Statement of Financial Accounting Standards No. 149

FAS149 Status Page
FAS149 Summary

Amendment of Statement 133 on
Derivative Instruments and Hedging Activities

April 2003

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Statement of Financial Accounting Standards No. 149

Amendment of Statement 133 on Derivative Instruments and Hedging Activities

April 2003

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FAS 149: Amendment of Statement 133 on Derivative Instruments and Hedging Activities

FAS 149 Summary

This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Reasons for Issuing This Statement

This Statement amends Statement 133 for decisions made (1) as part of the Derivatives Implementation Group process that effectively required amendments to Statement 133, (2) in connection with other Board projects dealing with financial instruments, and (3) in connection with implementation issues raised in relation to the application of the definition of a derivative, in particular, the meaning of *an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors,* the meaning of *underlying,* and the characteristics of a derivative that contains financing components.

How the Changes in This Statement Improve Financial Reporting

The changes in this Statement improve financial reporting by requiring that contracts with comparable characteristics be accounted for similarly. In particular, this Statement (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative discussed in paragraph 6(b) of Statement 133, (2) clarifies when a derivative contains a financing component, (3) amends the definition of an underlying to conform it to language used in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* and (4) amends certain other existing pronouncements. Those changes will result in more consistent reporting of contracts as either derivatives or hybrid instruments.

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The Effective Date of This Statement

This Statement is effective for contracts entered into or modified after June 30, 2003, except as stated below and for hedging relationships designated after June 30, 2003. In addition, except as stated below, all provisions of this Statement should be applied prospectively.

The provisions of this Statement that relate to Statement 133 Implementation Issues that have been effective for fiscal quarters that began prior to June 15, 2003, should continue to be applied in accordance with their respective effective dates. In addition, paragraphs 7(a) and 23(a), which relate to forward purchases or sales of *when-issued* securities or other securities that do not yet exist, should be applied to both existing contracts and new contracts entered into after June 30, 2003.

INTRODUCTION

1. FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities,* and No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities,* establish accounting and reporting standards for derivative instruments including derivatives embedded in other contracts (collectively referred to as derivatives) and for hedging activities.

2. This Statement amends Statement 133 for certain decisions made by the Board as part of the Derivatives Implementation Group (DIG) process. For those amendments that relate to Statement 133 implementation guidance, the specific Statement 133 Implementation Issue necessitating the amendment is identified. If the amendment relates to a cleared issue, the clearance date also is noted. This Statement also amends Statement 133 to incorporate clarifications of the definition of a derivative. This Statement contains amendments relating to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* and FASB Statements No. 65, *Accounting for Certain Mortgage Banking Activities,* No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* No. 95, *Statement of Cash Flows,* and No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities.*

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STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to Statement 133

3. The following is added to paragraph 6 after subparagraph (c):

> Notwithstanding the above characteristics, loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 21 of FASB Statement No. 65, *Accounting for Mortgage Banking Activities* (as amended), shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). Paragraph 10(i) provides a scope exception for the accounting for loan commitments by issuers of certain commitments to originate loans and all holders of commitments to originate loans (that is, the potential borrowers).

4. The phrase *(including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract)* is added at the end of the first sentence in paragraph 7.

[FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others]

5. The following sentence and footnote are added at the end of paragraph 8:

> If the initial net investment in the contract (after adjustment for the time value of money) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying or to incur the obligation related to the underlying, the characteristic in paragraph 6(b) is met. The amount of that asset acquired or liability incurred should be comparable to the effective notional amount* of the contract.
>
> *The effective notional amount is the stated notional amount adjusted for any leverage factor.

6. In the first sentence of paragraph 9(a), *or* is replaced by *and* between *that is associated with the underlying* and *that has a principal amount.*

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[Statement 133 Implementation Issue No. A17, "Contracts That Provide for Net Share Settlement," cleared March 21, 2001]

7. Paragraph 10 is amended as follows:

a. Subparagraph (a) is replaced by the following:

> *"Regular-way" security trades.* Regular-way security trades are contracts that provide for delivery of a security within the time generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. However, a contract for an existing security does not qualify for the regular-way security trades exception if it requires or permits net settlement (as discussed in paragraphs 9(a) and 57(c)(1)) or if a market mechanism to facilitate net settlement of that contract (as discussed in paragraphs 9(b) and 57(c)(2)) exists, except as provided in the following sentence. If an entity is required to account for a contract to purchase or sell an existing security on a trade-date basis, rather than a settlement-date basis, and thus recognizes the acquisition (or disposition) of the security at the inception of the contract, then the entity shall apply the regular-way security trades exception to that contract. A contract for the purchase or sale of *when-issued* securities or other securities that do not yet exist is addressed in paragraph 59(a).

[Statement 133 Implementation Issue No. C18, "Shortest Period Criterion for Applying the Regular-Way Security Trades Exception to When-Issued Securities"]

b. Subparagraph (b), as amended by Statement 138, is replaced by the following:

> *Normal purchases and normal sales*. Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. The following guidance should be considered in determining whether a specific type of contract qualifies for the normal purchases and normal sales exception:
>
> (1) *Forward contracts (non-option-based contracts)*. Forward contracts are eligible to qualify for the normal purchases and normal sales exception. However, forward contracts that contain net settlement provisions as described in either paragraph 9(a) or paragraph 9(b) are not eligible for the normal purchases and normal sales exception unless it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery.* Net settlement (as described in paragraphs 9(a) and 9(b)) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of

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gains or losses or are otherwise settled net on a periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for this exception.

(2) *Freestanding option contracts.* Option contracts that would require delivery of the related asset at an established price under the contract only if exercised are not eligible to qualify for the normal purchases and normal sales exception, except as indicated in paragraph 10(b)(4) below.

(3) *Forward contracts that contain optionality features.* Forward contracts that contain optionality features that do not modify the quantity of the asset to be delivered under the contract are eligible to qualify for the normal purchases and normal sales exception. Except for power purchase or sales agreements addressed in paragraph 10(b)(4), if an option component permits modification of the quantity of the assets to be delivered, the contract is not eligible for the normal purchases and normal sales exception, unless the option component permits the holder only to purchase or sell additional quantities at the market price at the date of delivery. In order for forward contracts that contain optionality features to qualify for the normal purchases and normal sales exception, the criteria discussed in paragraph 10(b)(1) must be met.

(4) *Power purchase or sales agreements.* Not withstanding the criteria in paragraphs 10(b)(1) and 10(b)(3), a power purchase or sales agreement (whether a forward contract, option contract, or a combination of both) that is a **capacity contract** also qualifies for the normal purchases and normal sales exception if it meets the criteria in paragraph 58(b).

However, contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that meets none of the criteria in paragraphs 15(a)–15(d) shall not be considered normal purchases and normal sales. For contracts that qualify for the normal purchases and normal sales exception, the entity shall document the designation of the contract as a normal purchase or normal sale. For contracts that qualify for the normal purchases and normal sales exception under paragraphs 10(b)(1) and 10(b)(3), the entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery. For contracts that qualify for the normal purchases and normal sales exception under paragraph 10(b)(4), the entity shall document the basis for concluding that the agreement meets the criteria in paragraph 58(b). The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract. Failure to comply with the documentation requirements precludes application of the normal purchases and normal sales exception to contracts that would otherwise qualify for that exception.

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*Contracts that are subject to unplanned netting (referred to as a "book out" in the electric utility industry) do not qualify for this exception except as specified in paragraph 58(b).

[Statement 133 Implementation Issue No. C10, "Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Normal Sales Exception," cleared March 21, 2001, revised June 27, 2001; Statement 133 Implementation Issue No. C15, "Normal Purchases and Normal Sales Exception for Certain Option-Type Contracts and Forward Contracts in Electricity," cleared June 27, 2001, revised December 19, 2001; and 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," cleared September 19, 2001, revised December 19, 2001]

c. Subparagraph (d) is replaced by the following:

Financial guarantee contracts. Financial guarantee contracts are not subject to this Statement only if:

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

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

d. The following subparagraph is added after subparagraph (f):

g. *Investments in life insurance.* A policyholder's investment in a life insurance contract that is accounted for under FASB Technical Bulletin No. 85-4,

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Accounting for Purchases of Life Insurance, is not subject to this Statement. The exception in this subparagraph affects only the accounting by the policyholder; it does not affect the accounting by the issuer of the life insurance contract.

[Statement 133 Implementation Issue No. B31, "Accounting for Purchases of Life Insurance," cleared July 11, 2001]

e. The following subparagraphs are added after subparagraph (g):

h. *Certain investment contracts.* A contract that is accounted for under either paragraph 4 of FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts,* or paragraph 12 of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* as amended by Statement 110, is not subject to this Statement. Similarly, a contract that is accounted for under either paragraph 4 or paragraph 5 of AICPA Statement of Position 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans,* is not subject to this Statement. Those exceptions apply only to the party that accounts for the contract under Statement 35, Statement 110, or SOP 94-4.

[Statement 133 Implementation Issue No. C19, "Contracts Subject to Statement 35, Statement 110, or Statement of Position 94-4"]

i. *Loan commitments.* The holder of any commitment to originate a loan (that is, the potential borrower) is not subject to the requirements of this Statement. Issuers of commitments to originate mortgage loans that will be held for investment purposes, as discussed in paragraphs 21 and 25 of Statement 65, are not subject to this Statement. In addition, issuers of loan commitments to originate other types of loans (that is, other than mortgage loans) are not subject to the requirements of this Statement.

[Statement 133 Implementation Issue No. C13, "When a Loan Commitment Is Included in the Scope of Statement 133," guidance previously cleared on March 13, 2002, and subsequently revised by the Board]

8. Paragraph 13 is amended as follows:

a. The following footnote is added at the end of subparagraph (a):

*The condition in paragraph 13(a) does not apply to a situation in which the terms of a hybrid instrument permit, but do not require, the investor to settle the hybrid instrument in a manner that causes it not to recover substantially all of its initial recorded investment, provided that the issuer does not have the contractual right to

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demand a settlement that causes the investor not to recover substantially all of its initial net investment.

[Statement 133 Implementation Issue No. B5, "Investor Permitted, but Not Forced, to Settle without Recovering Substantially All of the Initial Net Investment," cleared July 28, 1999]

b. Subparagraph (b) is replaced by the following:

The embedded derivative meets both of the following conditions:

(1) There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor's initial rate of return on the host contract.
(2) For each of the possible interest rate scenarios under which the investor's initial rate of return on the host contract would be doubled (as discussed under paragraph 13(b)(1)), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under each of those future interest rate scenarios) for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer's credit quality at inception.

9. Paragraph 15 is amended as follows:

a. In item (a) of the first sentence, *functional* is inserted between *the* and *currency* and *the primary economic environment in which* and *operates (that is, its functional currency) or* are deleted.

b. In item (b) of the first sentence, the following footnote is added after *(for example, the U.S. dollar for crude oil transactions)*:

*If similar transactions for a certain product or service are routinely denominated in international commerce in various different currencies, the transaction does not qualify for the exception.

c. The following is added at the end of the first sentence:

, (c) the local currency of any substantial party to the contract, or (d) the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary (as discussed in paragraph 11 of Statement 52). The evaluation of whether a contract qualifies for the exception in this paragraph should be performed only at inception of the contract.

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[Statement 133 Implementation Issue No. B21, "When Embedded Foreign Currency Derivatives Warrant Separate Accounting," cleared June 28, 2000]

10. In the fourth sentence of paragraph 17, the following footnote is added after *expected cash flows*:

> *This Statement was issued prior to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* and therefore the term *expected cash flows* does not necessarily have the same meaning as that term does in Concepts Statement 7.

11. Paragraph 19 is deleted.

12. In the first sentence of paragraph 20(c), *or an unrecognized firm commitment* is added after *a recognized asset or liability.*

13. Footnote 8 to paragraph 21 is amended as follows:

a. In the first sentence, *(as defined in paragraph 540)* is added after *A firm commitment.*

b. The following sentence is added at the end of the footnote:

> 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.

[Statement 133 Implementation Issue No. F10, "Definition of Firm Commitment in Relation to Long-Term Supply Contracts with Embedded Price Caps or Floors," cleared June 27, 2001]

14. In paragraph 21(a)(2)(c), *A put option, a call option, an interest rate cap, or an interest rate floor* is replaced by *A put option or call option (including an interest rate or price cap or an interest rate or price floor).*

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[Implementation Issue F10]

15. In paragraphs 27, 34, 64, 65(c), 94, 96, and 97, the following footnote is added after *expected cash flows*, and in paragraphs 95, 99, and 143, the following footnote is added after the first mention of *expected cash flows*:

> †Refer to footnote* to paragraph 17 of Statement 133.

16. In the first sentence of paragraph 28(c), *or an unrecognized firm commitment* is added after *recognized asset or liability.*

17. Paragraph 30(d), which was added by Statement 138, is replaced by the following:

> If a non-option-based contract is the hedging instrument in a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 15 of Statement 52, an amount that will offset the related transaction gain or loss arising from that remeasurement shall be reclassified each period from other comprehensive income to earnings if the assessment of effectiveness and measurement of ineffectiveness are based on total changes in the non-option-based instrument's cash flows. If an option contract is used as the hedging instrument in a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 15 of Statement 52 to provide only one-sided offset against the hedged foreign exchange risk, an amount shall be reclassified each period to or from other comprehensive income with respect to the changes in the underlying that result in a change in the hedging option's intrinsic value. In addition, if the assessment of effectiveness and measurement of ineffectiveness are also based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in fair value—its entire gain or loss), an amount that adjusts earnings for the amortization of the cost of the option on a rational basis shall be reclassified each period from other comprehensive income to earnings. *
>
> *The guidance in this subparagraph is limited to foreign currency hedging relationships because of their unique attributes. That accounting guidance is an exception for foreign currency hedging relationships.

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[Statement 133 Implementation Issue No. G20, "Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge," cleared June 27, 2001; Implementation Issue G20 is still in effect for the non-foreign-currency situations discussed therein.]

18. The following heading and paragraph are added after paragraph 45:

> **Reporting Cash Flows of Derivative Instruments That Contain Financing Elements**
>
> 45A. An instrument accounted for as a derivative under this Statement that at its inception includes off-market terms, or requires an up-front cash payment, or both often contains a financing element. Identifying a financing element within a derivative is a matter of judgment that depends on facts and circumstances. If an other-than-insignificant financing element is present at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract),* then the borrower shall report all cash inflows and outflows associated with that derivative instrument in a manner consistent with financing activities as described in paragraphs 18–20 of FASB Statement No. 95, *Statement of Cash Flows*.
>
> *An at-the-money plain-vanilla interest rate swap that involves no payments between the parties at inception would not be considered as having a financing element present at inception even though, due to the implicit forward rates derived from the yield curve, the parties to the contract have an expectation that the comparison of the fixed and floating legs will result in payments being made by one party in the earlier periods and being made by the counterparty in the later periods of the swap's term. If a derivative instrument is an at-the-money or out-of-the-money option contract or contains an at-the-money or out-of-the-money option contract, a payment made at inception to the writer of the option for the option's time value by the counterparty should not be viewed as evidence that the derivative instrument contains a financing element. In contrast, if the contractual terms of a derivative have been structured to ensure that net payments will be made by one party in the earlier periods and subsequently returned by the counterparty in the later periods of the derivative's term, that derivative instrument should be viewed as containing a financing element even if the derivative has a fair value of zero at inception.

19. The following footnote is added at the end of paragraph 49:

> *If immediately prior to the application of Statement 133 an entity has a fair value or cash flow hedging relationship in which an intercompany interest rate swap is the hedging instrument and if that relationship would have qualified for the shortcut method under the criteria in paragraph 68 had that swap not been an intercompany transaction, that entity may qualify for applying the shortcut method to a newly designated hedging relationship that is effectively the continuation of the preexisting hedging relationship provided that (a) the post-Statement 133 hedging relationship is hedging the same exposure to interest rate risk (that is, exposure to changes in fair value of the same hedged item or exposure to changes in variable cash flows for the

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same forecasted transaction) and (b) the hedging instrument is a third-party interest rate swap whose terms exactly match the terms of the intercompany swap with respect to its remaining cash flows. In that case, if the shortcut method is applied to the new hedging relationship upon adoption of Statement 133, the transition adjustment should include the appropriate adjustments at the date of adoption to reflect the retroactive application of the shortcut method.

[Statement 133 Implementation Issue No. J12, "Intercompany Derivatives and the Shortcut Method," cleared June 28, 2000]

20. The following sentence is added at the end of paragraph 57(c)(2):

> The evaluation of whether a market mechanism exists and whether items to be delivered under a contract are readily convertible to cash must be performed at inception and on an ongoing basis throughout a contract's life.

21. Paragraph 57(c)(3) is amended as follows:

a. The following footnote is added at the end of the first sentence:

> *The evaluation of *readily convertible to cash* shall be applied to a contract throughout its life.

b. The following is added at the end of the paragraph:

> Shares of stock in a publicly traded company to be received upon the exercise of a stock purchase warrant do not meet the characteristic of being readily convertible to cash if both of the following conditions exist: (a) the stock purchase warrant is issued by an entity for only its own stock (or stock of its consolidated subsidiaries) and (b) the sale or transfer of the issued shares is restricted (other than in connection with being pledged as collateral) for a period of 32 days or more from the date the stock purchase warrant is exercised. In contrast, restrictions imposed by a stock purchase warrant on the sale or transfer of shares of stock that are received from the exercise of that warrant issued by an entity for *other* than its own stock (whether those restrictions are for more or less than 32 days) do not affect the determination of whether those shares are readily convertible to cash. The accounting for restricted stock to be received upon exercise of a stock purchase warrant should not be analogized to any other type of contract.

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[Statement 133 Implementation Issue No. A14, "Derivative Treatment of Stock Purchase Warrants Issued by a Company for Its Own Shares of Stock Where the Subsequent Sale or Transfer Is Restricted," cleared December 6, 2000, and revised May 8, 2002]

22. Paragraph 58 is amended as follows:

a. Subparagraph (a) is amended as follows:

(1) At the end of the first sentence after the reference to footnote 16, *except (1) as provided in paragraph 59(a) for a contract for the purchase or sale of when-issued securities or other securities that do not yet exist and (2) for contracts that are required to be accounted for on a trade-date basis by the reporting entity* is added.

(2) In the fourth sentence, both references to *regular-way exception* are replaced by *regular-way security trades exception*, and *unless the reporting entity is required to account for the contract on a trade-date basis* is added at the end of that sentence.

(3) The last sentence is deleted.

(4) Footnote 16 is amended as follows:

(a) The parenthetical phrase *(and thus do not permit net settlement)* is added after *not readily convertible to cash.*

(b) The parenthetical phrase *(as described in paragraphs 9(b) and 57(c)(2))* is added at the end of the sentence.

b. The following is added at the end of subparagraph (b) (as amended by Statement 138):

Power purchase or sales agreements (whether a forward contract, an option contract, or a combination of both) for the purchase or sale of electricity qualify for the normal purchases and normal sales exception in paragraph 10(b)(4) if all of the following applicable criteria are met:

(1) For both parties to the contract:

(a) The terms of the contract require physical delivery of electricity. That is, the contract does not permit net settlement, as described in paragraphs 9(a) and 57(c)(1). For an option contract, physical delivery is required if the option contract is exercised.

(b) The power purchase or sales agreement is a capacity contract.* Differentiating between a capacity contract and a traditional option contract (that is, a financial option on electricity) is a matter of judgment that depends

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on the facts and circumstances.

(2) For the seller of electricity: The electricity that would be deliverable under the contract involves quantities that are expected to be sold by the reporting entity in the normal course of business.

(3) For the buyer of electricity:

(a) The electricity that would be deliverable under the contract involves quantities that are expected to be used or sold by the reporting entity in the normal course of business.

(b) The buyer of the electricity under the power purchase or sales agreement is an entity that is engaged in selling electricity to retail or wholesale customers and is statutorily or otherwise contractually obligated to maintain sufficient capacity to meet electricity needs of its customer base.

(c) The contracts are entered into to meet the buyer's obligation to maintain a sufficient capacity, including a reasonable reserve margin established by or based on a regulatory commission, local standards, regional reliability councils, or regional transmission organizations.

Power purchase or sales agreements that meet only the above applicable criteria in paragraph 58(b) qualify for the normal purchases and normal sales exception even if they are subject to being booked out or are scheduled to be booked out. Forward contracts for the purchase or sale of electricity that do not meet the above applicable criteria are nevertheless eligible to qualify for the normal purchases and normal sales exception by meeting the criteria in paragraph 10(b) other than paragraph 10(b)(4).

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*As defined in paragraph 540.

[Implementation Issues C10, C15, and C16, cleared March 21, 2001; June 27, 2001; and September 19, 2001, respectively]

23. Paragraph 59 is amended as follows:

a. Subparagraph (a) is replaced by the following:

a. *Forward purchases or sales of when-issued securities or other securities that do not yet exist.* Contracts for the purchase or sale of when-issued securities or other securities that do not yet exist are excluded from the requirements of this Statement as a regular-way security trade only if (1) there is no other way to purchase or sell that security, (2) delivery of that security and settlement will occur within the shortest period possible for that type of security, and (3) it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery of a security when it is issued. A contract for the

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purchase or sale of when-issued securities or other securities that do not yet exist is eligible to qualify for the regular-way security trades exception even though that contract permits net settlement (as discussed in paragraphs 9(a) and 57(c)(1)) or a market mechanism to facilitate net settlement of that contract (as discussed in paragraphs 9(b) and 57(c)(2)) exists. The entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery. Net settlement (as described in paragraphs 9(a) and 9(b)) of contracts in a group of contracts similarly designated as regular-way security trades would call into question the continued exemption of such contracts. In addition, if an entity is required to account for a contract for the purchase or sale of when-issued securities or other securities that do not yet exist on a trade-date basis, rather than a settlement-date basis, and thus recognizes the acquisition or disposition of the securities at the inception of the contract, that entity shall apply the regular-way security trades exception to those contracts.

b. Subparagraph (c) is amended as follows:

(1) The following footnote is added at the end of the second sentence:

*In certain circumstances, a take-or-pay contract may represent or contain a lease that should be accounted for in accordance with FASB Statement No. 13, *Accounting for Leases*.

(2) In the fourth sentence, item (3) *little or no initial net investment in the contract is required* is replaced by *the contract requires no initial net investment or an initial net investment that is smaller by more than a nominal amount than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (Refer to paragraph 8.)*

c. In the fifth sentence following the list in subparagraph (d), *little or no initial net investment, is not present* is replaced by *no initial net investment or an initial net investment that is smaller by more than a nominal amount than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, is not present. (Refer to paragraph 8.)*

24. Paragraph 61 is amended as follows:

a. In item 2 of subparagraph (a), *also* is replaced by *at the same time* and *then-current* is inserted between *would be the* and *market return*.

b. Subparagraph (d) is amended as follows:

(1) At the end of the first sentence, *, provided the call options (or put options) are also*

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considered to be clearly and closely related to the debt host contract under paragraph 13 is added.

(2) In the last sentence, after the amendment by Statement 138, *and would be separated from the host contract* is deleted.

c. Subparagraph (e) is amended as follows:

(1) At the end of the second sentence, *if the criteria in paragraphs 12(b) and 12(c) are also met* is added.

(2) In the last sentence, *, if the criteria in paragraphs 12(b) and 12(c) were met,* is inserted between *equity instrument and* and *should be separated*.

d. Subparagraph (f) is replaced by the following:

Interest rate floors, caps, and collars. Floors or caps (or collars, which are combinations of caps and floors) on interest rates and the interest rate on a debt instrument are considered to be clearly and closely related unless the conditions in either paragraph 13(a) or paragraph 13(b) are met, in which case the floors or the caps are not considered to be clearly and closely related.

e. In the second sentence of subparagraph (g), *must be separated from the host contract and accounted for as a derivative instrument* is replaced by *is not clearly and closely related to the host contract.*

25. Paragraph 68 is amended as follows:

a. In the second sentence, as amended by Statement 138, *(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)* is inserted between *interest rate swap* and *if all of the applicable.*

b. In subparagraph (a), *being hedged* is added at the end of the sentence.

[Statement 133 Implementation Issue No. E10, "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," cleared June 28, 2000, and revised September 25, 2000]

c. Subparagraph (b), as amended by Statement 138, is replaced by the following:

If the hedging instrument is solely an interest rate swap, the fair value of that swap at the inception of the hedging relationship is zero. If the hedging instrument is a

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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.

d. Subparagraph (d), as amended by Statement 138, is amended as follows:

(1) In the second sentence, *the hedging interest rate swap contains an embedded mirror-image call option* is replaced by *the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image call option.*

(2) In the third sentence, *embedded in the swap* is deleted.

(3) In the last sentence, *the hedging interest rate swap contains an embedded mirror-image put option* is replaced by *the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image put option.*

e. In subparagraph (g), *ceiling* is replaced by *cap.*

26. The first sentence of paragraph 95 is replaced by the following:

In assessing hedge effectiveness on an ongoing basis, Company G also must consider the extent of offset between the change in expected cash flows† on its Colombian coffee forward contract and the expected net change in expected cash flows for the forecasted purchase of Brazilian coffee.

†Refer to footnote* to paragraph 17 of Statement 133.

27. In the first sentence of paragraph 154, *interest payments on* is replaced by *quarterly interest payments on the company's 5-year $5 million borrowing program, initially expected to be accomplished by.*

28. Paragraph 176 is replaced by the following:

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The following examples in Section 2 discuss instruments that contain a variety of embedded derivative instruments. They illustrate how the provisions of paragraphs 12–16 of this Statement would be applied to contracts with the described terms. If the terms of a contract are different from the described terms, the application of this Statement by either party to the contract may be affected. Furthermore, if any contract of the types discussed in Section 2 meets the definition of a derivative instrument in its entirety under paragraphs 6-9 and related paragraphs, the guidance in this section for the application of the provisions of paragraphs 12–16 to embedded derivative instruments does not apply. The illustrative instruments and related assumptions in Examples 12–27 are based on examples in Exhibit 96-12A of EITF Issue No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structured Notes."

29. Paragraph 540 is amended as follows:

a. The following definition is added to the glossary:

Capacity contract
An agreement by an owner of capacity to sell the right to that capacity to another party so that it can satisfy its obligations. For example, in the electric industry, capacity (sometimes referred to as installed capacity) is the capability to deliver electric power to the electric transmission system of an operating control area. A control area is a portion of the electric grid that schedules, dispatches, and controls generating resources to serve area load (ultimate users of electricity) and coordinates scheduling of the flow of electric power over the transmission system to neighboring control areas. A control area requires entities that serve load within the control area to demonstrate ownership or contractual rights to capacity sufficient to serve that load at time of peak demand and to provide a reserve margin to protect the integrity of the system against potential generating unit outages in the control area.

b. The phrase *(including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract)* is added at the end of the first sentence under the definition of *underlying.*

Amendments to Existing Pronouncements Relating to the Definition of *Expected Cash Flows* in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*

30. FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*. In the last sentence of paragraph 13, the following footnote is added after the first mention of *expected cash flows*:

*This pronouncement was issued prior to FASB Concepts Statement No. 7, *Using*

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Cash Flow Information and Present Value in Accounting Measurements, and therefore the term *expected cash flows* does not necessarily have the same meaning as that term in Concepts Statement 7.

31. FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans.* In the last sentence of paragraph 11, the following footnote is added after the first mention of *expected cash flows*:

> *This pronouncement was issued prior to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* and therefore the term *expected cash flows* does not necessarily have the same meaning as that term in Concepts Statement 7.

32. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.* In the second sentence of paragraph 19, the following footnote is added after the first mention of *expected cash flows*:

> *This pronouncement was issued prior to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* and therefore the term *expected cash flows* does not necessarily have the same meaning as that term in Concepts Statement 7.

33. FASB Statement No. 87, *Employers' Accounting for Pensions.* In the last sentence of paragraph 49, the following footnote is added after the first mention of *expected cash flows*:

> *This pronouncement was issued prior to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* and therefore the term *expected cash flows* does not necessarily have the same meaning as that term in Concepts Statement 7.

34. FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* In the last sentence of paragraph 65, the following footnote is added after the first mention of *expected cash flows*:

> *This pronouncement was issued prior to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* and therefore the term *expected cash flows* does not necessarily have the same meaning as that term in Concepts Statement 7.

Amendments to Other Existing Pronouncements

35. FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities.* The

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following sentence is added at the end of paragraph 3:

> In addition, this Statement does not apply to commitments related to the origination of mortgage loans to be held for sale, or fees and costs related to commitments to sell or purchase loans that are accounted for as derivatives under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

36. FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.* The following sentence is added at the end of paragraph 3:

> In addition, this Statement does not apply to fees and costs related to commitments to originate, sell, or purchase loans that are accounted for as derivatives under FASB Statement No. 133, *Accounting for Derivatives Instruments and Hedging Activities.*

37. FASB Statement No. 95, *Statement of Cash Flows,* is amended as follows:

a. Footnote 4 of paragraph 14, as amended by Statements 104 and 133, is replaced by the following:

> Generally, each cash receipt or payment is to be classified according to its nature without regard to whether it stems from an item intended as a hedge of another item. For example, the proceeds of a borrowing are a financing cash inflow even though the debt is intended as a hedge of an investment, and the purchase or sale of a futures contract is an investing activity even though the contract is intended as a hedge of a firm commitment to purchase inventory. However, cash flows from a derivative instrument that is accounted for as a fair value hedge or cash flow hedge may be classified in the same category as the cash flows from the items being hedged provided that the derivative instrument does not include an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract) and that the accounting policy is disclosed. If the derivative instrument includes an other-than-insignificant financing element at inception, all cash inflows and outflows of the derivative instrument shall be considered cash flows from financing activities by the borrower. If for any reason hedge accounting for an instrument that hedges an identifiable transaction or event is discontinued, then any cash flows subsequent to the date of discontinuance shall be classified consistent with the nature of the instrument.

b. The following is added after paragraph 19(c), as added by FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations:*

> d. Proceeds received* from derivative instruments that include financing elements†

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at inception.

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*Whether at inception or over the term of the derivative instrument.

†Other than a financing element inherently included in an at-the-market derivative instrument with no prepayments.

c. The following is added after paragraph 20(c):

d. Distributions* to counterparties of derivative instruments that include financing elements† at inception.

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*Whether at inception or over the term of the derivative instrument.

†Other than a financing element inherently included in an at-the-market derivative instrument with no prepayments.

d. The following sentences are added at the end of paragraph 24:

Another example where cash receipts and payments include more than one class of cash flows involves a derivative instrument that includes a financing element† at inception because the borrower's cash flows are associated with both the financing element and the derivative. For that derivative instrument, all cash inflows and outflows shall be considered cash flows from financing activities by the borrower.

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†Other than a financing element inherently included in an at-the-market derivative instrument with no prepayments.

38. FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities.* In paragraph 2(c), as amended by Statement 133, *other than commitments related to the origination of mortgage loans to be held for sale* is added before *during the reporting period.*

Effective Dates and Transition

39. This Statement shall be effective for contracts entered into or modified after June 30, 2003, except as stated in paragraph 40. This Statement also is effective for hedging relationships designated after June 30, 2003, except as stated in paragraph 40. Except as stated below, all provisions of this Statement shall be applied prospectively.

Effective Date and Transition for Other Amendments to Statement 133 That Resulted Principally from the Derivatives Implementation Group Process

40. Paragraphs 6, 7(b), 7(d), 8(a), 9, 13, 14, 17, 19, 21(b), 22(b), and 25(b) of this Statement,

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which relate to guidance in Statement 133 Implementation Issues that have been cleared by the Board and have been effective for fiscal quarters that began prior to June 15, 2003, shall continue to be applied in accordance with their respective effective dates. Because Implementation Issues C7 and C13 have been modified in accordance with the decisions made as part of the amendment process, entities should apply the guidance in those Issues as revised in this amendment prospectively to contracts entered into after June 30, 2003. In addition, paragraphs 7(a) and 23(a), which relate to forward purchases or sales of when-issued or other securities that do not yet exist, shall be applied to both existing contracts and new contracts entered into after June 30, 2003.

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

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

Robert H. Herz*, Chairman*
G. Michael Crooch
John M. Foster
Gary S. Schieneman
Katherine Schipper
Edward W. Trott
John K. Wulff

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Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix A: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

A2. Statement 133 was issued in June 1998. It has been amended by FASB Statements No. 137, *Accounting for Derivative Instruments and Hedging Activities— Deferral of the Effective Date of FASB Statement No. 133,* and No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities.* After Statement 133's issuance, the Derivatives Implementation Group (DIG) was formed to consider a number of implementation issues. Many of the amendments in this standard are derived from Statement 133 Implementation Issues that were cleared by the Board during the derivatives implementation process, after soliciting public comment on tentative guidance posted on the FASB website.

A3. In May 2002, the Board issued an Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,* for a 60-day comment period. Forty organizations and individuals responded to the Exposure Draft. The Board considered the comments received in its redeliberations of the issues raised by the Exposure Draft during the fourth quarter of 2002. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing.

A4. The Board initially concluded that paragraph 6 of Statement 133 should be amended to resolve issues raised in connection with the definition of a derivative. Those issues were identified in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets." Paragraph 6 of Statement 133 sets forth a characteristic-based definition of a derivative. For certain types of instruments, the meaning of the characteristic in paragraph 6(b)—the instrument has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors—is especially important in determining whether the instrument meets the definition of a derivative in its entirety. Constituents indicated that without further clarification, they would have difficulty determining whether an instrument is a hybrid instrument that contains an embedded derivative or a derivative in its entirety.

A5. In the Exposure Draft of this Statement, the Board proposed amending paragraph 6(b) of Statement 133 to require that entities consider a financial instrument or other contract as meeting

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that paragraph's criteria if (a) the contract was option-based and had an initial net investment that was equal to the fair value of the option component or (b) the contract was non-option-based and had an initial net investment of less than 5 percent of the fully prepaid amount. The Board also proposed amending paragraph 12 to permit entities that held a contract that, in its entirety, met the definition of a derivative but was non-option-based and required an initial net investment that was less than 5 percent of the fully prepaid amount to account for the contract as either a derivative in its entirety or a hybrid instrument that must be bifurcated into a debt host and a derivative with a fair value of zero at acquisition of the hybrid instrument. Those proposed amendments would have resulted in fewer instruments meeting the definition of a derivative in its entirety.

A6. A number of respondents to the Exposure Draft, both those that were involved with accounting for beneficial interests in securitizations and those that were not, expressed concerns that the proposed changes to the definition had far-reaching consequences for all parties subject to Statement 133. Respondents cited increased cost, complexity, adverse consequences (such as constituents misreading the language for option-based contracts or arbitrarily using 5 percent as a precedent for defining materiality under Statement 133), and lack of comparability as reasons why the definition of a derivative should not be amended.

A7. The Board reconsidered its decision to amend the definition of a derivative because it concluded that doing so would not clarify the basic issue—the amount of initial net investment that distinguishes a hybrid instrument from a derivative—and would create issues for certain derivative instruments that are not beneficial interests. After reviewing constituents' requests not to amend paragraph 6(b), the Board concluded that it would not amend the current definition of a derivative but would (a) clarify the meaning of *an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors* in paragraph 6(b) of Statement 133 and (b) develop guidance to ensure the transparency of financing or debt elements embedded in derivatives at inception. For those reasons, and the reasons cited in paragraphs A11 and A12 of this Statement, the Board concluded that the definition of a derivative should be clarified, not amended.

Benefits and Costs

A8. The Board's mission statement charges the Board to determine that a proposed standard will fill a significant need and that the costs it imposes will be justified in relation to the overall benefits.

A9. The amendments to Statement 133 fall principally into three categories: amendments related to Statement 133 Implementation Issues that were previously cleared by the Board during the DIG process, amendments clarifying the definition of a derivative, and amendments relating to the definition of *expected cash flows* in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. The Board believes that the incremental costs of implementing the amendments to this Statement are minimal given that

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most are simply clarifications of existing literature. The Board decided that the amendments that are not already effective should be applied prospectively and that retroactive application of those amendments was not appropriate given that they are to be applied to contracts or hedging relationships. The Board also evaluated whether to apply retroactively the requirement to report cash flows of derivatives with an other-than-insignificant financing element at inception as cash flows from financing activities in the statement of cash flows. The Board decided that the amount of time needed and costs incurred to collect that information would exceed the benefits of retroactively reporting that financing element as a cash flow from financing activities and that prospective application was the most appropriate transition.

Amendments to Statement 133

A10. This Statement amends paragraphs 10(a) and 59(a) of Statement 133 to remove from the scope of Statement 133 contracts for the purchase or sale of securities referred to as *when-issued* securities or other securities that do not yet exist if the contracts meet all three criteria in paragraph 59(a) of Statement 133. The Board decided to provide that scope exception to eliminate the potential burden associated with accounting for those contracts as derivatives. The amendments of those paragraphs similarly remove from the scope of that Statement contracts for the purchase or sale of when-issued securities or other securities that do not yet exist for which the acquisition or disposition of securities is required by the entity to be accounted for on a trade-date basis. Language relating to trade-date accounting was added to clarify that if an entity is required to account for a contract under trade-date accounting and thus already recognizes the acquisition or disposition of the securities at inception of the contract, that contract is not included within the scope of Statement 133. This Statement also adds new scope exceptions in paragraphs 10(g)–10(i). In addition, this Statement amends paragraph 10(b) to clarify when the normal purchases and normal sales exception can be applied to option-type contracts and forward contracts on electricity and paragraph 10(d) to clarify which financial guarantee contracts are within that scope exception. In each case, the Board decided to provide a scope exception for practical reasons.

Amendments Relating to the Definition of a Derivative

A11. The Board decided not to establish a quantitative threshold for evaluating when a contract meets the criterion in paragraph 6(b) that the contract "requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors." The Board concluded that broader qualitative guidance would (a) result in more consistent accounting for economically similar contracts and (b) provide a means of clarifying when derivatives contain financing elements. The Board added qualitative guidance to paragraph 8 of Statement 133 related to when an initial net investment is considered to be an initial net investment that "is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors." That guidance indicates that a contract meets the criterion in paragraph 6(b) if the initial net investment is less, by more than a nominal amount,

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than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying or to incur the obligation related to the underlying. The Board did not intend that guidance to imply that a slightly off-market contract cannot be a derivative in its entirety. That determination is a matter of facts and circumstances and should be evaluated on a case-by-case basis.

A12. The Board also amended paragraph 7 of Statement 133 to reflect its decision in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* to clarify the definition of an underlying. In that Interpretation, the Board clarifies how the definition of an underlying in Statement 133 applies to a guarantee contract. The Board added the phrase *(including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract)* to explain what was meant by the phrase *or other variable* in the first sentence of paragraph 7 of Statement 133. Footnote 2 of Interpretation 45 states, "The occurrence or nonoccurrence of a specified event (such as a scheduled payment under a contract) is a variable that is considered an underlying under [the] definition [in Statement 133] . . . "; therefore, the clarification's inclusion in this amendment does not require further due process. However, because that clarification was included in an Interpretation involving guarantor's accounting and disclosure requirements for guarantees, constituents may not have focused on the clarification. Therefore, the Board decided that the clarification should be applied prospectively for contracts entered into after June 30, 2003.

Amendment of Paragraph 10

A13. As a result of issues addressed as part of the DIG process and various other Statement 133 Implementation Issues raised by constituents, the Board amended paragraph 10 of Statement 133 as discussed below.

Securities Referred to as When-Issued Securities or Other Securities That Do Not Yet Exist

A14. The Board concluded in paragraph 276 of Statement 133 that the regular-way security trades exception in paragraph 10(a) should be extended to securities referred to as when-issued securities or other securities that do not yet exist "only if (a) there is no other way to purchase or sell the security and (b) the trade will settle within the shortest period permitted for the security." Paragraph 10(a) indicates that contracts are eligible for that exception only if they have no net settlement provision and there is no market mechanism to facilitate net settlement. Paragraph 59(a) of Statement 133 discusses the application of that scope exception to when-issued securities or other securities that do not yet exist. Constituents questioned whether that exception was applicable to when-issued securities or other securities that do not yet exist if a market mechanism exists, which is the case for GNMA to-be-announced forward contracts. If that exception is not applicable when a market mechanism exists, constituents asked that a special exception be made for when-issued securities or other securities that do not yet exist.

A15. The Board considered constituents' comments and decided that the regular-way security

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trades exception in paragraph 10(a) should apply to certain securities referred to as when-issued securities or other securities that do not yet exist, even if they have net settlement provisions or a market mechanism exists if it is probable at inception and throughout the term that the contract will not settle net and will result in physical delivery. The Board reasoned that requiring when-issued securities or other securities that do not yet exist to be accounted for as derivatives if there is no intention to net settle the contract would not be cost beneficial. Accordingly, this Statement amends paragraphs 10(a) and 59(a) to indicate that the regular-way security trades exception may be applied to securities referred to as when-issued securities or other securities that do not yet exist even though a market mechanism exists. Paragraph 59(a) also is amended to include the additional requirement that it be probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery of a security when it is issued.

Power Purchase or Sales Agreements

A16. This Statement amends Statement 133 to permit a scope exception for a power purchase or sales agreement if specific criteria are met. Under Statement 133 Implementation Issue No. C10, "Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Normal Sales Exception," option and forward contracts that contain optionality features that can modify the quantity of the asset to be delivered under the contract cannot qualify for the normal purchases and normal sales exception in paragraph 10(b). Companies in the electric industry enter into contracts, which frequently provide optionality about the quantity to be delivered, that permit, but do not require, one party to purchase electricity (also referred to as "power").

A17. The Board decided that certain unique characteristics of the electric industry justify extending the scope exception in paragraph 10(b) to certain power purchase or sales agreements. The Board understands that deregulation has influenced the way contracts to buy and sell power are structured. A unique characteristic of the industry is that electricity cannot be readily stored in significant quantities. Another unique characteristic is that many suppliers are statutorily or contractually obligated to maintain a specified level of electricity supply to meet demand. Therefore, suppliers must maintain access to an additional supply of electricity (through generation or purchase) to meet spikes in demand. As a result, some contracts to buy and sell electricity permit the buyer some flexibility in determining when to take electricity and in what quantities in order to match power to fluctuating demand.

A18. The Board understands that another important characteristic of the industry is that fixed costs are a very high percentage of the total cost of producing power. To provide for recovery of fixed costs, power contracts typically include a specified charge (sometimes referred to as the capacity or demand charge) to provide for recovery of the cost of the plant (or, in some cases, recovery of the market-based value of the plant) and related financing. Generally, contracts also will include a variable charge to recover, among other things, the variable cost of producing power (the energy charge). For the regulated electric industry, regulators set rates in order to

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recover plant fixed costs and variable costs plus a reasonable return. Tariffs are established that generally separate the capacity charge and the energy charges, among other charges. Some contracts to buy and sell power of independent power producers, which are not regulated, also include capacity charges and energy charges, which, in the past, were generally established by regulators. The intent to physically deliver power at rates that will recover the plant fixed costs and variable cost to produce power while giving the buyer the ability to have some control over when and in what quantity power is delivered is a consistent characteristic of these contracts.

A19. The Board decided to permit the normal purchases and normal sales exception to be applied to a power purchase or sales agreement if certain criteria are met, regardless of whether the agreement includes optionality features that can modify the quantity of the asset to be delivered. Those criteria are outlined in paragraph 58(b) of Statement 133 as amended by this Statement.

Financial Guarantee Contracts

A20. This Statement amends Statement 133 to clarify the types of financial guarantee contracts that are included in the scope exception in paragraph 10(d). Constituents questioned whether this scope exception was intended to encompass financial guarantee contracts acquired by entities to obtain protection against events of default that are stipulated in the legal documents used to consummate a credit agreement. Financial guarantee contracts typically provide for payment upon several default events (as specified in the underlying credit agreement) and not just the single triggering event described in paragraph 10(d)—that is, failure to pay when payment is due. The events of default specified in credit agreements may be either "payment-based" (for example, payment of principal or interest when due) or "non-payment-based" (for example, violation of a covenant or a change in control). Constituents questioned whether a guarantee contract that mirrors exactly the events of default covered by the original loan agreement and permits the guaranteed party to deliver the loan to the guarantor upon the occurrence of a non-payment-based event of default (such as a change in control of the debtor) would qualify for the scope exception. Under that scenario, the guaranteed party would receive payment under the contract even though the debtor did not literally fail to pay when payment was due.

A21. In considering this issue, the Board discussed two possible alternatives: (a) amend paragraph 10(d) to permit financial guarantee contracts that provide protection to a guaranteed party in any event of default to qualify for the scope exception or (b) clarify paragraph 10(d) to emphasize the need for the guaranteed party to demand payment prior to collecting any payment from the guarantor in order for a guarantee contract to be eligible for the scope exception. Both alternatives contemplate that, as part of the financial guarantee arrangement, the guarantor receives either the rights to any payments subsequently advanced to the guaranteed party or delivery of the defaulted receivable upon an event of default.

A22. The Board selected the second alternative, because it is more consistent with the Board's

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original intent in Statement 133. The Board concluded that the intent of the scope exception for guarantee contracts in paragraph 10(d) of Statement 133 was to more closely align that exception with the scope exception for traditional insurance contracts addressed in paragraph 10(c). The Board reasoned that guarantees eligible for the scope exception are similar to insurance contracts in that they entitle the holder to compensation only if, as a result of an insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. Accordingly, the Board determined that, in order for a financial guarantee contract to qualify for the scope exception in paragraph 10(d), the guaranteed party must demand payment from the debtor and that once it is determined that the required obligation will not be satisfied by the debtor, the guaranteed party must relinquish to the guarantor its rights to receive payment from the debtor in order to receive payment from the guarantor. The Board also concluded that the language in paragraph 10(d) should be clarified to eliminate use of the term *loss incurred* and instead focus on amounts due to the guaranteed party but not paid by the debtor.

A23. In addition, the Board decided that the concepts in Statement 133 Implementation Issue No. C7, "Certain Financial Guarantee Contracts," are critical to differentiating guarantee contracts covered by the scope exception in paragraph 10(d) from credit derivatives that provide payments in response to a change in credit rating or credit spreads of a reference credit. The amended language in paragraph 7(c) of this Statement was written to include financial guarantees with all of the following characteristics: (a) the guaranteed party's direct exposure on the referenced asset must be present both at the inception of the contract and throughout its life; (b) to be paid under the financial guarantee, the guaranteed party has an amount that is due from the debtor (at either pre-specified payment dates or accelerated payment dates as a result of the occurrence of an event of default, as defined in the guarantee contract, or notice of acceleration to the debtor by the creditor) and that amount is past due; and (c) the compensation paid to the guaranteed party under the contract does not exceed the direct exposure of the guaranteed party relating to the referenced asset either from owning the referenced asset or from back-to-back arrangements with another party that is required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation.

Investments in Life Insurance

A24. If a hybrid instrument is remeasured at fair value with changes in fair value reported in earnings as they occur, the hybrid instrument does not satisfy the criterion in paragraph 12(b) of Statement 133 and, thus, the embedded derivative instrument is not separated from the host contract. Certain life insurance policies (for example, corporate-owned life insurance, business-owned life insurance, or key-man insurance subject to FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*) that contain embedded derivatives satisfy the criterion in paragraph 12(b). While Technical Bulletin 85-4 requires that those contracts be measured at cash surrender value or contract value with changes in value recognized in the income statement during the contract period, contract value may not equal the fair value of the insurance policy. In those instances, policyholders otherwise would be required to separate the

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embedded derivative from the host contract and account for the host contract under generally accepted accounting principles. However, because the policyholder would not have a table of cash surrender values that relate only to the host contract, application of existing guidance in Technical Bulletin 85-4 for only the host contract is not feasible. For that reason, the Board decided that the policyholder should not separate the embedded derivative from the host contract and should continue to account for those policies in accordance with Technical Bulletin 85-4. A new scope exception has been added as paragraph 10(g).

Contracts Held by Benefit Plans

A25. Constituents identified conflicts between the requirements of Statement 133 and both FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts* (which amends FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*), and AICPA Statement of Position 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*. Paragraph 7(b) of Statement 110 requires a defined benefit plan to report insurance contracts "in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA; that is, either at fair value or at amounts determined by the insurance enterprise (contract value)," while Statement 133 requires that the embedded derivative in some insurance contracts be bifurcated. In addition, SOP 94-4 indicates that a fully benefit-responsive investment contract (such as a guaranteed investment contract [GIC] that is subject to SOP 94-4) should be reported at contract value. However, Statement 133 Implementation Issue No. A16, "Synthetic Guaranteed Investment Contracts," concludes that synthetic GICs meet Statement 133's definition of a derivative. Statement 133 does not contain an exception for synthetic GICs held by reporting entities subject to SOP 94-4. Due to the limited scope of those identified conflicts, the Board decided to exclude contracts that are subject to Statements 35 and 110 or SOP 94-4 from the scope of Statement 133 for the party that accounts for those contracts under those pronouncements.

Loan Commitments

A26. Paragraph 291 of Statement 133 addresses loan commitments. Under that paragraph, a loan commitment would be excluded from the scope of Statement 133 "if it (a) requires the holder to deliver a promissory note that would not be readily convertible to cash and (b) cannot readily be settled net." Constituents questioned whether any loan commitments are subject to Statement 133 and, if so, which types of loan commitments meet the definition of a derivative. Constituents noted that if a loan commitment is subject to Statement 133, an overlap exists between a requirement to account for that arrangement as a derivative and the existing accounting guidance for commitment fees and costs in FASB Statements No. 65, *Accounting for Certain Mortgage Banking Activities,* and No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* as amended. Statements 65 and 91 were not amended by Statement 133.

A27. As reflected in paragraph 291, the Board believed that the characteristic of net settlement in

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paragraph 6(c) determines whether a loan commitment meets the definition of a derivative and that loan commitments generally meet the characteristics of a derivative described in paragraphs 6(a) and 6(b) of Statement 133. That is, a loan commitment contains an underlying (the specified interest rate) and a notional amount (the maximum amount of the borrowing), and the initial net investment in the contract is similar to a premium on other option-type contracts. In considering the net settlement characteristic, the Board had understood that most loan commitments are not contractually required or permitted to be net settled as discussed in paragraph 9(a) of Statement 133. While the Board acknowledged that a loan commitment may meet the characteristic of net settlement either because there is a market mechanism that facilitates net settlement (under paragraph 9(b)) or because the underlying asset that will be delivered under the contract (the loan) is readily convertible to cash (under paragraph 9(c)), during the development of Statement 133, the Board was under the impression that most loan commitments would not meet the net settlement characteristic. The Board subsequently was informed that certain types of loan commitments meet the net settlement characteristic and, therefore, meet the definition of a derivative.

A28. In an effort to resolve the scope overlap of Statement 133 and Statements 65 and 91, in December 2000, the FASB issued tentative guidance on the application of Statement 133 to loan commitments in Statement 133 Implementation Issue No. C13, "When a Loan Commitment Is Included in the Scope of Statement 133." That tentative guidance provided that only loan commitments that relate to the origination or acquisition of mortgage loans held for resale under Statement 65 would be accounted for as derivatives under Statement 133. However, Statement 65 would continue to apply to loan commitments that relate to the origination or acquisition of mortgage loans held for investment. Also, Statement 91 would continue to apply to all commitments that relate to the origination of loans that are not mortgage loans (for example, loan commitments issued to commercial and industrial enterprises). The Board recognized that the approach in Implementation Issue C13 could have included in the scope of Statement 133 certain loan commitments that technically do not meet the definition of a derivative. For example, commitments that relate to mortgage loans classified as held for sale under Statement 65 would be considered derivatives under that guidance, even if the underlying loans did not meet the definition of *readily convertible to cash* under paragraph 9(c) of Statement 133.

A29. Because of concerns about the possible outcomes under Implementation Issue C13, the Board studied several alternatives for accounting for loan commitments. Those alternatives included (a) requiring the characteristic-based definition of a derivative to be applied to loan commitments and (b) providing a scope exception for some or all loan commitments. The Board consulted with members of the DIG and other constituents. Constituents highlighted the unique considerations surrounding the application of the definition of a derivative to different types of loan commitments. Many constituents indicated that additional guidance would be needed to assist in the application of the net settlement characteristic, including how to determine whether a market mechanism exists for commercial loan commitments and when a loan is considered readily convertible to cash. Constituents highlighted the operational burden of applying the characteristic-based definition of a derivative to various types of loan commitments.

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A30. During the deliberations leading up to the Exposure Draft, the Board decided to clear the guidance in Implementation Issue C13 and include that guidance in the Exposure Draft, rather than going forward with a characteristic-based approach previously identified. The Board observed that requiring an evaluation of loan commitments under the characteristic-based definition of a derivative in Statement 133 would impose a significant operational burden on entities, for example, by requiring an evaluation of some types of loan commitments on a contract-by-contract basis. In addition, the Board was persuaded by constituents that there would be significant disagreement as to whether a given loan had a market mechanism or was readily convertible to cash. Consequently, the Board was concerned that requiring entities to determine whether either of those requirements was met would result in both diversity of practice and ongoing requests for implementation guidance. Because of those concerns, the Board believed that if that requirement was imposed, the costs that entities could incur would exceed the incremental improvement to financial reporting for banks' lending activities. The Board also observed that the approach in Implementation Issue C13 would limit the need for ongoing implementation guidance because many entities had already developed procedures for its implementation.

A31. During redeliberations, the Board discovered that Implementation Issue C13's use of the phrase *loan commitments that relate to the origination or acquisition of mortgage loans,* specifically the inclusion of the phrase *or acquisition,* caused confusion. That language had been carried forward from Statements 65 and 91. The Exposure Draft and Implementation Issue C13 included the phrase *or acquisition* simply to be consistent with those Statements. However, that phrase was not meant to include commitments to purchase or sell existing loans in the scope exception of paragraph 10(i).

A32. The Board affirmed its intent that commitments to purchase or sell existing loans are not included in the new paragraph 10(i) scope exception and that the definition of a derivative in Statement 133 should be applied to those commitments to determine if they are subject to the provisions of Statement 133. The Board noted that both parties to those contracts need to evaluate the commitment. To clarify this point, the Board decided to remove the references to *acquiring loans* that were in the proposed amendment to Statement 133 and Implementation Issue C13 and amend Statements 65 and 91 to indicate that those Statements should not be applied to fees and costs related to commitments to purchase or sell loans that are accounted for as derivatives under Statement 133. The Board also affirmed that commitments to originate nonmortgage loans are exempt from Statement 133 and that the accounting by the issuer of a commitment to issue nonmortgage loans should not be analogized to in the accounting for mortgage loans because that accounting was based on specialized accounting and reporting principles that were developed specifically for mortgage banking activities.

A33. Paragraph 10(i) of Statement 133 therefore provides a scope exception for holders (the potential borrowers) of all commitments to originate loans, issuers of commitments to originate other than mortgage loans, and issuers of commitments to originate mortgage loans that will be

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held for investment. However, with respect to issuers of commitments to originate loans that will be held for resale under Statement 65, the Board concluded that those commitments should be accounted for by issuers as derivatives under Statement 133. Paragraph 35 of this Statement amends Statement 65 to exclude from the scope of that Statement any loan commitments that are required to be accounted for as derivatives by the issuer (that is, the potential lender) under Statement 133. Paragraph 36 of this Statement amends Statement 91 to exclude from the scope of that Statement any fees and costs related to commitments to sell or purchase loans that are accounted for as derivatives under Statement 133. In addition, paragraph 38 of this Statement amends FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities,* to indicate that certain disclosures about the fair value of financial instruments would continue to be optional for a nonpublic entity that holds loan commitments to originate mortgage loans to be held for sale that are considered derivatives under Statement 133.

Amendment of Paragraphs 13(b) and 61(f)

A34. Paragraph 61(f) of Statement 133 states that interest rate caps that are at or above the current market price (or rate) and interest rate floors that are at or below the current market price (or rate) at issuance of an instrument are considered to be clearly and closely related to the debt host. The last sentence of that paragraph references paragraph 13(b) of Statement 133 and states that the derivative embedded in a variable-rate debt instrument that has a floor on the interest rate would not be separated from the host contract and accounted for separately even though, in a falling interest rate environment, the debt instrument may have a return to the investor that is significantly above the market return of a debt instrument without a floor provision. Constituents' views differed on the application of paragraph 61(f). Some constituents said that any embedded floor or cap that is in-the-money must be accounted for separately. Other constituents said that an embedded floor would never be accounted for separately.

A35. To clarify this issue, the Board decided to modify paragraph 61(f) to indicate that interest rate floors and caps are typically considered clearly and closely related to a debt host. However, determining whether any floor or cap is considered clearly and closely related depends on the analysis required in paragraph 13 for embedded derivative instruments in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract.

A36. Constituents' views differed on the application of paragraph 13(b) in the context of an interest rate cap or an interest rate floor. Prior to this amendment, paragraph 13(b) indicated that if an embedded derivative could at least double the investor's initial rate of return on the host contract *and* could also result in a rate of return that is at least twice what otherwise would be the *market return* for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality, the embedded derivative would not be clearly and closely related to the host contract. Some constituents interpreted paragraph 13(b) to indicate that the two conditions in that paragraph were identical.

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A37. As a result of constituent concerns, the Board decided to clarify paragraph 13(b) to indicate that if an embedded derivative could at least double the investor's initial rate of return on the host contract and at the same time result in a rate of return that is at least twice what otherwise would be the *then-current market return* for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer's credit quality at inception, the embedded derivative is not clearly and closely related to the debt host contract. In other words, application of paragraph 13(b) requires first that the embedded derivative could, considering all possible interest rate scenarios, at least double the investor's initial rate of return on a contract that did not contain the embedded derivative. When that condition is met, the embedded derivative is not considered clearly and closely related if, for any of those possible scenarios in which the investor's initial rate of return is at least doubled, the rate of return the investor will obtain in the future on the host contract is at least twice the then-current market return for that contract.

Amendments Relating to Reporting Cash Flows

A38. This Statement adds a requirement to report all cash flows associated with a derivative that contains an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract), as cash flows from financing activities in the statement of cash flows as opposed to reporting only the cash flows related to a financing element of a derivative as a financing activity. The Board acknowledged that a derivative containing an other-than-insignificant financing element is already shown on the balance sheet. Even so, the Board believes that transparency would be improved by focusing on the cash flows associated with those derivatives.

A39. Two characteristics often are associated with a derivative that contains a financing element—up-front cash payments and off-market terms (for example, terms, rates, or prices that are not consistent with the current market for that type of contract). The Board agreed that those characteristics indicate that the derivative contains a financing element at inception. However, the Board chose not to establish a specific criterion for when a derivative does or does not contain a financing element because of the unlimited ways to structure those arrangements. Rather, identification of a financing element should be based on the specific facts and circumstances. The Board decided that the presence of only an insignificant financing element at inception does not warrant modifying the entity's cash flow reporting. However, when an other-than-insignificant financing element is present at inception, the borrower in the arrangement should report all of the derivative's cash inflows and outflows as a financing activity in the statement of cash flows. The Board noted that while it may be conceptually preferable to report only those cash flows associated with the financing element as a financing activity in the statement of cash flows, identifying those cash flows would be difficult. Therefore, because of cost-benefit concerns, the Board decided to require in those circumstances that all cash inflows and outflows associated with derivatives that contain an

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other-than-insignificant financing element at inception be reported as cash flows from financing activities. As a result, the Board also amended FASB Statement No. 95, *Statement of Cash Flows.* The Board considered whether it should require entities to revise their statements of cash flows retroactively for this change in reporting but decided that retroactive application would be overly burdensome and would not be cost beneficial.

Other Amendments and Clarifications

Amendment to Paragraph 19

A40. Paragraph 19 of Statement 133 was deleted because the guidance in that paragraph was considered unnecessary. For example, it should be readily apparent that the notion of a hedging derivative's change in fair value (gain or loss) for a period is not merely the difference between the beginning fair value and the ending fair value when payments under that derivative have been received or made during the period. In addition, it contained guidance that was not appropriate in all instances. For example, the guidance in paragraph 19 would preclude the changes in a derivative's fair value due to the passage of time from being reported in other comprehensive income when it is used in a cash flow hedge. That consequence was not intended in Statement 133.

Amendment to Paragraph 57(c)(3)

A41. In connection with Statement 133 Implementation Issue No. A14, "Derivative Treatment of Stock Purchase Warrants Issued by a Company for Its Own Shares of Stock Where the Subsequent Sale or Transfer Is Restricted," the Board chose to clarify in paragraph 57(c)(3) that restrictions (whether temporary or permanent) imposed by either party on the sale or transfer of the assets that are received upon exercise of the contract do not affect the determination of whether those assets are readily convertible to cash except as indicated in the following sentence. Stock that is traded in an active market and is to be delivered under a stock purchase warrant is not considered to be readily convertible to cash when both of the following conditions exist: (a) the contract is a stock purchase warrant issued by an entity for its own stock (or stock of its consolidated subsidiaries) and (b) the sale or transfer of the issued shares is restricted (other than in connection with being pledged as collateral) by the issuer for a period of 32 days or more from the date the stock purchase warrant is exercised.

Clarification of the Notion of* Clearly and Closely Related *Used in Paragraphs 10(b), 12(a), and 60

A42. The use of the phrase *clearly and closely related* in the normal purchases and normal sales exception in paragraph 10(b) has a different meaning than it does in paragraphs 12(a) and 60 of Statement 133 that address the relationship between an embedded derivative and the host contract. In that context (paragraphs 12(a) and 60), the phrase focuses on the *economic characteristics and risks* of the embedded derivative and the host contract. In the context of the assessment of whether a contract qualifies for the normal purchase and normal sales exception, the phrase *clearly and closely related* focuses on whether a price adjustment within the contract

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is clearly and closely related to the asset being sold or purchased.

Amendments Relating to the Definition of Expected Cash Flows in Concepts Statement 7

A43. The Board concluded that it was necessary to add footnotes to the term *expected cash flows* in Statements No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* No. 60, *Accounting and Reporting by Insurance Enterprises,* No. 87, *Employers' Accounting for Pensions,* No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* and Statements 35 and 133 because the use of that term in those Statements is not consistent with the definition of *expected cash flows* in the glossary to Concepts Statement 7. In addition to the footnotes added to Statement 133, paragraphs 30–34 of this Statement amend other pronouncements to reflect the fact that because those pronouncements were issued prior to Concepts Statement 7, the term *expected cash flows* does not necessarily have the same meaning as it does in Concepts Statement 7.

Effective Dates and Transition

A44. The Board decided that, except as stated in paragraph A45, this Statement should be effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. In addition, except as stated in paragraph A45, all provisions of this Statement should be applied prospectively. The Board decided not to require retroactive application of this Statement because it concluded that obtaining or developing the information necessary to apply this Statement retroactively could be burdensome for many entities.

A45. The Board chose not to readdress the effective dates of the Statement 133 Implementation Issues referenced in the provisions of paragraphs 6, 7(b), 7(d), 8(a), 9, 13, 14, 17, 19, 21(b), 22(b), and 25(b) of this Statement. It concluded that those effective dates should remain unchanged from those noted in the respective Statement 133 Implementation Issues that were cleared by the Board. However, because Implementation Issues C7 and C13 have been modified in accordance with the decisions made as part of the amendment process, the Board decided that entities should apply the guidance in those issues as revised in this amendment prospectively to contracts entered into after June 30, 2003. In addition, the Board decided that paragraphs 7(a) and 23(a), which relate to forward purchases or sales of when-issued or other securities that do not yet exist, should be applied to both existing contracts and new contracts entered into after June 30, 2003, in order to allow entities that would now meet the regular-way security trades exception to discontinue accounting for those transactions as derivatives.

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

B1. This appendix contains paragraphs of Statement 133, as amended by Statements 138, 140, 141, and 145 marked to integrate changes from this amendment. The Board plans to issue an amended version of Statement 133 that includes the standards section, the implementation guidance (including examples), and the glossary.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Derivative Instruments

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

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

Notwithstanding the above characteristics, loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 21 of FASB Statement No. 65, *Accounting for Mortgage Banking Activities* (as amended), shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). Paragraph 10(i) provides a scope exception for the accounting for loan commitments by issuers of certain commitments to originate loans and all holders of commitments to originate loans (that is, the potential borrowers).

7. *Underlying, notional amount, and payment provision*. An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the

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underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

8. *Initial net investment*. Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for time value (for example, a premium on an option) or for terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price). Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged. A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying. If the initial net investment in the contract (after adjustment for the time value of money) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying or to incur the obligation related to the underlying, the characteristic in paragraph 6(b) is met. The amount of that asset acquired or liability incurred should be comparable to the effective notional amount* of the contract.

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

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

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

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

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a. *"Regular-way" security trades.* Regular-way security trades are contracts ~~with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9(a) and 9(b)). They~~ that provide for delivery of a security within the time generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. However, a contract for an existing security does not qualify for the regular-way security trades exception if it requires or permits net settlement (as discussed in paragraphs 9(a) and 57(c)(1)) or if a market mechanism to facilitate net settlement of that contract (as discussed in paragraphs 9(b) and 57(c)(2)) exists, except as provided in the following sentence. If an entity is required to account for a contract to purchase or sell an existing security on a trade-date basis, rather than a settlement-date basis, and thus recognizes the acquisition (or disposition) of the security at the inception of the contract, then the entity shall apply the regular-way security trades exception to that contract. A contract for the purchase or sale of *when-issued* securities or other securities that do not yet exist is addressed in paragraph 59(a).

b. *Normal purchases and normal sales*. Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. ~~However, contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that meets neither of the criteria in paragraphs 15(a) and 15(b) shall not be considered normal purchases and normal sales.~~ The following guidance should be considered in determining whether a specific type of contract qualifies for the normal purchases and normal sales exception:

(1) *Forward contracts (non-option-based contracts).* Forward contracts are eligible to qualify for the normal purchases and normal sales exception. However, forward ~~C~~contracts that contain net settlement provisions as described in either paragraph~~s~~ 9(a) ~~and~~or paragraph 9(b) are not eligible ~~may qualify~~ for the normal purchases and normal sales exception unless~~if~~ it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery.* Net settlement (as described in paragraphs 9(a) and 9(b)) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses or are otherwise settled net on a periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for this exception.

(2) *Freestanding option contracts*. Option contracts that would require delivery of the related asset at an established price under the contract only if exercised are not eligible to qualify for the normal purchases and normal sales exception, except as indicated in paragraph 10(b)(4) below.

(3) *Forward contracts that contain optionality features.* Forward contracts that contain

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optionality features that do not modify the quantity of the asset to be delivered under the contract are eligible to qualify for the normal purchases and normal sales exception. Except for power purchase or sales agreements addressed in paragraph 10(b)(4), if an option component permits modification of the quantity of the assets to be delivered, the contract is not eligible for the normal purchases and normal sales exception, unless the option component permits the holder only to purchase or sell additional quantities at the market price at the date of delivery. In order for forward contracts that contain optionality features to qualify for the normal purchases and normal sales exception, the criteria discussed in paragraph 10(b)(1) must be met.

(4) *Power purchase or sales agreements.* Not withstanding the criteria in paragraphs 10(b)(1) and 10(b)(3), a power purchase or sales agreement (whether a forward contract, option contract, or a combination of both) that is a **capacity contract** also qualifies for the normal purchases and normal sales exception if it meets the criteria in paragraph 58(b).

However, contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that meets ~~neither~~none of the criteria in paragraphs 15(a) ~~and 15(b)~~ –15(d) shall not be considered normal purchases and normal sales. For contracts that qualify for the normal purchases and normal sales exception, the entity shall document the designation of the contract as a normal purchase or normal sale. For contracts that qualify for the normal purchases and normal sales exception under paragraphs 10(b)(1) and 10(b)(3), the entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery. For contracts that qualify for the normal purchases and normal sales exception under paragraph 10(b)(4), the entity shall document the basis for concluding that the agreement meets the criteria in paragraph 58(b). The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract. Failure to comply with the documentation requirements precludes application of the normal purchases and normal sales exception to contracts that would otherwise qualify for that exception.

c. *Certain insurance contracts.* Generally, contracts of the type that are within the scope of FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises,* No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* are not subject to the requirements of this Statement whether or not they are written by insurance enterprises. That is, a contract is not subject to the requirements of this Statement if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. The following types of contracts written by insurance enterprises or held by the insureds are not subject to the requirements of this Statement for the reasons given:

(1) *Traditional life insurance contracts.* The payment of death benefits is the result of an

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identifiable insurable event (death of the insured) instead of changes in a variable.

(2) *Traditional property and casualty contracts.* The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.

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

d. ~~*Certain* *F~~*inancial guarantee contracts.* Financial guarantee contracts are not subject to this Statement only if:

(1) ~~t~~They provide for payments to be made ~~only~~solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations under a nonderivative contract, either at pre-specified payment dates or accelerated payment dates as a result of the occurrence of an event of default (as defined in the financial obligation covered by the guarantee contract) or notice of acceleration being made to the debtor by the creditor.

(2) Payment under the financial guarantee contract is made only if the debtor's obligation to make payments as a result of conditions as described in (1) above is past due.

(3) The guaranteed party is, as a precondition in the contract (or in the back-to-back arrangement, if applicable) for receiving payment of any claim under the guarantee, exposed to the risk of nonpayment both at inception of the financial guarantee contract and throughout its term either through direct legal ownership of the guaranteed obligation or through a back-to-back arrangement with another party that is required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation.~~a loss incurred because the debtor fails to pay when payment is due, which is an identifiable insurable event .~~

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

e. *Certain contracts that are not traded on an exchange.* Contracts that are not exchange-traded are not subject to the requirements of this Statement if the underlying on which the settlement is based is one of the following:

(1) A climatic or geological variable or other physical variable

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

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

If a contract has more than one underlying and some, but not all, of them qualify for one of the exceptions in paragraphs 10(e)(1), 10(e)(2), and 10(e)(3), the application of this

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Statement to that contract depends on its predominant characteristics. That is, the contract is subject to the requirements of this Statement if all of its underlyings, considered in combination, behave in a manner that is highly correlated with the behavior of any of the component variables that do not qualify for an exception.

f. *Derivatives that serve as impediments to sales accounting.* A derivative instrument (whether freestanding or embedded in another contract) whose existence serves as an impediment to recognizing a related contract as a sale by one party or a purchase by the counterparty is not subject to this Statement. For example, the existence of a guarantee of the residual value of a leased asset by the lessor may be an impediment to treating a contract as a sales-type lease, in which case the contract would be treated by the lessor as an operating lease. Another example is the existence of a call option enabling a transferor to repurchase transferred assets that is an impediment to sales accounting under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

g. *Investments in life insurance.* A policyholder's investment in a life insurance contract that is accounted for under FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance,* is not subject to this Statement. The exception in this subparagraph affects only the accounting by the policyholder; it does not affect the accounting by the issuer of the life insurance contract.

h. *Certain investment contracts.* A contract that is accounted for under either paragraph 4 of FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts,* or paragraph 12 of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* as amended by Statement 110, is not subject to this Statement. Similarly, a contract that is accounted for under either paragraph 4 or paragraph 5 of AICPA Statement of Position 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans,* is not subject to this Statement. Those exceptions apply only to the party that accounts for the contract under Statement 35, Statement 110, or SOP 94-4.

i. *Loan commitments.* The holder of any commitment to originate a loan (that is, the potential borrower) is not subject to the requirements of this Statement. Issuers of commitments to originate mortgage loans that will be held for investment purposes, as discussed in paragraphs 21 and 25 of Statement 65, are not subject to this Statement. In addition, issuers of loan commitments to originate other types of loans (that is, other than mortgage loans) are not subject to the requirements of this Statement.

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

a. The hybrid instrument can contractually be settled in such a way that the investor (holder) would not recover *substantially all* of its initial recorded investment.*

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b. The embedded derivative meets both of the following conditions:
   (1) There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would~~could~~ at least double the investor's initial rate of return on the host contract.
   (2) For each of the possible interest rate scenarios under which the investor's initial rate of return on the host contract would be doubled (as discussed under paragraph 13(b)(1)), the embedded derivative would at the same time~~and could also~~ result in a rate of return that is at least twice what otherwise would be the then-current market return (under each of those future interest rate scenarios) for a contract that has the same terms as the host contract and that involves a debtor with a ~~similar~~ credit quality similar to the issuer's credit quality at inception.

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

15. An embedded foreign currency derivative instrument shall *not* be separated from the host contract and considered a derivative instrument under paragraph 12 if the host contract is not a financial instrument and it requires payment(s) denominated in (a) the functional currency of ~~the primary economic environment in which~~ any substantial party to that contract, ~~operates (that is, its functional currency) or~~ (b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions),* (c) the local currency of any substantial party to the contract, or (d) the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary (as discussed in paragraph 11 of Statement 52). The evaluation of whether a contract qualifies for the exception in this paragraph should be performed only at inception of the contract. Unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both denominated in a foreign currency are subject to the requirement in Statement 52 to recognize any foreign currency transaction gain or loss in earnings and shall not be considered to contain embedded foreign currency derivative instruments under this Statement. The same proscription applies to available-for-sale or trading securities that have cash flows denominated in a foreign currency.

Recognition of Derivatives and Measurement of Derivatives and Hedged Items

17. An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights or obligations under the contracts.

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

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

Fair Value Hedges

General

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

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

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

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

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

The Hedged Item

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

a. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment.[8] The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof).
   (1) If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent.

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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.[9]

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

(a) A percentage of the entire asset or liability (or of the entire portfolio)

(b) One or more selected contractual cash flows (such as the portion of the asset or liability representing the present value of the interest payments in the first two years of a four-year debt instrument)

(c) A put option~~,~~ or ~~a~~ call option~~,~~ (including an interest rate or price cap~~,~~ or 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

(d) The residual value in a lessor's net investment in a direct financing or sales-type lease.

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

b. The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings. The reference to affecting reported earnings does not apply to an entity that does not report earnings as a separate caption in a statement of financial performance, such as a not-for-profit organization, as discussed in paragraph 43.

c. The hedged item is not (1) an asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings, (2) an investment accounted for by the equity method in accordance with the requirements of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* (3) a minority interest in one or more consolidated subsidiaries, (4) an equity investment in a consolidated subsidiary, (5) a firm commitment either to enter into a business combination or to acquire or dispose of a subsidiary, a minority interest, or an equity method investee, or (6) an equity instrument issued by the entity and classified in stockholders' equity in the statement of financial position.

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

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security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component. (The designated hedged risk for a held-to-maturity security may not be the risk of changes in its fair value attributable to interest rate risk. If the hedged item is other than an option component that permits its prepayment, the designated hedged risk also may not be the risk of changes in its overall fair value.)

e. If the hedged item is a nonfinancial asset or liability (other than a recognized loan servicing right or a nonfinancial firm commitment with financial components), the designated risk being hedged is the risk of changes in the fair value of the entire hedged asset or liability (reflecting its actual location if a physical asset). That is, the price risk of a similar asset in a different location or of a major ingredient may not be the hedged risk. Thus, in hedging the exposure to changes in the fair value of gasoline, an entity may not designate the risk of changes in the price of crude oil as the risk being hedged for purposes of determining effectiveness of the fair value hedge of gasoline.

f. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is:
   (1) The risk of changes in the overall fair value of the entire hedged item,
   (2) The risk of changes in its fair value attributable to changes in 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) (refer to paragraphs 37, 37A, and 38), or
   (4) The risk of changes in its fair value attributable to both changes in the obligor's creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (referred to as credit risk).

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

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objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of interest rate risk.

Impairment

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

Cash Flow Hedges

General

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

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

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

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

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

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

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

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

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

   That adjustment of accumulated other comprehensive income shall incorporate recognition in other comprehensive income of part or all of the gain or loss on the hedging derivative, as necessary.
c. A gain or loss shall be recognized in earnings, as necessary, for any remaining gain or loss on the hedging derivative or to adjust other comprehensive income to the balance specified in paragraph 30(b) above.
d. If a non-option-based contract is the hedging instrument ~~I~~in a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 15 of Statement 52, an amount that will offset the related transaction gain or loss arising from ~~the~~that remeasurement ~~and adjust earnings for the cost to the purchaser~~

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~~(income to the seller) of the hedging instrument~~ shall be reclassified each period from other comprehensive income to earnings if the assessment of effectiveness and measurement of ineffectiveness are based on total changes in the non-option-based instrument's cash flows. If an option contract is used as the hedging instrument in a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 15 of Statement 52 to provide only one-sided offset against the hedged foreign exchange risk, an amount shall be reclassified each period to or from other comprehensive income with respect to the changes in the underlying that result in a change in the hedging option's intrinsic value. In addition, if the assessment of effectiveness and measurement of ineffectiveness are also based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in fair value—its entire gain or loss), an amount that adjusts earnings for the amortization of the cost of the option on a rational basis shall be reclassified each period from other comprehensive income to earnings.*

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

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

Reporting Cash Flows of Derivative Instruments That Contain Financing Elements

45A. An instrument accounted for as a derivative under this Statement that at its inception includes off-market terms, or requires an up-front cash payment, or both often contains a financing element. Identifying a financing element within a derivative instrument is a matter of judgment that depends on facts and circumstances. If an other-than-insignificant financing element is present at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract),* then the borrower shall report all cash inflows and outflows associated with that derivative instrument in a manner consistent with financing activities as described in paragraphs 18–20 of FASB Statement No. 95, *Statement of Cash Flows*.

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Effective Date and Transition

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

IMPLEMENTATION GUIDANCE

Section 1: Scope and Definition

Application of Paragraphs 6–11

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

a. *Underlying.* An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative. An underlying usually is one or a combination of the following:
   (1) A security price or security price index
   (2) A commodity price or commodity price index
   (3) An interest rate or interest rate index
   (4) A credit rating or credit index
   (5) An exchange rate or exchange rate index

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(6) An insurance index or catastrophe loss index
(7) A climatic or geological condition (such as temperature, earthquake severity, or rainfall), another physical variable, or a related index.

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

b. *Initial net investment.* A derivative requires no initial net investment or a smaller initial net investment than other types of contracts that have a similar response to changes in market factors. For example, entering into a commodity futures contract generally requires no net investment, while purchasing the same commodity requires an initial net investment equal to its market price. However, both contracts reflect changes in the price of the commodity in the same way (that is, similar gains or losses will be incurred). A swap or forward contract also generally does not require an initial net investment unless the terms favor one party over the other. An option generally requires that one party make an initial net investment (a premium) because that party has the rights under the contract and the other party has the obligations. The phrase *initial net investment* is stated from the perspective of only one party to the contract, but it determines the application of the Statement for both parties.[15]

c. *Net settlement.* A contract that meets any one of the following criteria has the characteristic described as net settlement:
(1) Its terms implicitly or explicitly require or permit net settlement. For example, a penalty for nonperformance in a purchase order is a net settlement provision if the amount of the penalty is based on changes in the price of the items that are the subject of the contract. Net settlement may be made in cash or by delivery of any other asset, whether or not it is readily convertible to cash. A fixed penalty for nonperformance is not a net settlement provision.
(2) There is an established market mechanism that facilitates net settlement outside the contract. The term *market mechanism* is to be interpreted broadly. Any institutional arrangement or other agreement that enables either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost is considered net settlement. The evaluation of whether a market mechanism exists and whether items to be delivered under a contract are readily convertible to cash must be performed at inception and on an ongoing basis throughout a contract's life.
(3) It requires delivery of an asset that is readily convertible to cash.* The definition of *readily convertible to cash* in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* includes, for example, a security or commodity traded in an active market and a unit of foreign currency that is readily convertible into the functional currency of the reporting entity. A security that is publicly traded but for which the market is not very active is readily convertible to

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cash if the number of shares or other units of the security to be exchanged is small relative to the daily transaction volume. That same security would not be readily convertible if the number of shares to be exchanged is large relative to the daily transaction volume. The ability to use a security that is not publicly traded or an agricultural or mineral product without an active market as collateral in a borrowing does not, in and of itself, mean that the security or the commodity is readily convertible to cash. Shares of stock in a publicly traded company to be received upon the exercise of a stock purchase warrant do not meet the characteristic of being readily convertible to cash if both of the following conditions exist: (a) the stock purchase warrant is issued by an entity for only its own stock (or stock of its consolidated subsidiaries) and (b) the sale or transfer of the issued shares is restricted (other than in connection with being pledged as collateral) for a period of 32 days or more from the date the stock purchase warrant is exercised. In contrast, restrictions imposed by a stock purchase warrant on the sale or transfer of shares of stock that are received from the exercise of that warrant issued by an entity for *other* than its own stock (whether those restrictions are for more or less than 32 days) do not affect the determination of whether those shares are readily convertible to cash. The accounting for restricted stock to be received upon exercise of a stock purchase warrant should not be analogized to any other type of contract.

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

a. *"Regular-way" security trades*. The exception in paragraph 10(a) applies only to a contract that requires delivery of securities that are readily convertible to cash[16] except (1) as provided in paragraph 59(a) for a contract for the purchase or sale of when-issued securities or other securities that do not yet exist and (2) for contracts that are required to be accounted for on a trade-date basis by the reporting entity. To qualify, a contract must require delivery of such a security within the period of time after the trade date that is customary in the market in which the trade takes place. For example, a contract to purchase or sell a publicly traded equity security in the United States customarily requires settlement within three business days. If a contract for purchase of that type of security requires settlement in three business days, the regular-way security trades exception applies, but if the contract requires settlement in five days, the regular-way security trades exception does not apply unless the reporting entity is required to account for the contract on a trade-date basis. This Statement does not change whether an entity recognizes regular-way security trades on the trade date or the settlement date. ~~However, trades that do not qualify for the regular-way exception are subject to the requirements of this Statement regardless of the method an entity uses to report its security trades.~~
b. *Normal purchases and normal sales.* The exception in paragraph 10(b) applies only to a contract that involves future delivery of assets (other than financial instruments or derivative instruments). To qualify for the exception, a contract's terms also must be consistent with the terms of an entity's normal purchases or normal sales, that is, the quantity purchased or

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sold must be reasonable in relation to the entity's business needs. Determining whether or not the terms are consistent will require judgment. In making those judgments, an entity should consider all relevant factors, such as (1) the quantities provided under the contract and the entity's need for the related assets, (2) the locations to which delivery of the items will be made, (3) the period of time between entering into the contract and delivery, and (4) the entity's prior practices with regard to such contracts. Evidence such as past trends, expected future demand, other contracts for delivery of similar items, an entity's and industry's customs for acquiring and storing the related commodities, and an entity's operating locations should help in identifying contracts that qualify as normal purchases or normal sales. Also, in order for a contract that meets the net settlement provisions of paragraphs 9(a) and 57(c)(1) and the market mechanism provisions of paragraphs 9(b) and 57(c)(2) to qualify for the exception, it must be probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery. Power purchase or sales agreements (whether a forward contract, an option contract, or a combination of both) for the purchase or sale of electricity qualify for the normal purchases and normal sales exception in paragraph 10(b)(4) if all of the following applicable criteria are met:

(1) For both parties to the contract:
   (a) The terms of the contract require physical delivery of electricity. That is, the contract does not permit net settlement, as described in paragraphs 9(a) and 57(c)(1). For an option contract, physical delivery is required if the option contract is exercised.
   (b) The power purchase or sales agreement is a capacity contract.* Differentiating between a capacity contract and a traditional option contract (that is, a financial option on electricity) is a matter of judgment that depends on the facts and circumstances.
(2) For the seller of electricity: The electricity that would be deliverable under the contract involves quantities that are expected to be sold by the reporting entity in the normal course of business.
(3) For the buyer of electricity:
   (a) The electricity that would be deliverable under the contract involves quantities that are expected to be used or sold by the reporting entity in the normal course of business.
   (b) The buyer of the electricity under the power purchase or sales agreement is an entity that is engaged in selling electricity to retail or wholesale customers and is statutorily or otherwise contractually obligated to maintain sufficient capacity to meet electricity needs of its customer base.
   (c) The contracts are entered into to meet the buyer's obligation to maintain a sufficient capacity, including a reasonable reserve margin established by or based on a regulatory commission, local standards, regional reliability councils, or regional transmission organizations.

Power purchase or sales agreements that meet only the above applicable criteria in

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paragraph 58(b) qualify for the normal purchases and normal sales exception even if they are subject to being booked out or are scheduled to be booked out. Forward contracts for the purchase or sale of electricity that do not meet the above applicable criteria are nevertheless eligible to qualify for the normal purchases and normal sales exception by meeting the criteria in paragraph 10(b) other than paragraph 10(b)(4).

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

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

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

a. *Forward purchases or sales* ~~of to-be-announced securities or securities when-issued, as-issued, or if-issued~~*of when-issued securities or other securities that do not yet exist.* ~~A contract for the purchase and sale of a security when, as, or if issued or to be announced is excluded from the requirements of this Statement as a regular-way security trade if~~Contracts for the purchase or sale of when-issued securities or other securities that do not yet exist are excluded from the requirements of this Statement as a regular-way security trade only if (1) there is no other way to purchase or sell that security, ~~and~~ (2) delivery of that security and settlement will occur within the shortest period possible for that type of security, and (3) it is

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probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery of a security when it is issued. A contract for the purchase or sale of when-issued securities or other securities that do not yet exist is eligible to qualify for the regular-way security trades exception even though that contract permits net settlement (as discussed in paragraphs 9(a) and 57(c)(1)) or a market mechanism to facilitate net settlement of that contract (as discussed in paragraphs 9(b) and 57(c)(2)) exists. The entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery. Net settlement (as described in paragraphs 9(a) and 9(b)) of contracts in a group of contracts similarly designated as regular-way security trades would call into question the continued exemption of such contracts. In addition, if an entity is required to account for a contract for the purchase or sale of when-issued securities or other securities that do not yet exist on a trade-date basis, rather than a settlement-date basis, and thus recognizes the acquisition or disposition of the securities at the inception of the contract, that entity shall apply the regular-way security trades exception to those contracts.

b. *Credit-indexed contracts (often referred to as credit derivatives)*. Many different types of contracts are indexed to the creditworthiness of a specified entity or group of entities, but not all of them are derivative instruments. Credit-indexed contracts that have certain characteristics described in paragraph 10(d) are guarantees and are not subject to the requirements of this Statement. Credit-indexed contracts that do not have the characteristics necessary to qualify for the exception in paragraph 10(d) are subject to the requirements of this Statement. One example of the latter is a credit-indexed contract that requires a payment due to changes in the creditworthiness of a specified entity even if neither party incurs a loss due to the change (other than a loss caused by the payment under the credit-indexed contract).

c. *Take-or-pay contracts*. Under a take-or-pay contract, an entity agrees to pay a specified price for a specified quantity of a product whether or not it takes delivery. Whether a take-or-pay contract is subject to this Statement depends on its terms.* For example, if the product to be delivered is not readily convertible to cash and there is no net settlement option, the contract fails to meet the criterion in paragraph 6(c) and is not subject to the requirements of this Statement. However, a contract that meets all of the following conditions is subject to the requirements of this Statement: (1) the product to be delivered is readily convertible to cash, (2) the contract does not qualify for the normal purchases and normal sales exception in paragraph 10(b), and (3) ~~little or no initial net investment in the contract is required~~ the contract requires no initial net investment or an initial net investment that is smaller by more than a nominal amount than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. (Refer to paragraph 8.)

d. *Short sales (sales of borrowed securities)*.[18] Short sales typically involve the following activities:
   (1) Selling a security (by the short seller to the purchaser)
   (2) Borrowing a security (by the short seller from the lender)
   (3) Delivering the borrowed security (by the short seller to the purchaser)

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(4) Purchasing a security (by the short seller from the market)
(5) Delivering the purchased security (by the short seller to the lender).

Those five activities involve three separate contracts. A contract that distinguishes a short sale involves activities (2) and (5), borrowing a security and replacing it by delivering an identical security. Such a contract has two of the three characteristics of a derivative instrument. The settlement is based on an underlying (the price of the security) and a notional amount (the face amount of the security or the number of shares), and the settlement is made by delivery of a security that is readily convertible to cash. However, the other characteristic, ~~little or~~ no initial net investment or an initial net investment that is smaller by more than a nominal amount than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, is not present. (Refer to paragraph 8.) The borrowed security is the lender's initial net investment in the contract. Consequently, the contract relating to activities (2) and (5) is not a derivative instrument. The other two contracts (one for activities (1) and (3) and the other for activity (4)) are routine and do not generally involve derivative instruments. However, if a forward purchase or sale is involved, and the contract does not qualify for the exception in paragraph 10(a), it is subject to the requirements of this Statement.

e. *Repurchase agreements and "wash sales"* (accounted for as sales as described in paragraphs 98 and 99 of Statement 140). A transfer of financial assets accounted for as a sale under Statement 140 in which the transferor is both obligated and entitled to repurchase the transferred asset at a fixed or determinable price contains two separate features, one of which may be a derivative. The initial exchange of financial assets for cash is a sale-purchase transaction—generally not a transaction that involves a derivative instrument. However, the accompanying forward contract that gives the transferor the right and obligation to repurchase the transferred asset involves an underlying and a notional amount (the price of the security and its denomination), and it does not require an initial net investment in the contract. Consequently, if the forward contract requires delivery of a security that is readily convertible to cash or otherwise meets the net settlement criterion in paragraph 9, it is subject to the requirements of this Statement.

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

a. *Interest rate indexes.* An embedded derivative in which the underlying is an interest rate or interest rate index and a host contract that is considered a debt instrument are considered to be clearly and closely related unless, as discussed in paragraph 13, the embedded derivative contains a provision that (1) permits any possibility whatsoever that the investor's (or creditor's) undiscounted net cash inflows over the life of the instrument would not recover substantially all of its initial recorded investment in the hybrid instrument under its contractual terms or (2) could under any possibility whatsoever at least double the investor's initial rate of return on the host contract and ~~also~~at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return for a contract

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that has the same terms as the host contract and that involves a debtor with a similar credit quality. The requirement to separate the embedded derivative from the host contract applies to *both parties* to the hybrid instrument even though the above tests focus on the investor's net cash inflows. Plain-vanilla servicing rights, which involve an obligation to perform servicing and the right to receive fees for performing that servicing, do not contain an embedded derivative that would be separated from those servicing rights and accounted for as a derivative.

b. *Inflation-indexed interest payments.* The interest rate and the rate of inflation in the economic environment for the currency in which a debt instrument is denominated are considered to be clearly and closely related. Thus, nonleveraged inflation-indexed contracts (debt instruments, capitalized lease obligations, pension obligations, and so forth) would *not* have the inflation-related embedded derivative separated from the host contract.

c. *Credit-sensitive payments.* The creditworthiness of the debtor and the interest rate on a debt instrument are considered to be clearly and closely related. Thus, for debt instruments that have the interest rate reset in the event of (1) default (such as violation of a credit-risk-related covenant), (2) a change in the debtor's published credit rating, or (3) a change in the debtor's creditworthiness indicated by a change in its spread over Treasury bonds, the related embedded derivative would *not* be separated from the host contract.

d. *Calls and puts on debt instruments.* Call options (or put options) that can accelerate the repayment of principal on a debt instrument are considered to be clearly and closely related to a debt instrument that requires principal repayments unless both (1) the debt involves a substantial premium or discount (which is common with zero-coupon bonds) and (2) the put or call option is only contingently exercisable, provided the call options (or put options) are also considered to be clearly and closely related to the debt host contract under paragraph 13. Thus, if a substantial premium or discount is not involved, embedded calls and puts (including contingent call or put options that are not exercisable unless an event of default occurs) would *not* be separated from the host contract. However, for contingently exercisable calls and puts to be considered clearly and closely related, they can be indexed only to interest rates or credit risk, not some extraneous event or factor. In contrast, call options (or put options) that do not accelerate the repayment of principal on a debt instrument but instead require a cash settlement that is equal to the price of the option at the date of exercise would *not* be considered to be clearly and closely related to the debt instrument in which it is embedded ~~and would be separated from the host contract~~.

e. *Calls and puts on equity instruments.* A put option that enables the holder to require the issuer of an equity instrument to reacquire that equity instrument for cash or other assets is *not* clearly and closely related to that equity instrument. Thus, such a put option embedded in a publicly traded equity instrument to which it relates should be separated from the host contract by the holder of the equity instrument if the criteria in paragraphs 12(b) and 12(c) are also met. That put option also should be separated from the host contract by the issuer of the equity instrument except in those cases in which the put option is not considered to be a derivative instrument pursuant to paragraph 11(a) because it is classified in stockholders' equity. A purchased call option that enables the issuer of an equity instrument (such as common stock) to reacquire that equity instrument would not be considered to be a

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derivative instrument by the issuer of the equity instrument pursuant to paragraph 11(a). Thus, if the call option were embedded in the related equity instrument, it would not be separated from the host contract by the issuer. However, for the holder of the related equity instrument, the embedded written call option would *not* be considered to be clearly and closely related to the equity instrument and, if the criteria in paragraphs 12(b) and 12(c) were met, should be separated from the host contract.

f. *Interest rate ~~F~~floors, caps, and collars.* Floors or caps (or collars, which are combinations of caps and floors) on interest rates and the interest rate on a debt instrument are considered to be clearly and closely related~~,~~ unless the conditions in either paragraph 13(a) or paragraph 13(b) are met, in which case the floors or the caps are not considered to be clearly and closely related.~~provided the cap is at or above the current market price (or rate) and the floor is at or below the current market price (or rate) at issuance of the instrument. Thus, the derivative embedded in a variable-rate debt instrument that has a floor on the interest rate (that is, the floor option) would not be separated from the host contract and accounted for separately even though, in a falling interest rate environment, the debt instrument may have a return to the investor that is a significant amount above the market return of a debt instrument without the floor provision (refer to paragraph 13(b)).~~

g. *Term-extending options.* An embedded derivative provision that either (1) unilaterally enables one party to extend significantly the remaining term to maturity or (2) automatically extends significantly the remaining term triggered by specific events or conditions is *not* clearly and closely related to the interest rate on a debt instrument unless the interest rate is concurrently reset to the approximate current market rate for the extended term and the debt instrument initially involved no significant discount. Thus, if there is no reset of interest rates, the embedded derivative is not clearly and closely related to ~~must be separated from~~ the host contract~~ and accounted for as a derivative instrument~~. That is, a term-extending option cannot be used to circumvent the restriction in paragraph 61(a) regarding the investor's not recovering substantially all of its initial recorded investment.

h. *Equity-indexed interest payments.* The changes in fair value of an equity interest and the interest yield on a debt instrument are *not* clearly and closely related. Thus, an equity-related derivative embedded in an equity-indexed debt instrument (whether based on the price of a specific common stock or on an index that is based on a basket of equity instruments) must be separated from the host contract and accounted for as a derivative instrument.

i. *Commodity-indexed interest or principal payments.* The changes in fair value of a commodity (or other asset) and the interest yield on a debt instrument are *not* clearly and closely related. Thus, a commodity-related derivative embedded in a commodity-indexed debt instrument must be separated from the noncommodity host contract and accounted for as a derivative instrument.

j. *Indexed rentals:*

   (1) *Inflation-indexed rentals.* Rentals for the use of leased assets and adjustments for inflation on similar property are considered to be clearly and closely related. Thus, unless a significant leverage factor is involved, the inflation-related derivative embedded in an inflation-indexed lease contract would *not* be separated from the host

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contract.

(2) *Contingent rentals based on related sales.* Lease contracts that include contingent rentals based on certain sales of the lessee would *not* have the contingent-rental-related embedded derivative separated from the host contract because, under paragraph 10(e)(3), a non-exchange-traded contract whose underlying is specified volumes of sales by one of the parties to the contract would not be subject to the requirements of this Statement.

(3) *Contingent rentals based on a variable interest rate.* The obligation to make future payments for the use of leased assets and the adjustment of those payments to reflect changes in a variable-interest-rate index are considered to be clearly and closely related. Thus, lease contracts that include contingent rentals based on changes in the prime rate would *not* have the contingent-rental-related embedded derivative separated from the host contract.

k. *Convertible debt.* The changes in fair value of an equity interest and the interest rates on a debt instrument are not clearly and closely related. Thus, for a debt security that is convertible into a specified number of shares of the debtor's common stock or another entity's common stock, the embedded derivative (that is, the conversion option) must be separated from the debt host contract and accounted for as a derivative instrument provided that the conversion option would, as a freestanding instrument, be a derivative instrument subject to the requirements of this Statement. (For example, if the common stock was not readily convertible to cash, a conversion option that requires purchase of the common stock would not be accounted for as a derivative.) That accounting applies only to the holder (investor) if the debt is convertible to the debtor's common stock because, under paragraph 11(a), a separate option with the same terms would not be considered to be a derivative for the issuer.

l. *Convertible preferred stock.* Because the changes in fair value of an equity interest and interest rates on a debt instrument are not clearly and closely related, the terms of the preferred stock (other than the conversion option) must be analyzed to determine whether the preferred stock (and thus the potential host contract) is more akin to an equity instrument or a debt instrument. A typical cumulative fixed-rate preferred stock that has a mandatory redemption feature is more akin to debt, whereas cumulative participating perpetual preferred stock is more akin to an equity instrument.

Section 2: Assessment of Hedge Effectiveness

Hedge Effectiveness Requirements of This Statement

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

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from reinvestment (or funding) of daily settlement gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows† when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

65. Whether a hedging relationship qualifies as highly effective sometimes will be easy to assess, and there will be no ineffectiveness to recognize in earnings during the term of the hedge. If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be highly effective and that there will be no ineffectiveness to be recognized in earnings if:

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

Assuming No Ineffectiveness in a Hedge with an Interest Rate Swap

68. An assumption of no ineffectiveness is especially important in a hedging relationship involving an interest-bearing financial instrument and an interest rate swap because it significantly simplifies the computations necessary to make the accounting entries. An entity may assume no ineffectiveness in a hedging relationship of interest rate risk involving a recognized 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) if all of the applicable conditions in the following list are met:

Conditions applicable to both fair value hedges and cash flow hedges

a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged.
b. If the hedging instrument is solely an interest rate swap, ~~T~~the fair value of ~~the~~that swap at the inception of the hedging relationship is zero. 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

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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.

c. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)

d. The interest-bearing asset or liability is not prepayable (that is, able to be settled by either party prior to its scheduled maturity), except as indicated in the following sentences. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option provided that the hedging instrument is a compound derivative composed of an interest rate swap ~~contains~~ and a ~~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 instrument is a compound derivative composed of an interest rate swap ~~contains~~ and a ~~embedded~~ mirror-image put option.

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

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

Conditions applicable to fair value hedges only

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

g. There is no floor or ~~ceiling~~cap on the variable interest rate of the swap.

h. The interval between repricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).

Conditions applicable to cash flow hedges only

i. All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged.

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j. There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap's variable rate is LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the asset.)
k. The repricing dates match those of the variable-rate asset or liability.

Assessing the hedge's expected effectiveness and measuring ineffectiveness

94. Company G bases its assessment of hedge effectiveness and measure of ineffectiveness on changes in forward prices, with the resulting gain or loss discounted to reflect the time value of money. Because of the difference in the bases of the forecasted transaction (Brazilian coffee) and forward contract (Colombian coffee), Company G may not assume that the hedge will automatically be highly effective in achieving offsetting cash flows. Both at inception and on an ongoing basis, Company G could assess the effectiveness of the hedge by comparing changes in the expected cash flows† from the Colombian coffee forward contract with the expected net change in cash outflows for purchasing the Brazilian coffee for different market prices. (A simpler method that should produce the same results would consider the expected future correlation of the prices of Brazilian and Colombian coffee, based on the correlation of those prices over past six-month periods.)

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

96. Because the only difference between the forward contract and forecasted purchase relates to the type of coffee (Colombian versus Brazilian), Company G could consider the changes in the cash flows on a forward contract for Brazilian coffee to be a measure of perfectly offsetting changes in cash flows for its forecasted purchase of Brazilian coffee. For example, for given changes in the U.S. dollar prices of six-month and three-month Brazilian and Colombian contracts, Company G could compute the effect of a change in the price of coffee on the expected cash flows† of its forward contract on Colombian coffee and of a forward contract for Brazilian coffee as follows:

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

97. Using the above amounts, Company G could evaluate effectiveness 3 months into the hedge by comparing the $45,000 change on its Colombian coffee contract with what would have been a perfectly offsetting change in cash flow for its forecasted purchase—the $50,000 change on an otherwise identical forward contract for Brazilian coffee. The hedge would be ineffective to the extent that there was a difference between the changes in the present value of the expected cash flows† on (a) the company's Colombian coffee contract and (b) a comparable forward contract for Brazilian coffee (the equivalent of the present value of $5,000 in the numerical example).

Assessing the hedge's expected effectiveness and measuring ineffectiveness

99. Company H may not automatically assume that the hedge always will be highly effective at achieving offsetting changes in cash flows because the reset date on the receive leg of the swap differs from the reset date on the corresponding variable-rate liability. Both at hedge inception and on an ongoing basis, the company's assessment of expected effectiveness could be based on the extent to which changes in LIBOR have occurred during comparable 10-day periods in the past. Company H's ongoing assessment of expected effectiveness and measurement of actual ineffectiveness would be on a cumulative basis and would incorporate the actual interest rate changes to date. The hedge would be ineffective to the extent that the cumulative change in cash flows on the prime leg of the swap did not offset the cumulative change in expected cash flows† on the asset, *and* the cumulative change in cash flows on the LIBOR leg of the swap did not offset the change in expected cash flows on the hedged portion of the liability. The terms of the swap, the asset, and the portion of the liability that is hedged are

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the same, with the exception of the reset dates on the liability and the receive leg of the swap. Thus, the hedge will only be ineffective to the extent that LIBOR has changed between the first of the month (the reset date for the swap) and the tenth of the month (the reset date for the liability).

EXAMPLES ILLUSTRATING APPLICATION OF THIS STATEMENT

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

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

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

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

Background

154. MNO Company enters into an interest rate swap (Swap 1) and designates it as a hedge of the variable quarterly interest payments on the company's 5-year $5 million borrowing program, initially expected to be accomplished by a series of $5 million notes with 90-day terms. MNO plans to continue issuing new 90-day notes over the next 5 years as each outstanding note matures. The interest on each note will be determined based on LIBOR at the time each note is issued. Swap 1 requires a settlement every 90 days, and the variable interest rate is reset immediately following each payment. MNO pays a fixed rate of interest (6.5 percent) and receives interest at LIBOR. MNO neither pays nor receives a premium at the inception of Swap 1. The notional amount of the contract is $5 million, and it expires in 5 years.

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

176. The following examples in Section 2 discuss instruments that contain a variety of embedded derivative instruments. They illustrate how the provisions of paragraphs 12–16 of this Statement would be applied to contracts with the described terms. If the terms of a contract are different from the described terms, the application of this Statement by either party to the contract may be affected. Furthermore, if any contract of the types discussed in Section 2 meets the definition of a derivative instrument in its entirety under paragraphs 6-9 and related paragraphs, the guidance in this section for the application of the provisions of paragraphs 12-16 to embedded derivative instruments does not apply. The illustrative instruments and related assumptions in Examples 12–27 are based on examples in Exhibit 96-12A of EITF Issue No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structured Notes."

GLOSSARY

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

Benchmark interest rate

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

In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the

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benchmark interest rate may be an interbank offered rate. In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government and, for practical reasons, the LIBOR swap rate are considered to be benchmark interest rates. In each financial market, only the one or two most widely used and quoted rates that meet the above criteria may be considered benchmark interest rates.

Capacity contract

An agreement by an owner of capacity to sell the right to that capacity to another party so that it can satisfy its obligations. For example, in the electric industry, capacity (sometimes referred to as installed capacity) is the capability to deliver electric power to the electric transmission system of an operating control area. A control area is a portion of the electric grid that schedules, dispatches, and controls generating resources to serve area load (ultimate users of electricity) and coordinates scheduling of the flow of electric power over the transmission system to neighboring control areas. A control area requires entities that serve load within the control area to demonstrate ownership or contractual rights to capacity sufficient to serve that load at time of peak demand and to provide a reserve margin to protect the integrity of the system against potential generating unit outages in the control area.

Comprehensive income

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

Derivative instrument

Refer to paragraphs 6–9.

Fair value

The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times that market price. If a quoted market price is not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using discount rates commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for

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measuring assets and liabilities should be consistent with the objective of measuring fair value. Those techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring forward contracts, such as foreign currency forward contracts, at fair value by discounting estimated future cash flows, an entity should base the estimate of future cash flows on the changes in the forward rate (rather than the spot rate). In measuring financial liabilities and nonfinancial derivatives that are liabilities at fair value by discounting estimated future cash flows (or equivalent outflows of other assets), an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

Financial instrument

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

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

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

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

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

Firm commitment

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

a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be

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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.

LIBOR swap rate

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

Notional amount

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

Underlying

A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

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Footnotes

FAS133 Footnote 3—Sometimes other names are used. For example, the notional amount is called a face amount in some contracts.

FAS133 Footnote 4—The terms *underlying, notional amount, payments provision,* and *settlement* are intended to include the plural forms in the remainder of this Statement. Including both the singular and plural forms used in this paragraph is more accurate but much more awkward and impairs the readability.

FAS 133, Paragraph 8, Footnote *—The effective notional amount is the stated notional amount adjusted for any leverage factor.

FAS133, Footnote 5--FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* states that assets that are readily convertible to cash "have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price" (paragraph 83(a)). For contracts that involve multiple deliveries of the asset, the phrase *in an active market that can rapidly absorb the quantity held by the entity* should be applied separately to the expected quantity in each delivery.

FAS133, Paragraph 10, Footnote *—Contracts that are subject to unplanned netting (referred to as a "book out" in the electricity utility industry) do not qualify for this exception except as specified in paragraph 58(b).

FAS133, Footnote 6--Examples are an interest rate cap or an interest rate collar. An embedded derivative instrument that alters net interest payments based on changes in a stock price index (or another non-interest-rate index) is not addressed in paragraph 13.

FAS133, Paragraph 13, Footnote *—The condition in paragraph 13(a) does not apply to a situation in which the terms of a hybrid instrument permit, but do not require, the investor to settle the hybrid instrument in a manner that causes it not to recover substantially all of its initial recorded investment, provided that the issuer does not have the contractual right to demand a settlement that causes the investor not to recover substantially all of its initial net investment.

FAS133, Paragraph 15, Footnote *—If similar transactions for a certain product or service are routinely denominated in international commerce in various different currencies, the transaction does not qualify for the exception.

FAS133, Paragraph 17, Footnote *—This Statement was issued prior to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* and therefore the term *expected cash flows* does not necessarily have the same meaning as that term does in Concepts Statement 7.

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FAS148, Footnote 7--The reference to *combined instruments* refers to the written option and the hedged item, such as an embedded purchased option.

FAS133, Footnote 8--A firm commitment (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.

FAS148, Footnote 9--Mortgage bankers and other servicers of financial assets that designate a hedged portfolio by aggregating servicing rights within one or more risk strata used under paragraph 63(g) of Statement 140 would not necessarily comply with the requirement in this paragraph for portfolios of similar assets. The risk stratum under paragraph 63(g) of Statement 140 can be based on any predominant risk characteristic, including date of origination or geographic location.

FAS133, Paragraph 21, Footnote *—The first sentence of paragraph 21(a) that specifically permits the hedged item to be identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment is not affected by the provisions in this subparagraph.

FAS133, Paragraph 27, Footnote †—Refer to footnote* to paragraph 17 of Statement 133.

FAS133 Footnote 10--For purposes of paragraphs 28–35, the individual cash flows related to a recognized asset or liability and the cash flows related to a forecasted transaction are both referred to as a *forecasted transaction* or *hedged transaction*.

FAS133, Paragraph 30, Footnote *—The guidance in this subparagraph is limited to foreign currency hedging relationships because of their unique attributes. That accounting guidance is an exception for foreign currency hedging relationships.

FAS133, Paragraph 34, Footnote †—Refer to footnote* to paragraph 17 of Statement 133.

FAS133, Paragraph 45A, Footnote *—An at-the-money plain-vanilla interest rate swap that

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involves no payments between the parties at inception would not be considered as having a financing element present at inception even though, due to the implicit forward rates derived from the yield curve, the parties to the contract have an expectation that the comparison of the fixed and floating legs will result in payments being made by one party in the earlier periods and being made by the counterparty in the later periods of the swap's term. If a derivative instrument is an at-the-money or out-of-the-money option contract or contains an at-the-money or out-of-the-money option contract, a payment made at inception to the writer of the option for the option's time value by the counterparty should not be viewed as evidence that the derivative instrument contains a financing element. In contrast, if the contractual terms of a derivative have been structured to ensure that net payments will be made by one party in the earlier periods and subsequently returned by the counterparty in the later periods of the derivative's term, that derivative instrument should be viewed as containing a financing element even if the derivative has a fair value of zero at inception.

FAS133, Footnote 13—For a compound derivative that has a foreign currency exchange risk component (such as a foreign currency interest rate swap), an entity is permitted at the date of initial application to separate the compound derivative into two parts: the foreign currency derivative and the remaining derivative. Each of them would thereafter be accounted for at fair value, with an overall limit that the sum of their fair values could not exceed the fair value of the compound derivative. An entity may not separate a compound derivative into components representing different risks after the date of initial application.

FAS133, Paragraph 49, Footnote *—If immediately prior to the application of Statement 133 an entity has a fair value or cash flow hedging relationship in which an intercompany interest rate swap is the hedging instrument and if that relationship would have qualified for the shortcut method under the criteria in paragraph 68 had that swap not been an intercompany transaction, that entity may qualify for applying the shortcut method to a newly designated hedging relationship that is effectively the continuation of the preexisting hedging relationship provided that (a) the post–Statement 133 hedging relationship is hedging the same exposure to interest rate risk (that is, exposure to changes in fair value of the same hedged item or exposure to changes in variable cash flows for the same forecasted transaction) and (b) the hedging instrument is a third-party interest rate swap whose terms exactly match the terms of the intercompany swap with respect to its remaining cash flows. In that case, if the shortcut method is applied to the new hedging relationship upon adoption of Statement 133, the transition adjustment should include the appropriate adjustments at the date of adoption to reflect the retroactive application of the shortcut method.

FAS148, Footnote 15--Even though a contract may be a derivative as described in paragraphs 6–10 for both parties, the exceptions in paragraph 11 apply only to the issuer of the contract and will result in different reporting by the two parties. The exception in paragraph 10(b) also may apply to one of the parties but not the other.

FAS133, Paragraph 57, Footnote *—The evaluation of *readily convertible to cash* shall be applied to a contract throughout its life.

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FAS133, Footnote 16—Contracts that require delivery of securities that are not readily convertible to cash (and thus do not permit net settlement) are not subject to the requirements of this Statement unless there is a market mechanism outside the contract to facilitate net settlement (as described in paragraphs 9(b) and 57(c)(2)).

FAS133, Paragraph 58, Footnote *—As defined in paragraph 540.

FAS133, Paragraph 59, Footnote *—In certain circumstances, a take-or-pay contract may represent or contain a lease that should be accounted for in accordance with FASB Statement No. 13, *Accounting for Leases.*

FAS133, Footnote 18—This discussion applies only to short sales with the characteristics described here. Some groups of transactions that are referred to as short sales may have different characteristics. If so, a different analysis would be appropriate, and other derivative instruments may be involved.

FAS133, Paragraph 64, Footnote †—Refer to footnote* to paragraph 17 of Statement 133.

FAS133, Paragraph 65, Footnote †—Refer to footnote* to paragraph 17 of Statement 133.

FAS133, Paragraph 68, Footnote *—For cash flow hedge situations in which the cash flows of the hedged item and the hedging instrument are based on the same index but that index is not the benchmark interest rate, the shortcut method is not permitted. However, the entity may obtain results similar to results obtained if the shortcut method was permitted.

FAS133, Paragraph 94, Footnote † —Refer to footnote * to paragraph 17 of Statement 133.

FAS133, Paragraph 95, Footnote † —Refer to footnote * to paragraph 17 of Statement 133.

FAS133, Paragraph 96, Footnote † —Refer to footnote * to paragraph 17 of Statement 133.

FAS133, Paragraph 97, Footnote † —Refer to footnote * to paragraph 17 of Statement 133.

FAS133, Paragraph 99, Footnote † —Refer to footnote * to paragraph 17 of Statement 133.

FAS133, Paragraph 143, Footnote † —Refer to footnote * to paragraph 17 of Statement 133.

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