documentation in accordance with hedging based on total changes in the option's cash flows is put in place, if later) for which financial statements have not been issued is permitted for cash flow hedging relationships in which the assessment of effectiveness was initially documented as being based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in fair value). (The guidance in this Issue does not apply to cash flow hedging relationships in which the assessment of effectiveness is documented as being based on only the changes in the hedging instrument's intrinsic value.)

If at the date of initial adoption of the guidance (the first day of a fiscal quarter) the reporting entity has any cash flow hedges for which the assessment of effectiveness was initially documented as being based on total changes in the hedging option's cash flows (that is, the assessment will include the hedging instrument's entire change in fair value), the reporting entity should report at the date of initial adoption cumulative-effect-type adjustments of net income and accumulated OCI for the amount (if any) needed to adjust accumulated OCI to a balance that reflects at that date the lesser of either the cumulative change in the fair value of the actual hedging instrument or the cumulative change in the fair value of the hypothetical derivative as well as any adjustments of accumulated OCI to conform with the guidance to Question 3 regarding the reclassification of derivative gains or losses into earnings.

For example, shortly after the tentative conclusions on this Issue were released on April 16, 2001, an entity with an April 30 fiscal quarter-end dedesignated some of its cash flow hedges in which the assessment of effectiveness was documented as being based on only the changes in intrinsic value and designated new cash flow hedges in which the assessment of effectiveness was documented as being based on total changes in the option's cash flows (that is, the assessment includes each hedging instrument's entire change in fair value). If those new hedging relationships do not qualify to be considered perfectly effective under the above guidance, the entity would recognize a cumulative-effect-type adjustment of accumulated OCI for the

excess of (a) the cumulative change in the fair value of the actual hedging instrument over (b) the cumulative change in the fair value of the hypothetical derivative at the date of initial adoption. The offsetting entry is a cumulative-effect-type adjustment of net income.

If an entity dedesignated some of its cash flow hedges in which the assessment of effectiveness was documented as being based on only the changes in intrinsic value and designated new cash flow hedges on or after April 16, 2001, in an attempt to comply with the tentative conclusions on this Issue, those new cash flow hedges should be considered as having been documented as being based on total changes in the option's cash flows even though the actual documentation for that new cash flow hedge used language consistent with those tentative conclusions without explicitly referring to the assessment as "being based on total changes in the option's cash flows" or "including the hedging instrument's entire change in fair value." In that situation, the documentation for those new cash flow hedges should be revised to conform with the guidance in this Issue.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Cash Flow Hedges: Determination of the Appropriate Hypothetical Derivative for Floating-Rate Debt That Is Prepayable at Par at Each Interest Reset Date
Paragraph references:	30(b), 68
Date cleared by Board:	June 27, 2001
Date posted to website:	July 10, 2001

QUESTION

What is the appropriate hypothetical derivative under Statement 133 Implementation Issue No. G7, "Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method Is Not Applied," for the following cash flow hedging relationship, which involves the use of an interest rate swap designated as a hedge of the variable interest payments on floating-rate debt that is prepayable at par at each interest rate reset date?

Company A issues floating-rate debt that is prepayable at par on each interest rate reset date. The credit sector spread on the debt issuance is not reset on the interest rate reset dates. For example, the debt bears interest at a rate of LIBOR plus 100 basis points, with LIBOR reset every quarter. Company A also enters into a receive-floating, pay-fixed interest rate swap that is designated as a hedge of the variability in the debt interest payments due to changes in the benchmark interest rate (LIBOR). During the term of the hedging relationship (that is, the specific term of the swap), Company A expects to issue new floating-rate debt (in the event the original debt is repaid prior to maturity) to maintain an aggregate debt principal balance equal to or greater than the notional amount of the swap, and expects the new debt (if any) to share the key characteristics of the original debt issuance (specifically, quarterly repricing to the LIBOR index and no minimum, maximum, or periodic constraints of the debt interest rate). The hedging relationship meets all of the criteria for shortcut method accounting in paragraph 68 of Statement 133 except for criterion 68(d); the debt is prepayable and the swap does not contain a mirror-image call option to match the call option embedded in the debt instrument, as required by paragraph 68(d).

BACKGROUND

Company A wishes to apply the hypothetical derivative method described in Implementation Issue G7 to calculate the amount of ineffectiveness in the hedging relationship to be recognized in earnings in accordance with paragraph 30(b). Implementation Issue G7 states that "the hypothetical derivative would need to satisfy all of the applicable conditions in paragraph 68 (as amended) necessary to qualify for use of the shortcut method except criterion 68(dd). Thus, the hypothetical swap would be expected to perfectly offset the hedged cash flows." Since the actual interest rate swap used in Company A's hedging relationship already meets all of the criteria in paragraph 68 except criterion 68(d), this guidance would seem to suggest that the hypothetical swap would need to be the same as the actual swap except that a mirror-image call option would

need to be added in order to meet criterion 68(d) and the guidance in Implementation Issue G7. However, Company A observes that since the hedged transactions are the variable interest payments (on debt with a principal amount equal to the notional amount of the swap) due to changes in the benchmark interest rate (LIBOR), and since the transaction had to be probable of occurring under paragraph 29(b) in order for it to qualify for hedge accounting, the actual swap would be expected to perfectly offset the hedged cash flows.

RESPONSE

In this fact pattern, the hypothetical swap under Implementation Issue G7 would be the same as the actual swap described in the background section. Since Company A has concluded that if the original debt issuance is repaid prior to maturity, it is probable that a sufficient principal amount of floating-rate debt with key characteristics that match those of the original debt issuance (specifically quarterly repricing to the LIBOR index and no minimum, maximum, or periodic constraints of the debt interest rate) will be issued and remain outstanding during the term of the hedging relationship (providing exposure to benchmark-interest-rate-based variable cash payments), the prepayment provisions of the debt instrument should not be considered in determining the appropriate hypothetical derivative under Implementation Issue G7. The prepayment of the original floating-rate debt eliminates the contractual obligation to make those interest payments; however, Statement 133 permits replacing the hedged interest payments that are no longer contractually obligated to be paid without triggering the dedesignation of the original cash flow hedging relationship. Replacing the original debt issuance with a new floating-rate debt issuance is permissible in a cash flow hedge of interest rate risk and does not automatically result in the discontinuation of the original cash flow hedging relationship. Paragraph 29(a) of Statement 133 does not require that the variable interest payments relate to a specific unchanging obligation or group of floating-rate obligations when those obligations are prepayable.

Implementation Issue G7 incorporates all of the requirements of paragraph 68 except criterion 68(dd) for purposes of determining the hypothetical derivative. Since the requirements of paragraph 68(d) were developed with an emphasis on fair value hedging relationships, they do not fit the more general principle in Implementation Issue G7 that the hypothetical derivative in a cash flow hedging relationship should be expected to perfectly offset the hedged cash flows. Although the company can terminate the debt at any interest rate reset date for reasons that may be totally unrelated to changes in the benchmark interest rate (which is the hedged risk), it expects to be at risk for variability in cash flows due to changes in the benchmark interest rate in an amount based upon debt principal equal to or greater than the notional amount of the swap during the specific term of the swap. Therefore, the prepayment feature of the debt is not relevant for purposes of determining the appropriate hypothetical swap under Implementation Issue G7 as long as the relevant conditions to qualify for cash flow hedge accounting have been met with respect to the hedged transaction.

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after July 10, 2001, the date that the Board-cleared guidance was posted on the FASB website.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Cash Flow Hedges: Using a Complex Option as a Hedging Derivative
Paragraph references:	29(a), 29(h), 390
Date cleared by Board:	September 19, 2001
Date posted to website:	October 10, 2001

QUESTIONS

Can the complex option described in the example in the background section be designated as a hedging instrument and used in the following cash flow hedging relationships:

1. To hedge the variability in the difference between interest payments and sales proceeds on oil?
2. To hedge the variability in interest cash flows attributable to changes in LIBOR above 7 percent?
3. To hedge the variability in proceeds from the forecasted sale of oil?

BACKGROUND

Company A enters into a complex option contract with multiple underlyings for which no net premium is received. The payoffs under the contract are nontraditional. Company A wishes to designate the option in a cash flow hedging relationship.

For example, Company A is an oil producer with five-year floating-rate debt (indexed to three-month LIBOR) and is concerned that an environment of falling oil prices and rising interest rates could affect its ability to meet increasing interest payments on the floating-rate debt. To limit its exposure, Company A enters into a five-year oil-linked interest rate cap with a notional amount equal to the principal amount of Company A's three-month LIBOR-based floating-rate debt. The oil-linked interest rate cap (a complex option) has the following terms: if (1) 3-month LIBOR is greater than 7 percent and (2) the price of oil is less than $25 per barrel, Company A receives payments under the cap equal to the increased interest payments (that is, for floating-rate amounts above 7 percent) due on their floating-rate debt. However, if the daily price of oil goes above $25 per barrel at any time during a quarter, the option is knocked out for only that specific quarter. The option's knock-out feature is reset each quarter such that the interest rate coverage is knocked out for a specific quarter only if the daily price of oil goes above $25 per barrel at any time during that specific quarter. Thus, the option limits Company A's exposure to increases in interest rates for all quarters in which oil prices remain under $25 per barrel throughout the quarter.

RESPONSE

Question 1

No. The oil-linked interest rate cap purchased by Company A is attempting to hedge Company A's exposure to variability in the *net* cash flows related to certain revenue inflows and certain

expense outflows. In the example, Company A wishes to reduce the risk that an increase in cash outflows due to increases in interest rates will occur without a concurrent increase in cash inflows due to increases in the price of oil per barrel. Those are separate and dissimilar risks that Company A wishes to hedge with a single derivative.

Paragraph 29(a) states, "If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged." Thus, the hedged forecasted transaction cannot be a group of oil sales inflows and interest payment outflows. Statement 133 was not structured to permit hedge accounting for strategies involving hedges of a spread between revenues and expenses as Company A is attempting to accomplish.

Question 2

Generally, no, because Company A could not simply define its hedged risk as the risk of changes in cash flows attributable to changes in the three-month LIBOR rate for only those periods when the price of oil per barrel is below a specified dollar amount. Paragraphs 29(g) and 29(h) indicate the risks that an entity may designate as the hedged risk. When hedging any of these risks, the hedging relationship must be expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk.

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

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

In the unlikely event that Company A was able to conclude that the relationship was expected to be highly effective (because the complex option was expected to be highly effective for all

changes in the three-month LIBOR rate above the contractually specified rate due to the remoteness that the price of oil per barrel would not be below the contractually specified amount over the contractual life of the debt), the complex option could be used as the hedging derivative.

Question 3

No. If Company A wanted to designate the oil-linked interest rate cap as a cash flow hedge of the risk of overall changes in the sales proceeds from the forecasted sale of oil below the contractually specified price per barrel in the interest rate cap, the hedging relationship would fail to qualify under paragraph 28(b) because the cash inflows from the oil-linked interest rate cap are calculated based on the debt's principal amount and the excess of 3-month LIBOR over 7 percent. Because the cash inflows from the oil-linked interest rate cap are unrelated to the proceeds from oil sales, Company A could not expect the proposed hedging relationship to be highly effective at achieving offsetting cash flows.

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after October 10, 2001, the date that the Board-cleared guidance was posted on the FASB website.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Cash Flow Hedges: Hedging Portions of a Foreign-Currency-Denominated Financial Asset or Liability Using the Cash Flow Model
Paragraph references:	29(a), 29(h), 30(d), 40(e)
Date cleared by Board:	September 19, 2001
Date posted to website:	October 10, 2001

QUESTIONS

Is an entity allowed to identify as the hedged forecasted transaction in a cash flow hedge specific foreign currency cash flows associated with foreign-currency-denominated financial assets and liabilities if all of the variability of the functional-currency-equivalent cash flows is eliminated as a result of the hedge? In which of the following situations can an entity utilize cash flow hedge accounting to hedge the variability in specific principal and/or interest cash flows?

1. In Example 1 in the background section, can ABC Company utilize cash flow hedge accounting to hedge the variability in its functional-currency-equivalent cash flows associated with the following:
   a. All of the payments of *both principal and interest* of the debt
   b. All of the payments of *principal* of the debt
   c. All or a fixed portion of *selected payments of either principal or interest* of the debt (such as either principal or interest payments on 12/31/01 and 12/31/03)
   d. *Selected payments of both principal and interest* of the debt (such as principal and interest payments on 12/31/01 and 12/31/03)?
2. In Example 2 in the background section, can XYZ Company utilize cash flow hedge accounting to hedge the variability in its functional-currency-equivalent cash flows associated with the following:
   a. All of the payments of *both principal and interest* of the debt
   b. All of the payments of *principal* of the debt
   c. All or a fixed portion of selected payments of *either principal or interest* of the debt
   d. *Selected payments of both principal and interest* of the debt (such as principal and interest payments on 12/31/01 and 12/31/03)?

BACKGROUND

Paragraph 40(e) of Statement 133, as amended by Statement 138, indicates that "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.)"

Paragraph 29(a) of Statement 133 states that the hedged item in a cash flow hedge may be a single transaction or a group of transactions. Further, paragraph 29(h) sets forth risks that may

be hedged in a cash flow hedge of a financial asset or liability (as well as forecasted transactions to purchase financial assets/liabilities). Paragraphs 29(a) and 29(h) in combination have allowed entities to apply cash flow hedge accounting to specific transactions resulting from financial assets or liabilities (for example, hedge the first four contractual interest payments in a variable-rate liability).

The following are examples of fixed-rate and variable-rate foreign-currency-denominated debt.

Example 1
ABC Company, a U.S. dollar functional company, issues a five-year foreign-currency-denominated fixed-rate debt obligation that requires interest payments and partial principal payments annually in the foreign currency with the remaining principal due at the end of five years (maturity) in the foreign currency. More specifically, ABC Company issues an FC45 million debt obligation on December 31, 20X0 with FC5 million due on December 31 of each of the next 4 years and FC25 million due on December 31, 20X5. Interest payments at 10 percent are paid annually.

Example 2
XYZ Company, a U.S. dollar functional company, issues a five-year foreign-currency-denominated floating-rate debt obligation that requires interest payments and partial principal payments annually in the foreign currency with the remaining principal due at the end of five years (maturity) in the foreign currency. More specifically, XYZ Company issues an FC45 million debt obligation on December 31, 20X0 with FC5 million due on December 31 of each of the next 4 years and FC25 million due on December 31, 20X5. Interest payments are paid annually based on LIBOR.

RESPONSE

Yes, an entity is allowed to identify as the hedged forecasted transaction in a cash flow hedge specific foreign currency cash flows associated with foreign-currency-denominated financial assets and liabilities if all of the variability of the functional-currency-equivalent cash flows is eliminated as a result of the hedge.

Statement 133 permits entities to hedge the variability in cash flows for specific transactions, and the guidance applies to cash flow hedges of recognized foreign-currency-denominated assets and liabilities. In order for recognized foreign-currency-denominated assets and liabilities to qualify for cash flow hedge accounting, paragraph 40(e) requires that all of the variability in the hedged item's functional-currency-equivalent cash flows must be eliminated by the effect of the hedge. For instance, in Example 1 in the background section, an entity could use a receive-fixed-rate, pay-fixed-rate cross-currency interest rate swap or a series of forward contracts to eliminate variability attributable to foreign exchange rates. In Example 2 in the background section, an entity could use a receive-variable-rate, pay-fixed-rate cross-currency interest rate swap to eliminate variability attributable to interest rates and foreign exchange rates. In cash flow hedges of recognized foreign-currency-denominated assets and liabilities, the entity must assess whether the changes in cash flows attributable to the risk being hedged are expected to offset

at the inception of the hedging relationship and on an ongoing basis. As the hedging relationship does not qualify for the shortcut method, the entity must measure ineffectiveness. In a manner similar to Statement 133 Implementation Issue No. G7, "Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method Is Not Applied," the entity would measure the ineffectiveness of the hedge using the hypothetical derivative method.

For each of the eight situations presented in the question section, an entity can utilize cash flow hedge accounting to hedge the variability in the specific principal repayments, interest cash flows, or both by applying the guidance in paragraph 30(d) to the specifically identified hedged cash flows. Only an amount that would offset the transaction gain or loss arising from the remeasurement of a hedged cash flow would be reclassified each period from other comprehensive income (OCI) to earnings. Also, the change in the fair value of the forward points (time value) attributable to the hedged future cash flows would be reported in OCI, while the change in the fair value of the forward points (time value) attributable to the unhedged future cash flows would be reported in earnings.

An illustration of Question 1(b) (hedging the variability in all principal cash flows attributable to foreign exchange risk) is presented below for Example 1 of the background section.

Cash Flow Hedge of All Principal Cash Flows

- ABC Company enters into the following 5 forward contracts to hedge all principal cash flows:
  - Forward contract to purchase FC5,000 on 12/31/X1 at a forward rate of 1.05061019
  - Forward contract to purchase FC5,000 on 12/31/X2 at a forward rate of 1.06061601
  - Forward contract to purchase FC5,000 on 12/31/X3 at a forward rate of 1.07066924
  - Forward contract to purchase FC5,000 on 12/31/X4 at a forward rate of 1.08076989
  - Forward contract to purchase FC25,000 on 12/31/X5 at a forward rate of 1.090871

Exchange rates are as follows:

Period	Spot	12/31/X1 Forward	12/31/X2 Forward	12/31/X3 Forward	12/31/X4 Forward	12/31/X5 Forward
12/31/X0	1.04060438	1.05061019	1.06061601	1.07066924	1.08076989	1.090871
12/31/X1	1.1		1.12125604	1.14271548	1.16448149	1.18655697
12/31/X2	1.1			1.12125604	1.14272548	1.16448149
12/31/X3	1.1				1.12125604	1.14272548
12/31/X4	1.1					1.12125604
12/31/X5	1.1					

	Debit (Credit)				
	Cash	**Forward Contracts**	**Note Payable**	**Income/ Expense**	**Accum. OCI**
Inception 12/31/X0	46,827		(46,827)		
<u>December 31, 20X1 entries:</u>					
-Repayment of Principal	(5,500)		5,203	297	
-Payment of Interest	(4,950)			4,950	
-Transaction loss on N/P			(2,376)	2,376	
-FV of Forward Contract #1		247			(247)
-Settlement of Forward #1	247	(247)			
-Offset $247 of loss on principal ($50 related to cost of hedge remains in earnings)				(247)	247
-FV of Forward Contracts #2-5 (based on 6% discount rate)		2,853			(2,853)
-Par. 30(d) adjustment – offset the transaction loss related to principal				(1,734)	1,734
-Par. 30(d) adjustment – effect of hedge				396	(396)
<u>December 31, 20X2 entries:</u>					
-Repayment of Principal	(5,500)		5,203	297	
-Payment of Interest	(4,400)			4,400	
-FV of Forward Contract #2		(89)			89
-Settlement of Forward #2	197	(197)			
-Offset $197 of loss on principal ($100 related to cost of hedge remains in earnings)				(197)	197
-FV of Forward Contracts #3-5 (based on 6% discount rate)		(507)			507
-Par. 30(d) adjustment – effect of hedge				299	(299)
-Change in time value related to principal goes to OCI / change in time value related to interest goes to earnings[1]			297	(180)	(117)

[1] The entry recording the $297 gain for the period ended 12/31/X2 results from the spot exchange rate remaining unchanged from 12/31/X1 and one less period remaining on the loan payable. The $117 principal portion of the gain goes to OCI since only principal is being hedged. The $180 interest portion of the gain goes to earnings since interest is not being hedged.

	Debit (Credit)				
	Cash	**Forward Contracts**	**Note Payable**	**Income/ Expense**	**Accum. OCI**
<u>December 31, 20X3 entries:</u>					
-Repayment of Principal	(5,500)		5,203	297	
-Payment of Interest	(3,850)			(3,850)	
-FV of Forward Contract #3		(92)			92
-Settlement of Forward #3	147	(147)			
-Offset $147 of loss on principal ($150 related to cost of hedge remains in earnings)				(147)	147
-FV of Forward Contracts #4-5 (based on 6% discount rate)		(477)			477
-Par. 30(d) adjustment – effect of hedge				202	(202)
-Change in time value related to principal goes to OCI / change in time value related to interest goes to earnings			297	(168)	(129)
<u>December 31, 20X4 entries:</u>					
-Repayment of Principal	(5,500)		5,203	297	
-Payment of Interest	(3,300)			3,300	
-FV of Forward Contract #4		(95)			95
-Settlement of Forward #4	96	(96)			
-Offset $96 of loss on principal ($201 related to cost of hedge remains in earnings)				(96)	96
-FV of Forward Contract #5 (based on 6% discount rate)		(437)			437
-Par. 30(d) adjustment – effect of hedge				104	(104)
-Change in time value related to principal goes to OCI / change in time value related to interest goes to earnings			297	(154)	(143)

	Debit (Credit)				
	Cash	**Forward Contracts**	**Note Payable**	**Income/ Expense**	**Accum. OCI**
December 31, 20X5 entries:					
-Repayment of Principal	(27,500)		26,015	1,485	
-Payment of Interest	(2,750)			2,750	
-FV of Forward Contract #5		(488)			488
-Settlement of Forward #5	228	(228)			
-Offset $228 of loss on principal				(228)	228
-Par. 30(d) adjustment – effect of hedge			1,485	(1,001)	(484)
-Change in time value related to principal goes to OCI / change in time value related to interest goes to earnings				(140)	140
	(21,008)	**0**	**0**	*****	**0**

***** Refer to Schedule 3 below for income/expense for each period.

The following schedules support the above entries.

Schedule 1	Foreign Currency	Functional Currency at 12/31/X0 Spot Rate (A)	Functional Currency at Current Spot Rate (B)	Transaction Gain or Loss	(B)-(A)	Change in Time Value
12/31/X0						
Principal	30,976 [2]	32,234				
Interest	14,024 [3]	14,593				
Loan value	45,000	46,827				
12/31/X1						
Principal	29,192	30,377	32,111	1,734		
Interest	10,808	11,247	11,889	642		
Loan value	40,000	41,624	44,000			

[2] The value ascribed to the principal portion was determined by discounting the future principal payments at an annual rate of 10% compounded quarterly.

[3] The value ascribed to the interest portion was determined by discounting future quarterly interest accruals at an annual rate of 10%.

Schedule 1 (Continued)	Foreign Currency	Functional Currency at 12/31/X0 Spot Rate (A)	Functional Currency at Current Spot Rate (B)	Transaction Gain or Loss	(B)-(A)	Change in Time Value
12/31/X2						
Principal	27,222	28,328	29,945		1,617	117=(1,734-1,617) [4]
Interest	7,778	8,093	8,555		462	180=(642 - 462) [4]
Loan value	35,000	36,421	38,500			
12/31/X3						
Principal	25,048	26,065	27,553		1,488	129=(1,617 - 1,488)
Interest	4,952	5,153	5,447		294	168=(462 - 294)
Loan value	30,000	31,218	33,000			
12/31/X4						
Principal	22,649	23,568	24,913		1,345	143
Interest	2,351	2,447	2,586		140	154
Loan value	25,000	26,015	27,500			
12/31/X5 (before final principal payment is made)						
Principal	25,000	26,015	27,500		1,485	(140)
Interest	0	0	0			140
Loan value	25,000	26,015	27,500			

Schedule 2 provides the amount of cost attributed to each period for each forward contract. Each period's cost is determined based on applying the interest method to each forward contract.

Schedule 2	**Forward contract #1**	**Forward contract #2**	**Forward contract #3**	**Forward contract #4**	**Forward contract #5**	**Total**
12/31/X1	50.03	49.79	49.63	49.50	246.61	445.56
12/31/X2		50.27	50.11	49.97	248.95	399.30
12/31/X3			50.59	50.44	251.31	352.34
12/31/X4				50.92	253.69	304.61
12/31/X5					256.11	256.11
Total	50.03	100.06	150.33	200.83	1,256.67	1,757.92

[4] Refer to footnote 1.

Schedule 3 provides a breakdown of income/expense for each year-end reporting period.

Schedule 3	
12/31/X1	
4,950	Interest expense
446	Cost of hedge (396 + (297 - 247))
642	Transaction loss related to unhedged interest (2,376 - 1,734)
6,038	Total expense
12/31/X2	
4,400	Interest expense
399	Cost of hedge (299 + (297 - 197))
(180)	Time value related to unhedged interest
4,619	Total expense
12/31/X3	
3,850	Interest expense
352	Cost of hedge (202 + (297 - 147))
(168)	Time value related to unhedged interest
4,034	Total expense
12/31/X4	
3,300	Interest expense
305	Cost of hedge (104 + (297 - 96))
(154)	Time value related to unhedged interest
3,451	Total expense
12/31/X5	
2,750	Interest expense
256	Cost of hedge (1,485 - (1,001 + 228))
(140)	Time value related to unhedged interest
2,866	Total expense

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after October 10, 2001, the date that the Board-cleared guidance was posted on the FASB website.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Cash Flow Hedges: Using the First-Payments-Received Technique in Hedging the Variable Interest Payments on a Group of Non-Benchmark-Rate-Based Loans
Paragraph references:	28, 29, 32, 98, 99, 462, 540
Date cleared by Board:	July 27, 2004
Date posted to website:	August 9, 2004

QUESTION

Can the first-payments-received technique for identifying the hedged interest payments be used in a cash flow hedge of the variable prime-rate-based or other variable non-benchmark-rate-based interest payments for a rolling portfolio of prepayable interest-bearing loans? That technique, which is more fully described in the response to Question 1 of Statement 133 Implementation Issue No. G13, "Hedging the Variable Interest Payments on a Group of Floating-Rate Interest-Bearing Loans," involves identifying the hedged forecasted transactions in a cash flow hedge as the first interest payments based on the specific nonbenchmark rate received by an entity during each recurring period of a specified length and beginning date for the period covered by the hedging instrument.

BACKGROUND

A U.S. entity makes prime-rate-based loans to its customers for which interest payments are due at the beginning of each month, based on the preceding month's beginning prime rate being applied to the average outstanding balance throughout the preceding month. The entity determines that it will always have at least $100 million of those prime-rate-based loans outstanding throughout the next 3 years, even though the composition of those loans in the rolling portfolio will likely change to some degree due to prepayments, loan sales, defaults, and additional lending. Replacement of loans within the portfolio may involve loans existing at the inception of the hedging relationship or loans originated after the inception of the hedging relationship.

The entity wishes to hedge the variability in cash flows (resulting from changes in the prime interest rate) from its monthly interest receipts on $100 million principal of those prime-rate-based loans by entering into a 3-year interest rate swap that provides for monthly net settlements based on the entity receiving a fixed interest rate on a $100 million notional amount and paying a floating rate based on a specific prime rate index on a $100 million notional amount. The entity wishes to use, by analogy, the guidance to Question 1 in Implementation Issue G13 and identify the hedged forecasted transactions in its cash flow hedge by designating the hedging relationships as hedging the risk of changes in the entity's first prime-rate-based interest payments received during each 4-week period that begins 1 week before each monthly due date for the next 3 years that, in the aggregate for each month, are interest payments on $100 million principal of its then-existing prime-rate-indexed floating-rate loans.

Paragraph 28(a)(2) of Statement 133 states, "The hedged forecasted transaction shall be described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction."

Paragraph 29(a) of Statement 133 specifies the following criterion for designation as a hedged transaction in a cash flow hedge:

> The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.

Paragraph 462 elaborates on the requirements of paragraph 29(a) as follows:

> To illustrate, under the guidance in this Statement, a single derivative of appropriate size could be designated as hedging a given amount of aggregated forecasted transactions such as the following:…
>
> c. Forecasted interest payments on several variable-rate debt instruments within a specified time period.
>
> However, the transactions in each group must share the risk exposure for which they are being hedged. For example, the interest payments in group (c) above must vary with the same index to qualify for hedging with a single derivative.

Paragraph 29(h) of Statement 133 (as amended) states, in part:

> 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.

RESPONSE

Yes. The first-payments-received technique for identifying the hedged forecasted transactions (that is, the hedged interest payments) can be used in a cash flow hedge of the variable prime-rate-based or other variable non-benchmark-rate-based interest payments for a rolling portfolio of

prepayable interest-bearing loans (or other interest-bearing financial assets), provided all other conditions for a cash flow hedge have been met. Similarly, a comparable first-payments-made technique can be used to identify the hedged forecasted transactions in a cash flow hedge of the variable non-benchmark-rate-based interest payments for a group of the reporting entity's financial liabilities, provided all other conditions for a cash flow hedge have been met.

In cash flow hedging relationships involving variable non-benchmark-rate-based interest payments, the entity continues to be limited to designating the hedged risk as the risk of overall changes in those hedged cash flows (including the risk of decreases in cash flows attributable to credit default) because paragraph 29(h) of Statement 133 (as amended by Statement 138) prohibits an entity from designating interest rate risk as the hedged risk if the cash flows of the hedged transaction are explicitly based on an index different from either of the two designated benchmark interest rates permitted by paragraph 540. Consequently, the shortcut method described in paragraphs 68, 114, and 132 cannot be used because that method is limited to hedges of interest rate risk.

The use of the first-payments-received technique as described in the first paragraph of the response section is permitted by this Implementation Issue as an exception even though that technique excludes the variable interest payments that are contractually due but not paid by the debtor from being hedged transactions, thereby excluding some of the risk of decreases in interest payment inflows attributable to credit default. The guidance in this Implementation Issue related to applying the first-payments-received technique to variable non-benchmark-rate-based interest payments for a rolling portfolio of interest-bearing financial assets should not be applied by analogy to other circumstances.

The guidance in this response regarding use of a first-cash-flows technique may also be applied to a cash flow hedging relationship in which the hedging instrument is a basis swap as discussed in paragraph 28(d). However, use of that technique for those "basis swap" hedging relationships may not be common since paragraph 28(d) limits designating a basis swap as the hedging instrument to cash flow hedges of the interest payments of only recognized financial assets and liabilities existing at the inception of the hedge, whereas the first-cash-flows technique is typically applied to interest payments for rolling portfolios whose composition of financial assets changes over the period of the hedge. As a point of clarification, the example in paragraphs 98 and 99 of Statement 133, in which one leg of the basis swap is used in a hedge of the prime-rate-based payments on an existing five-year asset, implicitly incorporates the unstated assumption that the hedged risk is the risk of overall changes in the interest payments received on that asset and paid on the liability, and not interest rate risk (to be consistent with the amendments of Statement 133 effected by Statement 138), and that the likelihood of credit default and principal prepayments is each remote.

Entities that choose to use the first-payments-received technique are still required by Statement 133 (as amended) to assess the effectiveness of the cash flow hedging relationship and to recognize ineffectiveness in earnings attributable to overhedges. For example, if the hedged

interest payments on a variable-rate bank loan are based on the bank's own prime rate but the hedging interest rate swap is based on the prime rate specified in the Federal Reserve Statistical Release H-15, and the hedging relationship is not expected to be highly effective in achieving offsetting of the overall changes in designated cash flows (pursuant to either prospective considerations or retrospective evaluations), then hedge accounting would not be permitted. In contrast, if the hedging relationship is expected to be highly effective (and all hedge accounting criteria have been met), any difference between the changes in each of those two prime rates (for the period between assessment dates) could cause the hedging relationship to have some ineffectiveness in achieving offsetting cash flows. However, that ineffectiveness would be recognized immediately in earnings only if it resulted from an overhedge pursuant to paragraph 30 of Statement 133. Another potential source of ineffectiveness is margin variability (that is, changes in the spread over the nonbenchmark rate) attributable to the replacement loans being added to (and existing loans removed from) the rolling portfolio of interest-bearing loans. Margin variability would cause changes over time in the hedged cash flows (which are the interest payments received first chronologically), with no offset in the cash flows of the hedging derivative. As a reminder, in determining which interest payments are received first and thus are the hedged transations, interest payments that are received concurrently may not be arbitrarily sorted to minimize or achieve a desired amount of ineffectiveness in the hedging relationship.

At its July 27, 2004 meeting, the Board reached the above answer. Absent that, the staff would not have been able to provide guidance that the hedging entity may use the first-payments-received technique in identifying the hedged forecasted transactions in a cash flow hedging relationship in which the hedged risk is the risk of overall changes in those hedged cash flows (including the risk of decreases in cash flows attributable to credit default).

EFFECTIVE DATE AND TRANSITION

The effective date of the guidance in this Implementation Issue for each reporting entity is the first day of the first fiscal quarter beginning after August 9, 2004. The guidance in this Implementation Issue should be applied to all of the reporting entity's hedging relationships at the effective date. If a pre-existing cash flow hedging relationship had identified the hedged transactions using the first-payments-received technique in a manner consistent with the guidance in this Implementation Issue, the issuance of this guidance as an exception should not be viewed as requiring a restatement of previously issued financial statements. Early application of the guidance in this Implementation Issue is permitted.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Cash Flow Hedges: Hedging Interest Cash Flows on Variable-Rate Assets and Liabilities That Are Not Based on a Benchmark Interest Rate
Paragraph references:	29(h)
Date cleared by Board:	December 13, 2006
Date posted to website	January 8, 2007

QUESTIONS

In a cash flow hedge of a variable-rate financial asset or liability for which the interest rate is not based solely on an index, including situations in which an interest rate is reset through an auction process, can the designated risk being hedged be:

4. The risk of overall changes in the hedged cash flows related to the variable-rate financial asset or liability?
5. The risk of changes attributable to *interest rate risk* as defined in Statement 133 (that is, the risk of changes in cash flows attributable to changes in a specifically designated benchmark interest rate) even though the cash flows of the hedged transaction are not explicitly based on that designated benchmark interest rate?

BACKGROUND

Auction rate notes are an example of a variable-rate financial instrument whose interest rate is not explicitly based on a benchmark rate. Auction rate notes generally have long-term nominal maturities and interest rates that reset periodically through a Dutch auction process, typically every 7, 28, or 35 days. At an auction, existing holders of auction rate notes and potential buyers enter a competitive bidding process through a broker-dealer, specifying the number of shares (units) to purchase with the lowest interest rate they are willing to accept. Generally, the lowest bid rate at which all shares can be sold at the notes' par value establishes the interest rate, also known as the "clearing rate," to be applied until the next auction.

Paragraph 29(h) of Statement 133 defines *interest rate risk* for an existing financial asset or liability as "the risk of changes in cash flows attributable to changes in the designated benchmark rate." That paragraph further requires the following:

> 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. [Emphasis added.]

Statement 133, as amended by FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, identifies rates on direct Treasury obligations of the U.S. government and the interest rate swap rates based on the London Interbank Offered Rate (LIBOR) as the only rates that can be designated as benchmark interest rates in the United States for purposes of applying the definition of *interest rate risk*. Some have suggested that because an auction rate is not an index, it is not subject to the limitation in paragraph 29(h).

Statement 133 Implementation Issue No. G19, "Cash Flow Hedges: Hedging Interest Rate Risk for the Forecasted Issuances of Fixed-Rate Debt Arising from a Rollover Strategy," provides guidance for the planned issuance of a series of fixed-rate debt instruments, such as commercial paper (thereby resulting in a variable interest expense pattern) and states:

> The restriction against hedging interest rate risk in paragraph 29(h) of Statement 133 is not intended to apply to scenarios whereby the cash flow hedging model is being applied to the forecasted issuance of fixed-rate debt. Provided the entity meets all the other cash flow hedging criteria, an entity may hedge the risk of changes in either (a) the coupon payments (or the interest element of the final cash flow if interest is paid only at maturity) or (b) the total proceeds attributable to changes in the benchmark interest rate related to the forecasted issuance of fixed-rate debt. It should be noted that the derivative used to hedge either of these risks must provide offsetting cash flows in order for the hedging relationship to be effective in accordance with paragraph 30 of Statement 133.

Issue G19 addresses its applicability to variable-rate debt as follows:

> Although the variable-rate debt does, after each reset, have a fixed rate for each monthly period, it is inappropriate to characterize that debt as a series of fixed-rate debt instruments whose issuances would not be subject to the restriction against hedging interest rate risk in paragraph 29(h). When each reset occurs, it is not a new issuance of fixed-rate debt based on current market interest rates for that debtor; instead, it is a contractual continuation of a debtor-creditor relationship and the "fixed rate" for each month is explicitly (and contractually) based on a specific index (a specified bank's Prime rate) that is different from a designated benchmark interest rate. Thus, the restriction against hedging interest rate risk in paragraph 29(h) must be applied to the variable-rate debt instrument.

In conjunction with resolving this Issue, the last sentence of the third paragraph under the Commercial Paper heading in the Background section of Issue G19, "Those short-term instruments are not 'indexed' to any market rate," has been deleted because it has caused confusion in practice.

RESPONSE

Question 1

Yes. Provided all of the other cash flow hedging criteria in Statement 133 are met, an entity may hedge the variability in cash flows (for example, in auction rate notes) pursuant to paragraph 29(h)(1) of Statement 133 by designating the hedged risk as the risk of overall changes in cash flows.

Question 2

No. In a cash flow hedge of a variable-rate financial asset or liability, the risk being hedged cannot be designated as *interest rate risk* (that is, the risk of changes in cash flows attributable to changes in the designated benchmark interest rate) unless the cash flows of the hedged transaction are **explicitly** based on that same benchmark interest rate. For example, a variable-rate financial asset or liability that is reset through an auction process is not based on a benchmark interest rate. Although the interest rate may be described as a designated benchmark interest rate plus or minus an adjustment specified by the bidder, the "clearing rate" is effectively established by a bidding process that does not provide for transparent separation of *interest rate risk* and *credit risk.* Thus, the designated risk being hedged in an auction rate note cannot be *interest rate risk.* Additionally, Issue G19 explicitly prohibits entities from characterizing their variable-rate debt as fixed-rate debt that, at each interest rate reset, rolls over to another issuance of fixed-rate debt that has a new fixed interest rate until the next reset date.

EFFECTIVE DATE AND TRANSITION

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after the date that the Board-cleared guidance was posted on the FASB website.

Pursuant to Statement 133 Implementation Issue No. K5, "Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues," entities that have previously designated an otherwise qualifying hedging relationship that no longer qualifies for hedge accounting based on the guidance in this Issue, must dedesignate the hedging relationships prospectively as of the effective date of this Issue. The derivative's gain or loss for the period prior to the effective date shall remain in accumulated other comprehensive income and be reclassified into earnings consistent with the provisions of paragraphs 32 and 33 of Statement 133.

The above response has been approved by the Board by written ballot.

Title:	Foreign Currency Hedges: Hedging at the Operating Unit Level
Paragraph references:	40(a), 40(b)
Date cleared by Board:	February 17, 1999
Affected by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*

Revised September 25, 2000

QUESTION

Must the criteria in paragraphs 40(a) and 40(b) of Statement 133 required for a foreign currency cash flow hedge also be applied to a foreign currency fair value hedge and a hedge of the net investment in a foreign operation? Those paragraphs require that 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 certain restrictions) is a party to the hedging instrument and that the hedged transaction (or exposure) be denominated in a currency other than the hedging unit's functional currency.

RESPONSE

Yes. The requirements in paragraphs 40(a) and 40(b) are applicable to foreign currency cash flow hedges, foreign currency fair value hedges, and hedges of the net investment in a foreign operation. Under the functional currency concept of FASB Statement No. 52, *Foreign Currency Translation*, exposure to a foreign currency exists only in relation to a specific unit's designated functional currency cash flows. Therefore, exposure to foreign currency risk must be assessed at the unit level. A unit has exposure to foreign currency risk only if it enters into a transaction (or has an exposure) denominated in a currency other than the unit's functional currency. Due to the requirement in Statement 52 for remeasurement of assets and liabilities denominated in a foreign currency into the unit's functional currency, changes in exchange rates for those currencies will give rise to exchange gains or losses, which results in direct foreign currency exposure for the unit but not for the parent company if its functional currency differs from its unit's functional currency. The functional currency concepts of Statement 52 are relevant if the foreign currency exposure being hedged relates to (a) an unrecognized foreign-currency-denominated firm commitment or a recognized foreign-currency-denominated asset or liability that may be hedged in a fair value hedge, (b) a foreign-currency-denominated forecasted transaction, an unrecognized foreign-currency-denominated firm commitment, or the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability that may be hedged in a cash flow hedge, or (c) a net investment in a foreign operation.

Because a parent company whose functional currency differs from its subsidiary's functional currency is not directly exposed to the risk of exchange rate changes due to a subsidiary transaction that is denominated in a currency other than a subsidiary's functional currency, the parent cannot hedge that risk. Accordingly, a parent company that has a different functional currency may not directly hedge a subsidiary's recognized asset or liability, unrecognized firm commitment or forecasted transaction denominated in a currency other than the subsidiary's

functional currency. Also, a parent that has a different functional currency may not hedge a net investment of a first-tier subsidiary in a second-tier subsidiary. However, a subsidiary may enter into an intercompany hedge contract with the parent company, and that contract can be a hedging instrument in the consolidated financial statements if the parent company enters into an offsetting contract (pursuant to paragraph 36 or 40A for the appropriate hedge relationship) with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the subsidiary that initiated the hedge.

If a subsidiary has the same functional currency as the parent company or other member of the consolidated group, the parent company or that other member of the consolidated group may, subject to certain restrictions, enter into a derivative or nonderivative instrument that is designated as the hedging instrument in a hedge of that subsidiary's foreign currency exchange risk in consolidated financial statements.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Foreign Currency Hedges: Requirement That the Unit with the Exposure Must Be a Party to the Hedge
Date cleared by Board:	February 17, 1999
Superseded by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*

Title:	Foreign Currency Hedges: Hedging the Entire Fair Value of a Foreign-Currency-Denominated Asset or Liability
Date cleared by Board:	July 28, 1999
Superseded by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*

Title:	Foreign Currency Hedges: Hedging Foreign-Currency-Denominated Interest Payments
Paragraph references:	21, 29, 37, 40, 540
Date cleared by Board:	July 28, 1999
Affected by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*

Revised September 25, 2000

QUESTION

May a company treat foreign-currency-denominated fixed-rate interest coupon payments arising from an issuance of foreign-currency-denominated fixed rate debt as (a) an unrecognized firm commitment that may be designated as a hedged item in a foreign currency fair value hedge or (b) forecasted transactions that may be designated as hedged transactions in a foreign currency cash flow hedge?

BACKGROUND

A company whose functional currency is the U.S. dollar issues fixed-rate debt denominated in a foreign currency. The debt has a fixed interest coupon that is payable semi-annually in that foreign currency. The company wishes to lock in, in U.S. dollar functional currency terms, the future interest expense that will result from the debt and enters into a derivative instrument to hedge the foreign currency risk of the fixed foreign-currency-denominated interest coupon payments. For example, the company may enter into a foreign currency swap to receive an amount of the foreign currency required to satisfy the interest coupon obligation in exchange for U.S. dollars at each coupon date, or, alternatively, it may enter into a strip of foreign currency forward contracts that provide for receipt of an amount of foreign currency required to satisfy the interest coupon obligation in exchange for the payment of U.S. dollars at each coupon date.

Paragraph 37 of Statement 133 states:

> A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in paragraphs 22-27 if all the fair value hedge criteria in paragraphs 20 and 21 and the conditions in paragraphs 40(a) and 40(b) are met. [Footnote reference omitted.]

Paragraph 40 of Statement 133 states, in part:

> A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with a

forecasted transaction…, a recognized asset or liability, an unrecognized firm commitment, or a forecasted intercompany transaction…qualifies for hedge accounting if all 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.) [Footnote reference omitted.]
b. The hedged transaction is denominated in a currency other than 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 a foreign currency cannot both be included in the same group.

Paragraph 540 of Statement 133 includes the following definitions:

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.

RESPONSE

A company may not treat foreign-currency-denominated fixed-rate interest coupon payments arising from an issuance of foreign-currency-denominated fixed-rate debt as an unrecognized firm commitment that may be designated as a hedged item in a foreign currency fair value hedge. The foreign-currency exposure of the future interest payments would not meet Statement 133's definition of an unrecognized firm commitment because the obligation is recognized on the balance sheet—that is, the carrying amount of the foreign-currency-denominated fixed-rate debt incorporates the entity's obligation to make those future interest payments as well as the repayment of principal. However, those fixed-rate interest payments could be designated as the hedged transaction in a cash flow hedge.

The above guidance also applies to dual-currency bonds that provide for repayment of principal in the functional currency and periodic fixed-rate interest payments denominated in a foreign currency. FASB Statement No. 52, *Foreign Currency Translation*, applies to dual-currency bonds and requires the present value of the interest payments denominated in a foreign currency to be remeasured and the transaction gain or loss recognized in earnings. Thus, those fixed-rate interest payments on a dual-currency bond could be designated as the hedged transaction in a cash flow hedge of foreign exchange risk.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Foreign Currency Hedges: Hedging a Firm Commitment or Fixed-Price Agreement Denominated in a Foreign Currency
Paragraph references: 36, 40, 442, 540
Date cleared by Board: July 28, 1999

Revised September 25, 2000

QUESTION

If an agreement to sell a nonfinancial asset that qualifies as a normal sale in accordance with paragraph 10(b) of Statement 133 requires payment in a foreign currency, may the seller choose to hedge its exposure to foreign currency risk under the cash flow hedging model if the agreement meets Statement 133's definition of a firm commitment? If the agreement does not meet Statement 133's definition of a firm commitment but contains a foreign-currency-denominated fixed price, may the seller hedge the exposure to foreign currency risk under either the fair value hedging model or the cash flow hedging model?

Examples of the alternative structures are described below:

Scenario 1—A Firm Commitment
On January 1, an entity enters into an agreement to sell 1,000 tons of a nonfinancial asset to an unrelated party on June 30. The agreement meets the definition of a firm commitment in paragraph 540 of Statement 133. The firm commitment is denominated in the buyer's functional currency, which is not seller's functional currency. Accordingly, the firm commitment exposes the seller to foreign currency risk. It is clear under Statement 133 that the seller may hedge the foreign currency exposure arising from the firm commitment under the fair value hedging model. May the seller choose to hedge that foreign currency exposure under the cash flow hedging model?

Scenario 2—A Fixed-Price Agreement
On January 1, an entity enters into an agreement to sell 1,000 tons of a nonfinancial asset to an unrelated party on June 30. Although the agreement in this scenario does not meet the definition of a firm commitment in paragraph 540 of Statement 133, the seller's assessment of the observable facts and circumstances is that performance under the agreement is probable. The agreement is denominated in the buyer's functional currency, which is not seller's functional currency. Accordingly, the foreign-currency-denominated fixed-price agreement exposes the seller to foreign currency risk. May the seller choose to hedge that foreign currency risk under either the fair value hedging model or cash flow hedging model?

BACKGROUND

Paragraph 540 of Statement 133 includes the following definitions:

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.

Paragraph 442 elaborates on the definition of a firm commitment:

> The definition of a firm commitment in this Statement requires that the fixed price be specified in terms of a currency (or an interest rate) rather than an index or in terms of the price or a number of units of an asset other than a currency, such as ounces of gold. A price that varies with the market price of the item that is the subject of the firm commitment cannot qualify as a "fixed" price. For example, a price that is specified in terms of ounces of gold would not be a fixed price if the market price of the item to be purchased or sold under the firm commitment varied with the price of gold. To avoid such a situation, the Board decided that it was necessary to require that the fixed price in a firm commitment be specified in terms of a currency or a rate. A similar situation can exist for a firm commitment that is denominated in a foreign currency if the price of the item to be purchased or sold varies with changes in exchange rates. The Board accepted that possibility because it had been accepted under Statement 52, and it did not want to undertake a complete reconsideration of the hedging provisions of that Statement at this time. Therefore, the price may be specified in any currency—it need not be in the entity's functional currency.

RESPONSE

Scenario 1—A Firm Commitment

The seller may hedge its exposure to foreign currency risk under the cash flow hedging model even though the agreement meets Statement 133's definition of a firm commitment. Although that definition of a firm commitment requires a fixed price, it permits the fixed price to be denominated in a foreign currency. Consequently, a firm commitment can expose the parties to

variability in their functional-currency-equivalent cash flows. The reference in Statement 133's definition of a forecasted transaction indicating that a forecasted transaction is not a firm commitment focuses on firm commitments that have no variability. The reference is not intended to preclude a cash flow hedge of the variability in functional-currency-equivalent cash flows when the commitment's fixed price is denominated in a foreign currency. The definition of a forecasted transaction also indicates that the transaction or event will occur at the *prevailing market price*. From the perspective of the hedged risk (foreign exchange risk), the translation of the foreign currency proceeds from the sale of the nonfinancial assets will occur at the prevailing market price (that is, current exchange rate). Accordingly, in Scenario 1, the seller may hedge the foreign currency exposure arising from the firm commitment to sell 1,000 tons of the nonfinancial asset under the cash flow hedging model, even though the seller has previously hedged its foreign currency exposure arising from another similar firm commitment under the fair value hedging model.

Scenario 2—A Fixed-Price Agreement

If the agreement does not meet Statement 133's definition of a firm commitment, but contains a fixed foreign-currency-denominated price, the seller may not hedge the foreign currency risk relating to the agreement to sell the nonfinancial asset *under the fair value hedging model* because the agreement is not a recognized asset, a recognized liability, or a firm commitment (as defined in Statement 133), which are the only items that can be designated as the hedged item in a fair value hedge.

However, the seller may hedge the foreign currency risk relating to the agreement *under the cash flow hedging model*. The agreement is by definition a forecasted transaction because the sale of the nonfinancial assets will occur at the prevailing market price, that is, the fixed foreign-currency-denominated market price converted into the seller's functional currency at the prevailing exchange rate when the transaction occurs. Therefore, because the agreement includes a fixed foreign-currency-denominated price, the agreement exposes the seller to Statement 133 variability in the functional-currency-equivalent cash flows. Accordingly, in Scenario 2, the seller may not hedge the foreign currency risk relating to the agreement to sell 1,000 tons of the nonfinancial asset under the fair value hedging model but may hedge the foreign currency risk under the cash flow hedging model.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Foreign Currency Hedges: Accounting for Premium or Discount on a Forward Contract Used as the Hedging Instrument in a Net Investment Hedge
Paragraph references: 42, 474–477
Date cleared by Board: November 23, 1999

QUESTION

Under Statement 133, may an entity choose to defer the premium or discount on a foreign currency forward contract that is used to hedge the foreign exchange exposure of the entity's net investment in foreign operations and amortize that amount to earnings ratably over the period of the contract?

BACKGROUND

Paragraph 474 of Statement 133 provides the following as the Board's objectives in providing hedge accounting for hedges of foreign currency exposures:

a. To continue to permit hedge accounting for the types of hedged items and hedging instruments that were permitted hedge accounting under FASB Statement No. 52, *Foreign Currency Translation.*
b. To increase the consistency of hedge accounting guidance for foreign currency hedges and other types of hedges by broadening the scope of foreign currency hedges that are eligible for hedge accounting, as necessary.

Paragraph 18 of Statement 52 had provided the reporting entity the option to amortize the discount or premium of a derivative that is used as the hedging instrument.

RESPONSE

No. Statement 133 does not permit the premium or discount (also referred to as the forward points) on a foreign currency forward contract that is used to hedge the foreign exchange exposure of the entity's net investment in foreign operations to be accounted for separately. It supersedes paragraph 18 in Statement 52 and requires all derivatives to be reported at fair value.

Paragraph 42 of Statement 133 provides that "the gain or loss on a hedging derivative 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." That paragraph does not provide an entity the option of separately amortizing the premium or discount on the forward exchange contract to earnings ratably over the period of the contract.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Foreign Currency Hedges: Frequency of Designation of Hedged Net Investment
Paragraph reference: 42
Date cleared by Board: November 23, 1999

QUESTION

If an entity documents that the effectiveness of its hedge of the net investment in a foreign operation will be assessed based on the beginning balance of its net investment, how frequently must an entity consider the need to redesignate the hedging relationship to reflect a revised beginning balance?

RESPONSE

If an entity documents that the effectiveness of its hedge of the net investment in a foreign operation will be assessed based on the beginning balance of its net investment and the entity's net investment changes during the year, the entity must consider the need to redesignate the hedging relationship (to indicate what the hedging instrument is and what numerical portion of the current net investment is the hedged portion) whenever financial statements or earnings are reported, and at least every three months.

For example, assume that a company enters into a foreign currency forward contract that has a notional amount that is equal to the beginning balance of its investment in a foreign operation (for example, 100,000 foreign currency units–FCUs). This foreign currency forward contract is immediately designated as a hedge of the entire beginning balance of the net investment at the inception of the hedge. As the net investment changes, the company would periodically assess the original hedging relationship and decide whether it needs to remove (that is, dedesignate) that original relationship and designate a new hedging relationship for the following assessment period. The following presents one method of such redesignation in those circumstances in which the entity chooses not to obtain a new derivative:

- If the net investment had increased (for example, to 120,000 FCUs), the entire forward contract would be designated prospectively as hedging only a portion of the beginning balance of the net investment in that foreign operation. The hedged portion would be the ratio of the net investment at the inception of the hedge to the net investment at the beginning of the new assessment period (for example, five-sixths of the 120,000 FCUs).
- If the net investment had decreased (for example, to 90,000 FCUs), only a proportion of the forward contract would be designated prospectively as hedging the entire beginning balance of the net investment in that foreign operation. The proportion of the forward contract designated prospectively as the hedging instrument would be the ratio of the net investment at the beginning of the new assessment period to the net investment at the inception of the hedge (for example, nine-tenths of the forward contract). The proportion of the forward contract not designated prospectively as the hedging instrument in the net investment hedge

could be designated as a hedging instrument in a different hedging relationship or simply reported at fair value with its gain or loss subsequent to the dedesignation date recognized currently in earnings pursuant to paragraph 18(a).

An entity is not required to redesignate the hedging relationship more frequently than discussed above even when a significant transaction (for example, a dividend) occurs during the interim period.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Foreign Currency Hedges: Measuring the Amount of Ineffectiveness in a Net Investment Hedge
Paragraph references:	42, 71
Date cleared by Board:	December 13, 2000
Date posted to website:	January 10, 2001
Date revision posted to website:	March 1, 2001 Revised February 28, 2001

QUESTIONS

1. How should an entity measure the amount of ineffectiveness that must be recognized in earnings for a derivative instrument designated as a hedge of a net investment in a foreign operation?
2. How should an entity measure the amount of ineffectiveness that must be recognized in earnings for a nonderivative instrument designated as a hedge of a net investment in a foreign operation?

BACKGROUND

Under paragraph 13 of FASB Statement No. 52, *Foreign Currency Translation*, the entire amount of the translation gain or loss on the net investment shall be recognized in the cumulative translation adjustment account, which is one component of other comprehensive income (OCI).

Paragraph 42 of Statement 133 states, in part:

> 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*. [Emphasis added.]

The phrase *to the extent it is effective as a hedge* determines the amount of ineffectiveness that is recognized in earnings. However, Statement 133 does not provide detailed guidance regarding the application of that phrase or how to determine the amount of hedge ineffectiveness in a net investment hedge.

RESPONSE

Question 1

Paragraph 42 provides guidance for hedging the foreign currency exposure of a net investment in a foreign operation. Paragraph 42 states, in part, that "the gain or loss on a hedging derivative instrument (or the foreign currency transaction gain or loss on the nonderivative 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." If a derivative is used as the hedging instrument, that guidance should be interpreted to permit an entity to measure the amount of ineffectiveness in a net investment hedge using either a method based on changes in spot exchange rates or a method based on changes in forward exchange rates. However, an entity must consistently use the same method for all its net investment hedges in which the hedging instrument is a derivative; use of the spot method for some net investment hedges and the forward method for other net investment hedges is not permitted. Entities that have already adopted Statement 133 have a one-time opportunity to change the method of measuring the amount of ineffectiveness from the forward-rate-based method to the spot-rate-based method or vice versa. That one-time opportunity would need to be implemented no later than in the first fiscal quarter that begins after January 10, 2001; early application in the fiscal quarter that includes January 10, 2001 is permitted. The change in the method of measuring the amount of ineffectiveness should be made as of the beginning of the fiscal quarter in which the change is initially applied. For hedging relationships existing at the beginning of the fiscal quarter in which the change is initially applied, those relationships should be considered to have been dedesignated as of that date and a new hedging relationship designated to which the new method would be applied prospectively. The above interpretation of paragraph 42 can also be applied to purchased options used as hedging instruments in a net investment hedge.

Method Based on Changes in Forward Rates

If the notional amount of the derivative designated as a hedge of a net investment in a foreign operation matches (that is, equals) the portion of the net investment designated as being hedged and the derivative's underlying relates solely to the foreign exchange rate between the functional currency of the hedged net investment and the investor's functional currency, all changes in fair value of the derivative should be reported in the same manner as a translation adjustment (that is, reported in the cumulative translation adjustment section of OCI). In that case, no hedge ineffectiveness would be recognized in earnings (including the time value component of purchased options or the interest accrual/periodic cash settlement components of qualifying receive-floating-rate, pay-floating-rate and receive-fixed-rate, pay-fixed-rate cross-currency interest rate swaps). However, recognition of hedge ineffectiveness in earnings is required if (a) the notional amount of the derivative does not match the portion of the net investment designated as being hedged, (b) the derivative's underlying exchange rate is not the exchange rate between the functional currency of the hedged net investment and the investor's functional currency, or (c) the hedging derivative is a cross-currency interest rate swap as permitted by Statement 133 Implementation Issue No. H9, "Hedging a Net Investment with a Compound Derivative That Incorporates Exposure to Multiple Risks," in which both legs are not based on comparable interest rate curves (for example, pay foreign currency based on three-month LIBOR, receive functional currency based on three-month commercial paper rates). If the derivative has multiple underlyings — one based on foreign exchange risk and one or more not based on foreign exchange risk — as discussed in Implementation Issue H9, that derivative cannot be used as the hedging instrument in a net investment hedge unless it is a receive-floating-rate, pay-floating-rate interest rate swap that meets the criteria in Implementation Issue H9.

The measurement of hedge ineffectiveness due to the differences described above between the hedging derivative and the hedged net investment is as follows:

1. ***Different Notional Amounts.*** If the notional amount of the derivative designated as a hedge of the net investment does not match the portion of the net investment designated as being hedged, the amount of hedge ineffectiveness required to be recognized in earnings must be measured by comparing the change in fair value of the actual derivative designated as the hedging instrument and the change in fair value of a "hypothetical" derivative contract that has a notional amount that matches the portion of the net investment being hedged. (Refer to the final paragraph below for situations in which the hedge of a net investment in a foreign operation is hedging foreign currency risk on an after-tax basis, as permitted by paragraph 71 of Statement 133.) The hypothetical derivative must also have a maturity that matches the maturity of the actual derivative designated as the net investment hedge.

2. ***Different Currencies.*** If the derivative designated as the hedging instrument has an underlying foreign exchange rate that is not the exchange rate between the functional currency of the hedged net investment and the investor's functional currency (a "tandem currency" hedge), the amount of hedge ineffectiveness required to be recognized in earnings must be measured by comparing the change in fair value of the actual cross-currency hedging instrument with the change in fair value of a hypothetical derivative contract that has as its underlying the foreign exchange rate between the functional currency of the hedged net investment and the investor's functional currency. The hypothetical derivative must also have a maturity and repricing and payment frequencies for any interim payments that match the maturity and repricing and payment frequencies for any interim payments of the actual derivative designated as the net investment hedge.

3. ***Multiple Underlyings.*** In accordance with Implementation Issue H9, the only derivatives with multiple underlyings permitted to be designated as a hedge of a net investment are receive-floating-rate, pay-floating-rate cross-currency interest rate swaps that meet certain criteria. Implementation Issue H9 also permits receive-fixed-rate, pay-fixed-rate cross-currency interest rate swaps to be designated as a hedge of a net investment. If a receive-floating-rate, pay-floating-rate cross-currency interest rate swap is designated as the hedging instrument in a net investment hedge, the amount of hedge ineffectiveness required to be recognized in earnings must be measured by comparing the change in fair value of the actual cross-currency interest rate swap designated as the hedging instrument with the change in fair value of a hypothetical receive-floating-rate, pay-floating-rate cross-currency interest rate swap in which the interest rates are based on the same currencies contained in the hypothetical swap and both legs of the hypothetical swap have the same repricing intervals and dates. If a receive-fixed-rate, pay-fixed-rate cross-currency interest rate swap is designated as the hedging instrument in a net investment hedge, the amount of hedge ineffectiveness required to be recognized in earnings must be measured by comparing the change in fair value of the actual cross-currency interest rate swap designated as the hedging instrument with the change in fair value of a hypothetical receive-fixed-rate, pay-fixed-rate cross-currency interest rate swap in which the interest rates are based on the same currencies

contained in the hypothetical swap. The hypothetical derivative must also have a maturity that matches the maturity of the actual cross-currency interest rate swap designated as the net investment hedge.

It should be noted that, in order to designate a derivative as a hedge of a net investment, an entity is required to have an expectation that the derivative will be effective as an economic hedge of foreign exchange risk associated with the hedged net investment. Accordingly, if any difference in notional amount, currencies, or underlyings (as described in the paragraphs above) is present, the entity must establish an expectation that the actual derivative designated as the hedging instrument will be effective as an economic hedge. For example, if an entity designates a derivative that has an underlying exchange rate involving a currency *other* than the functional currency of the net investment, that exchange rate must be expected to move in tandem with the exchange rate between the functional currency of the hedged net investment and the investor's functional currency. The determination of whether the derivative qualifies for net investment hedge accounting should be consistent with the approach used in the prior application of Statement 52 to determine whether a hedging instrument would be economically effective as a net investment hedge. Under Statement 133, use of a currency different from the exposed currency is not limited to cases in which it is not practical or feasible to hedge in the exposed currency if all other qualifying criteria are met.

If any differences described above exist between the hedging derivative and the hedged net investment, changes in value of the hypothetical derivative must be recorded in the cumulative translation adjustment section of OCI. Any difference between the change in fair value of the hypothetical derivative and the actual hedging derivative must be recognized in earnings. Because the provisions of paragraph 42, which in large part were carried forward from Statement 52, clearly imply that hedge ineffectiveness must be recognized currently in earnings, ineffectiveness in a net investment hedge must be recognized in earnings for both overhedges and underhedges. As a result, if the change in the fair value of the actual derivative designated as the hedging instrument exceeds the change in fair value of the hypothetical derivative contract, the difference represents an overhedge that must be recognized in earnings. Similarly, if the change in fair value of the actual derivative designated as the hedging instrument is smaller than the change in fair value of the hypothetical derivative contract, the difference represents an underhedge that must be recognized in earnings. (The recognition of hedge ineffectiveness for an underhedge of an entity's net investment in a foreign operation deliberately differs from the accounting for cash flow hedges.)

If ineffectiveness must be recognized in earnings because the hedging instrument involves multiple differences (that is, different notional amounts, currencies, and underlyings), the amount of ineffectiveness can be determined by a single comparison to the appropriate hypothetical derivative contract that does not incorporate those differences.

Paragraph 71 of Statement 133 permits hedging foreign currency risk on an after-tax basis, provided that the documentation of the hedge at its inception indicated that the assessment of effectiveness, including the calculation of ineffectiveness, will be on an after-tax basis (rather

than on a pre-tax basis). If an entity has elected to hedge foreign currency risk on an after-tax basis, it must adjust the notional amount of its derivative appropriately to reflect the effect of tax rates. In that case, the hypothetical derivative contract used to measure ineffectiveness should have a notional amount that has been appropriately adjusted (pursuant to the documentation at inception) to reflect the effect of the after-tax approach.

Method Based on Changes in Spot Rates

If (a) the notional amount of the derivative designated as a hedge of a net investment in a foreign operation matches (that is, equals) the portion of the net investment designated as being hedged, (b) the derivative's underlying exchange rate is the exchange rate between the functional currency of the hedged net investment and the investor's functional currency, and (c) the hedging derivative is a cross-currency interest rate swap as permitted by Implementation Issue H9, the change in the fair value of the derivative attributable to changes in the difference between the forward rate and spot rate would be excluded from the measure of hedge ineffectiveness and that difference would be reported directly in earnings. The interest accrual/periodic cash settlement components of qualifying receive-floating-rate, pay-floating-rate and receive-fixed rate, pay-fixed-rate cross-currency interest rate swaps would also be reported directly in earnings. The effective portion of the change in fair value should be reported in the same manner as a translation adjustment (that is, reported in the cumulative translation adjustment section of OCI). The effective portion that would be reported in the cumulative translation adjustment section of OCI should be determined by looking to changes in spot exchange rates. The spot-to-spot changes in value reported in the cumulative translation adjustment section of OCI should not be discounted.

If (a) the notional amount of the derivative does not match the portion of the net investment designated as being hedged, (b) the derivative's underlying exchange rate is not the exchange rate between the functional currency of the hedged net investment and the investor's functional currency, or (c) the hedging derivative is a cross-currency interest rate swap as permitted by Implementation Issue H9 in which both legs are not based on comparable interest rate curves (for example, pay foreign currency based on three-month LIBOR, receive functional currency based on three-month commercial paper rates), the effective portion that would be reported in the cumulative translation adjustment section of OCI of a hypothetical derivative that does not incorporate those differences must be compared to the change in fair value of the actual derivative to determine the hedging ineffectiveness. Any difference must be recognized in earnings. The hypothetical derivative must also have a maturity and repricing and payment frequencies for any interim payments that match the maturity and repricing and payment frequencies for any interim payments of the actual derivative designated as the hedging instrument in the net investment hedge.

Question 2

If the notional amount of the nonderivative instrument matches the portion of the net investment designated as being hedged and the nonderivative instrument is denominated in the functional

currency of the hedged net investment, the translation gain or loss determined under Statement 52 by reference to the spot exchange rate between the transaction currency of the debt and the functional currency of the investor (after tax effects, if appropriate) should be reported in the same manner as the translation adjustment associated with the hedged net investment (that is, reported in the cumulative translation adjustment section of OCI). In that case, no hedge ineffectiveness would be recognized in earnings.

Recognition of hedge ineffectiveness in earnings is required if (a) the notional amount of the nonderivative instrument does not match the portion of the net investment designated as being hedged or (b) the nonderivative instrument is denominated in a currency other than the functional currency of the hedged net investment. In that case, ineffectiveness must be recognized in earnings by comparing the foreign currency transaction gain or loss based on the spot rate change (after tax effects, if appropriate) of that nonderivative instrument to the transaction gain or loss based on the spot rate change (after tax effects, if appropriate) that would result from the appropriate hypothetical nonderivative instrument that does not incorporate those differences. Any difference between the spot rate change of the hypothetical nonderivative instrument and the actual hedging nonderivative instrument must be recognized in earnings. That is, ineffectiveness must be recognized in earnings for both overhedges and underhedges. The hypothetical nonderivative must also have a maturity that matches the maturity of the actual nonderivative designated as the net investment hedge.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Foreign Currency Hedges: Hedging a Net Investment with a Compound Derivative That Incorporates Exposure to Multiple Risks
Paragraph references:	18, 42, 477
Date cleared by Board:	December 13, 2000

QUESTION

Can an entity use, as the hedging instrument in a net investment hedge, a compound derivative that has multiple underlyings—one based on foreign exchange risk and one or more *not* based on foreign exchange risk?

BACKGROUND

Paragraph 18 states, in part:

> Either all or a proportion of a derivative may be designated as the hedging instrument. The proportion must be expressed as a percentage of the entire derivative so that the profile of risk exposures in the hedging portion of the derivative is the same as that in the entire derivative. (Thus, an entity is prohibited from separating a compound derivative into components representing different risks and designating any such component as the hedging instrument, except as permitted at the date of initial application by the transition provisions in paragraph 49.)

Paragraph 42 states:

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

Paragraph 477 states, in part, "Net investment hedges are subject only to the criteria in paragraph 20 of Statement 52."

RESPONSE

No. An entity cannot use a compound derivative that has multiple underlyings—one based on foreign exchange risk and one or more *not* based on foreign exchange risk—as the hedging instrument in a net investment hedge, except as indicated below for certain cross-currency interest rate swaps.

A receive-floating-rate, pay-floating-rate cross-currency interest rate swap can be designated as the hedging instrument in a net investment hedge provided the following conditions are met: (1) the interest rates are based on the same currencies contained in the swap and (2) both legs of the swap have the same repricing intervals and dates. In addition, a receive-fixed-rate, pay-fixed-rate cross-currency interest rate swap can be designated as the hedging instrument in a net investment hedge. Based on the guidance in Statement 133 Implementation Issue No. J6, "Fixed-Rate Currency Swaps," a cross-currency interest-rate swap that has two fixed legs is not a compound derivative and, therefore, is not subject to the above criteria. Under the guidance in this Issue, a cross-currency interest rate swap with one fixed-rate leg and one floating-rate leg may not be designated as the hedging instrument in a net investment hedge. Detailed guidance on the measurement of hedge effectiveness for net investment hedges where the hedging instrument has multiple underlyings is provided in Statement 133 Implementation Issue No. H8, "Measuring the Amount of Ineffectiveness in a Net Investment Hedge."

Statement 133 essentially retained hedge accounting for net investment hedges under FASB Statement No. 52, *Foreign Currency Translation*, except that a hedging derivative must now be reported at fair value and the premium or discount cannot be accounted for separately. Statement 52 permitted *only transaction gains and losses* attributable to a foreign currency transaction that is designated as, and is effective as, an economic hedge of a net investment in a foreign entity to be reported in the cumulative translation adjustment (CTA) portion of other comprehensive income. Similarly, paragraph 42 of Statement 133 requires the derivative's gain or loss to be reported in CTA to the extent it is effective as an economic hedge. Because of Statement 133's intended consistency with Statement 52 regarding the amount of the gain or loss related to the hedging instrument that may be reported in CTA, Statement 133 intended that a derivative with an underlying based solely on foreign exchange rates may qualify as the hedging instrument under paragraph 42. Thus, Statement 133 does not permit a compound derivative that involves an underlying that is <u>not</u> based on foreign-currency risk (for example, the price of gold or the price of an S&P 500 contract) to be designated as the hedging instrument in a net investment hedge, except as indicated in the paragraph above for certain cross-currency interest rate swaps. That exception for certain cross-currency interest rate swaps is compatible with the underlying objective of Statement 52 because of the close interrelationship between currency rates and interest rates and because of the restrictions placed on the type of cross-currency interest rate swap that may be designated as a net investment hedge. A cross-currency interest rate swap that has either two floating legs or two fixed legs has a fair value that is primarily driven by changes

in foreign exchange rates rather than changes in interest rates. Therefore, foreign exchange risk, rather than interest rate risk, is the dominant risk exposure in such a swap.

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Title: Foreign Currency Hedges: Hedging Net Investment with the Combination of a Derivative and a Cash Instrument
Paragraph references: 18, 42
Date cleared by Board: May 17, 2000

QUESTION

Does Statement 133 permit a combination of a derivative and a cash instrument to be designated as a single hedging instrument in a hedge of a net investment in a foreign operation?

For example, a parent company that has the U.S. dollar as its functional and reporting currency has a net investment in a Japanese yen-functional-currency subsidiary. The parent borrows in Deutsche marks on a fixed-rate basis and simultaneously enters into a receive-Deutsche mark, pay-Japanese yen currency swap (for all interest and principal payments) to synthetically convert the borrowing into a yen-denominated borrowing. Can the parent company in the above example designate the Deutsche mark-denominated borrowing and the currency swap in combination as a hedging instrument for its net investment in the Japanese yen-functional-currency subsidiary?

RESPONSE

No. A derivative and a cash instrument may not be designated *in combination* as a single hedging instrument in a hedge of a net investment in a foreign operation. Although Statement 133 permits nonderivative instruments to be designated as net investment hedges, it prohibits considering a separate derivative and a cash instrument as a single synthetic instrument for accounting purposes. For example, a debt instrument denominated in the investor's functional currency and a cross-currency interest rate swap cannot be accounted for as synthetically created foreign-currency-denominated debt to be designated as a hedge of the entity's net investment in a foreign operation. An approach that would involve measuring a derivative and a cash instrument as a single unit at the current spot rate (which is used in the translation of the hedged net investment) violates the requirements of FASB Statement No. 52, *Foreign Currency Translation*, for translation of foreign-currency-denominated borrowings at the spot rate relevant to the currency of the borrowing. It also violates the requirements of Statement 133 for measurement of all derivatives at fair value. Accordingly, in the example in the question section, combining the Deutsche mark-denominated borrowing and the currency swap for designation as a single hedging instrument—a yen-denominated borrowing—in a net investment hedge is not permitted.

In contrast with the above example, an entity could designate a foreign currency derivative and a foreign-currency-denominated cash instrument individually as hedging different portions of its net investment in a foreign operation provided the derivative and the cash instrument each individually qualified as a hedging instrument. For example, a Japanese yen-U.S. dollar forward contract and a Japanese yen-denominated cash instrument could each be designated as the

hedging instrument in a hedge of different portions of the net investment in a Japanese yen-functional-currency subsidiary (that is, two separate hedging relationships would be designated).

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Title: Foreign Currency Hedges: Designation of a Foreign-Currency-Denominated Debt Instrument as both the Hedging Instrument in a Net Investment Hedge and the Hedged Item in a Fair Value Hedge
Paragraph references: 42, 423
Date cleared by Board: June 28, 2000

QUESTION

May an entity designate a foreign-currency-denominated debt instrument as the hedging instrument in a net investment hedge and also designate that debt instrument as the hedged item in a fair value hedge of interest rate risk?

BACKGROUND

A U.S. parent company (Parent A) with a U.S. dollar functional currency has a German subsidiary that has the Euro as its functional currency. On January 1, 2001, Parent A issues a five-year, fixed-rate Euro-denominated debt instrument and designates that Euro-denominated debt instrument as a hedge of its net investment in the German subsidiary. On the same date, Parent A enters into a five-year Euro-denominated receive-fixed, pay-Euribor-interest rate swap. Parent A designates the interest rate swap as a hedge of the foreign-currency-denominated fair value of the fixed-rate Euro-denominated debt instrument attributable to changes in Euribor interest rates, which is considered the benchmark interest rate for a hedge of the Euro-denominated fair value of that instrument.

RESPONSE

Yes. A foreign-currency-denominated debt instrument that is designated as the hedging instrument in a net investment hedge may also be designated as the hedged item in a fair value hedge of interest rate risk. The two hedging relationships address separate risk types that are permitted to be hedged individually under Statement 133. Paragraph 42 of Statement 133 permits a nonderivative financial instrument that gives rise to a foreign currency transaction gain or loss under FASB Statement No. 52, *Foreign Currency Translation*, to be designated as a hedge of the foreign currency exposure of a net investment in a foreign operation. In addition, paragraph 21(f)(2) of Statement 133 specifically permits fair value hedge accounting for hedges of interest rate risk, which encompasses the notion of using an interest rate derivative to hedge the changes in a debt instrument's foreign-currency-denominated fair value due to changes in the designated benchmark interest rate. Thus, in the example described in the background section, Parent A may designate the Euro-denominated debt instrument as a hedge of its net investment in the German subsidiary and also as the hedged item in a fair value hedge of the debt instrument's foreign-currency-denominated fair value attributable to changes in the designated benchmark interest rate.

As a result of applying fair value hedge accounting, the debt's carrying amount will be adjusted to reflect changes in its foreign-currency-denominated fair value attributable to interest rate risk. The notional amount of the debt that is designated as the hedging instrument in the net investment hedge will change over time such that it may not match the notional amount of the hedged net investment. Consistent with the guidance in Statement 133 Implementation Issue No. H8, "Measuring the Amount of Ineffectiveness in a Net Investment Hedge," regarding the use of derivatives in hedging the net investment, if the notional amount of the hedging instrument (the foreign-currency-denominated debt instrument) does not match the notional amount of the hedged net investment, the amount of ineffectiveness to be recognized in earnings must be measured as the difference between the actual foreign currency transaction gain or loss on the hedging foreign-currency-denominated debt instrument and the foreign currency transaction gain or loss on a "hypothetical" hedging nonderivative instrument (the foreign-currency-denominated debt instrument) that has a notional amount that matches the hedged net investment.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Foreign Currency Hedges: Designation of an Intercompany Loan or Other Payable as the Hedging Instrument in a Fair Value Hedge of an Unrecognized Firm Commitment
Paragraph references: 36, 37, 487
Date cleared by Board: June 28, 2000

Revised September 25, 2000

QUESTION

May an entity designate an intercompany loan or other payable as the hedging instrument in a foreign currency fair value hedge of an unrecognized firm commitment and qualify for hedge accounting in the consolidated financial statements if, consistent with the requirement of paragraph 36, the member of the consolidated entity that is the counterparty to the intercompany loan has entered into a third-party contract that offsets the foreign exchange exposure of that entity's intercompany loan?

BACKGROUND

A parent company (Parent A) with the U.S. dollar as both its functional currency and reporting currency has a subsidiary with a Euro functional currency (Subsidiary B). Subsidiary B enters into an unrecognized firm commitment with a third party that will result in Japanese yen cash inflows. Concurrent with Subsidiary B entering into the firmly committed contract, Parent A extends a loan to Subsidiary B denominated in yen, which is funded by a third-party, yen-denominated borrowing by Parent A. Subsidiary B wishes to designate its yen-denominated intercompany loan payable as the hedging instrument in consolidated financial statements in a fair value hedge of foreign currency exposure related to its yen-denominated unrecognized firm commitment to a third party.

In accordance with paragraph 15 of FASB Statement No. 52, *Foreign Currency Translation*, at each balance sheet date, Subsidiary B's yen-denominated intercompany loan payable would be remeasured from the foreign currency (yen) into Subsidiary B's functional currency (Euro) at the current Euro/yen spot rate. Similarly, Parent A's intercompany yen-denominated receivable and its third-party yen-denominated loan payable are remeasured from the foreign currency (yen) in to Parent A's functional currency (U.S. dollar) at the current U.S. dollar/yen spot rate. The transaction gains or losses that are generated from remeasurement into functional currency are recorded in net income. If Subsidiary B designates its yen-denominated intercompany loan payable as the hedging instrument in consolidated financial statements, the transaction gains and losses related to the intercompany loan payable would offset the change in fair value of the firm commitment attributable to changes in foreign exchange rates in the consolidated income statement.

Paragraph 36 of Statement 133 states, in part:

> 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.

Paragraph 37 of Statement 133 states, in part:

> A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates. [Emphasis added.]

RESPONSE

Yes. An entity may designate an intercompany loan or other payable as the hedging instrument in a foreign currency fair value hedge of an unrecognized firm commitment and qualify for hedge accounting in the consolidated financial statements. That designation is consistent with the ability under paragraph 37 of Statement 133 to designate nonderivative instruments as hedging instruments in foreign currency fair value hedges of firm commitments. However, hedge accounting in the consolidated financial statements may only be applied if the member of the consolidated entity that is the counterparty to the intercompany loan has entered into a third-party contract that offsets the foreign exchange exposure of that entity's intercompany loan receivable. That is, the requirement in paragraph 36 that an intercompany derivative designated as a hedging instrument in a foreign currency fair value hedge be offset by a third-party contract would also apply to intercompany nonderivative instruments designated as hedging instruments. In order to remain consistent with the notion that the intercompany contract is simply a conduit for the third-party exposure, an intercompany loan designated as a hedging instrument must be offset by a third-party loan (that is, it may not be offset by a derivative contract). Hedge accounting may be applied in consolidation only to those gains and losses occurring during the period that the offsetting third-party loan is in place.

In the example described in the background section, Subsidiary B's yen-denominated intercompany payable may be designated as a fair value hedge of the foreign exchange exposure arising from the third-party yen-denominated firm commitment. Parent A has in place a third-party yen-denominated borrowing that offsets the exposure of its yen-denominated intercompany receivable from Subsidiary B during the period the intercompany loan receives hedge accounting.

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Title:	Foreign Currency Hedges: Reclassifying into Earnings Amounts Accumulated in Other Comprehensive Income Related to a Cash Flow Hedge of a Forecasted Foreign-Currency-Denominated Intercompany Sale
Paragraph references:	31, 40, 482–484
Date cleared by Board:	June 28, 2000

QUESTION

In instances where amounts in accumulated other comprehensive income (OCI) in the consolidated financial statements represent the effective portion of derivative gains and losses related to a cash flow hedge of a forecasted foreign-currency-denominated intercompany sale of an item that will be eventually resold to an unrelated third party, at what point should those amounts be reclassified into earnings? That is, should the amounts in OCI be reclassified into earnings when the hedged forecasted transaction—the intercompany sale—affects earnings of the hedging entity (that is, when the hedging subsidiary's intercompany sale occurs) or when consolidated earnings is affected by the eventual resale of the item to an unrelated third party occurs? Paragraph 31 of Statement 133 states, in part, "Amounts in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings."

BACKGROUND

Parent A is a multinational corporation that has the U.S. dollar as its functional currency. Parent A has two subsidiaries: Subsidiary B, which has the Euro as its functional currency, and Subsidiary C, which has the Japanese yen as its functional currency. Subsidiary B manufactures a product and has a forecasted sale of the product to Subsidiary C that will be transacted in yen. Eventually, Subsidiary C will sell the product to an unrelated third party in yen. Subsidiary B enters into a forward contract with an unrelated third party to hedge the cash flow exposure of its forecasted intercompany sale in yen to changes in the Euro-JPY exchange rate.

Paragraph 40 of Statement 133 permits a derivative instrument to be designated as a hedge of the foreign currency exposure of variability in the functional-currency-equivalent cash flows associated with a forecasted intercompany foreign-currency-denominated transaction if certain criteria are met. The example transaction meets the hedge criteria of paragraph 40. Specifically, the operating unit having the foreign currency exposure (Subsidiary B) is a party to the hedging instrument; the hedged transaction is denominated in yen, which is a currency other than Subsidiary B's functional currency; and all other applicable criteria in paragraphs 28 and 29 of Statement 133 are satisfied. Subsidiary B measures the derivative instrument at fair value and records the effective portion of the gain or loss on the derivative instrument in accumulated OCI, with the ineffective portion, if any, recorded in current earnings.

RESPONSE

In the consolidated financial statements, the amount in OCI representing the effective portion of the gain or loss on a derivative designated as a cash flow hedge of a forecasted foreign-currency-denominated intercompany sale should be reclassified into earnings in the period that the revenue from the sale of the manufactured product to an unrelated third party is recognized. In the example in the background section, the reclassification into earnings in the consolidated financial statements should occur when the forecasted sale affects the earnings of Parent A. Since the consolidated earnings of Parent A will not be affected until the sale of the product by Subsidiary C to the unrelated third party occurs, the reclassification of the amount of derivative gain or loss from OCI into earnings in the consolidated financial statements should occur upon the sale by Subsidiary C to an unrelated third party.

This guidance is relevant only with respect to the consolidated financial statements. In Subsidiary B's separate company financial statements, the reclassification of the amount of derivative gain or loss from OCI into earnings should occur in the period the forecasted intercompany sale is recorded since Subsidiary B's earnings are affected by the change in the Euro-JPY exchange rate when the sale to Subsidiary C occurs.

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Title:	Foreign Currency Hedges: Offsetting a Subsidiary's Exposure on a Net Basis in Which Neither Leg of the Third-Party Position Is in the Treasury Center's Functional Currency
Paragraph references:	40A, 40B
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001

QUESTION

In instances in which a qualifying foreign currency cash flow hedging relationship exists based on paragraph 40A(b)(2) of Statement 133 and the exposures arising from multiple internal derivative contracts are aggregated or netted for each foreign currency, could the Treasury Center enter into a third-party position with neither leg of the third-party position being the Treasury Center's functional currency to offset its exposure?

BACKGROUND

Paragraph 40B of Statement 133 (as amended) permits a Treasury Center to offset exposure arising from multiple internal derivative contracts on an aggregate or net basis if the following conditions are met:

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.

RESPONSE

Yes. In a qualifying foreign currency cash flow hedge that exists based on paragraph 40A(b)(2) and in which the exposures arising from multiple internal derivative contracts are aggregated or netted for each foreign currency, the Treasury Center could enter into a third-party position with neither leg of the third-party position being the Treasury Center's functional currency to offset its exposure provided that the amount of the respective currencies of each leg are equivalent with respect to each other based on forward exchange rates. Paragraph 40B requires that the derivative contract(s) with the unrelated third party provides offset for each foreign currency exposure and that the gains and losses generated from the third-party derivative contract(s) generates equal or approximating gains or losses generated by the internal derivatives entered into between the subsidiaries and the Treasury Center. For example, if a U.S. dollar functional currency Treasury Center was short 390 Euros and long 40,684.80 yen after netting its exposures obtained from internal derivative contracts and the forward exchange rate between Euros and yen was 1.00 Euro = 104.32 yen, then the Treasury Center could enter into a third-party receive 390 Euros/pay 40,684.80 yen contract to offset the exposures. In contrast, if the Treasury Center was short 390 Euros and long 51,000 yen, then the Treasury Center would need to enter into 2 third-party contracts with the receive leg of the second third-party position being the Treasury Center's functional currency. For example, the Treasury Center could enter into a third-party receive 390 Euros/pay 40,684.80 yen contract to offset the Euro exposure and partially offset the yen exposure. It would then need to enter into a receive functional currency/pay yen contract to hedge the remainder of its yen exposure.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Foreign Currency Hedges: Using a Forward Contract to Hedge a Forecasted Foreign Currency Transaction That Becomes Recognized
Paragraph references:	30, 31, 36A
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001
Date revision posted to website:	December 10, 2001 Revised November 21, 2001

QUESTION

In instances where a foreign currency forward derivative hedges a forecasted foreign currency transaction through its cash settlement date, what is the accounting treatment for other comprehensive income (OCI) from the time the transaction is recognized to the time the receivable or payable is cash settled?

BACKGROUND

Company A, a U.S. dollar functional currency entity, forecasts the purchase of inventory on credit for FC100,000 in 182 days with settlement of the payable in 227 days. Company A enters into a forward contract to purchase FC100,000 in 227 days at the forward rate of .6614 and designates a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of the foreign-currency-denominated payable resulting from the forecasted purchase on credit.

Paragraph 36A of Statement 133 permits a derivative instrument to be designated as a single cash flow hedge of the foreign currency exposure of variability in the functional-currency-equivalent cash flows associated with the settlement of a foreign-currency-denominated receivable or payable that results from a forecasted sale or purchase on credit. Paragraph 30 of Statement 133 requires, among other things, (1) that the effective portion of the gain or loss on a derivative designated as a cash flow hedge be reported in OCI and the ineffective portion be reported in earnings and (2) that 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 FASB Statement No. 52, *Foreign Currency Translation,* 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 OCI to earnings.

RESPONSE

Paragraph 36A permits an entity to designate a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of a foreign-currency-denominated receivable or payable resulting from

a forecasted sale or purchase on credit. For the transaction described in the background section, the guidance in paragraph 30 is applied as follows:

1. The effective portion of the gain or loss on the derivative is reported in OCI during the period prior to the forecasted purchase or sale.
2. The functional currency interest rate implicit in the hedging relationship as a result of entering into the forward contract is used to determine the amount of cost or income to be ascribed to each period of the hedging relationship.[1]
3. For forecasted sales on credit, the amount of cost or income ascribed to each forecasted period is reclassified from OCI to earnings on the date of the sale. For forecasted purchases on credit, the amount of cost or income ascribed to each forecasted period is reclassified from OCI to earnings in the same period or periods during which the asset acquired affects earnings. The reclassification from OCI to earnings of the amount of cost or income ascribed to each forecasted period is based on the guidance in paragraph 31 of Statement 133.
4. The income or cost ascribed to each period encompassed within the periods of the recognized foreign-currency-denominated receivable or payable is reclassified from OCI to earnings at the end of each reporting period.

An illustration of the transaction described in the background section is provided below.

[1] The cash flow hedging model for recognized foreign-currency-denominated assets and liabilities requires use of the interest method at the inception of the hedging relationship to determine the amount of cost or income to be ascribed to each relevant period of the hedging relationship. However, for simplicity, in hedging relationships in which the hedged item is a short-term non-interest-bearing account receivable or account payable, the amount of cost or income to be ascribed each period can also be determined using a pro rata method based on the number of days or months of the hedging relationship. In addition, in a short-term single cash flow hedging relationship that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of a foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit, the amount of cost or income to be ascribed each period can also be determined using a pro rata method or a method that uses two foreign currency forward exchange rates. The first foreign currency forward exchange rate would be based on the maturity date of the forecasted purchase or sale transaction. The second foreign currency forward exchange rate would be based on the settlement date of the resulting account receivable or account payable.

Purchase on Credit

- Company A forecasts the purchase of inventory on credit for FC100,000
- Purchase will occur July 15 on credit; payable will settle August 29
- Company A enters into forward contract to purchase FC100,000 at .6614 US$ = 1 FC
- Company A designates a single cash flow hedge of functional currency equivalent cash flows from settlement of the payable

Company measures effectiveness based on forward rates.

Exchange rates are as follows:

Period	Spot	8/29 Forward	7/15 Forward
1/14	0.6575	0.6614	0.6605
3/31	0.6757	0.6793	
6/30	0.6689	0.6734	
7/15	0.6761	0.6767	
8/29	0.6798	0.6798	

	Debit (Credit)					
	Cash	**Inventory**	**Forward Contract**	**Accounts Payable**	**Earnings**	**Accum. OCI**
Inception 1/14	--	--	--	--	--	--
March 31 entry (76 days):						
Mark forward to FV			$1,703			$(1,703)
June 30 entry (91 days)						
Mark forward to FV			(526)			526
July 15 entries (15 days)						
Inventory purchase		$67,610		$(67,610)		
August 29 entries (45 days)						
Mark forward to FV			663			(663)
FC transaction loss on payable				(370)	$370	
Par. 30(d) adjustment—offset the FC transaction loss					(370)	370
Par. 30(d) adjustment—effect of hedge (based on implicit interest rate; refer to "Illustration of #2" below)					78	(78)
Settlement of payable	$(67,980)			67,980		
Settlement of forward	1,840		(1,840)			
	$(66,140)	$67,610	$0	$0	$78	$(1,548)

Upon sale of the inventory, the entity would record cost of goods sold of $67,610 and reclassify $1,548 from OCI to earnings to achieve a net cost of goods sold of $66,062. The effect of the hedge would result in a net cost to the entity of $66,140 for the purchase of the inventory.

The "par. 30(d) adjustment" amount is that amount needed to ensure that a net amount in earnings reflects the effect of the hedge through each reporting period up to and including the final settlement of the payable.

Illustration of #2 in the response section regarding how to calculate the amount of cost or income to be ascribed to each period:

Daily interest rate implicit in the hedging relationship as a result of the forward contract: $65,750 PV, $66,140 FV, 227n, i =0.0026053%

1/14	$65,750	
3/31	65,880	$130
6/30	66,036	156
7/15	66,062	26
8/29	66,140	78
		$390

Pro rata method:

From 1/14 to 7/15:
$390 X 182/227 = $313

From 7/16 to 8/29:
$390 X 45/227 = 77

$390

Method using two foreign currency forward exchange rates:

From 1/14 to 7/15
7/15 Forward Rate .6605
$66,050 – $65,750 = $300

From 7/16 to 8/29
8/29 Forward Rate .6614
$66,140 – $66,050 = 90

$390

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Foreign Currency Hedges: Reference in Paragraph 40(e) about Eliminating All Variability in Cash Flows
Paragraph reference:	40(e)
Date cleared by Board:	September 19, 2001
Date posted to website:	October 10, 2001

QUESTION

Is the reference in paragraph 40(e) to the elimination of *all* variability in the functional-currency-equivalent cash flows intended to require that the hedging instrument be *perfectly* effective?

BACKGROUND

Statement 133 (as amended) allows an entity to designate a derivative instrument as a hedge of the foreign currency exposure of the forecasted foreign-currency-equivalent cash flows associated with a recognized foreign-currency-denominated asset or liability. Paragraph 40(e) specifically states that:

> 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.)

The issue is whether that paragraph's reference to the elimination of *all* variability in cash flows is intended to require that the hedging instrument be *perfectly* effective. Consider the following examples:

Example 1

An entity has issued a fixed-rate foreign-currency-denominated debt obligation that is callable (that is, by that entity) and desires to hedge its foreign currency exposure related to that obligation with a fixed-to-fixed cross-currency swap. Assuming that the swap otherwise would be highly effective in hedging the foreign currency exposure of the debt instrument and it is probable that the call option will not be exercised by the entity, must the swap contain a mirror image call option to qualify for hedge accounting?

Example 2

An entity has issued a variable-rate foreign-currency-denominated debt obligation and desires to hedge its foreign currency exposure related to that obligation. The entity uses a floating-to-fixed cross-currency interest rate swap in which it receives the same foreign currency based on the

variable rate index contained in the debt obligation and pays a fixed amount in its functional currency. Assuming that the swap would otherwise meet Statement 133's definition of providing high effectiveness in hedging the foreign currency exposure of the debt instrument, but there is a one day difference between the reset dates in the debt obligation and the swap (that is, the one day difference in reset dates results in the hedge being highly effective, but not perfectly effective), does paragraph 40(e) preclude the swap from qualifying for hedge accounting?

Example 3

The same facts as in Example 2, except that there is no difference in the reset dates. However, there is a slight difference in the notional amount of the swap and the hedged item. Assuming that the swap would otherwise meet Statement 133's definition of providing high effectiveness in hedging the foreign currency exposure of the debt instrument, does paragraph 40(e) preclude the swap from qualifying for hedge accounting because the notional amounts do not exactly match?

RESPONSE

No. Paragraph 40(e) does not require that the derivative instrument used to hedge the foreign currency exposure of the forecasted foreign-currency-equivalent cash flows associated with a recognized asset or liability be perfectly effective. To qualify for cash flow hedge accounting, Statement 133 requires an expectation that the derivative instrument will be highly effective at offsetting the exposure to the hedged transaction's variability in cash flows attributable to the hedged risk. The requirement in paragraph 40(e) to eliminate all variability is intended to ensure that the hedging relationship is highly effective at offsetting *all risks* that impact the variability of cash flows. Thus, paragraph 40(e) precludes only the specific exclusion of a risk from the hedge that will affect the variability in cash flows. As long as no element of risk that affects the variability in foreign-currency-equivalent cash flows has been specifically excluded from a foreign currency cash flow hedge and the hedging instrument is highly effective at providing the necessary offset in the variability of all cash flows, a less-than-perfect hedge would meet the requirement in paragraph 40(e).

Accordingly, in Example 1 above, a fixed-to-fixed currency swap could be used to hedge the fixed-rate foreign-currency-denominated debt instrument that is callable even though the swap does not contain a mirror image call option. This would be true as long as the terms of the swap and the debt instrument are such that they would be highly effective at providing offsetting cash flows and as long as it was probable that the debt instrument would not be called and would remain outstanding. Likewise in Examples 2 and 3, a floating-to-fixed cross-currency interest rate swap could be used to hedge the variable-rate foreign-currency-denominated debt instrument even though there is a one-day difference between the reset dates or a slight difference in the notional amounts in the debt instrument and the swap. This would be true as long as the difference in reset dates or notional amounts is not significant enough to cause the hedge to fail to be highly effective at providing offsetting cash flows. (In Example 3, the ineffectiveness attributable to the slight difference in the notional amount of the swap and the hedged item could be eliminated by designating only a portion of the contract with the larger notional amount as either the hedging instrument or hedged item, as appropriate.)

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after October 10, 2001, the date that the Board-cleared guidance was posted on the FASB website.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Disclosures: Interaction of the Disclosure Requirements of Statement 133 and Statement 47
Paragraph references:	44, 44A–44E, 45
Date cleared by Board:	May 17, 2000
Date revision posted to website:	April 21, 2008
Affected by:	FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*

Revised March 19, 2008

QUESTION

Does Statement 133 effectively supersede the disclosure requirements of FASB Statement No. 47, *Disclosure of Long-Term Obligations*, for an unconditional purchase obligation that is subject to the requirements of Statement 47 but accounted for as a derivative under Statement 133 and, thus, subject to the disclosure requirements of Statement 133?

BACKGROUND

Paragraph 6 of Statement 47 defines *unconditional purchase obligation* as "…an obligation to transfer funds in the future for fixed or minimum amounts or quantities of goods or services at fixed or minimum prices (for example, as in take-or-pay contracts or throughput contracts)." Paragraph 7 of Statement 47 requires an obligor to make certain disclosures about unconditional purchase obligations that have the characteristics specified in paragraph 6 of Statement 47 and *have not* been recognized on the balance sheet. Separately, paragraph 10 of Statement 47 requires an obligor to make other less extensive disclosures about unconditional purchase obligations that have the characteristics specified in paragraph 6 of Statement 47 and *have* been recognized on the balance sheet.

Certain unconditional purchase obligations (for example, a power purchase agreement entered into in connection with the financing of a generation facility) subject to the disclosure requirements of Statement 47 may also meet the definition of *derivative instrument* in paragraphs 6–9 of Statement 133 and are accounted for as derivatives at fair value in the balance sheet. (The determination of whether an unconditional purchase obligation meets the definition of a derivative instrument is beyond the scope of this issue.)

Statement 133 requires certain disclosures by an entity that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments). Paragraphs 44 through 45 of Statement 133 contain the disclosure requirements.

RESPONSE

No. If an unconditional purchase obligation is subject to the requirements of both Statement 47 and Statement 133, the entity must comply with the disclosure requirements of each Statement, including paragraph 7 of Statement 47, as discussed below.

If an unconditional purchase obligation meets the definition of a derivative instrument, it will be recorded on the purchaser's balance sheet at fair value under Statement 133. However, that recognition at fair value is insufficient to exempt the unconditional purchase obligation from the disclosure requirements of paragraph 7 of Statement 47, whose primary objective is to disclose the fixed and determinable amount of the gross obligation and provide information on the significance of those obligations. Therefore, since the accounting and disclosure requirements of Statement 47 and Statement 133 are each based on different objectives, the purchaser must comply with the disclosure requirements of both paragraph 7 of Statement 47 and paragraphs 44 through 45 of Statement 133 for an unconditional purchase obligation that meets the definition of a derivative instrument.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Disclosures: Near-Term Reclassification of Gains and Losses That Are Reported in Accumulated Other Comprehensive Income
Paragraph reference:	45(b)(2)
Date cleared by Board:	June 27, 2001
Date revision posted to website:	February 28, 2007
Affected by:	FASB Statement No. 157, *Fair Value Measurements* Revised September 15, 2006

QUESTION

For disclosure purposes, what is the appropriate way to calculate the amount of other comprehensive income to be reclassified into earnings in the coming 12 months when a single derivative is used to hedge multiple cash flow exposures?

BACKGROUND

For derivative instruments that have been designated and have qualified as cash flow hedging instruments and for the related hedged transactions, paragraph 45(b)(2) of Statement 133 requires disclosure of the following:

> 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.

When interest rate or commodity swaps are used for cash flow hedges, in effect a single derivative is being used to hedge multiple hedged forecasted transactions because a swap involves multiple cash flows (like a series of forward contracts). For instance, a five-year interest rate swap may be designated as the hedging instrument to hedge the variability in cash flows for each of the resets in a five-year variable-rate borrowing. The fair value of a swap may be the net of both positive discounted cash flows (that is, the right to receive future payments) and negative discounted cash flows (that is, the obligation to make future payments). This could happen, for example, if nearby forward rates were below the fixed rate on the swap and far-term forward rates were above the fixed rate on the swap, in which case an entity could have an expectation of having to make cash outflows on the swap for nearby exposures and to receive cash inflows on the swap for the far-term exposures.

RESPONSE

To measure the amount of other comprehensive income to be reclassified into earnings in the coming 12 months when multiple cash flow exposures are designated as the hedged items for a

single derivative, the total amount reported in other comprehensive income (as determined in accordance with paragraph 30(b)) for the hedging relationship first must be allocated to each of the forecasted transactions (hedged items) within the hedging relationship. The allocation method used must be applied consistently and must consider any cumulative gain or loss on the derivative that has been recognized in earnings as hedge ineffectiveness. After the amount reported in other comprehensive income has been allocated to each of the forecasted transactions within the hedging relationship, the entity would sum those estimated amounts to be reclassified into earnings in the coming 12 months. Accordingly, the amount required to be disclosed could be greater than or less than the net amount reported in accumulated other comprehensive income.

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after July 10, 2001, the date that the Board-cleared guidance was posted on the FASB website.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Transition Provisions: Embedded Derivatives Exercised or Expired Prior to Initial Application
Paragraph references: 50, 518–522
Date cleared by Board: February 17, 1999
Revised August 2, 1999, for the Issuance of Statement 137

QUESTION

An entity issued, acquired, or substantively modified a hybrid instrument on or after the entity's selected transition date for embedded derivatives (that is, January 1, 1998, or January 1, 1999) that contained an embedded derivative that warranted separate accounting (such as the conversion option in convertible debt). However, that embedded derivative expired or was exercised prior to the date that the entity initially applied Statement 133 (for example, prior to January 1, 2001). Must that entity include in its transition adjustment the results of separate accounting for both the host contract and the embedded derivative from the date of the hybrid instrument's issuance, acquisition, or modification?

RESPONSE

The application of Statement 133 to a hybrid instrument issued, acquired, or substantively modified on or after the entity's selected transition date for embedded derivatives (that is, January 1, 1998, or January 1, 1999) that contains an embedded derivative depends on whether, at the date of initial application, the entity continues to hold or report any component of the hybrid instrument (either the host contract or both the host contract and the embedded derivative).

If the entity no longer holds or reports any component of the hybrid instrument at the date of initial application (such as when the conversion option in convertible debt has been exercised and the debt security has been surrendered in conjunction with that exercise), the entity should not include in its transition adjustment the results of separate accounting for either the host contract or the embedded derivative from the date of the hybrid instrument's issuance, acquisition, or modification.

In contrast, if the entity continues to hold or report any component of the hybrid instrument at the date of initial application (such as when an embedded conversion option has expired unexercised but the host debt security is still held as an investment), the entity should include in its transition adjustment the results of separate accounting for both the host contract and the embedded derivative from the date of the hybrid instrument's issuance, acquisition, or modification.

The above response also applies to a hybrid instrument issued, acquired, or substantively modified prior to the entity's selected transition date for embedded derivatives (that is, January 1, 1998, or January 1, 1999) if the entity has not elected the optional scope exclusion described in

paragraph 50. (A hybrid instrument issued, acquired, or substantively modified on or after the entity's selected transition date for embedded derivatives (that is, January 1, 1998, or January 1, 1999) is not eligible for the optional scope exclusion described in paragraph 50.)

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Transition Provisions: Hedging with Intercompany Derivatives
Paragraph references:	18, 36, 52
Date cleared by Board:	July 28, 1999

QUESTION

Do the transition provisions of Statement 133 apply to an intercompany derivative treated as a hedge prior to the initial application of Statement 133 even though the intercompany derivative will not be eligible to be designated as the hedging instrument of certain risks under Statement 133?

BACKGROUND

Guidance presented in Statement 133 Implementation Issue No. E3, "Hedging with Intercompany Derivatives," discusses the acceptable practices under Statement 133 for hedging with intercompany derivatives.

Prior to the issuance and adoption of Statement 133, entities may have followed a variety of practices in hedging with intercompany derivatives. For example, a parent company's central treasury function may have entered into a derivative contract with a subsidiary to hedge that subsidiary's interest rate risk. The central treasury function would then have entered into a contract with an unrelated third party that would have offset the intercompany derivative, thereby hedging the exposure it had acquired from issuing the intercompany derivative instrument to the affiliate that desired the hedge.

RESPONSE

Yes. The transition provisions in paragraph 52 of Statement 133 apply to intercompany derivatives treated as hedges in the consolidated financial statements prior to the initial application of Statement 133.

Under Statement 133, an intercompany derivative does not qualify in consolidated financial statements as the hedging instrument for hedges of a risk other than foreign exchange risk. However, whether a derivative is designated as a hedging instrument after Statement 133 has been initially applied does not affect the determination of the transition adjustment. The transition guidance assumes that an entity had previously satisfied itself that, with respect to the intercompany derivative, it had an appropriate basis for special hedge accounting treatment under generally accepted accounting principles prior to the date of initial application of Statement 133.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Transition Provisions: Requirements for Hedge Designation and Documentation on the First Day of Initial Application
Paragraph references: 20, 28, 48, 54, 55, 385, 459, 515
Date cleared by Board: July 28, 1999

QUESTION

May a company that wishes to initially apply Statement 133 as of the beginning of a fiscal quarter (for example, January 1, 1999) for which it has not yet issued financial statements retroactively designate and document hedging relationships "as of" the beginning of the fiscal quarter?

RESPONSE

No. The designation and documentation of hedging relationships (such as that required by paragraphs 20(a) and 28(a)) must be concurrent with the date as of which Statement 133 is initially applied. For example, initial application of Statement 133 to the fiscal quarter ending March 31, 1999, requires designation and documentation of hedging relationships be completed no later than January 1, 1999, to qualify for hedge accounting for the value changes occurring after January 1. Paragraph 48 of Statement 133 states, "Initial application of this Statement shall be as of *the beginning* of an entity's fiscal quarter; *on that date*, hedging relationships shall be designated anew and documented pursuant to the provisions of this Statement" (emphasis added). The reference to designating hedging relationships in that paragraph includes the detailed requirements of paragraphs 20 and 28, that is, at inception of a fair value or cash flow hedge, there is formal documentation of the hedging relationship, the entity's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and the method of assessing the hedging instrument's effectiveness.

Because hedge accounting is based on management's intent, an entity is prohibited from reviewing transactions with hindsight and making retroactive decisions after hedge results are known. As stated in paragraph 385 of Statement 133's basis for conclusions, "The Board decided that concurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result." Paragraph 515 states, "Because hedge accounting is based on an entity's intent at the time a hedging relationship is established, the Board decided that retroactive application of the provisions of this Statement was not appropriate." In addition, as explained in paragraph 459 of Statement 133, concerns about "after-the-fact" designation led the Board to require in paragraph 28(a)(2) of Statement 133 that documentation at inception of a cash flow hedge specify the date on, or period within which, a forecasted transaction is expected to occur.

Hedging relationships, if any, that existed and were the basis for the company's accounting under generally accepted accounting principles before the date of initial application of Statement 133 affect transition adjustments but are not relevant to hedge accounting after initial application. Unless a hedging relationship has been designated anew and has been fully documented by the date of initial application (that is, on the first day of the quarter in which the Statement is initially applied), a derivative must be accounted for as having no hedging designation. Accordingly, any gain or loss on the derivative must be recognized currently in earnings prospectively from the date of initial application. The designation and formal documentation of a hedging relationship after the date of initial application achieves hedge accounting only prospectively from the date that the hedging relationship is designated and fully documented.

In addition, reclassifications of certain securities accounted for under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, that are permitted by paragraphs 54 and 55 of Statement 133, must also be made and documented at the date as of which Statement 133 is applied, rather than retroactively.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Transition Provisions: Transition Adjustment for Option Contracts Used in a Cash-Flow-Type Hedge
Date cleared by Board:	July 28, 1999
Date text deleted:	March 21, 2001 Guidance incorporated into Implementation Issue No. J15, "Pre-Existing Hedge Ineffectiveness of a Derivative"

Title:	Transition Provisions: Floating-Rate Currency Swaps
Paragraph references:	18, 523, 524, footnote 13 (to paragraph 49)
Date cleared by Board:	November 23, 1999
Affected by:	FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*

Revised September 25, 2000

QUESTION

Upon initial application of Statement 133, may a company separate a currency swap that has two floating-rate legs (for example, a receive-EUR-floating, pay-US$-floating swap) into three components in applying paragraph 49 and related footnote 13?

BACKGROUND

Footnote 13 to paragraph 49 of Statement 133 states:

> For a compound derivative that has a foreign currency exchange risk component (such as a foreign currency interest rate swap), an entity is permitted at the date of initial application to separate the compound derivative into two parts: the foreign currency derivative and the remaining derivative. Each of them would thereafter be accounted for at fair value, with an overall limit that the sum of their fair values could not exceed the fair value of the compound derivative. An entity may not separate a compound derivative into components representing different risks after the date of initial application.

As discussed in paragraphs 523 and 524 of the basis for conclusions, footnote 13 to paragraph 49 permits bifurcation of a compound derivative with a foreign currency exchange risk component upon initial application of Statement 133. The Board's decision to allow bifurcation upon initial application of Statement 133 acknowledged that a company may have entered into a long-term derivative that combines foreign currency exchange and interest rate risk components. Prior to being amended by Statement 138, Statement 133 prohibited hedge accounting for hedges of foreign currency risk of financial assets and liabilities for which transaction gains and losses are recognized currently in earnings as required by paragraph 15 of FASB Statement No. 52, *Foreign Currency Translation*. The result of the amendment permits such compound derivatives to qualify for hedge accounting in certain foreign currency hedges and, therefore, reduces the need for bifurcation upon initial application of Statement 133 of a currency swap that has two floating-rate legs into three components. Statement 133 otherwise prohibits bifurcation of a compound derivative. Paragraph 18 states, "…an entity is prohibited from separating a compound derivative into components representing different risks and designating any such component as the hedging instrument, except as permitted at the date of initial application by the transition provisions in paragraph 49."

RESPONSE

Yes. Upon initial application, a company may separate a currency swap that has two floating-rate legs into three components (two interest rate swaps and a currency swap), as follows:

	Receive Leg	Pay Leg
Existing Compound Swap	EUR floating	US$ floating
Separated Swaps:		
Interest Rate Swap 1	EUR floating	EUR fixed
Currency Swap	EUR fixed	US$ fixed
Interest Rate Swap 2	US$ fixed	US$ floating

A currency swap that has two floating-rate legs can be separated *only* into the following three derivatives: a currency swap and two interest rate swaps.

The above guidance applies only to the transition provisions for compound derivatives that include a foreign currency exchange risk component existing at the date of the initial application of Statement 133. A swap that has two floating legs is a compound derivative and, therefore, is subject to those transition provisions, because the cash flows that arise under that type of contract are based on multiple underlyings—interest rates in the relevant currencies and the foreign currency exchange rate. The conclusion in this issue should not be applied by analogy to derivatives entered into after Statement 133 has been adopted.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Transition Provisions: Fixed-Rate Currency Swaps
Paragraph references: 18, 523, 524, footnote 13 (to paragraph 49)
Date cleared by Board: November 23, 1999

QUESTION

Upon initial application of Statement 133, may a company separate a currency swap that has two fixed legs (for example, a receive-fixed-EUR-amount, pay-fixed-US$-amount swap) into derivative components in applying paragraph 49 and related footnote 13?

BACKGROUND

Footnote 13 to paragraph 49 of Statement 133 states:

> For a compound derivative that has a foreign currency exchange risk component (such as a foreign currency interest rate swap), an entity is permitted at the date of initial application to separate the compound derivative into two parts: the foreign currency derivative and the remaining derivative.

The tentative guidance on Statement 133 Implementation Issue No. J5, "Floating-Rate Currency Swaps," provides that, only upon initial application of Statement 133, a company may separate a currency swap that has two floating-rate legs into three derivative components: a fixed-to-fixed currency swap and two interest rate swaps (one in each currency). By analogy, it is suggested that, upon initial application of Statement 133, a currency swap that has two fixed legs could be separated into three derivative components: a currency swap that has two floating-rate legs and two interest rate swaps (one in each currency).

RESPONSE

The guidance in footnote 13 to paragraph 49 of Statement 133 and Implementation Issue J5 applies only to the transition provisions for compound derivatives. Unlike a currency swap that has two floating legs, a currency swap that has two fixed legs is not a compound derivative as that term is used in footnote 13. For a currency swap with two fixed legs, changes in interest rates do not directly impact the cash flows under the contract because the interest rates that determine the amount of each currency that is payable are fixed at the inception of the contract. Therefore, a currency swap that has two fixed legs may not be decomposed into two interest-rate-based derivatives and a foreign-exchange-rate-based derivative.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Transition Provisions: Transfer of Financial Assets Accounted for Like Available-for-Sale Securities into Trading
Paragraph reference:	55
Date cleared by Board:	November 23, 1999
Date revision posted to website:	June 16, 2006
Affected by:	FASB Statement No. 156, *Accounting for Servicing of Financial Assets*

Revised March 17, 2006

QUESTION

Can the transition provisions in paragraph 55 of Statement 133 be applied to financial assets within the scope of paragraph 14 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, thereby enabling those financial assets to be transferred into trading upon the initial adoption of Statement 133?

BACKGROUND

Creditor X enters into a loan agreement with Borrower Y that provides Borrower Y with a prepayment feature such that the loan can be contractually prepaid or otherwise settled in such a manner that Creditor X may not recover substantially all of its recorded investment in the loan to Borrower Y. Paragraph 14 of Statement 125, as amended by Statement 133, states the following:

> Interest-only strips, other interests that continue to be held by a transferor in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of Statement 133, shall be subsequently measured *like* investments in debt securities classified as available-for-sale or trading under Statement 115, as amended…. [Emphasis added.]

In accordance with Statement 140, paragraph 14, Creditor X subsequently measures the loan like an available-for-sale security under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, regarding transfers. The loan is still outstanding on the date of the initial adoption of Statement 133 by Creditor X.

The transition provisions in paragraph 55 of Statement 133 allow an entity, upon the initial adoption of that Statement, to transfer any available-for-sale security into the trading category and reclassify the related unrealized gains and losses into earnings consistent with the provisions of Statement 115. Paragraph 55 of Statement 133 does not mention the financial assets accounted for like available-for-sale securities pursuant to paragraph 14 of Statement 140.

RESPONSE

Yes. The transition provisions in paragraph 55 of Statement 133 can be applied to financial assets that are within the scope of paragraph 14 of Statement 140, thereby enabling those financial assets to be transferred into trading upon the initial adoption of Statement 133. Such a transfer would allow an entity to avoid separate accounting for the embedded derivative and the host contract embodied in the financial asset. Paragraph 12(b) does not permit an embedded derivative to be separated from the host contract and accounted for separately if the hybrid contract that embodies the embedded derivative and the host contract is remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.

The loan described within the example falls in the scope of paragraph 14 of Statement 140 and will be measured *like* available-for-sale securities under Statement 115. That is, even though the loan is not in the form of a security, it is accounted for *like* a security. Accordingly, all the measurement provisions of Statement 115 would apply to that loan, including those addressing recognition and measurement of impairment (refer to *FASB Staff Implementation Guide*—Statement 140, Questions 109 and 110). Consequently, the transition provisions in paragraph 55 of Statement 133 apply to loans measured *like* available-for-sale securities pursuant to paragraph 14 of Statement 140, despite the legal form of the asset.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Transition Provisions: Adjusting the Hedged Item's Carrying Amount for the Transition Adjustment Related to a Fair-Value-Type Hedging Relationship
Paragraph reference:	52
Date cleared by Board:	May 17, 2000

QUESTION

In determining the transition adjustment for a fair-value-type hedge of interest rate risk that existed prior to the initial adoption of Statement 133, should the adjustment of the hedged item's carrying amount be based on its overall unrecognized changes in fair value or on its unrecognized changes in fair value attributable only to changes in the designated benchmark interest rate during the pre-existing fair-value-type hedge? Should that transition adjustment be based on only the changes in the hedged item's fair value that occurred during the period of the pre-existing fair-value-type hedge?

RESPONSE

In determining the transition adjustment for a fair-value-type hedge of interest rate risk that existed prior to the initial adoption of Statement 133, the adjustment of the hedged item's carrying amount should be based on 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 pre-existing hedging relationship) (referred to as Method 1 in this Issue) or (2) the gain or loss on the hedged item attributable to changes in the designated benchmark interest rate during the period of the pre-existing hedging relationship (referred to as Method 2 in this Issue). The adjustment of the hedged item's carrying amount under Method 1 is based on the difference between the hedged item's fair value at the date of initial adoption and its carrying amount at that date, regardless of whether that difference is attributable to changes in the designated benchmark interest rate, changes in other unhedged risks, or changes in fair value arising prior to the designation of the pre-existing fair-value-type hedge. The adjustment of the hedged item's carrying amount under Method 2 is limited to the hedged risks that can be designated under paragraph 21 of Statement 133. An entity is permitted to use either of those two methods for each individual pre-existing fair-value-type hedge. An entity is not required to use the same method for similar hedges. This guidance is consistent with the amendment of paragraph 52 by FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities.*

Paragraph 52 (as amended) indicates that the difference between the derivative's previous carrying amount and its fair value at the date of initial adoption would be included in the transition adjustment and recorded as a cumulative-effect-type adjustment of other

comprehensive income (OCI) for derivatives previously designated in a cash-flow-type hedging relationship and as a cumulative-effect-type adjustment of net income for those previously designated in a fair-value-type hedging relationship. In addition, for a fair-value-type hedging relationship, an adjustment to the hedged item's carrying amount (based on either Method 1 or Method 2) is made, but only to the extent of an offsetting transition adjustment for the derivative. The adjustment to the hedged item's carrying amount under Method 1 is *not* limited to the changes in the hedged item's fair value attributable only to the hedged risk. Even though fair value hedge accounting under Statement 133 is based on a bifurcation-by-risk approach (that is, considering only the changes in the hedged item's fair value attributable to the hedged risk), under the transition provisions for a fair-value-type hedge that existed prior to the initial adoption of Statement 133, an entity may elect to focus on overall unrecognized changes in fair value that are not based on a bifurcation-by-risk approach.

Additionally, the adjustment to the hedged item's carrying amount under Method 1 is *not* limited to the changes in the hedged item's fair value that occurred during the hedge period that existed prior to the initial adoption of Statement 133. A portion of that change in fair value could have occurred prior to the designation of the original, pre-existing fair-value-type hedge of interest rate risk. In contrast, the adjustment to the hedged item's carrying amount under Method 2 is limited to the changes in the hedged item's fair value (attributable to the hedged risk) that occurred during the period that the fair-value-type hedging relationship existed prior to the initial adoption of Statement 133.

In the following examples, assume that prior to the initial adoption of Statement 133, an entity had acquired an interest-bearing asset for $100 and, after its fair value had fallen to $95 (a change in fair value considered temporary), designated an interest rate swap (whose fair value was zero) as hedging the fair value exposure of that asset. The examples demonstrate the application of only Method 1.

1. ***Example 1.*** The hedged item is an interest-bearing asset measured at amortized cost. If prior to the adoption of Statement 133, the hedged asset's fair value had increased by $9 to $104 and the swap's fair value had decreased by $10, the transition adjustment for that pre-existing fair-value-type hedging relationship would be a net $6 cumulative-effect-type reduction of net income, representing the $10 loss from recognizing the swap as a $10 liability and the $4 gain from adjusting the hedged asset's carrying amount from its $100 cost-based carrying amount to its $104 fair value.
2. ***Example 2.*** The hedged item is an interest-bearing asset measured at amortized cost. If prior to the adoption of Statement 133, the hedged asset's fair value had decreased by $9 to $86 and the swap's fair value had increased by $10, the transition adjustment for that pre-existing fair-value-type hedging relationship would be a net zero cumulative-effect-type adjustment of net income, representing the $10 gain from recognizing the swap as a $10 asset and the $10 loss from adjusting the hedged asset's carrying amount to $90 fair value. (Even though the difference between the hedged item's $86 fair value at the date of initial adoption and its $100 carrying amount was $14, the transition adjustment is limited to the extent of the offsetting $10 transition adjustment for the hedging swap.)

3. ***Example 3.*** The hedged item is an interest-bearing available-for-sale debt security measured at fair value with changes in fair value recognized in a separate component of OCI. Assume that the same fair value changes for the hedged item and the swap had occurred as in Example 1, with the changes in the swap's fair value also recognized in a separate component of OCI, pursuant to paragraph 115 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* Upon adoption of Statement 133, both the $10 loss on the swap and the $4 unrealized holding gain on the hedged security would be reclassified into earnings as a cumulative-effect-type adjustment of both net income and accumulated OCI.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Transition Provisions: Use of the Shortcut Method in the Transition Adjustment and upon Initial Adoption
Paragraph references: 48, 52, 68
Date cleared by Board: May 17, 2000

QUESTIONS

1. For a hedging relationship that existed prior to the initial adoption of Statement 133 and that would have met the requirements for the shortcut method in paragraph 68 at the inception of that pre-existing hedging relationship, may the transition adjustment upon initial adoption be calculated as though the shortcut method had been applied since the inception of that hedging relationship?
2. In deciding whether the shortcut method can be applied prospectively from the initial adoption of Statement 133 to a designated hedging relationship that is the continuation of a pre-existing hedging relationship, should the requirements of paragraph 68(b) (that the derivative has a zero fair value) be based on the swap's fair value at the inception of the pre-existing hedging relationship rather than at the inception of the hedging relationship newly designated under Statement 133 upon its initial adoption?

RESPONSE

Question 1

Yes. For a hedging relationship that involves an interest rate swap designated as the hedging instrument, that existed prior to the initial adoption of Statement 133, and that would have met the requirements for the shortcut method in paragraph 68 at the inception of that pre-existing hedging relationship, an entity may choose to calculate the transition adjustment upon initial adoption either (a) pursuant to the provisions of paragraph 52, as discussed in Statement 133 Implementation Issue No. J8, "Adjusting the Hedged Item's Carrying Amount for the Transition Adjustment Related to a Fair-Value-Type Hedging Relationship," or (b) as though the shortcut method had been applied since the inception of that hedging relationship, as discussed below. Under either approach, the interest rate swap would be recognized in the statement of financial position as either an asset or liability measured at fair value.

If the previous hedging relationship was a fair-value-type hedge, the difference between the swap's previous carrying amount and its fair value would be included in the transition adjustment and recorded as a cumulative-effect-type adjustment of net income. The hedged item's carrying amount would be adjusted to the amount that it would have been had the shortcut method for a fair value hedge of interest rate risk been applied from the inception of that pre-existing hedging relationship; that adjustment would be recorded as a cumulative-effect-type adjustment of net income.

If the previous hedging relationship was a cash-flow-type hedge, the difference between the swap's previous carrying amount and its fair value would be included in the transition adjustment and allocated between a cumulative-effect-type adjustment of other comprehensive income and a cumulative-effect-type adjustment of net income, as follows. The cumulative-effect-type adjustment of other comprehensive income would be the amount necessary to adjust the balance of other comprehensive income to the amount that it would have been (related to that swap) on the date of initial adoption had the shortcut method been applied from the inception of the pre-existing hedging relationship. The remainder, if any, of the transition adjustment would be recorded as a cumulative-effect-type adjustment of net income.

Question 2

Yes. In deciding whether the shortcut method can be applied prospectively from the initial adoption of Statement 133 to a designated hedging relationship that is the continuation of a pre-existing hedging relationship, the requirements of paragraph 68(b) (requiring that the derivative has a zero fair value) should be based on the swap's fair value at the inception of the pre-existing hedging relationship rather than at the inception of the hedging relationship newly designated under Statement 133 upon its initial adoption. However, if the hedging relationship that is designated upon adoption of Statement 133 is not the continuation of a pre-existing hedging relationship (that is, not the same hedging instrument and same hedged item or transaction), then the decision regarding whether the shortcut method can be applied prospectively from the initial adoption of Statement 133 should be based on the fair value of the swap at the date of initial adoption.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Transition Provisions: Transition Adjustment for a Fixed-Price Purchase or Sale Contract That Meets the Definition of a Derivative upon Initial Application
Paragraph reference:	52
Date cleared by Board:	June 28, 2000

QUESTION

Should the transition adjustment resulting from adopting Statement 133 be reported in net income or other comprehensive income for a fixed-price purchase or sale contract that (1) was not previously accounted for as a derivative under generally accepted accounting principles before the date of initial application of Statement 133, (2) meets the definition of a derivative under Statement 133, (3) does not qualify for the normal purchases and normal sales exception in paragraph 10(b), and (4) qualifies as the hedging instrument in an "all-in-one" cash flow hedge pursuant to Statement 133 Implementation Issue No. G2, "Hedged Transactions That Arise from Gross Settlement of a Derivative ('All-in-One' Hedges)"?

For example, prior to adoption of Statement 133 Company A entered into a fixed-price purchase order to eliminate the fluctuation in the price of items to be purchased for inventory. Upon the initial application of Statement 133, that fixed-price purchase order meets the definition of a derivative. Should Company A's transition adjustment resulting from adopting Statement 133 related to the fixed-price purchase order be reported in net income or other comprehensive income?

BACKGROUND

Statement 133 defines derivative instruments based on their characteristics; the resulting definition includes certain instruments that were not previously accounted for as derivatives. Therefore, prior to the initial application of Statement 133, those instruments were not designated in hedging relationships because they were not accounted for as derivatives. Those circumstances raise implementation questions regarding the application of paragraph 52 to the resultant transition adjustment.

Paragraph 52 of Statement 133 (as amended) states, in part, the following:

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

for that derivative instrument and that were the basis for accounting under generally accepted accounting principles before the date of initial application of this Statement.

a. If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment shall be reported as a cumulative-effect-type adjustment of accumulated other comprehensive income.
b. If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the fair value exposure of an asset, a liability, or a firm commitment, the transition adjustment for the derivative shall be reported as a cumulative-effect-type adjustment of net income. Concurrently, any gain or loss on the hedged item 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….
h. Other transition adjustments not encompassed by paragraphs 52(a), 52(b) and 52(c) above shall be reported as part of the cumulative-effect-type adjustment of net income.

RESPONSE

Upon transition, a fixed-price purchase or sale contract that (1) was not previously accounted for as a derivative under generally accepted accounting principles before the date of initial application of Statement 133, (2) meets the definition of a derivative under Statement 133, (3) does not qualify for the normal purchases and normal sales exception in paragraph 10(b), and (4) qualifies as the hedging instrument in an "all-in-one" hedge pursuant to Implementation Issue G2 should be measured at fair value with the difference between its carrying amount and fair value reported as a cumulative-effect-type adjustment of accumulated other comprehensive income. Therefore, the guidance in paragraph 52(a) should be applied in arriving at the transition adjustment for that contract. If that contract qualifies for the normal purchases and normal sales exception in paragraph 10(b) (as amended by FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*), there would be no transition adjustment upon initial adoption of Statement 133.

If an "all-in-one" hedging relationship *is not* designated and fully documented upon the date of initial application (even though the contract qualifies for such a hedging relationship), the derivative must subsequently be accounted for as having no hedging designation, assuming the normal purchases and normal sales exception does not apply. Accordingly, any gain or loss on the derivative must be recognized currently in earnings prospectively from the date of initial application. In those circumstances, the transition adjustment should continue to be reported in accumulated other comprehensive income until it is reclassified into earnings pursuant to either paragraph 31 or paragraph 33. Conversely, if an "all-in-one" hedging relationship *is* designated and fully documented by the date of initial application, the derivative may continue to be accounted for as an "all-in-one" hedge in accordance with the guidance in Implementation Issue G2. Thus, in the example discussed above, upon transition Company A should measure the purchase order at fair value with the difference between its carrying amount and fair value reported as a cumulative-effect-type adjustment of accumulated other comprehensive income. The gain or loss recorded in other comprehensive income will be reclassified into earnings when the forecasted inventory purchase impacts earnings. The purchase order qualifies as the hedging instrument in an "all-in-one" hedge pursuant to the guidance in Implementation Issue G2. Implementation Issue G2 indicates that a derivative instrument involving gross settlement may be designated as the hedging instrument in a cash flow hedge of the consideration to be paid or received in the forecasted transaction that will occur upon gross settlement of the derivative contract itself.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Transition Provisions: Transition Adjustment for Net Investment Hedges
Paragraph references: 42, 52, 515
Date cleared by Board: December 13, 2000

QUESTION

If, prior to adopting Statement 133, an entity separately accounted for the discount or premium on a forward contract (or the premium on a purchased foreign currency option) designated as a hedge of a net investment in a foreign operation and included the discount or premium in the determination of net income over the life of the forward contract as permitted by paragraph 18 of FASB Statement No. 52, *Foreign Currency Translation,* how should the transition adjustment for net investment hedges be reported upon initial application of Statement 133 (that is, as a cumulative-effect-type adjustment of net income or other comprehensive income [OCI])?

BACKGROUND

Prior to Statement 133, paragraph 18 of Statement 52 set forth the accounting guidance for a foreign currency forward contract designated as a hedge of a net investment in a foreign operation. Under that guidance, the change in value of a forward contract designated as a net investment hedge would be computed based on the change in spot rates. Also, the discount or premium on the forward contract (determined by multiplying the foreign currency amount of the contract by the difference between the contracted forward rate and the spot rate at the date of inception of the contract) would be accounted for separately from the gain or loss on the contract and may either (a) be included in net income over the life of the forward contract or (b) be included with translation adjustments in OCI.

Statement 133 changed the accounting for derivatives designated as net investment hedges. Because Statement 133 requires all derivatives to be reported at fair value, the discount or premium on a forward contract that is used to hedge the foreign exchange exposure of the entity's net investment in foreign operations may *not* be accounted for separately. That guidance is explicit in Statement 133 Implementation Issue No. H6, "Accounting for Premium or Discount on a Forward Contract Used as the Hedging Instrument in a Net Investment Hedge."

Paragraph 52 of Statement 133 sets forth general guidance for reporting transition adjustments. It states, "Whether a transition adjustment related to a specific derivative instrument is reported in net income, reported in other comprehensive income, or allocated between both is based on the hedging relationships, if any, that had existed for that derivative instrument and that were the basis for accounting under generally accepted accounting principles before the date of initial application of this Statement." None of the subparagraphs of paragraph 52 explicitly address derivatives designated as net investment hedges. Paragraph 52(d) states, "Other transition adjustments not encompassed by paragraphs 52(a), 52(b), and 52(c) above shall be reported as part of the cumulative-effect-type adjustment of net income."

Paragraph 515 of Statement 133 states, "…changes in the fair value of derivatives that arose before initial application of this Statement and were previously recognized in net income, added to the carrying amount of hedged assets or liabilities, or included in other comprehensive income as part of a hedge of a net investment in a foreign entity are not to be included in transition adjustments."

RESPONSE

If, (a) prior to adopting Statement 133, an entity separately accounted for the discount or premium on a forward contract (or the premium on a purchased foreign currency option) designated as a hedge of a net investment in a foreign operation and included the discount or premium in the determination of net income over the life of the forward contract and (b) upon application of Statement 133, an entity designates changes in spot exchange rates for the measurement of ineffectiveness in a net investment hedge, the transition adjustment should be reported as a cumulative-effect-type adjustment of net income. If, (a) prior to adopting Statement 133, an entity separately accounted for the discount or premium on a forward contract (or the premium on a purchased foreign currency option) designated as a hedge of a net investment in a foreign operation and included the discount or premium in the determination of net income over the life of the forward contract and (b) upon initial application of Statement 133, an entity designates changes in forward exchange rates for the measurement of ineffectiveness in a net investment hedge, the transition adjustment should be reported as a cumulative-effect-type adjustment of the cumulative translation adjustment section of OCI. Therefore, if an entity had previously designated a forward contract as a net investment hedge and chose to amortize the discount or premium to net income over the life of the forward contract, the transition adjustment that would be recorded upon initial application of Statement 133 would be equal to the amount by which the fair value of the forward contract differs from the amount recorded on the entity's balance sheet as a result of applying Statement 52. Under Statement 52, the amount on the entity's balance sheet would comprise the amortized amount of discount or premium related to the forward contract and the cumulative change in value of the forward contract attributable to spot rate changes.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Transition Provisions: Intercompany Derivatives and the Shortcut Method
Paragraph references:	42, 52, 68, 515
Date cleared by Board:	June 28, 2000
Superseded by:	FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

Title: Transition Provisions: Indexed Debt Hedging Equity Investment
Paragraph references: 50, 52
Date cleared by Board: December 6, 2000

QUESTION

Prior to the date of initial application of Statement 133, an issuer considered a debt's embedded equity-indexed payment provision as a hedge of a common stock investment. At initial application, the equity-based derivative embedded in the indexed debt instrument is accounted for separately upon adoption of Statement 133 (including those circumstances in which the reporting entity elects separate accounting under paragraph 50). What is the impact of the Statement 133 transition provisions and can the issuer designate the separated embedded derivative in a hedging relationship on a going-forward basis?

BACKGROUND

Statement 133 defines derivative instruments based on their characteristics; the resulting definition includes certain instruments that were not previously separately accounted for as derivatives. Therefore, prior to the initial application of Statement 133, those instruments were not designated in hedging relationships because they were not accounted for as derivatives. Those circumstances raise implementation questions regarding the application of paragraph 52 to the resultant transition adjustment.

Company A owns 10,000 shares of XYZ common stock that are classified as available-for-sale securities in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The original cost of the securities is $100,000. The shares have appreciated in value such that on January 2, 1999 the market value is $1,000,000. Therefore, in accordance with Statement 115, Company A has recorded a credit to other comprehensive income (OCI) for $900,000 (ignoring any deferred taxes for simplification). Wishing to monetize the appreciation of the XYZ shares, Company A issues a debt obligation on January 2, 1999 that is indexed to the market price of XYZ common stock. The principal balance and the proceeds from the obligation is $1,000,000. However, final settlement of the obligation fluctuates with the market price of XYZ common stock. For example, if the price of XYZ common stock rises to $150 per share, the principal repayment amount increases to $1,500,000; if the price declines to $75 per share, the principal repayment amount decreases to $750,000. This index feature is not separable from the debt obligation and Company A could, at its option, settle the debt obligation by delivery of XYZ shares.

Prior to the adoption of Statement 133, Company A had adjusted the balance of the debt obligation based upon changes in the value of XYZ common stock in accordance with EITF Issue No. 86-28, "Accounting Implications of Indexed Debt Instruments." (Issue 86-28 requires

the debt obligation to be recorded at its settlement amount at each balance sheet date.) Company A, by issuing the indexed debt, had eliminated the risk of loss associated with the XYZ shares. Accordingly, any losses or gains on XYZ shares were being offset by gains or losses on the indexed debt, and both the fair value of the asset and the settlement amount of the debt obligation were being recognized on the balance sheet. Changes in the fair value of the shares of XYZ common stock have been recognized in OCI in accordance with Statement 115. In addition, Company A has recognized changes in the indexed debt obligation's settlement amount in OCI, rather than in the income statement.

It is assumed that the embedded equity-based derivative in the indexed debt instrument is accounted for separately upon adoption of Statement 133.

RESPONSE

Upon transition, the embedded equity-based derivative that (1) was not previously separately accounted for as a derivative under generally accepted accounting principles before the date of initial application of Statement 133 and (2) meets the definition of a derivative under Statement 133 qualifies for the cumulative-effect-type adjustment described in paragraph 52(b) (as amended). Thus, the transition adjustment related to the gain or loss reported in accumulated OCI on the indexed debt obligation (that is, the embedded equity-based derivative instrument) that was considered a hedge of the available-for-sale securities, together with the loss or gain reported in accumulated OCI on the related securities (to the extent of an offsetting transition adjustment for the embedded equity-based derivative instrument), should be reclassified to earnings as a cumulative-effect-type adjustment of both net income and accumulated OCI.

Thus, in the example discussed above, upon initial application of Statement 133, Company A should apply the transition guidance in paragraph 52(b) (as amended) for the pre-existing implicit hedging relationship between the indexed debt obligation and the shares of XYZ common stock that was regarded as a fair value hedge.

The embedded derivative, subsequent to the adoption of Statement 133, may be designated as the hedging instrument in either a fair value or cash flow hedging relationship, provided the appropriate criteria are met.

However, if the reporting entity elects under paragraph 50 not to provide separate accounting for the equity-based derivative embedded in the indexed debt instrument, the entity recognizes no transition adjustment under paragraph 52 with respect to the embedded equity-based derivative, and the guidance in Issue 86-28 would continue to be relevant.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Transition Provisions: Using Either the Fair Value or Cash Flow Hedging Model to Hedge a Structured Note
Paragraph references: 21(a)(2)(c), 21(f), 29(h)
Date cleared by Board: December 6, 2000

QUESTION

During January 1998, Company A issued a $100 million structured note that pays quarterly a 3 percent annual rate of interest plus an additional quarterly return based on any increase in the S&P 500 index for that quarter, with a guaranteed return of principal at maturity. Upon adoption of Statement 133, Company A chose to grandfather those embedded derivatives that existed in hybrid instruments that were issued, acquired, or substantively modified before January 1, 1999. Therefore, the embedded equity derivative is not separated from the debt host contract.

Based on the guidance in paragraph 21(f) and paragraph 29(h) of Statement 133 (as amended), may Company A designate the following hedging relationships involving the example structured note:

a. Fair value hedge of the risk of changes in the structured note's overall fair value
b. Fair value hedge of the risk of changes in the fair value of the embedded equity derivative that is not being accounted for separately
c. Fair value hedge of the risk of changes in the structured note's fair value attributable to changes in the designated benchmark interest rate (for example, the U.S. Treasury rate)
d. Cash flow hedge of the risk of changes in the structured note's total quarterly cash flows
e. Cash flow hedge of the risk of changes in the structured note's cash flows attributable to changes in the designated benchmark interest rate (for example, the U.S. Treasury rate)?

BACKGROUND

Paragraph 4 of Statement 133 describes the exposures that may be hedged under Statement 133. Paragraph 4 states, in part:

> If certain conditions are met, a derivative instrument may be designated as a hedging instrument for the following exposures:
>
> a. A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to a particular risk (referred to as a fair value hedge)
> b. A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk (referred to as a cash flow hedge)…. [Footnote reference omitted.]

Paragraph 21(f) sets forth the types of risks that may be designated as being hedged in a fair value hedge. Paragraph 21(f) (as amended), states, in part:

> 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 [the following]:
>
> (1) The risk of changes in the overall fair value of the entire hedged item,
> (2) The risk of changes in its fair value attributable to changes in the designated benchmark interest rate (referred to as interest rate risk),
> (3) The risk of changes in its fair value attributable to changes in the related foreign currency exchange rates (referred to as foreign exchange risk)…, 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).
>
> If the risk designated as being hedged is not the risk in paragraph 21(f)(1) above, two or more of the other risks (interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged.

Paragraph 29(h) sets forth the risks that may be designated as being hedged in a cash flow hedge. Paragraph 29(h) (as amended) states, in part:

> 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 [the following]:
>
> (1) The risk of overall changes in the hedged cash flows related to the asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency),
> (2) The risk of changes in its cash flows attributable to changes in the designated benchmark interest rate (referred to as interest rate risk),
> (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)…, 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).

Two or more of the above risks may be designated simultaneously as being hedged.

RESPONSE

The following guidance relates to Company A's ability to designate various fair value and cash flow hedging relationships involving the example structured note in the question section:

a. Company A may designate a fair value hedge of the risk of changes in the structured note's overall fair value. Because Company A must have an expectation at the inception of the hedge and on an ongoing basis that the hedging relationship will be highly effective in achieving offsetting changes in fair value during the period the hedge is designated, it must obtain a derivative instrument or combination of derivatives that would be a highly effective hedge of changes in the structured note's overall fair value. While this strategy is permitted, it may be difficult to construct a hedging instrument that is highly effective in offsetting the interest-rate-based and equity-based components of the structured note's return while also encompassing a hedge of credit risk exposure. However, if it is expected that the embedded equity-based component of the structured note will generate *de minimis* changes in fair value during the hedge period, an expectation of high effectiveness may be established.

b. Company A may designate a fair value hedge of the risk of changes in the fair value of the embedded equity derivative that is not being accounted for separately. The equity-based component of the structured note is an equity derivative that provides the holder of the structured note with potential gains resulting from increases in the S&P 500 index. That equity derivative can be identified as the hedged item because it is a portion of a recognized liability that meets the requirements in paragraph 21(a)(2)(c). Paragraph 21(a)(2) states, in part, "If the hedged item is a specific portion of an asset or liability…the hedged item is one of the following:…(c) A put option, a call option, an interest rate cap, or an interest rate floor embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 12 of this Statement…."

c. Company A may designate a fair value hedge of the risk of changes in the structured note's fair value attributable to changes in the designated benchmark interest rate (for example, the U.S. Treasury rate). Similar to (a), Company A must have an expectation at the inception of the hedge and on an ongoing basis that the hedging relationship will be highly effective in achieving offsetting changes in fair value attributable to the benchmark interest rate during the period the hedge is designated. However, it is unlikely that Company A could establish an expectation that a derivative based on the benchmark interest rate would be highly effective as a hedge of the structured note's fair value attributable to interest rate risk because of the impact of the equity-based-component on the calculation of that change in fair value attributable to interest rate risk. As required by paragraph 21(f) of Statement 133 (as amended), the estimated cash flows used in calculating the change in the hedged item's fair value attributable to changes in the benchmark interest rate 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 is not permitted. Therefore, in employing this hedging strategy, Company A must incorporate into that calculation the cash flows that will be generated by both the structured note's interest-rate-based component (based on the 3 percent fixed rate) and an estimation of the cash flows that will be generated by the equity-based component (based on expected increases in the S&P 500 index). While this hedging relationship would typically be expected *not* to qualify as a fair value hedge of interest rate risk, if it is expected that the embedded equity-based component of the structured note will have a de minimis effect on the changes in fair value of the structured note during the hedge period, an expectation that the hedging relationship will be highly effective in achieving offsetting changes in fair value attributable to interest rate risk may be established.

d. Company A may designate a cash flow hedge of the risk of changes in the structured note's total quarterly cash flows. In order to be highly effective, the entity would be required to designate as the hedging instrument a derivative that is expected to produce offsetting cash flows as the S&P 500 index increases.

e. Company A may not designate a cash flow hedge of the risk of changes in the structured note's cash flows attributable to changes in the designated benchmark interest rate (for example, the U.S. Treasury rate). In accordance with paragraph 29(h) of Statement 133 (as amended), in order to designate a hedge of cash flow variability attributable to changes in the benchmark interest rate, the hedged variable interest flows must be explicitly based on the designated benchmark rate (that is, either the U.S. Treasury rate or the LIBOR swap rate in the United States). If the hedged transaction's variability is based on an index other than the designated benchmark rate, the risk being hedged must be the risk of overall changes in the hedged cash flows, as discussed in (d) above. In the example structured note in the question section, the variability in the structured note's cash flows is based on changes in the S&P index, not the designated benchmark rate.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Transition Provisions: Pre-Existing Hedge Ineffectiveness of a Derivative
Paragraph references: 30(b), 49, 52
Date cleared by Board: March 21, 2001
Date posted to website: April 10, 2001

QUESTIONS

1. If prior to adopting Statement 133 the effectiveness[1] of a cash-flow-type hedging relationship was effectively assessed based on the changes in only a component of the derivative's fair value (for example, on only the changes in the intrinsic value of an option contract or the spot value of a forward contract) and the other component(s) of the derivative's initial fair value (for example, the premium on a purchased option contract or the discount or premium on a forward contract) was being amortized to earnings over the life of the contract, should the transition adjustment for the derivative at the date of adoption be allocated between the cumulative-effect-type adjustment of net income and the cumulative-effect-type adjustment of other comprehensive income?

2. If prior to adopting Statement 133 the effectiveness of a fair-value-type hedging relationship was effectively assessed based on the changes in only a component of the derivative's fair value (for example, on only the changes in the intrinsic value of an option contract or the spot value of a forward contract) and the other component(s) of the derivative's initial fair value (for example, the premium on a purchased option contract or the discount or premium on a forward contract) was being amortized to earnings over the life of the contract, should the limit in paragraph 52(b) applicable to the transition adjustment on the hedged asset be (a) the full transition adjustment of the derivative (full derivative value less amortized cost) or (b) only the transition adjustment of the derivative related to the components deemed effective (that is, associated with the variability of the hedged transaction) because the change in the components of the derivative deemed ineffective (that is, being amortized to earnings over the life of the contract) is an excluded component of the hedge?

BACKGROUND

Paragraph 52(a) states:

> If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment shall be reported as a cumulative-effect-type adjustment of accumulated other comprehensive income.

[1] Prior to Statement 133, the terms *ineffectiveness* and *effectiveness* were not applicable or generally referred to when using an option as a hedging instrument. However, these terms are used throughout this Issue for purposes of consistent application of this guidance since these terms and related concepts are used throughout and explained in Statement 133.

Paragraph 30(b) addresses the limitation on amounts recorded in other comprehensive income for cash flow hedges. Specifically, it states:

> 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.

Paragraph 52(b) of Statement 133 (as amended) states, in part:

> 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.

For example, at the date of adopting Statement 133, an enterprise holds 2 purchased option contracts that were originally out of the money and purchased for $20 each. One has been used in a fair-value-type hedging relationship and the other has been used in a cash-flow-type hedging relationship. Both options are currently out of the money and both have a carrying value of $5 due to amortization of the purchase price. The fair value of each option at the transition date is

$100, which is entirely composed of time value. The enterprise has been amortizing the premiums paid for the options (all of which is considered time value) by the straight-line method because only the changes in the option's intrinsic value would be effective in each respective hedging relationship. For both options, the transition adjustment is equal to the difference between the amortized cost of the option (that is, the carrying amount prior to the adoption of Statement 133) and the fair value of the option.

RESPONSE

Question 1

Generally, yes. If prior to adopting Statement 133 the effectiveness of a cash-flow-type hedging relationship was effectively assessed based on the changes in only a component of the derivative's fair value, the transition adjustment for the derivative at the date of adoption should be allocated between the cumulative-effect-type adjustment of net income and the cumulative-effect-type adjustment of other comprehensive income but only if the other component(s) of the derivative's initial fair value (for example, the premium on a purchased option contract or the discount or premium on a forward contract) was being amortized to earnings over the life of the contract prior to the adoption of Statement 133. Because prior to the adoption of Statement 133 the changes in only a component of the derivative were deemed effective as a hedge (that is, associated with the hedged item) and the ineffective component was recognized in earnings (that is, being amortized to earnings over the life of the contract), only the portion of the transition adjustment equal to the changes in the derivative's effective component from inception of the derivative should be included in the cumulative-effect-type adjustment of other comprehensive income. Any remaining transition adjustment for the derivative should be recorded in the cumulative-effect-type adjustment of net income. In the example above, of the $95 transition adjustment, zero would be included in the cumulative-effect-type adjustment of other comprehensive income (because there was zero change in the option's intrinsic value from the inception of the hedge to the date of adopting Statement 133) and $95 would be included in the cumulative-effect-type adjustment of net income.

If the other component(s) of the derivative's initial fair value (for example, the premium on a purchased option contract or the discount or premium on a forward contract) was not recognized in earnings prior to the adoption of Statement 133 (for example, because an entity determined it was not necessary to amortize the initial premium (initial time value) to earnings under generally accepted accounting principles or because the initial fair value of the other component(s) of the hedging derivative at the inception of the hedge was zero (for example, a zero-cost collar) and thus no amortization to earnings occurred), the entire transition adjustment would be included in the cumulative-effect-type adjustment of other comprehensive income.

Whether an enterprise plans to designate a derivative as a hedging instrument upon adoption of Statement 133 is not relevant to the accounting for the transition adjustment in this Issue.

Question 2

If prior to adopting Statement 133 the effectiveness of a fair-value-type hedging relationship was effectively assessed based on the changes in only a component of the derivative's fair value and the changes in the other component(s) of the derivative's initial fair value (for example, the premium on a purchased option contract or the discount or premium on a forward contract) was being amortized to earnings over the life of the contract prior to the adoption of Statement 133, only the portion of the transition adjustment equal to the changes in the derivative's effective component from inception of the hedging relationship should be considered when determining the transition adjustment for the hedged item. Consequently, the transition adjustment to a hedged item is limited to recognizing an amount that is not greater than the gain or loss recognized on the hedging derivative excluding any value attributable to an excluded component(s). In the example above, the hedged item would not be adjusted because the entire transition adjustment of $95 relates to the time value of the option.

If the other component(s) of the derivative's initial fair value (for example, the premium on a purchased option contract or the discount or premium on a forward contract) was not recognized in earnings prior to the adoption of Statement 133 (for example, because an entity determined it was not necessary to amortize the initial premium [initial time value] to earnings under generally accepted accounting principles or because the initial fair value of the other component(s) of the hedging derivative at the inception of the hedge was zero [for example, a zero-cost collar] and thus no amortization to earnings occurred), this additional limitation to the transition adjustment on the hedged asset (as discussed in the preceding paragraph) would not be applicable. Instead, the provisions of paragraph 52(b) would be applied as amended.

Whether an enterprise plans to designate a derivative as a hedging instrument upon adoption of Statement 133 is not relevant to the accounting for the transition adjustment in this Issue.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Transition Provisions: Effect of a Transition Adjustment Included in Accumulated Other Comprehensive Income on the Application of Paragraph 30
Paragraph references:	30(b)(1), 48, 52(a), 53
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001

QUESTION

If upon adoption of Statement 133 an entity designates the same cash flow hedging relationship (same hedging instrument and same forecasted transaction) as it had previously designated, should "the cumulative gain or loss on the derivative from inception of the hedge" used in applying paragraph 30(b)(1) be based solely on the derivative's gains and losses from the date of adoption or should it also include the portion of that derivative's transition adjustment that was reported as a cumulative-effect-type adjustment of accumulated other comprehensive income in accordance with paragraph 52?

BACKGROUND

Paragraph 30(b) states:

> 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.

RESPONSE

Paragraph 48 of Statement 133 indicates that upon initial application of Statement 133, all hedging relationships must be designated anew; consequently, the portion of a derivative's transition adjustment that was included in the cumulative-effect-type adjustment of accumulated

other comprehensive income is not considered to be part of any post-adoption hedging relationship in which that derivative is the hedging instrument. Thus, the application of paragraph 30(b)(1) should not consider any part of the hedging derivative's transition adjustment. The cumulative gain or loss on the derivative from inception of the hedge in paragraph 30(b)(1) should be based solely on the derivative's gains and losses from the date of adoption. In accordance with paragraph 53, any transition adjustment reported as a cumulative-effect-type adjustment in accumulated other comprehensive income shall be subsequently reclassified into earnings in a manner consistent with paragraph 31.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Transition: Is a Pre-Existing Foreign Currency Hedge Related to an Intercompany "Firm Commitment" a Fair-Value-Type Hedge or a Cash-Flow-Type Hedge?
Paragraph references:	49, 52, 540
Date cleared by Board:	March 21, 2001
Date posted to website:	April 10, 2001

QUESTION

Should the transition adjustment resulting from adopting Statement 133 for the hedge of a foreign-currency-denominated intercompany "firm commitment" with a forward exchange contract (or net purchased forward currency option) be reported as a cumulative-effect-type adjustment of net income as a fair-value-type hedge or as a cumulative-effect-type adjustment appropriate for a cash-flow-type hedge?

BACKGROUND

A multinational U.S. parent has several foreign subsidiaries. The subsidiaries use forward exchange contracts (or net purchased forward currency option contracts) to hedge intercompany firm commitments denominated in currencies other than their own functional currencies. The hedging relationships meet the requirements of pre-Statement 133 GAAP, specifically EITF Issues No. 91-1, "Hedging Intercompany Foreign Currency Risks," and No. 95-2, "Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party." Accordingly, the entity is deferring the gains and losses on the forward exchange contracts (or net purchased forward currency option contracts) and amortizing the premiums and discounts (or premiums on the purchased options) to earnings over the life of the contracts. At the date of initial application of Statement 133, however, the hedging relationships will not qualify as hedges of firm commitments because the definition of a *firm commitment* within paragraph 540 requires that the agreement must be with an unrelated party and the commitments in this fact pattern are intercompany agreements. Accordingly, provided all the requirements are met, the entity would have to designate these hedging relationships as cash flow hedges at the date of initial application.

The following example illustrates the hedging relationships:

> Euro-functional-currency Subsidiary A has a firm commitment to sell its finished product to yen-functional-currency Subsidiary B in April 2001 and receive yen for the sale. On July 1, 2000, Subsidiary A enters into a receive Euro/pay yen forward exchange contract maturing in April 2001. The contract has a total premium of Euro 450. On January 1, 2001 (that is, the date of Statement 133 adoption), the forward contract has a deferred loss of Euro 10,000 and an unamortized premium of Euro 150. The forward contract's fair value under Statement 133 on January 1, 2001, is a liability of Euro 9,800. Pre-Statement 133, the entity has made the following cumulative journal entries:

Deferred Loss on Firm Commitment	Debit Euro 10,000	
Forward Contract Payable		Credit Euro 10,000

To defer losses on forward contracts that hedge firm commitments (as required by paragraph 21 of Statement 52)

Amortization of Forward Premium (expense)	Debit Euro 300	
Forward Contract Payable		Credit Euro 300

To amortize forward contract premium to earnings over the life of the contract (as permitted by paragraph 18 of Statement 52)[1]

Paragraph 52 of Statement 133 indicates that the reporting of the transition adjustment is based on the type of hedging relationship (either fair-value-type or cash-flow-type) that existed for the derivative instrument and that was the basis for accounting under generally accepted accounting principles before the date of initial application of Statement 133. Prior to adopting Statement 133, the entity was hedging an intercompany firm commitment as indicated in Issues 91-1 and 95-2. Applying the notions of a fair-value-type hedge or a cash-flow-type hedge in that circumstance is confusing because the aforementioned EITF Issues permit an entity to hedge the foreign currency risk inherent in a foreign-currency-denominated intercompany firm commitment (which appears to be more akin to a fair-value-type hedge), yet Statement 133 does not consider an intercompany commitment to be firm because it is not an agreement with an unrelated party; consequently, the foreign currency risk inherent in an intercompany agreement can only be hedged under the cash flow model under Statement 133.

RESPONSE

The transition adjustment for the derivative at the date of adoption should be allocated between the cumulative-effect-type adjustment of net income and the cumulative-effect-type adjustment of accumulated other comprehensive income, as discussed in Statement 133 Implementation Issue No. J15, "Pre-Existing Hedge Ineffectiveness of a Derivative," for cash-flow-type hedges. Although using a forward exchange contract (or net purchased forward currency option contract) to hedge a foreign-currency-denominated intercompany firm commitment prior to adopting Statement 133 may initially appear to be akin to a fair value hedge, the prohibition in Statement 133 against considering an intercompany agreement as a firm commitment requires that, for transition purposes, the hedge of a foreign-currency-denominated intercompany firm commitment with a forward exchange contract (or net purchased forward currency option contract) be considered to be akin to a cash flow hedge of the variability of the functional-currency-equivalent cash flows under that intercompany agreement.

[1] Prior to being amended by Statement 133, paragraphs 18 and 21 of Statement 52 did not *require* amortization of the forward premium or discount when the gain or loss on the forward contract is deferred as the contract is intended to hedge an identifiable foreign currency commitment. Instead, Statement 52 permitted the forward contract's discount or premium that related to the commitment period to be included in the measurement of the basis of the related foreign currency transaction when recorded.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Transition Provisions: Foreign-Currency-Denominated Transactions Accounted for under EITF Issue 88-18
Paragraph reference:	52
Date cleared by Board:	June 27, 2001
Date posted to website:	July 10, 2001

QUESTION

How should the adjustment upon adoption of Statement 133 related to a company's foreign-currency-denominated debt and foreign-currency-denominated royalty that were being accounted for pursuant to the provisions of EITF Issue No. 88-18, "Sales of Future Revenues," be presented in the financial statements? Specifically, in the fact pattern that follows, is Company X required to record a cumulative-effect-type adjustment in earnings or in other comprehensive income to reflect the outstanding balance on the yen-based loan (and the yen-based receivable for the previous month's royalty paid in arrears) at the current yen/dollar exchange rate upon adoption of Statement 133?

BACKGROUND

Company X, whose functional currency is the U.S. dollar, had an area license agreement with its Japanese area licensee (Company Y) pursuant to which Company X receives yen-denominated royalties from Company Y on a monthly basis based on Company Y's sales. Company X and Company Y are related parties in that they share a common parent company.

Subsequent to the inception of this area license agreement, Company X had borrowed yen from third-party lenders and assigned the royalty stream from Company Y as a basis for repayment. The debt is nonrecourse to Company X. The yen-denominated royalty had been designated as a hedge of the future yen-denominated principal and interest payments due on the yen-denominated loan for accounting purposes (pursuant to the provisions of Issue 88-18 as discussed below). Payments of interest and principal on the yen-denominated loan have been consistently made over past years from the yen-denominated royalty. There are no indications that this situation will not continue as Company Y's sales have continued to increase on an annual basis.

Company X had historically accounted for the yen-denominated loan and royalty pursuant to the provisions of Issue 88-18. As such, foreign currency transaction gains and losses on the debt (and the royalty) have not been recognized. The yen-denominated loan (and the related interest expense) have been consistently translated at the rate in effect upon inception of the debt (and the designation of the royalty as a hedge of foreign currency fluctuation exposure on the debt). The yen-denominated royalties have also been consistently recorded in Company X's financial statements based on the yen/dollar exchange rate in effect upon inception of the debt.

Statement 133 has superseded the provisions of Issue 88-18 that relate to the hedge-type accounting treatment previously afforded Company X in this situation. Thus, in spite of the

existence of a perfect economic hedge of foreign currency exposure on the yen-denominated based loan, Company X will be required, upon the adoption of Statement 133, to begin recognizing foreign currency gains and losses on the yen-denominated loan in its financial statements. Additionally, upon adoption of Statement 133, Company X will be required to record a material cumulative effect adjustment to reflect the outstanding balance on the yen-denominated loan (and the yen-denominated receivable for the previous month's royalty [paid one month in arrears]) at the current yen/dollar exchange rate.

Paragraph 52 of Statement 133 specifies whether the transition adjustments resulting from adopting that Statement should be reported as a cumulative-effect-type adjustment of net income or accumulated other comprehensive income. Under that paragraph, cumulative-effect-type adjustments of accumulated other comprehensive income are appropriate only for certain transition adjustments *related to a derivative instrument*.

RESPONSE

The adjustment related to a company's foreign-currency-denominated debt and foreign-currency-denominated royalty that had been accounted for pursuant to Issue 88-18 should be reported in net income as the effect of a change in accounting principle and presented in a manner similar to the cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, *Accounting Changes* (that is, presented as a cumulative-effect-type adjustment of net income). As noted above, the yen-denominated royalty had historically been accounted for in a manner similar to a hedge of the yen-denominated loan pursuant to the provisions of Issue 88-18. Thus, the carrying value of the yen-denominated loan in Company X's financial statements has been based on the exchange rate in effect at inception of the loan. Despite this historical hedge-type accounting treatment, upon adoption of Statement 133 Company X should record a cumulative-effect-type adjustment (through earnings) to adjust the carrying value of the yen-denominated loan and the yen-denominated receivable for the previous month's royalty to the current yen/dollar exchange rate in effect. This will be necessary to effectively "zero out" the U.S. dollar balance of the yen-denominated loan over time as payments on the debt will need to be recorded at current exchange rates in effect at that time pursuant to the provisions of FASB Statement No. 52, *Foreign Currency Translation* (absent hedge-type accounting treatment).

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the first day of its first fiscal quarter beginning after July 10, 2001, the date that the Board-cleared guidance was posted on the FASB website.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Transition Provisions: Application of the Normal Purchases and Normal Sales Exception on Initial Adoption to Certain Compound Derivatives
Paragraph references:	10(b), 360, 361, 523, 524, footnote 13 (to paragraph 49)
Date cleared by Board:	December 19, 2001
Date posted to website:	December 28, 2001

QUESTION

In initially adopting Statement 133, may an entity bifurcate and separately account for the forward component and the option component that make up a compound commodity contract that meets the definition of a derivative and exists at the date of initial application of Statement 133?

BACKGROUND

Many commodity contracts are structured to contain both a forward component and an option component. Typically there is a minimum volume to be delivered (the forward component) as well as an option to purchase an additional volume (an option component) to ensure that the buyer has a sufficient supply to meet production demands. In its entirety, that compound contract cannot qualify for the normal purchases and normal sales exception in paragraph 10(b) of Statement 133, as discussed in Statement 133 Implementation Issue No. C16, "Applying the Normal Purchases and Normal Sales Exception to Contracts That Combine a Forward Contract and a Purchased Option Contract." Statement 133 Implementation Issue No. C10, "Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Normal Sales Exception?" also points out that freestanding option contracts cannot qualify for the normal purchases and normal sales exception in paragraph 10(b).

Some constituents have desired to bifurcate the compound contract into its components, a forward contract and an option contract, in order to apply paragraph 10(b) solely to the forward component. However, paragraph 18 and Statement 133 Implementation Issue No. B15, "Separate Accounting for Multiple Derivative Features Embedded in a Single Hybrid Instrument," preclude a company from bifurcating a derivative instrument by risk. Thus, under the ongoing application of Statement 133, a company cannot bifurcate a compound commodity contract into a forward contract and an option contract. Paragraph 523 indicates that the prohibition to bifurcating a compound derivative instrument is not considered to be unduly burdensome on an ongoing basis. However, for the initial adoption of Statement 133, footnote 13 to paragraph 49 specifies one single exception to the general rule in paragraph 18 for a compound derivative that has a foreign currency exchange risk component. That exception permits an entity, at the date of initial application of Statement 133, to separate the compound derivative into two parts: the foreign currency derivative and the remaining derivative. FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, did not rescind that single exception even though the reasons cited in paragraph 524

for that exception were nullified when Statement 138 amended the provisions of Statement 133 for foreign currency hedges.

RESPONSE

No, in initially adopting Statement 133, an entity may not bifurcate and separately account for the forward component and the option component that make up a compound commodity contract that meets the definition of a derivative and exists at the date of initial application of Statement 133. Statement 133 does not permit such bifurcation.

In stating that a compound contract composed of a forward component and an option component cannot qualify for the normal purchases and normal sales exception in paragraph 10(b) of Statement 133, Implementation Issue C16 provides some relief in its transition provisions. Its guidance does not retroactively affect the accounting for the compound contract if that compound contract was negated and replaced by two separate contracts (a forward contract and an option contract) prior to the effective date of Implementation Issue C16. (The effective date of that Implementation Issue for each reporting entity is the first day of its second fiscal quarter beginning after October 10, 2001.)

EFFECTIVE DATE

The effective date of the implementation guidance in this Issue for each reporting entity is the date of its initial adoption of Statement 133.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title: Miscellaneous: Determining Whether Separate Transactions Should Be Viewed as a Unit
Paragraph reference: None
Date cleared by Board: February 17, 1999

QUESTION

Under what circumstances should two individual transactions be viewed as a unit in order to determine whether the combination of the transactions meets the definition of a derivative under Statement 133?

BACKGROUND

Statement 133 is designed to be applied to an individual transaction to determine whether it in its entirety, or a portion thereof, should be accounted for as a derivative under the Statement's provisions. However, in some circumstances, an entity could enter into two or more legally separate transactions that, if combined, would generate a result that is economically similar to entering into a single transaction that would be accounted for as a derivative under Statement 133. Two examples follow:

Example 1
Company A enters into a forward contract to purchase 1,500,000 units of a particular commodity in 3 months for $10 per unit. Simultaneously, Company A enters into a forward contract to sell 1,400,000 units of the same commodity in 3 months for $10 per unit. The purchase and sale contracts are with the same counterparty. There is no market mechanism to facilitate net settlement of the contracts, and both contracts require physical delivery of the commodity at the same location in exchange for the forward price. On a gross basis, neither contract is readily convertible to cash because the market cannot rapidly absorb the specified quantities without significantly affecting the price. However, on a net basis, Company A has a forward purchase contract for 100,000 units of the commodity, a quantity that can be rapidly absorbed by the market and thus is readily convertible to cash.

Example 2
Company C loans $100 to Company B. The loan has a 5-year bullet maturity and an 8 percent fixed interest rate, payable semi-annually. Company B simultaneously loans $100 to Company C. The loan has a five-year bullet maturity and a variable interest of LIBOR, payable semi-annually and reset on a semi-annual basis. Company B and Company C enter into a netting arrangement that permits each party to offset its rights and obligations under the agreements. The netting arrangement meets the criteria for offsetting in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts.* The net effect of offsetting the contracts for both Company B and Company C is the economic equivalent of an interest rate swap arrangement, that is, one party receives a fixed interest rate from, and pays a variable interest rate to, the other.

RESPONSE

If two or more separate transactions may have been entered into in an attempt to circumvent the provisions of Statement 133, the following indicators should be considered in the aggregate and, if present, should cause the transactions to be viewed as a unit and not separately:

a. The transactions were entered into contemporaneously and in contemplation of one another.
b. The transactions were executed with the same counterparty (or structured through an intermediary).
c. The transactions relate to the same risk.
d. There is no apparent economic need nor substantive business purpose for structuring the transactions separately that could *not* also have been accomplished in a single transaction.

In both examples, the transactions were entered into with the same counterparty, were executed simultaneously, and relate to the same risk. In Example 1, it appears that there is no clear business purpose for structuring the transactions separately. Therefore, the facts point to the conclusion that the purchase and sale were done as a structured transaction with one counterparty to circumvent the definition of a derivative under Statement 133. However, if the facts indicated that both contracts required physical delivery of the commodity at *different locations* that are significantly distant from one another and each counterparty is expected to deliver the gross amount of the commodity to the other, those facts *may* reflect a valid substantive business purpose for the transaction.

In Example 2, based on the facts presented, there is no clear business purpose for the separate transactions, and they should be accounted for as an interest rate swap under Statement 133. However, in other cases, a clear substantive business purpose for entering into two separate loan transactions *may* exist (for example, as a means to overcome foreign currency expatriation restrictions).

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Title: Miscellaneous: Are Transferable Options Freestanding or Embedded?
Paragraph reference: 12
Date cleared by Board: May 17, 2000

QUESTION

If a bond includes in its terms at issuance an option feature that is explicitly transferable independent of the bond and thus is potentially exercisable by a party other than either the issuer of the bond (the debtor) or the holder of the bond (the investor), should the option be considered under Statement 133 as an attached freestanding option or an embedded option by the writer and the holder of the option?

BACKGROUND

Certain structured transactions involving the issuance of a bond incorporate transferable options to call or put the bond. As such, those options are potentially exercisable by a party other than the debtor or the investor. For example, certain "put bond" structures involving three separate parties—the debtor, the investor, and an investment bank—may incorporate options that are ultimately held by the investment bank, giving that party the right to call the bond from the investor. Several put bond structures involving options that are exercisable by a party other than the debtor or investor are described in Statement 133 Implementation Issue No. B13, "Accounting for Remarketable Put Bonds."

RESPONSE

If a bond includes in its terms at issuance an option feature that is explicitly transferable independent of the bond and thus is potentially exercisable by a party other than either the issuer of the bond (the debtor) or the holder of the bond (the investor), that option should be considered under Statement 133 as an attached freestanding derivative instrument, rather than an embedded derivative, by both the writer and the holder of the option.

For example, a call option that is transferable either by the debtor to a third party (and thus is potentially exercisable by a party other than the debtor) or by the original investor based on the legal agreements governing the debt issuance can result in the investor having different counterparties for the option and the original debt instrument. Accordingly, even when incorporated into the terms of the original debt agreement, such an option may not be considered an embedded derivative by either the debtor or the investor because it can be separated from the bond and effectively sold to a third party. The notion of an embedded derivative, as discussed in paragraph 12, does not contemplate features that may be sold or traded separately from the contract in which those rights and obligations are embedded. Assuming they meet Statement 133's definition of a derivative, such features must be considered attached freestanding derivatives rather than embedded derivatives by both the writer and the current holder.

In addition, Statement 133 Implementation Issue No. B3, "Investor's Accounting for a Put or Call Option Attached to a Debt Instrument Contemporaneously with or Subsequent to Its Issuance," requires that an option that is added or attached to an existing debt instrument by a third party also results in the investor having different counterparties for the option and the debt instrument and, thus, the option should not be considered an embedded derivative.

An attached freestanding derivative is not an embedded derivative subject to grandfathering under the transition provisions of Statement 133.

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Title:	Miscellaneous: Determination of Whether Combinations of Options with the Same Terms Must Be Viewed as Separate Option Contracts or as a Single Forward Contract
Paragraph references:	12, 18, 20, 21
Date cleared by Board:	May 17, 2000
Date revision posted to website:	June 10, 2003
Affected by:	FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* Revised May 27, 2003

QUESTION

Should the combinations of purchased and written options described below be considered for accounting purposes as two separate option contracts or as a single forward contract:

1. An embedded (nontransferable) purchased call (put) option and an embedded (nontransferable) written put (call) option that are executed contemporaneously with the same counterparty as part of a single hybrid instrument
2. A freestanding purchased call (put) option and a freestanding or embedded (nontransferable) written put (call) option that are executed contemporaneously with the same counterparty at inception but where the purchased option may be transferred
3. A freestanding purchased call (put) option and a freestanding or embedded (nontransferable) written put (call) option that are executed contemporaneously with different counterparties at inception?

For the purposes of this question, in all cases, the purchased and written options have the same terms (strike price, notional amount, and exercise date) and the same underlying, and neither of the two options is required to be exercised. The notion of the "same counterparty" encompasses contracts entered into directly with a single counterparty and contracts entered into with a single party that are structured through an intermediary. In addition, consistent with the conclusion in Statement 133 Implementation Issue No. K2, "Are Transferable Options Freestanding or Embedded?" an option incorporated into the terms of a hybrid instrument at inception that is *explicitly* transferable should be considered a freestanding, rather than an embedded, derivative instrument.

RESPONSE

This section provides separate responses for each of the combinations of options in the question section.

1. A combination of an embedded (nontransferable) purchased call (put) option and an embedded (nontransferable) written put (call) option in a single hybrid instrument that have

the same terms (strike price, notional amount, and exercise date) and same underlying and that are entered into contemporaneously with the same counterparty should be considered as a single forward contract for purposes of applying the provisions of Statement 133 and related guidance.[1] Those embedded options are in substance an embedded forward contract because they (a) convey rights (to the holder) and obligations (to the writer) that are equivalent from an economic and risk perspective to an embedded forward contract and (b) cannot be separated from the hybrid instrument in which they are embedded. Even though neither party is required to exercise its purchased option, the result of the overall structure is a hybrid instrument that will likely be redeemed at a point earlier than its stated maturity. That result is expected by both the hybrid instrument's issuer and investor regardless of whether the embedded feature that triggers the redemption is in the form of two separate options or a single forward contract. (However, if either party is required to exercise its purchased "option" prior to the stated maturity date of the hybrid instrument, the hybrid instrument should not be viewed for accounting purposes as containing one or more embedded derivatives. In substance, the debtor [issuer] and creditor [investor] have agreed to terms that accelerate the stated maturity of the instrument and the exercise date of the "option" is essentially the hybrid's actual maturity date. As a result, it is inappropriate to characterize the hybrid instrument as containing two embedded option contracts that are exercisable only on the actual maturity date or as containing an embedded forward contract that is a combination of an embedded purchased call [put] and a written put [call] with the same terms.)[2]

Embedded options in a hybrid instrument that are required to be considered a single forward contract under Statement 133 as a result of the guidance contained herein may not be designated individually as hedged items in a fair value hedge in which the hedging instrument is a separate, unrelated freestanding option. Statement 133 does not permit a component of a derivative to be designated as the hedged item.

2. A combination of a freestanding purchased call (put) option and a freestanding or embedded (nontransferable) written put (call) option that have the same terms and same underlying and that are entered into contemporaneously with the same counterparty at inception should be considered for accounting purposes as separate option contracts, rather than a single forward contract, by both parties to the contracts. Derivatives that are transferable are, by their nature, separate and distinct contracts. That is consistent with the conclusion in Implementation Issue K2, which states, "…a call option that is either transferable by the debtor to a third party and thus is potentially exercisable by a party other than the debtor or

[1] A share of stock being puttable by the holder and callable by the issuer under the same terms does not render the stock mandatorily redeemable under the provisions of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*.

[2] Statement 150 requires that mandatorily redeemable financial instruments, as defined in that Statement, be classified as liabilities.

the original investor based on the legal agreements governing the debt issuance can result in the investor having different counterparties for the option and the original debt instrument. Accordingly, even when incorporated into the terms of the original debt agreement, such an option may not be considered an embedded derivative by either the debtor or the investor because it can be separated from the bond and effectively sold to a third party."

3. A combination of a freestanding purchased call (put) option and a freestanding or embedded (nontransferable) written put (call) option that have the same terms and same underlying and that are entered into contemporaneously with different counterparties at inception should be considered for accounting purposes as separate option contracts, rather than a single forward contract, by both parties to the contracts. Similarly, a combination of a freestanding written call (put) option and an embedded (nontransferable) purchased put (call) option that have the same terms and same underlying and that are entered into contemporaneously with different counterparties at inception should be considered for accounting purposes as separate option contracts, rather than a single forward contract, by both parties to the contracts. Separate purchased and written options with the same terms but that involve different counterparties convey rights and obligations that are distinct and do not warrant bundling as a single forward contract for accounting purposes under Statement 133. However, those separate purchased options and written options can be viewed in combination and jointly designated as the hedging instrument pursuant to paragraph 18 of Statement 133.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Miscellaneous: Income Statement Classification of Hedge Ineffectiveness and the Component of a Derivative's Gain or Loss Excluded from the Assessment of Hedge Effectiveness
Paragraph references:	22, 30, 44C(b)(1)–44((b)(4), 63
Date cleared by Board:	December 6, 2000
Date revision posted to website:	April 21, 2008
Affected by:	FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*

Revised March 19, 2008

QUESTION

May an entity classify as part of interest income or interest expense in its income statement (a) the amount of hedge ineffectiveness and (b) the component of the derivative instrument's gain or loss, if any, excluded from the assessment of hedge effectiveness arising from qualifying fair value hedges of its existing interest-bearing assets and interest-bearing liabilities or qualifying cash flow hedges of the forecasted receipt or payment of interest or forecasted acquisitions of debt securities or forecasted borrowings?

BACKGROUND

In defining how hedge effectiveness will be assessed, an entity may specify whether it will include in that assessment all of the gain or loss on a hedging instrument. Paragraph 63 of Statement 133 permits an entity to exclude all or a part of the hedging instrument's time value from the assessment of hedge effectiveness. When an entity excludes all or a part of the hedging instrument's time value from the assessment of hedge effectiveness, changes in the excluded component of the hedging instrument's value are recorded in earnings. In addition, any hedge ineffectiveness that results under the entity's defined method of assessing effectiveness is recognized in current earnings.

With respect to financial institutions, analysis of the financial statements of those institutions considers various measures of performance that take into account the institutions' reported interest income and interest expense. In addition, certain financial institutions are subject to regulatory disclosure requirements that include the average yield for each major category of interest-bearing asset, the average rate paid for each major category of interest-bearing liability, the average yield on all interest-earning assets, the average effective rate paid on all interest-bearing liabilities, and the net yield on interest-earning assets. This suggests that there should be comparability in the income statement category in which financial institutions report the amount of their hedges' ineffectiveness and the excluded component of their derivative instruments' gains or losses.

RESPONSE

Statement 133 does not provide guidance on the required income statement classification of the amount of hedge ineffectiveness and the component of a derivative instrument's gain or loss, if any, excluded from the assessment of hedge effectiveness. While Statement 133 does not specify whether certain income statement categories are either permitted or appropriate, the Statement does contain specific disclosure requirements for those items.

Paragraph 44C of Statement 133 states, in part:

> An entity that holds or issues derivative instruments (and nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 37 and 42)[12a2] shall disclose for every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented:…
>
> a. The location and amount of the gains and losses reported in the statement of financial performance (or when applicable, the statement of financial position, for example, gains and losses initially recognized in other comprehensive income [OCI]) on derivative instruments and related hedged items. Gains and losses shall be presented separately for:
> (1) Derivative instruments designated and qualifying as hedging instruments in fair value hedges and related hedged items designated and qualifying in fair value hedges.
> (2) The effective portion of gains and losses on derivative instruments designated and qualifying in cash flow hedges and net investment hedges that was recognized in OCI during the current period.
> (3) The effective portion of gains and losses on derivative instruments designated and qualifying in cash flow hedges and net investment hedges recorded in accumulated other comprehensive income during the term of the hedging relationship and reclassified into earnings during the current period.
> (4) The portion of gains and losses on derivative instruments designated and qualifying in cash flow hedges and net investment hedges representing (a) the amount of the hedges' ineffectiveness and (b) the amount, if any, excluded from the assessment of hedge effectiveness.…

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

Title:	Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues
Paragraph references:	48–55
Date cleared by Board:	June 27, 2001
Date revision posted to website:	July 13, 2007
Affected by:	FASB Statement No. 154, *Accounting Changes and Error Corrections*

Revised June 1, 2005

QUESTIONS

1. When should an entity that has adopted Statement 133 prior to the issuance of newly issued implementation guidance account for the effects of initially complying with that new implementation guidance?
2. How should an entity that has adopted Statement 133 prior to the issuance of newly issued implementation guidance account for the effects of initially complying with that new implementation guidance?

BACKGROUND

FASB Statement No. 154, *Accounting Changes and Error Corrections*, defines a *change in accounting principle* as follows:

> A change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply or when the accounting principle formerly used is no longer generally accepted. A change in the *method* of applying an accounting principle also is considered a change in accounting principle.

Statement 154 states in paragraph 4, "A presumption exists that an accounting principle once adopted shall not be changed in accounting for events and transactions of a similar type." In paragraph 5, it states, "A reporting entity shall change an accounting principle only if (a) the change is required by a newly issued accounting pronouncement or (b) the entity can justify the use of an allowable alternative accounting principle on the basis that it is preferable."

Paragraph 6 of Statement 154 states the following:

> It is expected that accounting pronouncements normally will provide specific transition requirements. However, in the unusual instance that there are no transition requirements specific to a particular accounting pronouncement, a change in accounting principle effected to adopt the requirements of that accounting pronouncement shall be reported in accordance with paragraphs 7–10 of this Statement. [Footnote omitted.]

Paragraph 48 of Statement 133 states in part that the provisions of Statement 133 "shall not be applied retroactively to financial statements of prior periods." The transition provisions in paragraphs 49–53 specify the measurement and reporting of the transition adjustments arising from the initial application of Statement 133.

RESPONSE

Question 1

An entity that has adopted Statement 133 prior to the issuance of Board-cleared implementation guidance should account for the effects of initially complying with that new implementation guidance as of the first day of its first fiscal quarter following the date that the Board-cleared guidance is posted on the FASB website unless the Board directs otherwise. That first day of its first fiscal quarter following the posting of the cleared guidance is considered the *effective date* of the guidance for the reporting entity. However, at the time that the implementation guidance for an issue is cleared, the Board may direct the staff to specify a different effective date if the circumstances for that issue so warrant. Board-cleared guidance will be posted to the website only between the sixth day and the tenth day of each month unless the Board directs otherwise. Each issue cleared in June 2001 or thereafter will indicate its effective date and the date that the issue was posted to the website.

Question 2

I. Application of Guidance on the Definition of a Derivative, Scope Exceptions, and the Recognition and Measurement of Derivatives

An entity that has applied the provisions of Statement 133 regarding the definition of a derivative (principally paragraphs 6–9 and related paragraphs), the scope exceptions (paragraphs 10, 11, 14, 15, and related paragraphs), and the recognition and measurement of derivatives differently than required by subsequently issued cleared implementation guidance should account for the effects of initially complying with that implementation guidance *prospectively* for all existing contracts and future transactions, as of the effective date for that guidance. The effects of initially applying that implementation guidance should be reported as a change in accounting principle consistent with the transition provisions of Statement 133 (that is, no restatement of the financial statements for either interim or annual periods prior to the effective date of that guidance). However, in order to be consistent with the transition provisions of Statement 133 and because no retroactive designation of hedging relationships and no retroactive application of the implementation guidance are permitted, no pro forma disclosures of the effects of retroactive application are required or permitted.

a. This guidance encompasses situations in which (1) an entity did not account for a contract as a freestanding derivative instrument under Statement 133 but is required to do so under the newly issued implementation guidance and (2) an entity accounted for a contract as a

derivative instrument under Statement 133 but will not account for that contract as a derivative instrument under the newly issued implementation guidance. Accounting for a contract as a freestanding derivative instrument to comply with newly issued implementation guidance could result in reporting a cumulative-effect-type adjustment in that period. The treatment described above is consistent with Statement 133's transition provisions, which require application to derivative instruments existing at the date of adoption, not just to contracts entered into after the Statement's adoption. If an entity had been accounting for a contract as a derivative under Statement 133 but will not do so under the newly issued implementation guidance, the contract's fair value at the effective date shall become its net carrying amount at that date. The entity should apply other generally accepted accounting principles that are applicable to that contract prospectively from the date that the contract ceased to be accounted for under Statement 133. (Prospective application only to future transactions would not be appropriate.) For entities that transferred securities subject to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, between categories of investments pursuant to paragraphs 54 and 55 of Statement 133 in conjunction with the initial application of Statement 133, the posting of newly issued implementation guidance does not justify reversing those transfers.

b. Relevant implementation guidance related to the application of the definition of a derivative, the scope exceptions, and the recognition and measurement of derivatives is found in Sections A, C, and D, respectively, of the implementation guidance. In addition, this method of transition would also be applicable to guidance of the type in Statement 133 Implementation Issue No. K1, "Determining Whether Separate Transactions Should be Viewed as a Unit," which addresses when separate transactions must be viewed as a unit in order to determine whether they meet the definition of a derivative.

Notwithstanding the above, at the time that the implementation guidance for an issue is cleared, the Board may direct the staff to specify different guidance if the circumstances for that issue so warrant.

II. Separate Accounting for Embedded Derivatives

This aspect of Statement 133, which is found in Section B of the implementation guidance, has two dimensions:

A. ***Determining whether or not an embedded derivative must be accounted for separately.*** An entity that has or has not separately accounted for an embedded derivative in a manner that is different from the requirements of the newly issued cleared implementation guidance should account for the effects of initially complying with that new implementation guidance prospectively, for all existing contracts and future transactions, as of the effective date, except for the existing contracts that qualify for the grandfathering provisions of paragraph 50 that exempt certain hybrid instruments from the embedded derivative provisions of Statement 133 on an all-or-none basis. (For example, if a company elected on adoption of Statement 133 pursuant to paragraph 50 to bifurcate only those hybrid instruments acquired

or substantively modified after December 31, 1998, the company could not apply newly issued implementation guidance to hybrid instruments acquired before January 1, 1999.) The effects of initially applying the implementation guidance should be reported as a change in accounting principle consistent with the transition provisions of Statement 133 (that is, no restatement of the financial statements for periods prior to the effective date of that guidance). However, in order to be consistent with the transition provisions of Statement 133 and because no retroactive designation of hedging relationships and no retroactive application are permitted, no pro forma disclosures of the effects of retroactive application are required or permitted. For entities that transferred securities subject to Statement 115 between categories of investments pursuant to paragraphs 54 and 55 of Statement 133 in conjunction with the initial application of Statement 133, the posting of newly issued implementation guidance does not justify reversing those transfers.

This guidance encompasses situations in which (1) an entity did not separately account for an embedded derivative but is required to do so under the newly issued cleared implementation guidance, (2) an entity accounted separately for an embedded derivative but may not account for that embedded derivative separately under the newly issued implementation guidance, and (3) an entity accounted for the entire hybrid instrument at fair value (pursuant to paragraph 16) based on a determination that it could not reliably identify and measure the separate embedded derivative, but the embedded derivative may not be accounted for separately under the newly issued implementation guidance (and, therefore, paragraph 16 cannot be cited as justification for accounting for the hybrid instrument at fair value). Consistent with the application of guidance on the definition of a derivative and scope exceptions, prospective application only to hybrid contracts entered into on or after the effective date of the guidance would not be appropriate. If under the newly issued implementation guidance an entity may not account separately for an embedded derivative that has been separately accounted for under the entity's application of Statement 133, the carrying amount of the related hybrid instrument at the guidance's effective date should be the sum of the carrying amount of the host contract and the fair value of the embedded derivative.

B. ***Different mechanics for separating an embedded derivative from a host instrument.***
Newly issued cleared implementation guidance that relates to the mechanics of separating an embedded derivative from a host instrument (rather than to the fundamental determination of whether an embedded derivative must be accounted for separately) should be applied prospectively; that is, only to future hybrid contracts entered into on or after the effective date of the guidance.

Examples of guidance that relates to the mechanics of separating an embedded derivative from a host instrument can be found in Statement 133 Implementation Issues No. B19, "Identifying the Characteristics of a Debt Host Contract," No. B20, "Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?," No. B22, "Whether the Terms of a Separated Option-Based Embedded Derivative Must Produce

a Zero Fair Value (Other Than Time Value)," and No. B23, "Terms of a Separated Non-Option Embedded Derivative When the Holder Has Acquired the Hybrid Instrument Subsequent to Its Inception."

Notwithstanding the above, at the time that the implementation guidance for an issue is cleared, the Board may direct the staff to specify different guidance on the accounting for embedded derivatives if the circumstances for that issue so warrant.

III. Hedging Relationships

This aspect of Statement 133 has two dimensions:

A. ***Not qualifying for hedge accounting.***
An entity that had designated a qualifying hedging relationship that no longer qualifies for hedge accounting based on newly issued cleared implementation guidance must dedesignate that hedging relationship prospectively (that is, the hedging relationship must be dedesignated at the effective date). If the hedging relationship had been a fair value hedge, the recognition in earnings of the adjustment of the carrying amount of the hedged asset or liability under paragraphs 22 and 23 for the period prior to the effective date should not be reversed. Rather, the adjustment of the carrying amount of the hedged item under paragraph 22 should be accounted for under paragraph 24. If the hedging relationship had been a cash flow hedge or a net investment hedge, the derivative's gain or loss for the period prior to the effective date shall remain in accumulated other comprehensive income (OCI) and be reclassified into earnings consistent with the provisions of paragraphs 33 and 42.

B. ***Different mechanics of hedge accounting.***
An entity that had applied the mechanics of hedge accounting (for example, the measurement of hedge effectiveness or the application of the shortcut method) differently than is required by newly issued cleared implementation guidance must apply that guidance prospectively to existing and future hedging relationships. (Thus, for example, an existing hedging relationship that is incorrectly being accounted for under the shortcut method would have to prospectively discontinue use of the shortcut method at the effective date and apply instead regular fair value or cash flow hedge accounting for that relationship, without any change to previously recognized amounts in OCI or to previous adjustments of the carrying amount of the hedged item.) Essentially, this is analogous to requiring dedesignation of hedging relationships with the previously used hedge accounting mechanics and redesignation of hedging relationships with the hedge accounting mechanics that are consistent with the newly issued implementation guidance. (For dedesignated cash flow hedges, the derivative's gain or loss for the period prior to the effective date shall remain in accumulated OCI and be reclassified into earnings consistent with the provisions of paragraph 33.) Thus, it is consistent with requiring (under (A) above) the dedesignation of previous hedging relationships that under the newly issued guidance no longer qualify as a fair value hedge, cash flow hedge, or net investment hedge.

Relevant implementation guidance related to the application of hedge accounting is included in Section E (Hedging—General), Section F (Fair Value Hedges), Section G (Cash Flow Hedges), and Section H (Foreign Currency Hedges) of the implementation guidance.

Notwithstanding the above, at the time that the implementation guidance for an issue is cleared, the Board may direct the staff to specify different guidance related to the application of hedge accounting if the circumstances for that issue so warrant.

IV. Application of Statement 133's Transition Provisions

An entity is permitted to apply newly issued implementation guidance related to the transition provisions retroactively to fiscal periods that ended prior to the effective date of that guidance provided that the entity has not published any interim or annual financial statements reflecting the related transition adjustment determined under the entity's application of Statement 133. (The phrase *published any interim or annual financial statements* is used in a manner analogous to the guidance in FASB Technical Bulletin No. 79-18, *Transition Requirement of Certain FASB Amendments and Interpretations of FASB Statement No. 13*.) However, an entity is not required to retroactively apply any transition implementation guidance that is posted after the entity has initially applied Statement 133. Relevant implementation guidance related to the transition provisions is included in Section J (Transition Provisions).

V. Other Aspects of Statement 133

An entity that adopted Statement 133 prior to the issuance of cleared implementation guidance related to other areas (including Section I [Disclosures] and Section K [Miscellaneous], with the exception of the type of guidance in Implementation Issue K1) should apply that guidance prospectively; that is, only to future events and transactions and future designated hedging relationships. Implementation guidance related to those areas may not be applied to hedging relationships designated and contracts entered into prior to the issuance of that guidance.

Notwithstanding the above, at the time that the implementation guidance for an issue is cleared, the Board may direct the staff to specify retroactive application of that guidance if the circumstances for that issue so warrant.

Implications of the Foregoing Guidance to Question 1

- If an instrument was previously accounted for as a derivative but may not be under the newly issued implementation guidance, and that instrument had been designated as a hedging instrument, the entity must dedesignate the hedging relationship at the effective date. (Such dedesignation has only a prospective impact, although if a cash flow hedge is dedesignated, paragraph 33 may require certain gains and losses in accumulated OCI to be reclassified into earnings on the effective date.) Similarly, if an embedded derivative was previously

- accounted for separately but may not be under the newly issued implementation guidance, and that instrument had been designated as a hedging instrument, the entity must dedesignate the hedging relationship at the effective date.
- If an instrument was not previously accounted for as a derivative but must be under the newly issued implementation guidance, an entity is not permitted to retroactively designate that instrument in a hedging relationship. Similarly, if an embedded derivative was not previously accounted for separately but must be under the newly issued cleared implementation guidance, an entity is not permitted to retroactively designate that embedded derivative as a hedging instrument. The separated derivative may be designated as a hedging instrument on a prospective basis.
- If newly issued cleared implementation guidance permits hedge accounting for a certain scenario (for which no hedging relationship had been designated), an entity is not permitted to retroactively apply hedge accounting (that is, an entity may not retroactively designate a hedging relationship). Hedge accounting may be applied for that scenario only on a prospective basis from the date that the relationship is designated and documented.
- If an entity had determined that an embedded derivative must be accounted for separately but had also determined that it could not reliably separate and measure the embedded derivative at fair value and therefore accounted for the entire hybrid instrument at fair value under paragraph 16, and if the newly issued cleared implementation guidance indicates that the embedded derivative may not be accounted for separately, the entity must discontinue mark-to-market accounting for the hybrid instrument as of the effective date and account for the hybrid instrument under relevant GAAP prospectively. In that case, the carrying amount of the hybrid instrument is its fair value at the effective date of the guidance.

This Issue does not apply to situations in which an entity's previous accounting treatment was not reasonable or was inconsistent with Statement 133 and previously posted cleared implementation issues.

EFFECTIVE DATE

The implementation guidance in this Issue is effective for all financial statements issued for fiscal quarters beginning after June 30, 2001.

The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.